Show

Part I The Nature and Structure of CANINE

Chapter 1 CANINE and What Drives It

CANINE (The Complete Article Nine) is a unique set of learning materials designed to assist law students to become effective Article 9 practitioners. CANINE consists of three parts. One part is a comprehensive collection of text and problems modeled after a conventional casebook or treatise. This part of CANINE, entitled "CANINE Hardcopy," is available in hard copy (or in electronic form suited to being printed). CANINE Hardcopy is aimed at those who prefer to work with printed, easier to read (but essentially linear and "one-way") materials. It is designed to be used with a commercially available set of commercial law statutes.

Another part of CANINE is entitled "CANINE Online." It consists of the same text and materials found in CANINE Hardcopy, but it is delivered in electronic form and is intended to be used online. The primary advantage of CANINE Online over CANINE Hardcopy is that it contains a wealth of hyperlinks that allow a reader (or, more accurately, a user) to pull up statutory and secondary references with the click of a mouse. Another advantage is ease of navigation facilitated by keyword searching that avoids the need to struggle with a conventional index or table of contents. Still another advantage of CANINE Online is that the online materials may be cut and pasted and organized to suit a user's particular learning style or research needs, subject, of course, to copyright constraints. The major disadvantage of CANINE Online is that it requires reading material displayed on a computer screen rather than in print.

The third part of CANINE is the most unique and ultimately is likely to be the most valuable to students. This part of CANINE consists of Problem Sets. The problems are essentially those found in both the hard copy and online versions of CANINE and probably are best used with those materials, but the problems also may be done as stand-alone exercises. The problems in the Problem Sets are in electronic form and are designed to be used online.

The special value of the electronic problems is that they were prepared with CALI Author (authoring software available from CALI, the Center for Computer-Assisted Learning Instruction) and are interactive. Users are given the immediate feedback that is important to effective learning. They are guided through the problems and feedback by means of complex branching that tailors a user's learning experience according to the user's responses. This tailoring of problems to fit a user's level of expertise and understanding allows a user to proceed at his or her own pace and to reexamine questions and feedback as the user may wish.

A special feature has been added to the CANINE materials beginning with the 2006 edition. The special feature is a "Case Commentary." The commentary consists of an informative and sometimes insightful discussion and analysis of selected cases decided after the effective date of new Article 9. The commentary will be published separately in hard copy.

There also will be an electronic version to which the electronic version of the CANINE materials will be linked. References to cases of particular relevance to a specific chapter or to specific chapters of CANINE will be added at the end of the chapter or chapters. Students will be responsible for the decisions in the Case Commentary only to the extent that they decisions are discussed in class or students are referred to them in a message or posting.

Eventually, CANINE may include an image map designed to assist users to visualize the essential features of Article 9 of the Uniform Commercial Code and the fundamental tasks associated with Article 9 practice.

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Part I The Nature and Structure of CANINE

Chapter 2 Some Thoughts about Pedagogy

Many commercially available teaching materials are prefaced with an insistence that there will be no "hiding the ball." However, even the best of such materials rarely make good on the promise. In my view this happens because the materials come at basic propositions too obliquely. The result is that instructors and students are forced to engage in the sometimes painful exercise of trying to tease from an often unnecessarily complicated or even convoluted fact situation the point or points to be made. The CANINE materials use relatively simple fact situations and cut to the chase as quickly as possible. The objective is to instill learners with the basic principles they need to engage in a higher level of discourse. Too often what seems apparent to faculty is anything but to learners.

Conventional commercial law materials also vary with respect to how they enter the interesting and challenging world of secured financing under Article 9 of the UCC. The better materials begin with a look at the debt collection options of an unsecured creditor. Doing so makes sense because it is necessary for learners to understand early on why secured credit generally, and an Article 9 security interest in particular, is important. CANINE begins by putting learners into a hypothetical transaction that they should be able to relate to as a matter of personal experience and poses the question: Why bother with an Article 9 security interest?

The initial glimpse at the nature and purpose of an Article 9 security interest serves another purpose. It brings home to learners the essential reality that Article 9 is rooted in basic legal doctrine, including the contracts law that should already have been learned in the first year. Many students will not have come willingly or readily to the subject of secured financing and they will benefit from some early assurance that the stuff of Article 9 is not so alien as it may first appear. This assurance will help prepare them to deal with the headier questions of how secured credit differs from unsecured credit and how secured creditors fare in competition with unsecured creditors (or trustees in bankruptcy).

Article 9 was extensively revised effective on July 1, 2001. For convenience the revised version is referred to as new Article 9 and the version it replaces as former Article 9 (which governed for over thirty years). Although new Article 9 makes important changes, including an extensive renumbering of parts and sections, the conceptual framework and foundational principles of former Article 9 remain firmly in place. For example, the concepts of a unitary security interest and notice filing and of the so-called "floating lien" continue in substantially unaltered form. Consequently, certain aspects of former Article 9 are treated along with the new Article 9 provisions, highlighting the similarities and differences .

Much of new Article 9 law is intended to remedy perceived deficiencies in former Article

9. Among the more important of the changes are a dramatic reconstruction and a re-conceptualizing of the "choice of law" and the place of filing rules. New Article 9 also quite properly seeks to respond to the impact of advanced computer and communications technology on the transactions that Article 9 is designed to govern. In particular, it undertakes to accommodate the movement away from hard copy documents and traditional notions of signatures to electronic records and, more generally, to the rapid emergence of electronic commerce. The extent to which new Article 9 will succeed in these efforts at reform remains to be seen.

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Part II Article 9 in a Nutshell

Chapter 3 The Nature of Secured Credit under Article 9

An appropriate starting place is to ask the following question: Why bother with an Article 9 security interest? The answer to this question is central to understanding Article 9 law and practice.

Consider the following problem.

Problem 3.1 (INTERACTIVE)

Last February, John Smith sold his portable basketball hoop, net and standard to Jane Jones, his neighbor, for $250. John spent a year in law school so he knew he should get something in writing. Jane signed the following piece of paper:

The undersigned, John Smith, hereinafter "Seller," sells to Jane Jones, hereinafter "Buyer," one used portable basketball set, consisting of a hoop, a net and a standard, for the price of $250. Buyer promises to pay Seller $50 on delivery and the remaining $200 over the next six months.

____

John Smith, Seller

____

Jane Jones, Buyer

Dated: 2-5-[year]

Jane paid John $50 and took delivery in February. It is now August of the year of sale. The portable basketball set is sitting in Jane's driveway and Jane shoots baskets almost every day. However, Jane has not paid John anything further towards what she owes John.

What are John's rights? What is the source of these rights?

Could John simply go over to Jane's house and take the portable basketball hoop back?

If not, why not?

What must John do to collect his $200? Explain your answers.

The major point of Problem 3.1 is that the breach of contract for sale of the basketball hoop alone does not give John an interest in any particular property of Jane, not even the basketball hoop, out of which to satisfy the claim for breach of contract. Even if John obtained a judgment against Jane for breach of contract, without more (see below), John would not be able to go after the basketball hoop to satisfy the debt owed by Jane. *See* W. Boyd & C. Smith, *Debtor Creditor Law in Arizona*, Ch. 6 (Banks-

Baldwin/West 1993). Later references to this work will be abbreviated "B & S."

If John had a lien the situation would be quite different. A "lien" is an interest in particular property to secure a debt. *See* BRA § 101(37) (defining "lien"). A lien is a "security interest" under Article 1, section 1-201(b)(35) when it is an interest in personal property to secure payment or performance of an obligation. Although the statute does not say so in so many words, it is understood that a security interest in personal property that arises out of an agreement (*i.e.*, the lien is "consensual") is an "Article 9 security interest." *See* Official Comment 2 to new 9-109. *Compare* BRA § 101(51).

A holder of an Article 9 security interest not only has an interest in particular property to secure a debt but, subject to limitations explored in Part VII, has certain rights of "self help" regarding the property securing the debt, meaning that the holder of the security interest need not seek the assistance of a court in trying to satisfy a debt out of the property in which the holder has a security interest.

Consider the next problem.

Problem 3.2 (INTERACTIVE)

Assume the facts of Problem 3.1. Assume further, however, that the writing that Jane signed contained the following provision:

" Buyer grants to Seller an interest in the portable basketball hoop to secure its unpaid price."

What does such a provision give to John that he does not otherwise have?

Does John have an "Article 9 security interest"?

Could John simply go and get the basketball hoop?

Check out new section 9-609 before you answer. (Don't fret the details of this section of Article 9, or other sections referred to in the remainder of this chapter, as they will be considered in depth in later chapters.)

If the provision in the agreement is enforceable and John can take back the basketball hoop when Jane fails to pay, what can John do with the basketball hoop after retaking it? *See* new 9-610 and new 9-620.

The basic points should be clear. In Problem 3.1 John is simply an unsecured creditor with no rights in the basketball hoop. In Problem 3.2 John has a lien on the basketball hoop. The lien is an Article 9 security interest and under Article 9 John has special rights with regard to the basketball hoop, including certain rights of self help.

The special rights enjoyed by a secured party as contrasted with an unsecured creditor do much to explain why getting an Article 9 security interest is worth the bother. If John has an Article 9 security interest in the basketball hoop he also likely is better off should Jane file bankruptcy. The explanation is as follows. If John has a security interest (or other lien) on the basketball hoop then he may also be a "secured claim holder " within the meaning of Bankruptcy Reform Act (BRA) § 506(a) under which a creditor is secured claimholder to the extent of the value of property on which the creditor has a lien (security interest) up to the amount of the debt secured by the lien.

If the basketball hoop is worth $250, then John has a secured claim of $200 because the amount of the debt is the upper limit. If the hoop is worth only $150, then John has a secured claim of $150 (and is unsecured as to the remaining $50).

Using the Chapter 7, or liquidation, proceeding as the paradigm, the distribution of assets in bankruptcy is relatively easily described. The trustee gathers all the property of the bankruptcy estate not timely taken out of the estate by the debtor as being exempt and satisfies out of these assets, in the following order, the claims of secured parties, priority unsecured claims, and general unsecured claims and equity interests.

Under this scheme a secured creditor takes essentially dollar-for-dollar while an unsecured creditor shares pro rata with other unsecured creditors after secured and priority claims are settled. This distribution scheme is captured in the following formula:

$$\text{Distribution to an Unsecured Claimholder in Bankruptcy} = \frac{\left(\text{Total assets} - \text{Secured claims} - \text{Priority unsecured claims}\right)}{\left(\text{Total of unsecured claims}\right)}$$

Another important advantage enjoyed by a secured creditor in bankruptcy is that secured claims are not subject to a discharge. Under BRA § 524(a), a discharge affects only personal liability, *i.e.*, unsecured debts. For a quick primer on bankruptcy law from an Article 9 practitioner's perspective, *see* B & S (cited above), Ch. 6.

Much will be made in later chapters of the fact that a security interest must be *perfected* if a secured party is to be protected against third parties who also have a claim to the collateral. Perfection generally requires notice of the existence of a security interest so as to protect third parties against "secret liens." Perfection most commonly is achieved by filing a document or record called a financing statement, but perfection also may be accomplished in other ways.   *See* Part V.

A security interest that is not perfected is at risk of being avoided in bankruptcy, leaving the creditor unsecured. In Problem 3.2, for example, if John had failed to perfect its security interest in the basketball hoop then John could end up being unsecured in the bankruptcy proceeding.

Consider the next Problem.

Problem 3.3   **(INTERACTIVE)**

Suppose Jane in Problem 3.2 files bankruptcy. Jane owes unsecured creditors a total of $10,000. There are priority claims of $100. The basketball hoop is worth $200. Jane has a total of non-exempt assets, including the basketball hoop worth $1300.

If John has an enforceable Article 9 security interest John how much will John take out of a liquidation bankruptcy? Would it matter whether or not John had perfected his security interest at the time of bankruptcy? If John is unsecured how much will he take out of a liquidation bankruptcy? What do other unsecured creditors take out of such a bankruptcy?

Why a secured creditor should be better off in and out of bankruptcy than an unsecured creditor is a nice question that has long been debated, most recently in connection with the adoption of new Article 9. *See* Symposium, 9 American Bankruptcy Institute Law Review, Number 1 (Spring 2001).

For completeness you should be aware that John in Problem 3.1 could get a lien on the basketball hoop after-the-fact. That is, John could start out unsecured and later become secured. One way for John to do so is for John to obtain an Article 9 security interest from Jane. However, as explained above, doing so would require Jane's consent and Jane is not all that likely to enter into the necessary agreement when she already has the basketball hoop. John also may become a secured creditor without getting Jane's consent. This route to becoming secured (getting a lien) after starting out unsecured can be messy. The following commentary from B & S (cited above), will give you the general idea:

> A holder of a money judgment is referred to as a ``judgment creditor,' and the party against whom the judgment is entered is the ``judgment debtor.' * * * As will be seen in [subsequent chapters], persons who have not recovered a judgment, such as those who have obtained a provisional remedy or who are the beneficiaries of a support order, are considered ``judgment creditors' for purposes of garnishment.
>
> A money judgment is of little value unless the plaintiff can realize the amount awarded. Various Arizona statutes set out procedures for collecting money judgments. The Rules of Civil Procedure expressly authorize the use of these procedures. Under the Federal Rules of Civil Procedure and a local federal court rule for the District of Arizona, the clerk of the federal district court may issue a writ of attachment or garnishment in the circumstances and in the manner under which these remedies are permitted by the laws of the State of Arizona.
>
> Certain traditional collection remedies available to judgment creditors have general application. They are (1) writs of execution; (2) writs of garnishment; (3) writs of attachment; (4) judgment liens; and (5) supplemental proceedings.
> Execution, which involves a forced sale of the debtor's nonexempt assets, probably is the most readily available and most widely used process to enforce a money judgment. Execution can lead to the creation of a judicial lien or be used to enforce preexisting liens, including consensual liens. Writs of execution are considered in Text Chapter 8 and execution sales in Text Chapter 9.
>
> * * * *
>
> Execution is a postjudgment collection remedy. It is most often used as a device for satisfying a money judgment, but it also may be needed in conjunction with another collection remedy, such as garnishment, and it may be used in connection with an action to foreclose a lien that arose independently of the execution, a real estate mortgage or a judgment lien. Execution may be general or it may be special. A writ of general execution commands the officer to whom it is directed to satisfy a judgment out of the debtor's property without specifying particular property. A writ of special execution directs that specific property be sold or be delivered as provided for in a judgment.

B&S 4.01, 4.02, 7.01 and 8.01.

So, if John sued Jane and got a judgment against Jane and then got a writ of execution and the sheriff levied on (took possession of) Jane's nonexempt property then John would have a judicial lien on that property. The basketball hoop very likely would be nonexempt and John would have a lien on the basketball hoop when it was levied upon by the sheriff and John would be secured. However, John would have a judicial lien, a lien obtained by litigation, not a lien by agreement (a security interest).

As you may have surmised, judicial liens are created outside Article 9. However, as we will discover later, a holder of a judicial lien is a "lien creditor" under Article 9 and lien creditors can come into conflict with Article 9 secured parties. The resolution of these conflicts is a "priority" matter and is the subject of Chapter 26 (Secured Party Versus Lien Creditor; Future Advances; Bankruptcy) and, more generally, Part VI.

In a manner that requires much fuller explanation, trustees in bankruptcy exercise the rights of lien creditors if a debtor files bankruptcy. This explanation also is best deferred to Chapter 26 (Secured Party Versus Lien Creditor; Future Advances; Bankruptcy).

To test your general understanding of judicial liens, consider the following problem.

Problem 3.4 (INTERACTIVE)

We saw in Problem 3.1 that to collect the $200 from Jane, John would have to sue Jane for breach of contract. As the CANINE materials point out, even if John obtained a judgment against Jane, John would have only an unsecured debt. But, as is also explained in the CANINE text, John can become secured after-the-fact and by doing so can obtain a lien that facilitates collection of the debt.

How does John obtain a lien after-the-fact?

Problem 3.5 (INTERACTIVE)

Complete the following statements by filling in the blanks:

(a) On the facts of Problem 3.1, John is an ________ creditor, even if John gets a judgment against Jane based upon a breach of contract.

(b) On the facts of Problem 3.2, John has a ______.

(c) On the facts of Problem 3.2, John has an Article 9 security interest because the security interest arises by ________.

(d) As the holder of an Article 9 security interest, John has certain rights of ______ ______, including the right to take back the basketball hoop without seeking judicial assistance.

(e) If Jane files a liquidation bankruptcy when Jane owes John $200 and the basketball hoop is worth $250 and John has a perfected security interest in the basketball hoop then John is a secured claimholder and will take $ _____ out of the bankruptcy.

(f) On the facts of Problem 3.1, John is an unsecured creditor but may become a secured creditor by obtaining a _____ _____.

(g) If Jane files bankruptcy and John has only an unsecured claim against Jane (for example, because John does not have an Article 9 security interest or has failed to perfect the security interest and John does not have a judicial lien), then the claim is subject to ______.

CASE COMMENTARY

In re Yates, 332 B.R. 1 (10th Cir. BAP 2005)

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Part III Scope of Article 9, Classification of Collateral and Choice of Law

Chapter 4 Scope of Article 9

Working with Article 9 requires knowing whether or not a particular credit transaction is governed by Article 9. This determination, in turn, requires familiarity with the definitions found both in Article 9 and in UCC Article 1 and also the scope and exclusionary provisions in Article 9. The definitions contained in Article 9 itself were in former section 9-105 and now are found in new section 9-102. The scope and exclusionary provisions, which were sections 9-102 and 9-104 of former Article 9, are combined in new Article 9, section 9-109. It is imperative going in to have a sense of what Article 9 does and does not cover.

Generally speaking, Article 9 applies only to transactions involving a "security interest" which, as we saw in Chapter 3 (The Nature of Secured Credit under Article 9), is essentially a lien by agreement on personal property. New section 9-109(a)(1) provides that, subject to exclusions in new sections 9-109(c) and 9-109(d) (discussed below), new Article 9 applies to "any transaction, regardless of its form, that creates a security interest in personal property or fixtures by contract." Thus, John's lien by agreement in the basketball hoop in Problem 3.2, in Chapter 3, clearly is covered by Article 9.

The case of *In re Wiersma*, 283 B.R. 294 (Bkcy D. Idaho 2002), offers a good example of the point that substance governs over form. In that case the debtor executed an “assignment” of a cause of action for breach of contract. The court concluded that the assignment created a security interest, notwithstanding the language of the document executed by the debtor, because it was clear that the debtor did not intend to divest itself of all interest in the cause of action and rather the parties understood that the cause of action was assigned for the purpose of securing a debt evidenced by a promissory note. Of course, a debtor may intend to transfer all of its interest in property outright and if that intention is clear then the assignment is not intended as security and does not create a security interest.

Likewise, a purported sale according to which all of the debtor’s assets or ownership of its business are transferred to a lender subject to a right of repurchase for a nominal price when the debt is paid in full but the right of repurchase terminates on default will be treated as in substance serving only to create a security interest. More generally, a transfer contingent on a default as to a loan debt, even if formulated in terms of a condition subsequent, is not an outright transfer but rather the creation of a security interest. *See*, *e.g.*, *Chesapeake Investment Services v. Olive Group Corp.*, 2003 WL 369682 (Mass. Super. 2003).

Insofar as a transaction in substance creates a security interest, the creditor must proceed as permitted by the enforcement provisions of Article 9 and cannot simply take ownership of the property. *Id*. Enforcement of a security interest is the subject of Part VII of the CANINE materials.

Personal property, which includes both tangibles, especially goods, and intangibles, for example, accounts receivables, is to be distinguished from real property. Under new section 9-109(d)(11) the creation of a security interest in real estate is outside the scope of new Article 9. *See* *Wells Fargo Home Mortgage, Inc. v. McCarthy*, 51 UCC Rep. Serv. 2d 853 (Minn. App. 2003) (Unpublished opinion). Excepted from this exclusion is the creation of an interest in fixtures. Fixtures are goods that have attached to real estate so as to give real estate parties an interest in the goods. Security interests in fixtures are examined more closely in Chapter 20 (Perfection As To Fixtures and Other Real Estate-Related Collateral).

As is apparent only from an examination of the definition of "goods" in new section 9-102(a)(44), security interests in timber to be cut are covered by new Article 9. New Article 9 also governs security interests in notes secured by interests in deeds of trust or mortgages. The complicated questions of how a security interest in a promissory note secured by a real estate mortgage or deed of trust is created and perfected are dealt with in Chapters 8 (The Specifics of Enforceability -- A Security Agreement Authenticated by the Debtor or Its Equivalent) and 20 (Perfection as to Fixtures and Other Real Estate-Related Collateral).

It is commonplace today to market various property, including equipment and even vehicles for personal use, under what is denominated a "lease." However, more often than not these transactions are in substance secured transactions or what are often referred to as "disguised conditional sales." Such transactions are clearly covered by new Article 9 under new section 9-109(a)(1). Nevertheless, what is in the form of a lease may in fact and law be a lease or what is conveniently referred to as a "true" lease.

Distinguishing a true lease from a lease intended for security is frequently a difficult task at best. Section 1-201(37), now section 1-201(b)(35), went to great lengths to offer guidance to courts and others faced with making the distinction. Among the more important factors tending to support a conclusion that the transaction is for security is that the ostensible lessee has an option to acquire the property for no additional consideration or for nominal consideration. But, in the end the determination of whether a lease is a true lease or creates a security interest must be made on the facts of each case.

The multitude of factors to be considered has been moved from former section 1-201(37), now section 1-201(b)(35), to section 1-203. The Official Comments to section 1-203 are extensive and helpful, but difficulties remain. Because of the uncertainties, under new section 9-505, a "lessor" is permitted to file a financing statement and doing so is not of itself to be a factor in determining whether the property secures an obligation.

It should be noted that a lessor under a true lease may create an Article 9 security interest. To the extent that a lessor who does so is relying on the security interest it creates the lessor must satisfy the requirements of Article 9 regarding enforceability, perfection and enforcement. As noted above, the fact that a lessor has filed a financing statement does not of itself render a true lease a lease intended as security. On the other hand, if a lessor files a financing statement and the transaction is determined to be for security then the lessor will have perfected any security interest attaching to the property.

Originally, former section 1-201(37), now section 1-201(b)(35), also sought to distinguish a true consignment from a consignment intended for security. Once again, making the distinction was no mean undertaking. Section 1-201(b)(35) and new section 9-109(a)(4) state unequivocally that consignments are covered by Article 9. However, all is not what first appears and it is necessary to study the definition of "consignment" found in new section 9-102(a)(20) to even begin to understand what is intended where that term is used. What the definition appears to encompass are bailments to merchants to whom goods are delivered for the purpose of sale. *See* Official Comment 14 to new 9-102.

If a transaction satisfies the definition contained in new section 9-102(a)(20), then special rules found in various sections of Article 9 apply. *See*, *e.g.*, new sections 9-319, 9-505 and 9-601. However, not all "true consignments" are covered. *See* new 9-102(a)(20)(B) and (C) and Official Comment 14 to new 9-102. And, a so-called "sale or return" as defined in Article 2, section 2-326, is not a consignment for purposes of Article 9 because the buyer becomes the owner of the goods and the seller may obtain an enforceable security interest in the goods only by satisfying the requirements of new section 9-203.

Of perhaps greatest importance, under new section 9-102(a)(20)(D), consignments intended for security are not consignments within the Article 9 scheme and the ostensible consignor must satisfy all the requirements of Article 9 applicable to security interests generally. Consequently, once again there is a need to distinguish true consignments from consignments intended as security as an initial matter and doing so may be less than easy.

For reasons associated with commercial practice former Article 9 covered sales of certain intangibles. New Article 9 does also. *See* new 9-109(a)(3). New section 9-109(a)(3) expands upon former Article 9 by including within its scope sales of payment intangibles, and promissory notes. By virtue of the expanded definition of "account," new Article 9 also covers sales of (and other security interests in) "health-care-insurance receivables." How these additional types of collateral are defined is discussed in Chapter 5 (Classification of Collateral).

As noted in Official Comment 4 to new section 9-109, although Article 9 occasionally distinguishes outright sales of accounts and other such collateral from sales that secure an obligation, how a particular transaction is to be classified is left to the courts. However, Official Comment 4 notes further that bringing sales of receivables within the scope of Article 9 "generally has been successful in avoiding difficult problems of distinguishing between transactions in which a receivable secures an obligation and those in which the receivable has been sold outright. Sales and assignments for security of accounts and other receivables are treated further in Chapter 37 (Foreclosure as to Intangibles).

Article 9 also covers security interests in the proceeds of original collateral, meaning, for the most part, property that replaces original collateral. For example, as to goods held for sale it is expected that the original collateral will be replaced and it makes sense for the security interest to continue in whatever is received when the original collateral is disposed of. Security interests in proceeds are treated at length in Chapters 9 (The Specifics of Enforceability -- After-Acquired Property, Proceeds and Future Advances), 16 (Perfecting Security Interests in Proceeds and Other Later Acquired Property) and 24 (Changes in the Use or in the Location of the Collateral or of the Debtor; Security Interests in Proceeds).

As noted in Chapter 3 (The Nature of Secured Credit under Article 9), Article 9 generally governs only *consensual* liens on personal property, *i.e.*, security interests in personal property created by agreement. The creation of most other types of liens is largely outside the scope of Article 9. In particular, judicial liens -- liens obtained by litigation -- are governed by the law outside Article 9. Thus, as we saw in Problem 3.4

in Chapter 3, an attempt by John to obtain a lien by litigation on the basketball hoop is a matter outside the scope of Article 9.

Liens also can arise by law, especially by statute. Among the more common such liens are an artisan's lien, a garage lien and a landlord lien. *See* B & S (cited in Chapter 3), Chs. 24 and 25. How most statutory liens arise and are perfected and enforced are matters outside the scope of Article 9. *See* new 9-109(d)(2). New Article 9 makes a significant change here by bringing agricultural liens, as defined in new section 9-102(a)(5), within the coverage of Article 9. *See* new 9-109(a)(2).

Former Article 9 governed conflicts between holders of judicial liens and certain statutory liens and Article 9 secured parties. The same is true under new Article 9. *See* new 9-317(a), new 9-109(d)(2), new 9-333 and Chapters 26 (Secured Party Versus Lien Creditor) and 31 (Secured Party Versus Statutory Liens Including Federal Tax Liens and Agricultural Liens).

As was true under former Article 9, new Article 9, section 9-109(d)(1) excludes rights of set-off from its coverage and although a right of set-off held by a bank has sometimes been referred to as a "banker's lien" the right of a bank to set off a debt against its debtor's bank account is not really a lien at all because once monies are deposited in a bank account the monies no longer belong to the debtor and a debtor-creditor relationship between the bank as the debtor and the depositor as the creditor is created. *See*, *e.g.*, *In re Quisenberry*, 295 B.R. 855 (Bkcy N.D. Tex. 2003).

New Article 9 adds a provision, section 9-340, that generally gives priority to a bank's right of set-off as against a secured party with a conflicting claim to the bank account. In so doing, new Article 9 has resolved in favor of the set-off party a question that had split courts under former Article 9. *See* B & S (cited in Chapter 3), 26.04(C) and Official Comment 2 to new 9-340.

It is worth noting that a person who has a lien or right of set-off arising by statute (or even as a matter of common law) is not precluded from creating an Article 9 security interest in the property subject to the lien and, as will be discussed further in Part VI, whether a creditor is relying on a lien or a right of set-off or on a consensual security interest may affect the outcome of priority disputes regarding the property involved.

However, as explained in Chapter 8 (The Specifics of Enforceability – A Security Agreement Authenticated by the Debtor or Its Equivalent), there must be an enforceable security agreement giving the holder of the lien or right of set-off a security interest in the property subject to the lien or right of set-off and an agreement between a bank and its customer creating (or acknowledging) a right of set-off does not satisfy this requirement. *See In re Quisenberry*, *supra*.

Former Article 9 expressly excluded certain consensual liens that otherwise would be covered because they satisfy the definition of a security interest and arose by agreement. These exclusions tended to reflect historical commercial practice or the existence of specialized and separate legal regimes. New Article 9 narrows some of the more noteworthy exclusions.

Thus, security interests in insurance claims and deposit accounts were covered by former Article 9 only as proceeds. New Article 9 covers security interests in such collateral as proceeds but extends coverage to original interests in health-care-insurance receivables and, other than in consumer transactions, deposit accounts. *See* new 9-109(d)(8) and 9-109(d)(13).

Former Article 9 contained a broad exclusion of interests in tort claims as original collateral. New Article 9 covers security interests in "commercial tort claims" as original collateral as well as proceeds while interests in other tort claims are covered only as proceeds. *See* new 9-109(d)(12). Note that if a tort claim has been settled and reduced to a contractual obligation it ceases to be a claim arising in tort and becomes a payment intangible.

Consequently, an interest in a settlement of a claim for other than a commercial claim as original collateral would be within the scope of new Article 9. *See* Official Comment 15 to new 9-109. On the other hand, an interest in a judgment based upon a tort claim would be excluded from Article 9 coverage by new section 9-109(d)(9) unless the tort was a commercial tort. *See* Official Comment 12 to new 9-109.

Former Article 9 also excluded all security interests created by governmental debtors. New Article 9 has eliminated that exclusion, but some states have adopted non-uniform versions of Article 9 (or have laws outside of Article 9) that reinstate the exclusion. For example, Arizona has added to new section 9-109(d) a subsection that reads "[This article does not apply to: 14. A transfer, pledge, assignment, grant or similar action by this state, another state or a governmental unit of this state or another state." *See also*, *MP Star Financial, Inc. v. Cleveland State University*, 2004 WL 1615067 (Ohio App. July 20, 2004) (Applying an Ohio version of new section 9-109(d) that excludes from the scope of Article 9 a transfer by a government, state or governmental unit).

As is explored further in Chapter 19 (Perfection Pursuant to Federal Law), transactions that otherwise would be covered by Article 9 may be outside the scope of the article because Article 9's application has been preempted by federal law.

More generally, in the aggregate, the various changes to new Article 9 may be understood to manifest a purpose towards inclusion rather than exclusion. Consequently, in general, it would seem to be a safe assume that unless new Article 9 (or some law outside of Article 9) expressly so provides otherwise the creation of a consensual interest in any and all tangible or intangible personal to secure a debt is covered by new Article 9.

The expanded scope of Article 9 likely will be felt most as to various contract rights and general intangibles, including software licenses. Thus, as stated in Official Comment 4 to new section 9-408, new sections 9-408(a) and 9-408(c) render ineffective restrictions on assignments . . . "to the extent" that the assignments restrict the "creation, attachment, or perfection of a security interest," including sales of payment intangibles and promissory notes.

As a further illustration, there was some uncertainty under former Article 9 as to whether an interest in a limited liability company to secure a debt was subject to Article 9. It should now be clear that this and related ownership interests may serve as collateral.

It must be emphasized that expanding the range of personal property an interest in which will be the subject of Article 9 does not alter such basic requirements as that, subject to specific qualifications, the interest must be given to secure a debt. *See* new section 9-109(a)(1), as discussed above. Moreover, certain realities that do not relate directly to question of the extent to which particular property may serve as collateral may impact the value of that property as collateral. Thus, as discussed in Chapter 10 (The Need for Value and Debtor's Rights in Collateral), a debtor may create a security interest in property only if the debtor has rights in that property sufficient to enable the debtor to create a security interest. *See* new section 9-203(b)(2) and Official Comment 3 to new 9-408.

Further, as will be explained more fully in Chapter 25 (The How and Why of Priority), although restrictions on alienability, such as so-called "negative pledge covenants," i.e., promises by a debtor not to create a subsequent security interest in favor of some other party, do not prevent a transfer from taking effect, the breach of such promises may result in a default. *See* new section 9-401(b) and Official Comment 5 to new 9-401.

And, in a more complicated fashion, as discussed further in Chapter 37 (Foreclosure as to Intangibles), although limitations on assignments may not be effective to prevent a security interest from being created, there may be difficulties in enforcing the security interest. *See* new section 9-408(d) and Official Comment 8 to new 9-408.

It should be noted that the foregoing discussion of the expanded scope of new Article 9 assumes that the subject of a transaction is property. According to Official Comment 3 to new section 9-408, what constitutes property to which an Article 9 security interest may attach is a matter that ultimately is determined by law outside Article 9.

As noted above, and as is discussed more fully in Chapter 25 (The How and Why of Priority), the intent of the drafters of new Article 9 clearly was to expand the scope of coverage of new Article 9 and, therefore, a court should use caution in concluding that something is not property for purposes of Article 9, but there may be situations in which law outside Article 9 leaves the court little choice but to do so. *See*, *e.g.*, *In re Chris-Don, Inc.*, 367 F. Supp. 2d 696 (D. N.J. 2005).

You may test your grasp of the basics of the coverage of former and new Article 9 in the next two problems.

Problem 4.1 (INTERACTIVE)

Which of the following transactions are within the scope of new Article 9?

(a) A sale of a television on credit under a contract providing that the seller has an interest in the television to secure its price.

(b) An arrangement under which a retailer of widgets on credit sells to a bank the contracts arising from the sale of widgets.

(c) A lien by statute on a television in favor of a television repair shop.

(d) A lien arising by statute on crops grown by a debtor who plants and harvests the crops.

(e) An interest to secure a loan in trees the lender and borrower understand will be cut and sold.

(f) An interest in an individual's bank account to secure a loan debt incurred for personal, family or household purposes.

Problem 4.2 (INTERACTIVE)

There are less common but no less important transactions that also pose the question of whether they are covered by Article 9. Which of the following transactions are within the scope of new Article 9?

(a) An interest in an individual's ownership interest in a limited liability company to secure a loan.

(b) An interest in equipment created by a governmental debtor to secure a loan.

(c) An assignment of a cause of action for breach of contract that by its terms will be effective only if the assignor fails to pay a debt in connection with which the assignment was made.

(d) An assignment of an interest in a commercial tort claim.

CASE COMMENTARY

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The Epicentre Strategic Corporation-Michigan v. Perrysburg Exempted Village School District, __ F.3d __, 2005 WL 3060104 (N.D. Ohio 2005)

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Part III Scope of Article 9, Classification of Collateral and Choice of Law

Chapter 5 Classification Of Collateral

A. Generally

The way collateral is classified impacts essentially every aspect of Article 9 from creation and perfection to priority and foreclosure. Proper classification of collateral is especially important in deciding how to describe property in security agreements and financing statements, matters considered in detail in Chapters 8-11 and 12-14.

Grappling with classification offers an early opportunity to engage in the statutory interpretation activity that is central to Article 9 law and practice and drives home the critical importance of definitions in working with statutory law. Working through the definitions can be tedious, but doing so provides an essential foundation for dealing with such important matters as adequately describing collateral, as discussed in Chapter 8 (The Specifics of Enforceability -- A Security Agreement Authenticated by the Debtor or Its Legal Equivalent) and perfection and priority, as considered in Parts V and VI.

It is useful to separate property that may serve as collateral under Article 9 into essentially three major categories. The first is "tangibles," including especially goods. The second category consists of "pure intangibles," including choses in action, ranging from rights to payment or performance to claims to special protection or privilege. The third category is "quasi goods," made up of intangibles that have taken on a certain tangible or goods-like quality because of the *merger* of some right or claim into a document or record, with the paradigm being a negotiable instrument.

You should be alert to the way that pledgeability -- or the lack thereof -- distinguishes property in the first and third categories from that in the second. Thus, collateral such as goods and negotiable instruments can be possessed or pledged, but pure intangibles cannot.

The next problem introduces the Article 9 classification scheme.

Problem 5.1 (INTERACTIVE)

To secure a loan, Ready Lender is about to take an interest in Danielle Debtor's accounts receivables (unsecured rights to payment for goods or services sold on credit), a drill press used in Danielle's business and a negotiable promissory note payable to Danielle. Without consulting the code, into which of the three general categories of classification (goods, quasi goods and pure intangibles) would you put the following collateral?

(a) A Negotiable Promissory Note

(b) Accounts Receivables

(c) Drill Press

Which of the foregoing items of collateral can be pledged?

B. Goods

1. Generally

As was true under former Article 9 "goods" are defined, in new section 9-102(a)(44), to mean all things that are movable when a security interest attaches, including fixtures, standing timber that is to be cut and removed under a conveyance or contract for sale, the unborn young of animals, crops grown, growing, or to be grown, even if the crops are produced on trees, vines, or bushes, and manufactured homes.

An important addition to the definition of goods made by new Article 9 is that under new section 9-102(a)(44) a computer program constitutes goods if the program is integrated with a computer in such a manner that it customarily is considered part of the goods or if by becoming the owner of the computer a person acquires a right to use the program in connection with the computer. The definition of goods in new section 9-102(a)(44) explicitly excludes pure intangibles and quasi goods and minerals before extraction (which do not qualify as "as-extracted collateral" under new section 9-102(a)(6)).

The next two problems will allow you to test your general understanding of the definition of goods.

Problem 5.2 (INTERACTIVE)

Ready Lender is about to take a mortgage on land owned by Donald Debtor. On the land is a stand of virgin oak trees.

Which of the following statements is true:

(a) The land constitutes goods but the stand of virgin oak trees does not constitute goods.

(b) The land does not constitute not goods but the stand of virgin oak trees constitutes goods.

(c) Neither the land nor the stand of virgin oak trees constitutes goods.

(d) Both the land and the stand of virgin oak trees constitutes goods.

Suppose that there is an outstanding contract of sale under which the oak trees are to be cut and removed. Are the oak trees now goods? What language of new section 9-102(a)(44) supports your conclusion?

Problem 5.3 (INTERACTIVE)

Computer Depot sells a large computer system to Byron Buyer on credit. A Microsoft XP operating system is installed on the computer and under the contract of sale Byron is licensed to use the operating system on the computer.

Should the operating system be classified as "goods"? What language of new section 9-102(a)(44) supports your answer.

Former Article 9 subdivided goods into "consumer goods, "equipment," "farm products " and "inventory." New Article 9 adopts the same breakdown in new section 9-102, the general definitional section. Although the intent could be stated more clearly, the classifications are intended to be mutually exclusive. *See* Official Comment 4(a) to new section 9-102.

As will be seen later, an item of property can be collateral for more than one security interest (*i.e.*, more than one party may have an interest in the same property to secure a debt). When this happens the same item of property may be classified differently for one security interest than it is for the other. For example, what constitutes consumer goods as between a seller and a buyer may be inventory as between the seller and the seller's lender.

Circumstances affecting the classification of collateral (such as the use to which it is put) may change during the time that property serves as collateral. However, as between any particular creditor and debtor, what the property is as to this debtor determines how the property should be classified and the classification is fixed at the time the security interest attaches as to this debtor.

To illustrate, if property is properly classified as consumer goods when the security interest of one creditor attaches but circumstances change so that the property is properly classified as equipment at the time the same debtor creates a security interest in the property in favor of another creditor, then the property continues to be consumer goods as between the debtor and the first creditor.

2. Consumer Goods

Under former section 9-109(1), goods were "consumer goods" if they were used or bought for use primarily for personal, family or household purposes. New section 9-102(a)(23) adopts this definition by providing that "consumer goods" means goods that are used or bought for use primarily for personal, family, or household purposes. Former Article 9, section 9-109(1), required that particular goods to be consumer goods had to be used or bought for use *primarily* for personal, family or household purposes. New section 9-102(a)(23) is to the same effect.

The next two problems allow you to explore the new Article 9 definition of "consumer goods."

Problem 5.4 (INTERACTIVE)

Six Star Electronics, an appliance retailer, sells Byron Buyer a television on credit and takes an interest in the television to secure its unpaid price. Byron buys the television for the personal viewing pleasure of Byron and his family.

Does the television constitute consumer goods as between Six Star and Byron?

Suppose that one month after buying the television, Byron takes the television to his office and places it in the waiting room of his office for the enjoyment of clients.

Does the television continue to be consumer goods (given that the television is no longer used for personal, family or household purposes) as between Six Star and Byron?

Is the television consumer goods as between Byron and a subsequent creditor, Ready Lender, who is contemplating taking an interest in the television to secure a loan to Byron?

Problem 5.5 (INTERACTIVE)

Danielle Debtor offers as collateral a computer that Danielle uses for personal electronic mail and to play various computer games. Danielle also uses the computer extensively in a consulting business that Danielle runs out of her home.

Does the computer constitute consumer goods?

3. Farm Products

Under new section 9-102(a)(34), "farm products" means essentially crops, aquacultural goods, livestock, supplies used in a farming operation and crops or products of livestock in their unmanufactured states. Standing timber is excluded from the definition of farm products. As was true under former section 9-109(3), goods can be farm products only if the debtor is engaged in a farming operation.

Under former Article 9 there sometimes were problems deciding what constituted a farming operation. New Article 9 defines "farming operation." in new section 9-102(a)(35) to mean "raising, cultivating, propagating, fattening, grazing, or any other farming, livestock, or aquacultural operation."

We saw in Chapter 4 (Scope of Article 9) that agricultural liens, which are statutory liens on farm products and not security interests, are brought within the scope of Article 9. To this extent the definition of farm products takes on added importance.

The next two problems will test your understanding of the new Article 9 farm products' definitions.

Problem 5.6 (INTERACTIVE)

Donald Debtor owns a feedlot. Donald buys pigs from area farmers, fattens the pigs on his feedlot and then sells them to wholesalers.

Are the pigs farm products as between Donald and a person taking an interest in the pigs to secure a loan?

Are the pigs farm products in the hands of a wholesaler who gives a person an interest in the pigs to secure a loan from that person to the wholesaler?

Problem 5.7 (INTERACTIVE)

As was illustrated in Problem 5.2, a stand of virgin oak trees constitutes goods only if it is contemplated that the trees will be cut and removed.

Are the trees to be cut and removed farm products?

What language of new section 9-102(a)(34) supports your conclusion?

4. Inventory

The definition of inventory in new Article 9 tracks that in former Article 9 but expands upon it. Under new section 9-102(a)(48) "inventory" means" goods, other than farm products, held by a person for sale or lease or to be furnished under a contract of service. Inventory also includes goods that have been leased (as distinguished from being held for lease) and raw materials, work in process, or materials used or consumed in a business.

Consider the next problem.

Problem 5.8 (INTERACTIVE)

Assume the facts of Problem 5.4 (Six Star Electronics, an appliance retailer, sells a television to Byron Buyer who buys the television for personal use and Six Star takes a security interest in the television to secure its unpaid price). Assume further that prior to the sale of the television, Second Bank took a security interest in all of Six Star's televisions to secure a loan made by Second Bank to Six Star.

Which of the following statements is true?

(a) As between Second Bank and Six Star the televisions are farm products.

(b) As between Second Bank and Six Star the televisions are consumer goods.

(c) As between Second Bank and Six Star the televisions are inventory.

Does the television sold to Byron continue to be inventory as between Six Star and Second Bank after the sale to Byron?

In Chapter 27 (Secured Party Versus Buyers) we will learn that Second Bank's security interest likely does not continue in the television sold to Byron but this happens because of a special priority rule and the classification analysis is not affected. Here we are focusing on the meaning of inventory.

Consider the next two problems.

Problem 5.9 (INTERACTIVE)

Sid Seller is a retailer who both sells and leases automobiles to businesses and to consumers.

Are all of the automobiles inventory in Sids hands. What of an automobile leased to Lisa Lessee? Is that automobile inventory irrespective of the use made of it by Lisa?

Suppose Betty Buyer bought an automobile from Sid for personal use and then Betty put the automobile up for sale. If Betty seeks to borrow from Friendly Finance Company and offers the automobile as collateral should Friendly treat the automobile as consumer goods or inventory?

Problem 5.10 (INTERACTIVE)

On the facts of Problem 5.6, Donald Debtor sold pigs it fattened on its feedlot to wholesalers.

Do you wish to reconsider the earlier conclusion that the pigs were farm products in Donalds hands?

Hint: Read the definition of inventory in new section 9-102(a)(48) carefully.

What language of new section 9-102(a)(48) supports the conclusion that goods cannot be inventory and farm products at the same time?

The new Article 9 definition of inventory in new section 9-102(a)(48) specifies that "raw materials, work in process, or materials used or consumed in a business" are inventory. Such language also appeared in former section 9-109(4). Former section 9-109(4) further provided that "inventory of a person is not to be classified as equipment."

Under former Article 9, courts grappled with the question of whether materials used or consumed in a manufacturing operation but not technically themselves held for sale or lease should be classified as equipment or as inventory. Official Comment 3 to former section 9-109 asserted that the answer depended on how long the goods were held before being used or consumed. The question for us is whether the new Article scheme gives courts any greater guidance. At this point we should turn to the definition of "equipment. "

5. Equipment

Former section 9-109(2) defined equipment essentially as goods used or bought for use primarily in the debtor's business. In doing so it employed a use test much like that for consumer goods. The use test led to the question referred to above of whether certain goods *used* in a manufacturing operation are properly classified as equipment or inventory.

New section 9-102(a)(33) provides very simply that "equipment" means goods other than inventory, farm products, or consumer goods. The use test is gone. In its place is the proposition that whatever does not fit into any of the other three classifications of goods is equipment. Note that the definition does not directly answer the question whether certain goods used in a manufacturing operation are properly classified as equipment or inventory. Official Comment 4(a) to new section 9-102 tracks the comment to former section 9-109 referred to above by asserting that how long goods are held is what distinguishes equipment from inventory.

The new Article 9 definition of "equipment" is explored in the next two problems.

Problem 5.11 (INTERACTIVE)

ABC, Inc. manufactures and sells newspaper printers.

How should the printers be classified?

The manufacturing process employs several computerized presses. Are these presses equipment or inventory?

Large amounts of lubricant are used in the manufacturing operation. Is the lubricant inventory or equipment?

What of metal used in the newspaper printers? Should the metal be classified as equipment or inventory?

Problem 5.12 (INTERACTIVE)

Assume the facts of Problem 5.9 (Sid Seller is a retailer of automobiles who sells and leases automobiles to businesses and to consumers).

Should an automobile that Sid uses as a "demo" but intends to sell or lease be classified as equipment or inventory?

6. Fixtures

As noted in Chapter 4 (Scope of Article 9), transfers of interests in real property to secure debts are outside the scope of Article 9. However, goods can become affixed to real property in such a way as to give parties who have or acquire interests in the real property an interest in the goods. Such goods are "fixtures." Thus, under former section 9-313(1)(a) goods that had become so related to particular real property that an interest in them arose under real property law were fixtures. New section 9-102(a)(41) is to the same effect.

Note that new section 9-102(a)(41) does not really define fixtures. Rather it sends you to local real estate law to learn when goods have become so related to particular real property that an interest in them arises under real estate law. We will have much more to say about fixtures in Chapter 20 (Perfection as to Fixtures and Other Real Estate-Related Collateral).

You can get the basic idea of when goods are or are not fixtures in the next problem.

Problem 5.13 (INTERACTIVE)

You are about to buy a house. The house has a nice swimming pool that is heated with a solar heating system that is welded to the roof of the house.

Would you expect to acquire the solar heating system under the contract providing for the sale of the house?

Suppose that the person who installed the solar heating system sold the system on credit and took an interest in the system to secure its price.

Does the seller of the solar heating system have an interest in the system as goods? As fixtures? Both?

New Article 9 includes in the definition of goods "as-extracted collateral," as defined in new section 9-102(a)(6). The sometimes complex issues associated with such collateral are best deferred to Chapter 20 (Perfection as to Fixtures and Other Real Estate-Related Collateral).

C. Quasi Goods

The description quasi goods is intended to capture the idea that an intangible can be merged into a document or record so that parties who deal with the right or claim do so by dealing with the document or record. In the case of a simple contract, there may or may not be a paper in which the rights under the contract are embodied. Any writing that does exist is only evidence that a contract was entered into. The rights under the contract can be transferred by an assignment that does not require transfer of any writing evidencing the contract.

By contrast, the rights associated with certain intangibles may have merged with the paper evidencing the rights. The classic example is a negotiable instrument, such as a check or a negotiable promissory note. Under the "merger doctrine," developed in negotiable instruments law, a negotiable instrument is a promise to pay in a certain form that is merged so completely into a piece of paper that the piece of paper comes to embody the promise. Transferring the piece of paper is necessary to transfer the promise to pay.

Negotiability adds the important consequence that a transferee of the instrument can acquire greater rights than were enjoyed by the transferor. This happens pursuant to the "holder in due course" doctrine. But, there can be merger even where an instrument is not negotiable. And, there can be what amounts to merger as to intangibles other than instruments, such as documents of title and tangible chattel paper.

The challenge is deciding when merger has occurred. *If* parties treat a right or claim as being so embodied in a document that they insist upon a delivery of the document when dealing with the right or claim *then* merger has occurred and the document takes on a goods like quality (*i.e.*, is "quasi goods").

As will be explained more fully in Part V, the principal reason it matters whether property constitutes quasi goods or is simply a pure intangible is that the choice between the two impacts whether a security interest in the property can be perfected by possession. Thus, for example, a security interest in a negotiable instrument may be perfected by possession but pure intangibles are not possessable and hence a security interest in them cannot be perfected by possession. Some examples of more commonly encountered quasi goods are considered below.

1. Instrument

New section 9-102(a)(47) defines "instrument" to mean "a negotiable instrument or any other writing that evidences a right to the payment of a monetary obligation, is not itself a security agreement or lease, and is of a type that in ordinary course of business is transferred by delivery with any necessary indorsement or assignment." Thus, as was true under former section 9-105(1)(i), instruments are quasi goods.

As seen in Chapter 4 (Scope of Article 9), new Article 9 encompasses interests in electronic records and documents as well as those that are in writing. However, to be an instrument there must be a writing. Moreover, the writing cannot itself be a security agreement. Not surprisingly, the definition includes negotiable instruments. Checks, promissory notes and certificates of deposit generally, although not always, are negotiable under Article 3 and are instruments under Article 9. Investment property, letters of credit rights, and writings arising out of the use of a credit or charge card are *not* instruments under new section 9-102(a)(47).

A useful discussion of the meaning of "instrument" under former Article 9 appears in the *In re Latin Investment Corp.* case. To visit the opinion, click on the name.

Latin Investment was decided under former Article 9. You may consider the continuing viability of the decision and opinion under new Article 9 in the next problem.

Problem 5.14 (INTERACTIVE)

Danielle Debtor owns a certificate of deposit issued by Second Bank. The particular CD is in writing and bears a conspicuous legend that it is "Non-Negotiable."

Would the CD be an instrument under *former* Article 9 as applied in *Latin Investment*?

If a CD bore a legend "non-transferable" as well as "non-negotiable," would the CD more clearly not have been an instrument under former Article 9 as applied in the *Latin Investment* case?

What language of new section 9-102(a)(47) suggests *Latin Investment* would be decided the same way under *new* Article 9 as it was under *former* Article 9?

The actual holding in *Latin Investment* was that whether the particular item was an instrument or not could not be decided on a motion for summary judgment. In *McFarland v. Brier*, 850 A.2d 965 (R.I. 2004), the court agreed that a writing labeled non-negotiable and non-transferable could be an instrument and that the controlling question was whether the writing was of a type transferred by delivery. But, it went on to determine that the question of whether a writing was of a type transferred by delivery was a question of law for the court.

The court in *Latin Investment* touched on the question of how a CD that is *not* an instrument should be classified. We will consider that question further below.

2. Investment Property

As seen above, investment property is excluded from the definition of "instrument." Security interests in investment property pose complicated questions, many of which are attributable to how such property is held and traded today. The subject is best deferred to Chapter 21 (Perfection as to Investment Property).

3. Tangible Chattel Paper

Historically, goods have sometimes been referred to as chattels. Under former Article 9 "chattel paper" was paper that was goods-like and under former section 9-105(1)(b) meant essentially a writing or writings that evidenced both a monetary obligation and a security interest. The classic example of chattel paper historically has been a conditional sales contract, for example, a contract under which a vehicle is sold on installment credit that is secured by an interest in the vehicle.

New Article 9 defines chattel paper essentially as property evidencing a monetary obligation that is itself secured. The complete definition is in new section 9-102(a)(11). Note the definition omits the reference to a writing or writings and refers rather to a record or records. The definition of a "record" in new section 9-102(a)(69) includes both tangible mediums and "an electronic or other medium [that is] retrievable in perceivable form."

What this means is that under new Article 9 chattel paper can be intangible as well as tangible. As discussed below, Article 9 separately defines electronic chattel paper.

However, only *tangible* chattel paper, as defined in new section 9-102(a)(78), constitutes quasi goods that may be possessed or pledged.

A final, non-obvious, but important point about chattel paper is that under the last sentence of the definition in new section 9-102(a)(11) if a transaction is evidenced by a records that qualify as chattel paper or lease *and* by an instrument or series of instruments, then the items together constitute chattel paper.

Under the specific language of the last sentence of new section 9-102(a)(11) ("If a transaction is evidenced by records that include an instrument or series of instruments, the group of records taken together constitutes chattel paper.") a transaction could consist of both electronic chattel paper, as discussed below, and an instrument (which must be in writing) and the electronic chattel paper and instrument would together constitute chattel paper but, presumably, not tangible chattel paper and, therefore, not quasi goods.

You may test your understanding of chattel paper in the next problem.

Problem 5.15 (INTERACTIVE)

Sid Seller sells a vehicle to Byron Buyer. Byron signs a promissory note in which Byron agrees to pay the unpaid price of the vehicle in 24 equal monthly installments. In the sales contract Byron repeats the promise to pay over time and gives to Sid an interest in the vehicle to secure the promise to pay. Which of the following statements are true (more than one may be true)?

(a) The promissory note is tangible chattel paper.

(b) The sales contract creating an interest in the vehicle to secure the unpaid sales price of the vehicle is tangible chattel paper.

(c) The sales contract creating an interest in the vehicle to secure the unpaid sales price of the vehicle and the promissory note together constitute tangible chattel paper.

4. Documents of Title

Security interests often are taken in warehouse receipts and bills of lading. A warehouse receipt is a document of title issued by a warehouse that is both a receipt evidencing a bailment of goods and a contract in which the terms of the bailment are spelled out. A bill of lading is a document of title issued by a carrier and it also is both a receipt and a contract. Documents of title are referred to in both former and new Article 9 simply as "documents."

Documents of title are the subject of a separate UCC article, Article 7. They may be negotiable or non-negotiable in form. Only negotiable documents of title are quasi goods security interests in which can be perfected by possession. Security interests in documents of title are treated in Chapter 15 (Perfection by Possession (Including Documents of Title)).

D. Pure Intangibles

1. Generally

Pure intangibles are neither goods nor goods-like. Stated differently, the defining characteristic of a pure intangible is that in law it cannot be possessed or pledged. This means that a security interest in such property cannot be perfected by possession.

Former Article 9 divided pure intangibles into accounts and general intangibles. Under former section 9-106, an "account" meant any right to payment for goods sold or leased or for services rendered which was not evidenced by an instrument or chattel paper, whether or not it had been earned by performance. Any personal property (including things in action) other than goods, accounts, chattel paper, documents, instruments, investment property, rights to proceeds of written letters of credit, and money was a "general intangible." New Article 9 significantly alters this scheme.

2. Accounts

"Account " is defined in new section 9-102(a)(2). A significant change from former section 9-106 is that the new definition expands the meaning of account to include a right to payment of a monetary obligation resulting *other than* from a sale of goods or services. Consequently, many things that likely were general intangibles under former Article 9 -- including especially license fees, credit card charges and lottery winnings -- are accounts under new Article 9.

However, the most common account continues to be an account receivable, *i.e.*, an unsecured right to payment for the sale of goods or services. As with former section 9-106, under new section 9-102(a)(2) a right to payment is an account whether or not it has been earned by performance (that is the debtor's performance may still be executory).

The definition of account also includes a "health-care-insurance receivable." Under the new definition, chattel paper, instruments, commercial tort claims, investment paper, letter of credit rights, and rights to payment for money or funds advanced or sold, other than rights arising out of the use of credit or charge cards, are not accounts.

3. General intangibles

"General intangible" is defined in new section 9-102(a)(42). Under the definition, "general intangible" includes things (choses) in action other than accounts. As was true under former section 9-106, what is an account cannot be a general intangible, but because the definition of account in new section 9-102(a)(2) has been expanded beyond rights to payment for sales of goods or services greater care must be used in deciding whether or not a particular pure intangible is a general intangible (and in describing the collateral in a security agreement or financing statement).

Instruments, chattel paper, commercial tort claims, deposit accounts, documents, investment property, letter of credit rights, money and minerals to be extracted are not general intangibles. Thus, under new Article 9, as was true under former Article 9, general intangibles is largely a "residual" category. *See* Official Comment 5d to new 9-102.

It should be noted that the definition of "general intangibles" in new 9-102(a)(42) expressly includes "payment intangibles" and "software." The former is defined in new section 9-102(a)(61) as a general intangible as to which the principal obligation is a monetary obligation. Consequently, property that *does not meet the definition of other separately defined property* can be a general intangible even though a payment obligation is involved. Where there is no payment obligation involved then a pure intangible most likely falls into the general intangibles category. Various forms of intellectual property, such as copyrights, are general intangibles. *See* Official Comment 5d to new 9-102.

The question in the case of *In re E-Z Serve Convenience Stores*, Inc., 299 B.R. 126 (Bkcy MDNC 2003), *affirmed*, 318 B.R. 637 (M.D. NC 2004), was how to classify a debtors right to the unpaid and unearned portion of a security retainer (a retainer given to secure the payment of future services any unearned portion of which was to be returned to the debtor) provided to a law firm in connection with a Chapter 11 bankruptcy and deposited by the law firm in a trust account. The court concluded that the debtors interest should be classified as a general intangible and, as such, was subject to a properly perfected security interest created in a security agreement that covered "general intangibles."

In reaching its conclusion the court invoked the proposition that general intangibles is a residual category and the particular interest was a general intangible because it was not money or a deposit account. According to the court, the debtors interest was not money because it did not fall within the definition of money in Article 1, section 1-201(b)(24) providing that money means a medium of exchange currently authorized or adopted by a domestic or foreign government and rather was a right to payment of money. The court reasoned that although the trust account might have been a deposit account as to the law firm it was not a deposit account as to the debtor because it was not a demand, time savings, passbook, or similar account maintained with a bank as required by new section 9-102(a)(29).

The court might have added that the debtor's interest was not an account under the expanded definition of account in new section 9-102(a)(2), discussed above, because as noted in that discussion, the definition expressly excludes "rights to payment for money or funds advanced or sold, other than rights arising out of the use of a credit or charge . . . card." The debtors interest would to seem meet the definition of a payment intangible, as defined in new section 9-102(a)(61) but, as explained above, a payment intangible is a general intangible and would be covered by a security agreement describing the collateral as "general intangibles."

It should be noted that the security agreement at issue in the case was executed prior to the effective date of new Article 9 and, therefore, it could be argued that the meaning of general intangible as used in that security agreement should be determined by reference to the definition of general intangibles in former Article 9, section 9-106. But, even if that argument succeeded, it would not affect the courts analysis because the debtors interest would be a general intangible under former Article 9 as well.

The court in *E-Z Serve Convenience Stores* also decided that the debtors rights as to the unearned retainer arose before and not after the debtor filed bankruptcy. As will be explained in Chapter 9 (The Specifics of Enforceability After-acquired Collateral, Future Advances, Transferred Collateral and Proceeds, and the New Debtor Problem), had it rather concluded that the rights arose after the bankruptcy petition was filed the secured partys security interest in the unearned retainer would not have been enforceable under BRA § 552 unless the unearned retainer constituted proceeds of original collateral.

A cause of action for breach of contract is a general intangible, even if the breach results from the negligence of the breaching party, so long as the negligence relates to performance of the contract. *In re Wiersma*, 283 B.R. 294 (Bkcy D. Idaho 2002).

If the cause of action is for negligence, or some other tort, not arising out of a contract, then it would be a tort claim and it must be determined whether it is a commercial tort claim or not because under new section 9-109(d)(12) security interests in commercial tort claims as original collateral are covered by new Article 9 while security interests in other tort claims are covered only as proceeds. *See* Chapter 4 (Scope of Article 9). Moreover, a commercial tort claim is defined separately in new section 9-102(a)(13) and is excluded from the definition of a general intangible under new section 9-102(a)(42) and would not be covered by a security agreement describing the collateral as general intangibles. *See Wiersma*, *supra*.

After having determined that a breach of contract claim was a general intangible and not a commercial tort claim, the court in *Wiersma*, *supra*, goes on to conclude that even if its analysis of the matter does not hold up the cause of action is a thing in action and for that reason is a general intangible. This conclusion is questionable because the category of general intangibles is residual and if a thing in action falls within a specific category, here a commercial tort claim, then it is not properly classified as a general intangible. *See* new 9-102(a)(42) (excluding, inter alia, from the definition of general intangible accounts, commercial tort claims, and deposit accounts).

Apparently in an effort to cover all the bases, the court also concludes that the cause of action is proceeds of the debtors cows and milk that were expressly covered by the security agreement. Discussion of this conclusion is best left to Chapter 9 (The Specifics of Enforceability After-acquired Collateral, Future Advances, Transferred Collateral and Proceeds, and the New Debtor Problem).

"Software" is a general intangible as defined in new section 9-102(a)(42) but is separately defined in new section 9-102(a)(75). The definition of software excludes a computer program that meets the definition of goods in new section 9-102(a)(44), as discussed earlier.

As is clear from the discussion of *Wiersma*, *supra*, commercial tort claims are not general intangibles. The definition of general intangible in new section 9-102(a)(42) also excludes such important collateral as deposit accounts and instruments. These and other exclusions affect the important questions of how collateral must be described in a security agreement or financings statement, matters that are dealt with in Chapter 8 (The Specifics of Enforceability After-acquired Collateral, Future Advances, Transferred Collateral and Proceeds, and the New Debtor Problem) and Chapter 14 (The Nitty Gritty of Filing). As is explained in Chapter 37 (Foreclosure as to Intangibles), the exclusions also affect enforcement of security interests in intangible collateral, especially where the collateral has been the subject of an assignment.

The definition of general intangibles also excludes investment property, defined in new section 9-102(a)(49) to mean a security, whether certificated or uncertificated, security entitlement, securities account, commodity contract, or commodity account. Were it not for this exclusion many types of investment property, other than certificated securities, might well be considered general intangibles. The exclusion leaves open the question of when property is investment property. In many cases the answer to the question will be clear. However, there are types of property as to which the answer is not entirely free of doubt.

For example, an interest in a limited liability company (LLC) may be offered to secure a debt. *See*, *e.g.*, *Chesapeake Investment Services v. Olive Group Corp.*, 2003 WL 36682 (Mass. Super. 2003). Unless the interest is "a medium of investment and by its terms expressly provides that it is a security governed by [Article 8]", and [the obligation] by its terms satisfies the other requirements of the definition of a security in Article 8, section 8-102(a)(15), in which case it would be investment property, then the interest would be a general intangible.

An interest in a limited partnership, on the other hand, could satisfy the requirements of the definition of a security, especially that it "is of a type, dealt or traded on securities exchanges or securities markets" and constitutes investment property and not general intangibles. As noted earlier, security interests in investment property pose special problems that are considered more completely in Chapter 21 (Perfection as to Investment Property). *See generally*, Coleman, Cowan & Forbes, Pledges of Partnership Interests: Panacea or Pandoras Box?, 368 PLI/Real 121 (1991).

You may explore the basics of the accounts and general intangibles classifications in the next two problems.

Problem 5-16 (INTERACTIVE)

ABC, Inc. manufactures and sells toys on credit on an unsecured basis. Second Bank takes a security interest in the contracts that are generated by the sale of toys by ABC. As of the time of the creation of the security interest ABC has delivered only some of the toys that ABC has contracted to sell and some of the toys ABC has contracted to sell have not yet even been manufactured.

Are the contracts for the sale of toys that have been manufactured and delivered goods, general intangibles, accounts or chattel paper?

How should the contracts for the sale of toys that have been manufactured but not delivered be classified under new Article 9?

Are the contracts for the sale of toys that have not yet been manufactured also accounts?

What language of new section 9-102(a)(2) supports your answer to the last question?

Can a security interest in any of the contracts be perfected by possession?

Problem 5.17 (INTERACTIVE)

First Bank is considering financing the acquisition of a tavern by Debbie Debtor in Arizona. Debbie is offering as collateral the liquor license that will be transferred to Debbie as part of the acquisition.

How should the liquor license be classified?

A word of caution about liquor licenses is in order. There has been some disagreement about the extent to which restrictions on the transfer of a liquor license may prevent them from the license from being property as is required for a security interest to attach. The dispute upon which this caveat is based was alluded to in Chapter 4 (Scope of Article 9) and is discussed more fully in Chapter 25 (The How and Why of Priority).

As with accounts and other pure intangibles, general intangibles cannot be possessed and a security interest in general intangibles cannot be perfected by possession.

4. Deposit Account

Pure intangibles also include "deposit accounts," defined in new section 9-102(a)(29) to include a demand, time, savings, passbook, or similar account maintained with a bank and to exclude investment property or an account evidenced by an instrument. In short, a deposit account is a general bank account. The definition generally tracks that found in former Article 9, section 9-105(1)(e). However, under former section 9-105(1)(e) a bank account evidenced by a certificate of deposit was not a deposit account. Under new section 9-102(a)(29), a bank account evidenced by a certificate of deposit may be a deposit account so long as the certificate of deposit is not an instrument.

As noted in the discussion of instruments and the *Latin Investment* case above, a certificate of deposit is an instrument only if it is transferred by delivery in the ordinary course of business. Moreover, to be an instrument there must be a writing. Consequently, an electronic certificate of deposit cannot be an instrument but it can be an deposit account. *See* Official Comment 12 to new 9-102.

The definition of a deposit account takes on greater importance in new Article 9 than it had under former Article 9 because, as was noted in Chapter 4 (Scope of Article 9), new Article 9 covers security interests in deposit accounts as original collateral, other than in the case of a consumer transaction, whereas former Article 9 covered security interests in deposit accounts only as proceeds.

The treatment of deposit accounts under new Article 9 is considered in the next problem.

Problem 5.18 (INTERACTIVE)

Donald Debtor has a certificate of deposit issued by Western Bank. The CD is labelled "non-negotiable." Donald offers an interest in the CD to Lenny Lender as collateral for a loan.

How should the CD be classified?

If the CD is in electronic form (*i.e.*, it is not evidenced by any writing) is it an instrument or a deposit account?

If the CD is in electronic form, and hence is not an instrument and rather is a deposit account, is any security interest taken by Lenny governed by new Article 9?

5. Commercial Tort Claim

A commercial tort claim is another pure intangible. As we saw in Chapter 4 (Scope of Article 9), the creation of security interests in tort claims was outside the scope of former Article 9, but proceeds interests in tort claims and interests in commercial tort claims as original collateral are covered by new Article 9. Under new section 9-102(a)(13), a tort claim is a "commercial tort claim" if the claimant is an organization *or* the claimant is an individual *and* the claim arose in the course of the claimant's business or profession and the claim does not include damages arising out of personal injury to or the death of an individual.

It should be noted that commercial tort claims are expressly excluded from the definitions of account and general intangible. Consequently, a description of a commercial tort claim as an account or general intangible in a security agreement would be improper. However, if a commercial tort claim has been settled and reduced to a contractual obligation to pay then the tort claim becomes a payment intangible as defined in new section 9-102(a)(61) and also falls within the definition of a general intangible in new section 9-102(a)(42), as discussed above. *See* Official Comment 15 to new 9-109.

In the case of *In re Wiersma*, 283 B.R. 294 (Bkcy D. Idaho 2002), also discussed in subpart D (3) above and in Chapter 4 (Scope of Article 9), the court concluded that a cause of action for breach of contract is a general intangible, and not a tort claim, even if the breach results from tortious behavior.

Problem 5.19 (INTERACTIVE)

Donna Debtor owns and operates a gift shop. Central Bank holds a perfected security interest in Donnas accounts, deposit accounts and general intangibles. Donna recently filed a lawsuit against one of her suppliers alleging fraud on the part of the supplier. Does Central Bank have a security interest in Donna's claim against the supplier?

Would your answer be different if Donna's claim against the supplier had been settled?

If Donna's claim against the supplier alleged a breach of contract involving fraud would the claim be covered by Central Banks security interest?

6. Health-care-insurance receivable

Recall from Chapter 4 (Scope of Article 9) that interests in insurance claims, other than as proceeds, were not covered by former Article 9. New Article 9, section 9-109(d)(8) contains a similar exclusion but under this provision new Article 9 covers health-care-insurance receivables as original collateral. "Health-care-insurance receivable" is defined in new section 9-102(a)(46) essentially as a right to payment of a monetary obligation for health-care goods or services provided.

Although separately defined, a health-care-insurance receivable still is either an account or a general intangible. Deciding which it is requires careful reading of the definitions of account and general intangible as discussed above. As seen in the discussion of commercial tort claims, the decision can be important because exactly how property is classified affects decisions about descriptions and ultimately determinations as to perfection. These matters get much fuller treatment in later chapters.

As has been noted, pure intangibles cannot be pledged or possessed so perfection of a security interest in such property cannot be accomplished by possession. In later chapters we will discover that perfection of a security interest in pure intangibles is usually accomplished by filing but as to some intangibles, in particular deposit accounts, perfection may require getting "control" of the property.

The next three problems allow you to revisit many of the points made above.

Problem 5.20 (INTERACTIVE)

Southern Bank wishes to lend to Virus Detect, Inc., a software developer. Virus Detect has offered as collateral an interest in a negotiable certificate of deposit, a general business bank account and its storeroom full of software products. How should each item of property be classified? You should have no difficulty with the negotiable certificate of deposit and the general bank account. The software is trickier. Consider new section 9-102(a)(75) (defining "software"). Later we will explore the difficulties posed by the fact that software ordinarily is copyrighted and federal law must be consulted.

May a security interest in any of the items be perfected by possession?

Problem 5.21 (INTERACTIVE)

As noted, the proper classification of collateral affects such important matters as the adequacy of a description. Would a security agreement drafted after the effective date of new Article 9 and describing the collateral as general intangibles cover a right to payment of lottery winnings? Before answering you may wish to consult new section 9-102(a)(2).

Problem 5.22 (INTERACTIVE)

Northern Bank is contemplating lending to Joe Jones and taking an interest in Joe's share of a limited partnership to secure the loan. How should the collateral being offered be classified?

CASE COMMENTARY

The Epicentre Strategic Corporation-Michigan v. Perrysburg Exempted Village School District, 2005 WL 3060104 (N.D. Ohio 2005)

Mackela v. Bentley, 614 S.E.2d 648 (S.C. App. 2005)

First National Bank v. Lubbock Feeders, L.P., 183 S.W.3d 875 (Tex. App. 2006

Feliciana Bank & Trust v. Manuel & Sessions, L.L.C., 943 So.2d 736 (Miss.App. 2006)

Coffey v. Singer Asset Finance Co., L.L.C., 2007 WL 258962 (Tex. App. 2007)

Madisonville State Bank v. Canterbury, Stuber, Elder, Gooch & Surratt, P.C., 209 S.W.3d 254 (Tex. App. 2006)

Vars v. Citrin, 470 F.3d 413 (1st Cir. 2006)

Stockman Bank of Montana v. AGSCO, Inc., 727 N.W.2d 742 (N.D. 2007)

In re Commercial Money Center, Inc., 350 B.R. 465 (B.A.P. 9th Cir. 2006)

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Part III Scope of Article 9, Classification of Collateral and Choice of Law

Chapter 6 Choice Of Law

Choice of law rules probably are most important when it comes to perfection of a security interest. Simply stated, the question that arises is in what state should whatever action is required to perfect be taken. Where perfection is by filing the choice of law rule question becomes in which state or states must the creditor file a financing statement. The rules will be revisited when we look at perfection. However, a brief overview of the choice of law rules is in order here.

To begin with you should understand that although the UCC is a uniform law, some states have enacted it with modifications. So, a practitioner always has to be careful to look to the UCC as it has been adopted in the state whose law governs. Further, with enactment of new Article 9 it may be necessary to decide which version of Article 9, former or new, governs the particular transaction.

Former section 9-103 contained the choice of law rules for former Article 9. Those rules underwent repeated revision but difficulties remained. Former section 9-103(1)(b) stated a "situs rule" under which the law of the jurisdiction where ordinary goods were located governed. Former section 9-103(2)(b) provided that the law of the state that had issued a certificate of title covering the goods applied. Under former section 9-103(3)(b), the law of the jurisdiction where the debtor was located governed as to security interests in accounts, general intangibles and mobile goods.

As for new Article 9 because of their complexity it is advisable to leave the choice of law rules applicable to goods covered by a certificate of title to Chapter 17 (Perfection as to Goods Subject to Certificate of Title Legislation). As to other collateral, new Article 9 effects a major change. Thus, the general rule in new section 9-301(1) is that while a debtor is located in a jurisdiction the local law of that jurisdiction governs perfection. There are numerous exceptions to the general rule and a "situs rule" sometimes governs. For example, under new section 9-301(2), the law of the jurisdiction where the collateral is located governs perfection by possession. A detailed discussion of these exceptions is best left to later chapters.

It should be noted that under new section 9-301(3)(C) the law of the jurisdiction where the collateral is located governs *the effect* of perfection or nonperfection and the priority of nonpossessory security interests in goods and quasi goods. *See* Official Comment 7 to new 9-301. The focus in this chapter is on the law governing perfection and nonperfection and the law governing perfection and nonperfection generally is the law of the jurisdiction where the debtor is located.

The application of the general rule requires that there be rules for determining where a debtor is located. These rules are found in new section 9-307. New section 9-307(b) provides that except as qualified by later subsections an individual debtor is located at the individual's place of residence and an organizational debtor is located at the place of business unless the debtor has more than one place of business in which case the debtor is located at its chief executive office.

Among the most important qualifications to rules in new section 9-307(b) is that found in new section 9-307(e). Under new section 9-307(e), a "registered organization" is located in the state in which the organization is registered. A registered organization, as defined in new section 9-102(a)(70), is an organization that exists by virtue of having been organized in a state or under federal law. The definition includes, in particular, corporations and limited partnerships.

The essential rules of new sections 9-301 and 9-307 may be appreciated by applying them in the next problem.

Problem 6.1 (INTERACTIVE)

ABC, Inc. is a consulting business incorporated in Delaware. ABC has offices in Arizona, California and New Mexico but its chief executive office is in Arizona. Second Bank located in New York has taken a security interest in ABC's computers used by ABC in its offices in Arizona, California and New Mexico and in ABC's accounts receivables.

In which state or states would Second Bank file a financing statement to perfect its security interest *in the computers* under *former* Article 9? *See* former 9-103(1)(b).

Where should Second Bank have had to file as to the computers under *new* Article 9?

Where would Second Bank be required to file to perfect its security interest in the *accounts* under *former* Article 9?

Where should Second Bank file to perfect its security interest in the accounts under *new* Article 9?

As will be seen further in Chapter 13 (Overview of Perfection by Filing), for the most part, parties cannot choose the law governing perfection. Former Article 1, section 1-105(2) so provided. The 2008 version of Article 1, section 1-301(c)(8), which replaces former Article 1, section 1-105(2), is to the same effect. However, new Article 9 introduces a non-obvious wrinkle to this rule. A bank may choose its jurisdiction and thereby choose the law governing perfection of a security interest in a deposit account maintained with the bank. *See* new 9-304.

The above limitations on the ability of the parties to choose the law determining perfection or non-perfection of a security interest apply only where the Uniform Commercial Code (UCC) governs a transaction. There will be situations in which the UCC does not apply. In particular, in international transactions, involving parties one of which is a resident or national of another country, a law other than the UCC could apply under choice of law principles.

To avoid a law the application of which is deemed to be undesirable, the parties may attempt to choose the governing law in their agreement. In an early version of new section 1-301, in subsection (c)(2), the drafters of the UCC sought to give parties the ability to choose the law of a jurisdiction that bore no relationship to the transaction. However, the attempt met with widespread resistance by the states and the latest version of new section 1-301, Article 1, section 1-301, reverts to the substance of former Article 1, section 1-105(1)), requiring that the law chosen bear a reasonable relationship to the transaction.

A review of state action as to various sections of Article 1, may be found at:

http://www.law.unlv.edu/faculty/rowley/ra1_updates.htm.

The next two problems illustrate the foregoing points.

Problem 6.2 (INTERACTIVE)

Assume the facts of Problem 6.1.

Could Second Bank avoid the hassle of deciding which state's law governs perfection by entering into an agreement with ABC, Inc. providing that New York law governs?

Does the fact that the secured party is a bank affect your answer?

Problem 6.3 (INTERACTIVE)

Soft as Silk, Inc. (SaS), a business incorporated in Mexico, is borrowing from Northwestern Bank (NB), a New York corporation. The loan will be secured by an interest in all of SaS's accounts receivables.

Is it possible for NB to draft a security agreement containing an enforceable provision under which the law of New York would govern perfection and non-perfection of the security interest? Explain your answer.

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Part IV Creating an Enforceable Article 9 Security Interest

Chapter 7 Overview Of Enforceability And Attachment

You have learned that a secured debt is better than an unsecured debt. To secure a debt a creditor must get a "lien," *i.e.*, an interest in property to secure a debt. When the lien is on personal property and is created by consent, the lien is a "security interest" and Article 9 likely governs in which case the interest is an "Article 9 security interest." *Recall* Chapter 3 (The Nature of Secured Credit under Article 9) and Chapter 4 (Scope of Article 9). The element of consent means that much of Article 9 is rooted in contract law, especially the principle that the objectively ascertainable intent of the parties is ultimately controlling.

To speak of an Article 9 security interest as "consensual" is to distinguish it from an interest, or "lien," obtained by litigation. A lien by litigation is a "judicial lien." *See* Chapter 4 (Scope of Article 9) and B & S (cited in Chapter 3), 4.03. 4.04 and 4.05. But, the fact that a debtor consents to the lien, *i.e.*, voluntarily gives a creditor an interest in property to secure a debt, does not mean the interest – the lien – is enforceable.

Certain conditions must be met before a security interest is enforceable. Give some thought as to why this is so. In particular, consider the impact of an enforceable lien on other creditors. For example, if a debtor's only non-exempt property, *see* B & S (cited in Chapter 3), 8.01 and 8.04, is worth $1000 and it is subject to a perfected security interest to secure a debt of $1000 owed to Creditor A, what is the effect on Creditor B who is also owed $1000 but is unsecured?

For the most complete protection a security interest must be perfected. As will be seen in Part VI, to be perfected a security interest must have attached. But, an interest attaches only when it is enforceable. So, we are back to the matter of enforceability. The requirements that must be met for a security interest to become enforceable (and attach) are the focus of this and the remaining chapters in Part IV.

Generally speaking, under former Article 9, a security interest created under Article 9 (as distinguished from interests arising under other articles of the UCC) became enforceable (and hence attached) when three basic conditions were satisfied. New Article 9 employs essentially the same enforceability scheme used in former Article 9. Under new section 9-203(b) a security interest is enforceable, and hence attaches, when (1) the creditor has given value; (2) the debtor has rights in the collateral or the power to transfer an interest in the collateral and (3) one of the specific conditions stated in new section 9-203(b)(3) has been met.

The section (b)(3) conditions are (a) that debtor has authenticated a security agreement describing the collateral; (b) the creditor has possession of collateral (other than a certificated security) pursuant to an agreement; (c) collateral that is a certificate in registered form has been delivered to the creditor pursuant to a security agreement; or (d) the collateral is deposit accounts, electronic chattel paper, investment property, letter-of-credit rights or electronic documents and the secured party has control pursuant to a security agreement.

Changes from former Article 9 include the addition of letters of credit and nominated persons under section 5-118 to the class of security interests arising under other articles of the UCC, the expansion of the scope of Article 9 to cover security interests in deposit accounts and electronic chattel paper as original collateral, *see* Chapter 4 (Scope of Article 9), and, more generally, an attempt to accommodate the movement to electronic commerce, something that has made rules tied exclusively to documents and signatures archaic and problematic. Possession, delivery of a certificated security and control, as conditions of enforceability are relatively infrequent and are best dealt with in the context of perfection which also can be effected by possession, delivery of a certificated security and control. *See* Chapter 15 (Perfection by Possession (Including Documents of Title)), Chapter 21 (Perfection as to Investment Property) and Chapter 22 (Perfection as to Deposit Accounts, Letter of Credit Rights and Electronic Chattel Paper). Most disputes as to as to enforceability involve the question of whether there is an authenticated security agreement that adequately describes the collateral and it is this condition of enforceability that is focused upon in the remainder of Part IV.

A final thought here is that all the requisites of enforceability must be met before a security interest is enforceable and before it can attach or be perfected, *see* 9-203(b), but the requirements need not be satisfied in any particular order. In similar fashion, to anticipate a bit, although some step (usually filing a financing statement) normally is needed to perfect a security interest, the step that is required to perfect may precede the satisfaction of the conditions of enforceability and attachment.

Notwithstanding these important realities about enforceability, attachment and perfection, enforceability and attachment are distinct from perfection and the fact that a security interest has been created and become enforceable and, hence, has attached does not mean it is perfected (except in the special case of "automatic" perfection, or as it is referred to in new Article 9, perfection on attachment, or the case of a possessory security interest where collateral is physically delivered to the secured party and becomes enforceable by possession and is perfected by possession).

In *In re Cadiz Properties, Inc.*, 278 B.R. 744 (Bkcy N.D. Tex. 2002), the court concluded that an agreement to place securities in escrow to secure a loan operated to perfect a security interest in securities transferred to the escrow party but, as explained in Chapter 15 (Perfection by Possession (Including Documents of Title), under new Article 9, section 9-313(c), perfection would occur only if the escrow party authenticated a record acknowledging that it held possession for the secured party).

It is because enforceability and attachment are distinguishable from perfection that enforceability and attachment are considered separately (in Part IV) from perfection (in Part V).

The next problem illustrates the difference between creation and enforceability and how they relate to secured and unsecured credit.

Problem 7.1 (INTERACTIVE)

Donald Debtor owes your client on an "open account." Donald owns a drill press the value of which is greater than Donald owes your client. However, Second Bank is asserting that it has an interest in the drill press to secure a debt that exceeds the value of the drill press.

How might your client defeat Second Bank's claim?

Why would your client wish to defeat Second Bank's claim?

CASE COMMENTARY

In re Sabol, 337 B.R. 195 (Bkcy C.D. Ill. February 6, 2006)

Wells Fargo Bank v. Robex, Inc., 711 N.W.2d 732 (Iowa App. 2006) (Unpublished opinion)

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Part IV Creating an Enforceable Article 9 Security Interest

Chapter 8 The Specifics of Enforceability

A. Getting A Grip

As noted in Chapter 7 (Overview of Enforceability and Attachment), under former Article 9, section 9-203(b), a security agreement attached when it was enforceable against the debtor. This coincidence of enforceability and attachment is preserved in new Article 9, section 9-203(a). The enforceability of security interests arising in certain specialized situations, such as upon the sale of investment property or when a bank takes a check for collection, is governed by rules referred to in new section 9-203(c).

But, generally speaking, a security interest becomes enforceable when (1) one or the other of the two general conditions is met, namely, a secured party has possession pursuant to agreement of property that is capable in law of being possessed or the debtor has authenticated a security agreement that adequately describes the collateral; (2) the secured party has given value; and (3) the debtor has sufficient rights in the collateral or the power to transfer rights in the collateral. *See* new 9-203(b).

Enforceability (and hence attachment) through possession occurs when the collateral has been pledged to a creditor to secure a debt. The pledge is probably the oldest form of security involving personal property. In civil law systems, including Mexico, arrangements under which security in personal property is given other than by pledge have not been readily accepted. By contrast, under Article 9, because as a practical matter debtors want or need to continue in possession of collateral, pledges tend to be limited to certain special situations.

Most of the interesting issues associated with pledges, including the question of whether or not a secured party actually has possession, arise in the context of perfection so the discussion of pledges is properly left to Chapter 15 (Perfection by Possession (Including Documents of Title)).

The requirements for enforceability in new section 9-203(b) that a secured party has given value and that the debtor has rights in the collateral are dealt with in Chapter 10 (The Need for Value and that the Debtor Have Rights in the Collateral). The need for a security agreement that is in proper form and meets the requisite formalities is the subject of the next subpart.

B. The Need for a Security Agreement

1. Meeting the "Statute of Frauds" Requirement

Former section 9-203(1)(a) provided that a security interest not involving a pledge was enforceable only if the debtor had signed a security agreement that contained a description of the collateral. One could reasonably have understood former section 9-203(1)(a) to require a formal document labeled "Security Agreement." However, the courts generally did not read the provision to require such a document.

In Re Ace Lumber Supply, Inc., 105 B.R. 964 (Bkcy D. Mont. 1989) provides a useful illustration. In that case the court reviewed several decisions under former section 9-203(1)(a) and concluded that the intent requirement imposed by that section had not been satisfied. To examine the decision and opinion, click the name of the case above.

In *Ace Lumber* the court noted that former section 9-203(1)(a) was understood to have both a statute of frauds and an evidentiary role. As to the former the question was whether the writings were sufficient to allow a court to conclude the parties intended to create a security interest. As with statutes of frauds' inquiries generally, decisions as to whatever threshold demands were imposed were fact-specific and depended upon a particular courts disposition to support or resist statute of frauds' requirements. Courts often were willing to look to a collection of writings in deciding whether the statute of frauds aspect of former section 9-203(1)(a) had been satisfied. The willingness of courts to do so was referred to as the "composite document doctrine."

The evidentiary aspect of former section 9-203(1)(a) tended to be concerned with a creditors ability to show that particular property was subject to whatever security interest the parties had created. As noted in *Ace Lumber*, parol evidence was admissible on this point but not as to the statute of frauds aspect of former section 9-203(1)(a). The question whether the collateral had been adequately described was pivotal in evidentiary determinations and is discussed at length in subpart C below.

New section 9-203(b)(3)(A) is the successor to former section 9-203(1)(a). New section 9-203(b)(3)(A) requires that a security agreement be authenticated rather than signed. As is discussed further below, the purpose of this change to accommodate electronic transactions. The initial question must be whether new section 9-203(b)(3)(A) should be understood to have the meaning given to former section 9-203(1)(a) by courts in cases such as *Ace Lumber*.

The next three problems and the text elaborating on the problems focus on this initial inquiry.

Problem 8.1 (INTERACTIVE)

What was lacking on the facts of Ace Lumber that in the court's view would have rendered the security interest enforceable under former Article 9? Explain your answer.

Would you expect the Ace Lumber case to come out the same way under new section 9-203(b)(3)(A)? Explain your answer.

Problem 8.2 (INTERACTIVE)

Sid Seller agreed to sell equipment to ABC, Inc. on credit. There was a bill of sale that specifically described the items of equipment. The bill of sale made no mention of a security interest. Some time after the sale the board of directors of ABC, Inc. passed a resolution directing corporate counsel to prepare a financing statement "on behalf of the corporation as debtor to Sid Seller as the secured party." On the same day that the board passed the resolution, ABC, Inc. issued a promissory note to Sid in the amount of the unpaid price of the equipment. The financing statement was prepared and filed. There was evidence that ABC, Inc.'s attorney prepared a security agreement but none was ever produced by either Sid or ABC, Inc.

Is the security interest in the equipment enforceable? *Cf.* *In the Matter of Numeric Corp.*, 485

F.2d 1328 (1st Cir. 1973).

The court in *Ace Lumber* indicated that parol evidence is admissible to establish the scope of a security interest. In the case of *In re Invenux*, 298 B.R. 442 (Bkcy D. Colo. 2003), decided under new Article 9, the court discusses the parol evidence rule and holds that it does not bar evidence that a security agreement does not express the true intent of the parties and reformation of a security agreement. The case is considered further in subpart C(2) below.

Not surprisingly, there was some disagreement about what was enough to satisfy the statute of frauds requirement of section 9-203. Thus, in *Gibson County Farm Bureau Co-op Assn v. Greer*, 643 N.E. 2d 313 (Ind. 1994), the Indiana Supreme Court in a thoughtful opinion concluded that a financing statement alone was enough to satisfy former section 9-203(1) and whether the parties actually intended to create a security interest was a question of fact as to which parol evidence was admissible.

However, as is explained more fully in Part V, because a financing statement states that there may be a security interest in loosely described collateral, most courts under former Article 9 would not go so far as did the court in *Gibson* and it seems likely that the view expressed in cases such as *Ace Lumber* will prevail under new Article 9.

In the case of *In re Wiersma*, 283 B.R. 294 (Bkcy D. Idaho 2002), the court concluded that a document using the language of assignment, given evidence that the assignment was intended to secure a promissory note, was sufficient to satisfy former section 9-203 and render the security interest enforceable and that the security interest would continue to be enforceable under new Article 9.

The court in the case of *In re Quisenberry*, 295 B.R. 855 (Bkcy N.D. Tex. 2003) explored the need for a security agreement and the requisites of enforceability of any security interest created by the agreement in the interesting and important context of a bank that had a right of set-off against the deposit account of a depositor who also was a debtor on a security agreement executed by the debtor in favor of the bank. The dispute involved a check of unknown origin deposited in the deposit account. The debtor had given the bank a security interest in certain vehicles to secure a truck loan.

Oversimplifying somewhat, the security agreement described the collateral as two vehicles and also accessions to the trucks, products of the trucks, certain intangibles arising out of any sale or lease of the trucks and all proceeds, including insurance proceeds, from the sale or loss of the trucks. The right of set-off was contained in the depositor's agreement between the debtor and the bank. For reasons that are explained in Chapter 30 (Secured Party Versus Trustee in Bankruptcy), the bank's ability to reach the deposit account depended on whether it had a security interest in the deposit account.

The court concluded that the set-off agreement was not a security agreement as defined in new section 9-102(a)(73) and there could be a security interest in the deposit account only to the extent it was covered by the security agreement executed in connection with the truck loan. Because the deposit account did not fall within the description of the collateral in the security agreement and because the bank had failed to show the deposit account constituted proceeds or otherwise arose as the result of a sale or other disposition of the vehicles there was no security interest in the deposit account arising out of the security agreement executed in connection with the truck loan.

The absence of a security agreement also meant the bank could not rely on new section 9-203(b)(3)(D) under which a security interest is enforceable where the collateral is a deposit account and the secured party has control under new section 9-104, "pursuant to the debtor's security agreement." In short, the bank did not have an enforceable security interest in the bank account because the security agreement executed by the debtor made no reference to the bank account and the depositor's agreement providing for a right of set-off did not satisfy the requirements of a security agreement under new section 9-203(b)(3). Control as an element of enforceability and perfection is considered in more detail in Chapter 22 (Perfection as to Deposit Accounts, Letter of Credit Rights and Electronic Chattel Paper.

It can happen that the parties agree on the specifics of a security agreement but fail to include certain terms in the document that emerges from their negotiations. Consider the following problem.

Problem 8.3 (INTERACTIVE)

Suppose a secured credit deal is closed on a day when the creditor's representative (you!) came to the meeting without a specific description of the collateral. Suppose further that the parties agreed that the description would be added later. If the description is actually added later -- literally entered into the writing -- is the security interest in the affected collateral enforceable? Suppose the facts in Problem 8.3 were that the descriptions of certain items of collateral were known and entered into the writing at the closing but the description of some important collateral was not. Could the necessary description of that collateral be added later? The court in *Longtree, Ltd. v. Resource Control Int'l, Inc.*, 755 P.2d 195 (Wyo. 1988) had the following to say about the matter under former Article 9:

> The RCI-Pacific Star log purchase agreement described the collateral as follows:
>
> RCI shall sell to Pacific Star and Pacific Star shall purchase from RCI, the logs which shall be made available to Pacific Star at its Star Studs Mill pursuant to the Logging Plan, a copy of which is attached hereto and made a part hereof. The parties recognize that the Logging Plan is subject to revision from time to time by RCI, with the reasonable consent of Pacific Star. The logs to be purchased and sold pursuant to the terms of this Agreement shall be delivered to Pacific Star's Star Studs Mill and stored at such location at the Mill site as Pacific Star shall designate from time to time.
>
> The agreement was signed by Darrell Jones for Pacific Star. The logging plan attached to the agreement covered logs to be delivered between May 1983 and March 1984. The logs claimed by RCI in this action were delivered after March 1984. Although these logs were not identified in the 1983-1984 logging plan, they were identified in subsequent revisions.
>
> [The argument against RCI's security interest is] that the revisions to the logging plan cannot serve as a description of the collateral because they were not signed by the debtor, Pacific Star. We disagree. . . .
>
> In this case, the log purchase agreement and the revised logging plan express an internal connection with one another. As a result, the absence of a signature on the revised logging plan does not render RCI's security interest unenforceable. RCI obtained a security agreement signed by the debtor describing the collateral and its security interest.

Note carefully the language of the last quoted paragraph. According to the court, exactly when will the necessary intent be found in documents executed at different times?

3. The Move to Electronic Transactions

It was noted above that new section 9-203(b)(3)(A) requires that a security agreement be "authenticated" rather than signed. It also was noted that this change was made to accommodate electronic transactions. A fuller explanation of the change is in order. The place to start is with the definition of authenticate. Under new section 9-102(a)(7), "authenticate" essentially means to sign, or to execute or adopt a symbol or encrypt a record with present intent to identify the authenticating party and to establish the authenticity of a record or term.

The definition of "authenticate" uses the terms "record" and "encrypt. "Record," as defined in new section 9-102(a)(69), essentially means information that is inscribed on a tangible medium or which is stored in an electronic or other medium *and* is retrievable in perceivable form. "Encrypt" is not defined in Article 9 but it is usually understood to refer to electronic communications that are coded so as to require the use of "keys" to open them. The purpose of encrypting of course is to make the communications secure and available only to persons holding the keys.

As the foregoing should suggest there has been a shift away from a concern with a sufficient writing to a desire to accommodate deals that are made electronically. Official Comment 9(a) to new section 9-102 explains the substitution of the term "record" for a "writing" as follows:

> In many, but not all instances, the term record replaces the term writing and written. A record includes information that is in intangible form (e.g., electronically stored) as well as tangible form (e.g., written on paper). Given the rapid development and commercial adoption of modern communication and storage technologies, requirements that documents or communications be written, in writing, or otherwise in tangible form do not necessarily reflect or aid commercial practices.
>
> A record need not be permanent or indestructible, but the term does not include any oral or other communication that is not stored or preserved by any means. The information must be stored on paper or in some other medium. Information that has not been retained other than through human memory does not qualify as a record. Examples of current technologies commercially used to communicate or store information include, but are not limited to, magnetic media, optical discs, digital voice messaging systems, electronic mail, audio tapes, and photographic media, as well as paper. . . . Any writing is a record.

Other definitions reinforce the attempt to respond to the move away from reliance on writings. Thus, under new section 9-102(a)(74) "send" essentially means to mail or to transmit by any other usual means of communication a record or notification, using an address reasonable under the circumstances and having paid the costs of mailing or transmitting, or to cause a record or notification to be received within the time it would have been received if properly mailed or transmitted.

"Communicate," as defined in new section 9-102(a)(18), essentially means to send a written or other tangible record, to transmit a record by any means agreed upon by the persons sending and receiving the record, or in the case of transmission of a record to or by a filing office, to transmit a record by any means prescribed by filing-office rule.

For the foreseeable future many deals will be concluded using written documents. Where this is true it is reasonable to expect that new section 9-203(b)(3)(A) will be given the same meaning as former section 9-203(1)(a). However, where the parties do business electronically courts will have to decide the extent to which electronic exchanges can satisfy new section 9-203(b)(3)(A) and produce an enforceable security interest.

Insofar as the interpretations of the prior law have been driven by the concerns that underlay statutes of frauds the prior law is not clearly applicable to a case where there is no writing. On the other hand, former Article 9 has been interpreted as requiring only that there have been sufficient communication between the parties to establish some threshold level of intent to create a security interest.

This requirement is readily transported to new Article 9. A creditor should be allowed to establish the threshold level of intent required through the use of stored and retrievable electronic communications. The emergence under new Article 9 of a "composite *record* doctrine" is quite conceivable. And, where both writings and electronic communications are involved, as is certainly possible, some amalgamation of the composite document and composite record approach could result.

There remains the problem of whether particular electronic communications are sufficiently attributable to the debtor to support a conclusion that a security interest in the property of that debtor is enforceable. Historically, the law has looked to manual signatures to provide the necessary attribution. There are no manual signatures in a purely electronic transaction and new Article 9 indicates it is enough that a security agreement has been "authenticated." As noted above, authentication requires that a record has been executed or encrypted with a present intent to identify the authenticating party and to establish the authenticity of the record.

Encrypted exchanges that involve the use of decoding keys seem clearly to provide the needed authentication. What other forms of electronic attribution will suffice remains to be seen. In particular, routine electronic mail exchanges could pose problems because even when it can be shown that a message originated from the debtor's server there may be a question of whether the debtor sent the message.

On the other hand, manual signatures do not guarantee authenticity. Manual signatures can be forged or otherwise be unauthorized. The law has dealt with this problem by requiring a party relying on a manual signature to prove it is the signature of the party it purports to be. Arguably, the same approach must be taken as to electronic "signatures." Depending on the form of the electronic communication it could happen that authenticity will pose less of a problem as to such communications than it is as to written communications.

It should be noted that electronic contracting is the subject of several international (*e.g.*, UNCITRAL) and state laws and, most recently, a federal statute. The Uniform Electronic Transactions Act (UETA) is a model law adopted in several states that requires that contracts not be denied effect because they are in electronic form. The federal Electronic Signatures law (E-Sign) tracks UETA and provides that the federal law has no application in states that adopt the uniform version of UETA.

Such laws tend to support an interpretation of Article 9 that facilitates the enforcement of electronic security agreements. However, it has been recognized that there is a risk of less than deliberate action by a debtor and that fraud could increase in the electronic environment. Thus, the federal electronic signatures statute requires that for consumer parties to be bound they must previously have agreed in some more conventional manner to be bound in an electronic exchange.

UETA and E-Sign specifically exclude contracts governed by the Uniform Commercial Code from their coverage, but only to the extent that the Uniform Commercial Code has been or will be revised to accomplish the objectives of E-Sign and UETA. New Article 1, section 1-108 provides that

> This [Act] modifies, limits, and supercedes the federal Electronic Signatures in Global and National Commerce Act [E-Sign], (15 U.S.C. Section 7001, et seq.) but does not modify, limit, or supercede Section 101(c) of that act (15 U.S.C. Section 7001(c) [requiring affirmative consent from a consumer to electronic delivery of transactional disclosures that are required by state law to be in writing] or authorize electronic delivery of any of the notices described in Section 103(b) of that act (15 U.S.C. Section 103(b)).

To say the least, it will take some time to learn how and when the UCC generally and

Article 9 in particular are to be reconciled with UETA and E-Sign.

The next four problems illustrate many of the foregoing points regarding the move to electronic dealings.

Problem 8.4 (INTERACTIVE)

Sid Seller has long been ABC, Inc.'s primary source of materials used in ABC, Inc.'s automotive parts manufacturing operation. ABC sends an electronic mail message to Sid in which ABC orders materials, described item-by-item, to be delivered immediately and paid for in three equal monthly payments. The message states "Buyer agrees that Seller will have an interest in Buyer's inventory, including former and to be manufactured widgets, and the materials that are the subject of this order." Sid sends ABC an e-mail message acknowledging receipt of ABC's order and accepting the terms stated therein. ABC fails to pay as promised. If ABC had signed a writing containing the terms in ABC's e-mail message there would be an enforceable security interest.

Is the debt represented by the unpaid sales price of the materials secured?

Problem 8.5 (INTERACTIVE)

If the Sid Seller and ABC, Inc. in Problem 8.4 concluded the deal set out in that problem through a series of electronic mail exchanges, rather than one exchange, would your answer to the question posed in that problem be different?

Problem 8.6 (INTERACTIVE)

Most of you are familiar with the practice of or actually have purchased goods or software over the Internet. Many, if not most, of those of you who have made Internet purchases have done so by clicking on the required buttons or links without reading the terms of the agreement made available to you online and which you have "accepted" by clicking on "I accept."

If one of the terms in that agreement provided for a security interest in whatever you have purchased did a secured debt result?

Suppose the purchases in Problem 8.6 were made for use in your business. Would your analysis change?

Problem 8.7 (INTERACTIVE)

ABC, Inc. and Sid Seller have had a long-standing business relationship. Early in their relationship Sid and ABC entered into a "master agreement" that was signed by both. This master agreement established procedures for doing business electronically, including a clause requiring encryption. The master agreement provided that there would be a security interest in all goods sold. It further provided that if Sid's computer system received from ABC's system an electronic order that complied with all the terms of the master agreement and included a specific description of goods ordered then Sid's computer system would automatically fill the order and send the materials and an invoice to ABC.

Is the debt incurred when Sid Seller ships goods ordered electronically secured?

C. An Adequate Description

1. The Role of an Adequate Description

If a creditor is able to meet whatever statute-of-frauds-type threshold Article 9 imposes, the creditor still must establish an interest in *particular* property. The focus then shifts to the requirement expressly stated in new section 9-203(b)(3)(A) that a security agreement describe the collateral.

As is implicit in the proposition that the creditor must establish the particular property in which it has an interest, the burden of proof as to the scope of a security interest is on the creditor. *See*, *e.g.*, *In re S.M. Acquisitions Co.*, 296 B.R. 452 (D. Ill. 2003). As was true under former Article 9, parol evidence generally is admissible to aid the creditors cause. *Id*.

Former section 9-203(1)(a) also required that the security agreement describe the collateral. Former section 9-110 provided that a description was sufficient (whether or not it was specific) if it reasonably identified what was described. The Official Comment to former section 9-110 indicated that nothing as precise as a serial number was necessary, but courts and commentators struggled with the question of when a description was otherwise adequate. The counterpart to former section 9-110 is new section 9-108. Our task is to determine when a description is adequate under new section 9-108.

2. What Constitutes an Adequate Description

New section 9-108(a) reiterates the "reasonably identifies" test. The remainder of new section 9-108 expands upon the "reasonably identifies" language both by embellishing it and expressly indicating what will not be sufficient. Under subsection (b) of new section 9-108 anything from a specific listing to a computational formula reasonably identifies collateral. A description by type, except as limited by subsection (e) is expressly authorized by new section 9-108(b)(3). Interestingly, while it has long been understood that a description by type is adequate, the precise meaning of type, in the context of a description is not entirely clear.

Under former Article 9, a description of goods according to the subcategories discussed in Chapter 5 (Classification of Collateral), consumer goods (subject to the discussion below), equipment, farm products or inventory, would be an acceptable description by type. So also would be a description of intangibles such as accounts, general intangibles, chattel paper and instruments. What tended to make these descriptions by type was that they were separately defined in former Article 9, sections 9-105, 9-106 and 9-109. That the foregoing would be considered sufficient descriptions by type under new Article 9 seems clear, especially insofar as there are separate definitions of such collateral in new section 9-102(a).

There is uncertainty as to the meaning of "type" because, although courts and commentators often ran together the terms type and category, new section 9-108(b)(2) specifically adds category to the embellishment of reasonably identifies, as required by new section 9-108(a), suggesting that type and category are somehow different. Nevertheless, it makes sense to view the use of both type and category in new section 9-108(b) as an attempt to be exhaustive and that the terms may well be used interchangeably. Of course, this leaves the question of what constitutes a description by type or by category. The answer would seem to be that if the collateral is specifically defined then it is a type or category of collateral.

It is important to understand, as explained in Chapter 5 (Classification of Collateral), that new Article 9 contains many more definitions than did former Article 9 and has created subsets within more generic groups or types.

Thus, for example, health-care-insurance receivable is separately defined in new section 9-102(a)(46) as a subset of account, as defined in new section 9-102(a)(2), payment intangible is defined in new section 9-102(a)(61) as a subset of general intangible, as defined in new section 9-102(a)(42), and chattel paper, as defined in new section 9-102(a)(11), includes electronic chattel paper, defined in new section 9-102(a)(31), and tangible chattel paper, defined in new section 9-102(a)(78). A description employing any of these definitions should pass muster as a description by type or category but, arguably, a description of the major set, for example, chattel paper, should suffice to include the subsets of electronic and tangible chattel paper.

Of course, the property sought to be reached as collateral must fit within the definition by type. Thus, as was seen in Chapter 5 (Classification of Collateral) the definition of account in new section 9-102(a)(2) is broader than that in former Article 9, section 9-106, and some property that would have been general intangibles under former Article 9 would be accounts under new Article 9.

For example, lottery winnings would be general intangibles under former Article 9 but are expressly included in the definition of account in new section 9-102(a)(2)(viii). Consequently, a security agreement describing the collateral as general intangibles would not be adequate to subject lottery winnings to the security interest created by the security agreement so describing the collateral.

New section 9-108(b)(2) approves the use of a category of collateral. It is not entirely clear what category adds to type as in common usage both mean a class or kind or group. However, if, as just explained, type refers to defined terms then category could be intended to go beyond type to include groupings that through usage in a trade or industry or between parties have taken on an accepted meaning.

Notwithstanding the broadening of potential descriptions by type resulting from the expanded list of definitions (or by category, which arguably goes beyond type), as is explained further below, it is good practice to describe collateral with as much specificity as is practicable, including describing collateral by item, thereby avoiding disputes about the meaning of type or category. Moreover, as also further explained below, new section 9-108(c) contains limitations on the use of what are clearly descriptions by type and one must be careful to avoid supergeneric descriptions as these are not allowed under new Article 9.

Perhaps the most revealing part of new section 9-108(b) is subsection (b)(6), which adds that any other method not precluded by subsection (c) is adequate if the identity of the collateral is objectively determinable. "Objectively determinable" is contracts law language. It goes to the point that security agreements are contracts and objectively ascertainable intent ultimately governs what an agreement's terms mean.

Consequently, at the root of the description requirement in new section 9-203(b)(3)(A) is the question of exactly what property the parties intended to be subject to the creditor's lien. *See In re Quisenberry, supra*.

However, it is objectively determinable intent that controls and what the parties actually intended is not likely to be permitted to give to the language of a security agreement a meaning that is at odds with the plain meaning of words or phrases that are defined in new Article 9. Thus, a secured party would be hard put to make the case that a security interest created by security agreement describing the collateral as general intangibles would cover lottery winnings or a right to payment for energy provided or to be provided, both of which would have been general intangibles under former Article 9 but are expressly included in the definition of an account in new section 9-102(a)(2).

It is not uncommon for a secured party to describe collateral by reference to its location. Thus, a description in a security agreement referring to equipment located at a particular place would properly be understood to limit the security interest to equipment located at that place and not that located elsewhere. However, a reference to a location as part of a description should be distinguished from a covenant in a security agreement by which a debtor agrees to keep collateral at a particular location, also not uncommon. *See*, *e.g.*, *In re S.M. Acquisitions Co.*, 296 B.R. 452 (D. Ill. 2003).

As noted earlier, parol evidence may be admissible to aid the court in determining the scope of a security interest. There are limits on the admission of parol evidence, although what they are is often less than clear. It is generally agreed that parol is not admissible to vary the terms of an agreement that is unambiguous on its face (although parol may be admissible to establish an ambiguity).

In *In re Invenux*, 298 B.R. 442 (Bkcy D. Colo. 2003), the court concluded that new section 9-203 does not displace the reformation of contracts doctrine and that reformation of a security agreement is possible under Article 1, section 1-103(b), providing for the application of supplementary principles of law not displaced by other provisions of the UCC. The court further held that the parol evidence rule does not apply to an action seeking reformation and parol evidence is admissible to reform a security agreement that fails to express the intent of the parties as to what is covered by the security interest. *In re Invenux*, *supra*. However, the court denied relief in the case because the burden on the party seeking reformation is great (clear an unequivocal proof) and a prior agreement expressing the true intent of the parties must be proven to exist and the secured party had failed to carry its burden.

In the last analysis, the question of what is intended by the use of a given description should be answered by reference to the consequences for the particular creditor and for other creditors that follow from a conclusion that particular property is or is not subject to a security interest. The consequences very simply are that the putative secured party will be left in a preferred position or, alternatively, have to compete with creditors generally for that property.

3. Being as Specific as is Practicable

Given what is at stake, and despite the breadth of new section 9-108(b), it is good practice to be as precise as is practicable under the circumstances. This rule is not always easily followed because drafting legal documents requires a combination of substantive knowledge, communication skills and experience. Forms, especially automated forms, including document assembly programs, can be valuable aids in drafting documents. However, these aids must be used with care in the context of security agreements because assuming that each transaction is like the next, even where a particular creditor does a high volume of the same kind of credit business, is risky. Ultimately, a secured party must determine what degree of specificity will best protect its interest in the property, taking into consideration whether the language used will achieve the secured party's intent int that it is neither too specific nor too general.

So, again, one should be as specific as is practicable under the circumstances. Of course, cost is a relevant circumstance and a creditor may be willing to take certain calculated risks, including delegating the final decisions about descriptions to loan officers and others. Whoever has the final responsibility should be sensitive to the above rule. When the collateral consists of one item or a few items, being specific to the point of using serial numbers or their equivalent is advisable.

Problem 8.8 (INTERACTIVE)

Endrun, Inc., an energy provider, has entered into contracts with several manufacturers to provide the energy needed by these manufacturers for a period of three years. Central Bank finances Endruns operations and to secure the loan made to Endrun has taken a security interest in property described in the security agreement as all of Enrun, Inc.s equipment, existing and later acquired, and all general intangibles, existing and later acquired.

Would Central Bank have an enforceable security interest in the contracts entered into between Endrun and its customers?

If the security agreement described Central Bank's collateral as "all of Endrun, Inc.'s equipment, existing and after-acquired, all of its accounts, existing and after-acquired, and all of its general intangibles, existing and after-acquired" would Central Bank have an enforceable security interest in the contracts entered in business bank accounts maintained by Endrun at Central Bank?

4. Super Generic Descriptions and the Risk of Exclusion by Specificity

A word of caution is in order. Specificity involves certain non-obvious risks. When courts interpret legal documents they often apply axioms of interpretation. One to remember is that ambiguities are likely to be resolved against the drafter. Another risk is that the specific governs the general according to the maxim expressio unius est exclusio alterius (under which the naming of one thing may exclude another). *See In re* *Quisenberry*, *supra*.

If a document describes the collateral as "all of the debtor's equipment located at the debtor's place of business" and then describes certain items of equipment with particularity, a court may conclude the general description is trumped by the specific. That a court would be so inclined is especially likely when pre-printed forms and boilerplate provisions are used. The usual, although not always fail safe, approach to the exclusio problem is that where the goal is to be sure that certain property is covered the description should refer to it specifically but the description should add a qualifying phrase such as "including but not limited to."

The risk of excluding collateral with a specific description that trumps a more general one (the *exclusio* axiom) typically arises in the context of "super generic" or "omnibus clause" descriptions that purport to claim *all* of the debtor's property (or all of a certain type). The judicial response to such clauses under former Article 9 was somewhat mixed. To see what the court in one case, In re *Legal Data Systems, Inc.*, 135 B.R. 199 (Bkcy D. Mass. 1991), had to say about the matter click on the case name.

New Article 9 addresses omnibus or "super generic" clauses directly. Thus, new section 9-108(c) provides that descriptions of collateral such as "all the debtor's assets" or "all the debtor's personal property" or descriptions using words of similar import do not reasonably identify the collateral. It will be noted that new section 9-108(c) says that a super-generic description does not reasonably identify collateral as required by new section 9-108(a). Official Comment 2 to new section 9-108 does no more than indicate that new section 9-108(c) codifies the prevailing view under former Article 9 with regard to such descriptions.

It is helpful to know why courts disfavored super-generic clauses. In a nutshell, these courts were concerned that allowing a secured party to tie up a debtors entire estate would severely limit the ability of a debtor to get credit from third parties and they were disinclined to find that a super-generic clause manifested a debtors intent to enter into such a disabling agreement.

Consider the next two problems.

Problem 8.9 **(INTERACTIVE)**

Is the Legal Data Systems decision good law under new Article 9? Explain your answer.

Problem 8.10 **(INTERACTIVE)**

Donald Debtor is a sole proprietor who develops and markets business computer systems. Ready Lender finances Donalds business operations. Donald and Ready Lender have entered into a security agreement under which the collateral is described as "all Debtor's business assets." At all relevant times, Donald's assets consisted of its inventory of computer systems on hand and in process, a checking account at Second Bank, a copyright on software installed on the computer systems it sells and a patent on the hardware design of the systems. The security agreement satisfies new section 9-203 in all other respects.

Does adding the modifier "business" get Ready Lender past the limitation in new section 9-108(c)?

What description would you have advised Ready Lender to use?

5. Variations on "All Assets"

There is another way for a creditor to reach all the assets of a business debtor. Instead of attempting to take an interest in all of the debtors business assets as such, the creditor could take as security an interest in the business that would give the creditor control over the business assets.

As to a corporation, for example, a creditor could take an interest in a sufficient number of shares of stock representing the ownership of the corporation to give the creditor control of the corporation. The same should be true of a limited liability company (LLC). As to a limited partnership, however, it seems that a creditor could not get control without displacing the general partner and that would seem to require an agreement by the general partner and it is not clear how that would be accomplished.

As to a general partnership, how control can be gained without dissolving the partnership presents a nice question. As to a sole proprietorship, there may be no alternative but to confront the limitation in new section 9-108(c) on super-generic descriptions.

It should be kept in mind, as will be explored further in Part VII, that it is not possible for a creditor to simply step in as the owner in the event of a default. The creditor is obliged to follow the enforcement provisions of Article 9 meaning, as a general rule, either selling the ownership interest or seeking to retain it in satisfaction of the debt. *See* Chapter 35 (Disposing of Collateral to Satisfy a Secured Debt) and Chapter 36 (Acceptance of Collateral in Full or Partial Satisfaction of a Debt).

As explained in Chapter 4 (Scope of Article 9), and also in Part VII, a purported sale of a business that is effective only on default is in substance a transfer for security and will be treated as such, meaning the creditor must foreclose on the ownership interest as permitted by Article 9.

In *Chesapeake Investment Services v. Olive Group Corp.*, 2003 WL 369682 (Mass. Super. 2003), the creditor seems to have attempted an all assets approach that would be problematic under new section 9-108(c). It also, however, sought to take an interest in the entire business. The court properly denied effect to an ostensible bill of sale that did not transfer ownership unless and until the debtor defaulted.

Of course, a creditor may take a security interest in the ownership of a business without regard to getting control of the business so as to reach its assets. Where the debtor is the owner of the business, as would be the case as to closed corporation, limited partnership or an LLC, the security interest may cover all of the ownership shares or some lesser number or percentage of shares.

Ownership interests in a corporation are represented shares of stock that are securities, as defined in Article 8, section 8-102(a)(15), and that would be investment property, as defined in new section 9-102(a)(49), under new Article 9. *See* new section 9-102(a)(49) and Chapter 5 (Classification of Collateral). Creating and perfecting security interests in investment property is considered more fully in Chapter 21 (Perfection as to Investment Property).

An interest in a limited partnership could be a security as defined in Article 8, section 8-102(a)(15), in which case it would investment property and warrant treatment similar to that of shares of stock. *See* Official Comment 15 to Article 1, section 8-102(a)(15). On the other hand, shares of an LLC likely would not be securities because they are not traded within the meaning of the definition of securities in Article 8, section 8-102(a)(15). *See* Official Comment 15 to Article 1, section 8-102(a)(15). Rather, a share of ownership of an LLC would be classified as general intangibles and should be so described in the security agreement. *See* Chapter 5 (Classification of Collateral).

Related to but distinguishable from the situations just discussed would be a sale of a business secured by the assets of the business or the business itself. The sale of a corporation entails transferring the shares of stock representing the ownership of the corporation and the seller may take an interest in stock so transferred to secure the selling price. The same, seemingly, would be true of a limited partnership.

As to a general partnership it would appear that the partnership could not be sold without dissolution and execution of a new partnership agreement. As to an LLC, it is more likely that a seller would want to take an interest in the assets of the business held as an LLC. The same would be true as to a sole proprietorship because there is nothing to represent the ownership of the business other than its assets, including its good will and other intangibles.

It may be asked whether the limitation on the use of super-generic descriptions in new section 9-108(c) should apply to the sales of LLCs and sole proprietorships because such secured sales are distinguishable from the all assets situations that led to the adoption of new section 9-108(c). It is true that a debtor/buyer in a sale of a business situation would be disabled from obtaining credit from third parties, a concern that was instrumental in the addition of new section 9-108(c), but insofar as it was a doubt about what the parties actually intended in using an all assets description, that doubt is pretty much dispelled in a sale of business transaction.

Nonetheless, to reduce the risk of litigation over the issue of whether the super-generic limitation applies to a sale of a business transaction it would be advisable to use a description such as all the assets being acquired in the sale of the business, or words to that effect. The more conservative and safest route, of course, would be to spell out exactly what assets are to be subject to the sellers security interest and to eschew the use of super-generic descriptions.

In Chapter 13 (Overview of Perfection by Filing) we will learn that a supergeneric description, by and large, is permissible in a *financing statement* even though such a description is not sufficient in a security agreement.

Problem 8.11 (INTERACTIVE)

Central Bank will be financing the sale of a business owned by Fix All, Inc. to General Repair, Inc. Central Bank's loan will be secured by all the assets of the sellers business. Central Bank seeks advice as to how to describe the collateral so as to avoid any difficulties that might be presented by the use of a super-generic description.

What do you advise?

6. Limitations on Descriptions by Type

As indicated above, new Article 9 explicitly authorizes the use of a description by type in new section 9-108(b)(3). Descriptions by type were commonly employed under former Article 9. However, courts often demanded more, for example, the debtors appliances or debtors electrical appliances or even washer or television, where consumers were involved. They did so in the belief that consumer transactions were different than commercial transactions generally because there typically is an inequality of bargaining power and a disparity in the levels of sophistication of the parties concerning matters dealt with in a security agreement.

Under new section 9-108(d), except as otherwise provided in subsection (e), a description of a security entitlement or securities account or a commodity account is sufficient if it describes the collateral by those terms or as investment property or it describes the underlying financial asset or commodity contract. According to Official Comment 4 to new section 9-108 this section allows the use of a description of investment property that is not technically by type so that the description "securities" rather than "securities entitlements, " for example, is adequate.

New section 9-108(e)(2) rather awkwardly provides that describing collateral as "consumer goods" or as a "securities entitlement," "securities account" or "commodities account" is not sufficient in a consumer transaction. We will look again at the limitations on the use of descriptions by type where consumers are involved in Chapter 11 (Enforceability of Security Interests Against Consumers).

Note that the application of the limitation in new section 9-108(e)(2) requires referring to the definition of a "consumer transaction." Under new section 9-102(a)(26) a "consumer transaction" essentially is one in which the debt is incurred by an individual primarily for personal, family, or household purposes and the debt is secured by an interest in collateral held for a personal, family or household purpose.

The question is what description *should* be used to describe the collateral subject to the limitation in new section 9-108(e)(2). The answer is that the collateral must be described with greater specificity than is provided by a description by type and in the case of consumer goods it will usually be practicable to describe the collateral by item.

In Chapter 4 (Scope of Article 9) we saw that new Article 9 brings a security interest in a "commercial tort claim," as defined in new section 9-102(a)(13), within its scope. Under new section 9-108(e)(1) the description "commercial tort claim" is not adequate and something more than a description only by type is necessary. However, the description need not be specific and a description such as all tort claims arising out of the explosion of the debtors factory will suffice. *See* Comment 5 to new 9-108.

On the other hand, because, as will be explained in Chapter 9 (The Specifics of Enforceability After-Acquired Property, Future Advances, Transferred Collateral and Proceeds and the New Debtor Problem) under new section 9-204(b)(2) a security interest cannot attach to a commercial tort claim that is not in existence at the time the security agreement is executed, describing the claim with some specificity is quite doable.

According to Comment 5 to new 9-108, the reason for the limitations in new section 9-108(e) on the use of descriptions only by type is to prevent debtors from inadvertently encumbering property as to which the limitations apply.

You may test your understanding of the effect of new section 9-108(e) through the following problems.

Problem 8.12 **(INTERACTIVE)**

Byron Buyer purchases from Sid Seller for use in his home a General Electric refrigerator, an Amana Washer, a Maytag dryer, a Hitachi large screen television and a personal computer. Byron agrees to pay for these items in twelve equal monthly installments. Byron further agrees that Sid will have an interest in all the items to secure the debt represented by the unpaid price of the items purchased.

Would a description "consumer goods" be sufficient on the facts of Problem 8.12?

Would the description "all the Buyer's consumer goods" be adequate?

What description would you propose be used given the facts of the problem?

Problem 8.13 **(INTERACTIVE)**

Byron Buyer runs a technology consulting business out of his home. Byron owns a refrigerator, a large screen television and a desktop computer. Only the desktop computer is used in Byron's business. Byron also has a securities account with Broker, Inc. Byron borrows from Ready Lender to pay some debts arising in connection with the consulting business and Byron gives Ready Lender a security interest in the foregoing items of property.

Would a description such as "consumer goods" or "all the debtor's consumer goods" be sufficient as to the desktop computer?

Would a description "consumer goods" or "all the debtor's consumer goods" be sufficient as to the refrigerator and television?

Would a description such as "debtor's securities accounts" be sufficient as to the account with Broker, Inc.?

Would "Debtor's securities" be adequate?

Would you still recommend a description such as you proposed in Problem 8.12?

7. Descriptions of Crops, Timber to be Cut and Fixtures

As we saw in Chapter 4 (Scope of Article 9), generally speaking, transfers of interests in real estate are outside the scope of Article 9. However, as we also saw in Chapter 4, and as is explored more fully later, as was true under former Article 9, new Article 9 covers security interests in certain real estate-related collateral, including crops, timber to be cut and fixtures.

Former section 9-203(1)(a) provided that a security interest in crops and timber to be cut was enforceable only if the security agreement described "the land concerned." New Article 9 section 9-203(b)(3)(A) requires a description of "the land concerned" only where the collateral is timber to be cut. A legal description of the land is not necessary and it is enough that the description of the land satisfies the "reasonably identifies" mandate of new section 9-108(a).

The next problem explores the treatment by new Article 9 of descriptions of real estate-related collateral.

Problem 8.14 (INTERACTIVE)

Danielle Debtor lives on a farm in Pinal County, Arizona. Danielle raises cotton on the farm, which is on the Pinal Parkway (Arizona Highway 77). Danielle also owns a two-acre plot of land adjacent to the farm on which there is a stand of mesquite trees. Danielle has entered into a contract under which the mesquite trees will be cut and sold during the next calendar year. Danielle borrows from Second Bank and gives Second Bank a security interest in certain of Danielles assets, including an irrigation system located on Danielles farm, Danielle's current crop of cotton and the mesquite trees on the parcel of land adjacent to Danielles farm.

Would a description in the security agreement "the irrigation system located on Debtor's farm " be sufficient to give Second Bank an enforceable security interest in the irrigation system?

Would a description "Debtor's farm products" be sufficient to subject the cotton crop to an enforceable security interest?

Would the description "Debtor's farm products" be adequate as to the mesquite trees?

What description would you propose for the mesquite trees?

Later we will see that the description in a *financing statement* covering timber to be cut must describe the collateral as timber to be cut and a financing statement filed as a fixture filing must describe the collateral as fixtures and as to both situations the financing statements must also describe the land involved.

CASE COMMENTARY

Citicorp Leasing, Inc. v. United American Funding, Inc., 2005 WL 1847300 (S.D.N.Y. 2005) (Not reported in F. Supp. 2d)

The Epicentre Strategic Corporation-Michigan v. Perrysburg Exempted Village School District, 2005 WL 3060104 (N.D. Ohio 2005)

In re Clayson, 341 B.R. 137 (Bkcy W.D.N.Y March 24, 2006)

In re Sabol, 337 B.R. 195 (Bkcy C.D. Ill. February 6, 2006)

In re Jeans, 326 B.R. 722 (Bkcy W.D. Tenn. June 28, 2006)

First National Bank of Izard County v. Garner, 86 Ark. App. 213, 167 S.W.3d 664 (Ark. App. 2004)

Sunflower Bank, N.A. v. Kindsvater, 144 p.3d 81 (Kan. App. 2006)

Feliciana Bank & Trust v. Manuel & Sessions, L.L.C., 943 So.2d 736 (Miss.App. 2006)

Alete, Inc. v. GEC Engineering, Inc., 726 N.W.2d 520 (Minn. App. 2007)

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2009-02-01 update

Part IV Creating an Enforceable Article 9 Security Interest

Chapter 9 The Specifics of Enforceability - After-acquired Collateral, Future Advances, Transferred Collateral and Proceeds, and the New Debtor Problem

No treatment of enforceability would be complete without a discussion of security interests in after-acquired property, proceeds, and interests to secure future advances. Often the collateral will change after the security agreement is executed. This happens when a debtor acquires more of the type of property of which the original collateral consists -- in which case there is after-acquired collateral -- and when a debtor disposes of collateral and receives something in its place -- in which case there are proceeds. Both after-acquired property and proceeds obviously are important to a secured creditor. Future advances security pertains to the amount of debt that is secured rather than what property may be claimed as collateral.

It can happen that the debtor transfers the collateral to another person who then becomes the debtor or a person becomes bound by a security agreement entered into by someone else. In both cases there are new debtors and new Article 9 contains special rules for dealing with new debtor situations. After-acquired property, proceeds, future advances and new debtor situations are the subjects of this chapter.

A. Security Interests in After-Acquired Property

Prior to adoption of Article 9 there were problems encumbering property that the debtor did not own at the time of the creation of the lien. Subject to a limitation in the consumer setting that will be explored in Chapter 11 (Enforceability and Attachment of Security Interests in Consumer Transactions), former section 9-204(1) explicitly authorized a creditor to take an interest in after-acquired property. In so doing, former Article 9 gave its blessing to the concept of a "floating (or continuing) lien," *i.e.*, a security interest that floats over a debtor's assets generally and descends on whatever is available as collateral at the time of a default. *See* Official Comment 2 to former 9-204.

New Article 9 continues former Article 9's treatment of security interests in after-acquired property in new section 9-204(a) by broadly authorizing the creation of security interests in after-acquired property. This broad authorization prompts the question of how such collateral should be described in a security agreement. Former Article 9 did not directly answer the question. Neither does new Article 9. Official Comment 3 to new section 9-108 states:

> Much litigation has arisen over whether a description in a security agreement is sufficient to include after-acquired property if the agreement does not explicitly so provide. The question is one of contract interpretation and is not susceptible to a statutory rule (other than a rule to the effect that it is a question of contract interpretation). Accordingly, this section contains no

reference to descriptions of after-acquired property.

This comment implicitly accepts the fact that new section 9-204(a) is permissive (a security agreement *may* include after-acquired property), but it leaves the determination of whether after-acquired property has been adequately described to an interpretation of a security agreement. There is no more effective way to express the intent that a security interest includes after-acquired property than to include a clause explicitly so providing. Conversely, a security agreement that does not refer to after-acquired property does not cover later acquired original collateral.

It might be argued that there is no need to include a description of after-acquired property in the case of collateral such as inventory and accounts that by its very nature "turns over." However, that argument does not apply to collateral that does not turn over and an after-acquired property clause is needed as to such collateral. For example, a security agreement covering equipment should say "equipment, existing and later-acquired." Moreover, adding an "after-acquired " or "later-acquired" property clause to the collateral description is easy and painless and it is the most sensible course as to all collateral, even inventory and accounts.

The following problem illustrates the need for an adequate after-acquired property provision in a security agreement.

Problem 9.1 (INTERACTIVE)

Exactly one year ago Danielle Debtor borrowed from Second Bank and signed a security agreement giving Second Bank an interest in Danielle's "crops growing on Debtor's farm in Pima County." Danielle has come to Ready Lender seeking another loan and has offered to Ready Lender a security interest in Danielle's future crop. The loan to Second Bank is still unpaid.

Is Ready Lender at risk of being subordinated to Second Bank if it makes the requested loan? (Assume that if Second Bank's security interest includes Danielle's current crop then Second Bank has first claim to the that crop.)

If you had been representing Second Bank at the time of the loan made by Second Bank what description of collateral would you have advised Bank to use?

If you had been representing Danielle, would you have agreed to such a description?

There is a non-obvious lesson to be learned from Problem 9.1. It is much better to structure a secured transaction correctly in the first place than be forced to come up with a solution when the deal breaks down. Ask yourself what options Ready Lender or Danielle has for getting a determination of the scope of its security interest where the language creates some doubt. A declaratory judgment action or even bankruptcy should come to mind. These are not appealing options. Of course, you cannot always be sure you have done it "right" in the first place. However, secured financing practice is very much about planning and only secondarily, and much less desirably, about litigation.

It should be understood that after-acquired property clauses only do what they do. They cannot be used to produce an enforceable security interest in something that is not covered by the description of the original collateral. If a creditor has a security interest in debtor's "equipment, existing and hereafter acquired" the after-acquired clause does not give the creditor an enforceable interest in later-acquired consumer goods or inventory. Less obviously, under new Article 9, describing collateral as "general intangibles" would not give the secured party an enforceable security interest in lottery winnings won after the security agreement was executed because, as noted in Chapter 5 (Classification of Collateral), lottery winnings fall within the definition of "account" in new section 9-102(a)(2).

Moreover, an after-acquired property clause will not always work even where the later-acquired property is within the basic description. Thus, an adequately described after-acquired security interest can fail in bankruptcy. There are several reasons for this and they will be explored more fully in Chapters 26 (Secured Party Versus Lien Creditor) and 30 (Secured Party Versus Trustee in Bankruptcy).

However, most pertinent here is Bankruptcy Reform Act (BRA) § 552. Under BRA § 552, security interests created before bankruptcy, *i.e.*, pre-petition, generally are not enforceable as to property acquired after a bankruptcy is filed, *i.e.*, post-petition. There is an exception for security interests in collateral acquired post-petition that qualifies as proceeds of collateral in existence pre-petition. The proceeds point is considered in subpart C below.

You may test your understanding of the general rule embodied in BRA § 552 through the next problem.

Problem 9.2 (INTERACTIVE)

Assume the facts of Problem 9.1. Assume further, however, that

(a) the security agreement between Danielle and Second Bank described the collateral as "crops growing and to be grown on Debtor's farm in Pima County ";

(b) Danielle has filed bankruptcy; and

(c) the only crops "growing or to be grown" are those planted after bankruptcy was filed.

Would Second Bank have an enforceable security interest in the crops *outside* of bankruptcy?

Does Second Bank have an enforceable security interest in the crops *in* bankruptcy?

What if the crops were planted before bankruptcy was filed but they did not begin "growing" until after bankruptcy was filed?

In Chapter 4 (Scope of Article 9) it was seen that former Article 9 covered security interests in tort claims only as proceeds but that the creation of a security interest in a commercial tort claim, as defined in new section 9-102(a)(13), as original collateral is within the scope of new Article 9. However, new section 9-204(b)(2) provides that a security interest cannot attach to an after-acquired commercial tort claim. Therefore, unless the commercial tort claim is in existence at the time the security agreement is authenticated a security interest in the claim is enforceable only if it constitutes proceeds. *See new section 9-102(a)(1) and* Official Comment 4 to new 9-204 and subpart C below.

In Chapter 11 (Enforceability and Attachment of Security Interests in Consumer Transactions), we will see that under new section 9-204(b)(1), a security interest cannot attach to after-acquired consumer goods that are acquired more than ten days after a secured party gives value unless the goods are accessions. "Accessions" are defined in new section 9-102(a)(1) to mean "goods that are physically united with other goods in such a manner that the identity of the original goods is not lost." Examples of accessions include memory added to a computer and a compact disk player installed in an automobile.

Accessions are distinguishable from "commingled goods," defined in new section 9-336(a) to mean "goods that are physically united with other goods in such a manner that *their identity is lost* in a product or mass." [Emphasis added.] Examples of commingled goods include flour used to bake a cake and, less obviously, ball bearings used in machinery.

It should be noted that from the perspective of a secured party who has a security interest in goods to which other goods are physically united so as to become accessions or commingled goods, the other goods are after-acquired in that a debtor acquires rights in them after the debtor has rights in the goods to which they become physically united. However, a description of collateral that describes only the goods to which accessions are physically united is not sufficient to give a secured party an enforceable interest in the accessions. The security agreement description must refer to accessions.

For example, if a secured party has a security interest in a tractor and the security agreement describes the collateral as the tractor, the secured party does not have an interest in a replacement engine unless the security agreement also refers to accessions. Likewise, a party with a security interest in goods that become accessions has an interest in the goods with which the accessions are physically united only if the security agreement describes as the collateral the goods with which the goods are physically united.

By contrast, a party with a security interest in goods with which other goods are commingled has a security interest in the product or mass resulting from the commingling without referring to the goods that are commingled in the security agreement. Thus, a party with a security interest in cakes described as such in a security agreement has a security interest in the cakes, including flour provided by another party and in which the other party has a security interest without the need to refer to flour in the security agreement covering the cakes.

Moreover, unlike the accessions situation, the party supplying the flour has a security interest in the cakes without the need to describe the cakes. This result might be reached by treating the cakes as proceeds, but new section 9-336(b) specifically provides that the security interest would attach to the cakes. *See* Official Comment 3 to new 9-336.

The new Article 9 treatment of security interests in accessions considered in the next problem.

Problem 9.3 (INTERACTIVE)

Second Bank lends to Donald Debtor who farms land in Pima County, Arizona. To secure the loan, Second Bank takes a security interest in collateral described as "Debtor's farm equipment." Subsequently, Donald replaces a John Deere tractor owned at the time the security interest was given to Second Bank with a new Ford tractor purchased from Selma Seller.

Does Second Bank have a security interest in the Ford tractor?

Suppose that the security agreement described the collateral as Debtors farm equipment, existing and after-acquired, but instead of replacing the John Deere tractor that Donald purchased a new motor from Selma and that Selma installed the motor in the tractor.

Would Second Bank have a security interest in the motor?

If Selma sold the motor on credit and took a security interest in the motor would Selma also have a security interest in the tractor?

B. Security Interests to Secure Future Advances

To this point the focus has been on what property secures a debt. There is the further question of what indebtedness is secured by the collateral to which the security interest has attached. Former section 9-204(3) provided that the obligations secured by a security interest could include future advances whether or not the advances were optional or binding. This section permited a creditor to take a security interest that secured not only an original extension of credit but later or future advances as well.

New section 9-204(c) similarly permits a security agreement to provide that collateral secures future advances or other value, whether or not the advances or value are given pursuant to commitment.

Given that the scheme is permissive, a creditor should be sure to include a future advance clause in the security agreement. The same advice was given as to after-acquired property in subpart A above. Moreover, decisions under former Article 9 regarding future advance clauses were consistent in reading former section 9-204(3) to mean that a later advance had to be of the same or similar type as the original advance if the later advance was to be secured by the security interest created at the time of the original advance. In so reading former section 9-204(3) the courts took the view that what debt was included in a future advance clause was, as with the scope of an after-acquired property clause, a matter of the parties intent.

A court might well say that a personal loan is not intended to be secured by a security interest created to secure a business debt. The insistence of the drafters in Official Comment 5 to new section 9-204 that decisions comparing the kinds of credit involved as between the original advance and the future advance are rejected is curious at best, especially because the text of new section 9-204(c) does not differ substantively from that in former section 9-204(c).

For completeness it should be noted that insofar as a provision may operate to secure previously unsecured debts could raise an avoidable preference issue under BRA § 547. *See* Chapter 30 (Secured Party Versus Trustee in Bankruptcy).

You may explore the treatment of future advances under new Article 9 in the next problem.

Problem 9.4 (INTERACTIVE)

Danielle Debtor sells machine tools at retail. Danielle just purchased a shipment of machine tools from All Tools, Inc. for $25,000. All Tools, Inc. sells only for cash. Danielle borrowed the $25,000 from Leslie Lender. The loan agreement between Danielle and Leslie gives Leslie an interest in the shipment of machine tools from All Tools, Inc. to secure the loan. The agreement further provides that "Lender shall have an interest in the machine tools to secure such advances as may be made from time to time by Lender to Debtor." Two months later Danielle borrows $5,000 from Leslie to finance her son's wedding.

Is the $5,000 debt secured by the interest in the machine tools?

How would you have drafted the agreement to try to avoid the question?

There is another, more elusive, concern. Note carefully the language used in the security agreement in Problem 9.4. Was Leslie obligated to make the $5,000 loan?

As the last question in Problem 9.4 illustrates, future advance clauses may be optional or binding. An optional clause provides that IF a later advance is made then the collateral that secures the original advance will also secure the later advance. But, subject to whatever limitations are imposed by an obligation of good faith that applies to all secured financing contracts under new Article 1, section 1-304 (formerly section 1-203), the decision whether or not to make a later advance belongs to the secured party. Good faith is defined in Article 1, section 1-201(b)(20) and for states that have not adopted the proposed revised version of Article 1, section 1-201(b)(20) in new section 9-102(a)(43). A binding future advance clause is one that obligates the secured party to make a future advance whereas under an optional clause making a future advance is in the discretion of the secured party.

The distinction between a binding future advance clause and an optional clause is important both to the debtor and creditor's relationship and, as we will discover in Part

VI, in resolving priority disputes with third parties. When we discuss priority matters we will see that a binding future advance clause can produce an advance "pursuant to commitment," *see* new section 9-102(a)(68), and consider how such a characterization can affect priority.

You must be aware that the basic effect of a future advance clause can be achieved with a new security agreement. Thus, whether or not the original agreement contains a future advance clause, the parties are free to negotiate a later extension of credit and enter into a new agreement to secure the later credit. Where the parties enter into a new security agreement exactly what collateral secures the new advance is a matter governed by the new security agreement. How a new security agreement as opposed to a future advance clause affects priority is another matter for discussion in Part VI. Of course if there is neither a future advance clause nor a new security agreement then the later advance is unsecured.

The next problem explores further the treatment of future advances by new Article 9.

Problem 9.5 (INTERACTIVE)

Donald Debtor owes Ready Lender $10,000 which Donald borrowed to finance his business operations. Ready Lender has a security interest in Debtor's inventory and accounts receivable. Donald borrows another $10,000.

What must be true if the second $10,000 loan is to be secured?

C. Security Interests in Transferred Collateral and Proceeds

1. Transferred Collateral

Under former section 9-306(2) if a debtor made an *unauthorized* disposition of the original collateral then the security interest continued in the transferred collateral. Whether a particular disposition was authorized is a matter of contract interpretation, but the Permanent Editorial Board of Article 9 (PEB) in P.E.B. Commentary No. 3 insisted that the security interest continued unless the secured party authorized the disposition free of the security interest.

New section 9-315(a)(1) adopts the position expressed in P.E.B. Commentary No. 3 by providing that a security interest or lien continues in original collateral unless the holder of the security interest or lien authorized the disposition "free of the security interest or lien."

The effect of the rule in new section 9-315(a)(1), that a security interest continues in collateral unless the secured party or lien holder authorized a disposition free of the security interest or lien, is to create a presumption that a transferee takes *subject to* the security interest or lien. To overcome the presumption it must be shown that the holder of the security interest or lien not only authorized the disposition but that the holder further authorized that it be "free of the security interest or lien." Whether there was the necessary authorization in a particular case will continue to be a question of the parties' intent, but the presumption will work in favor of secured parties.

Note that new section 9-315(a)(1) includes agricultural liens so that if collateral subject to an agricultural lien is transferred without required authorization then the lien continues in the original collateral.

New section 9-315(a)(1) further expands upon former section 9-306(2) by adding leases and licenses to the kinds of transfers that trigger the presumption that a security interest continues in transferred collateral. The inclusion of leases reflects the position taken by the PEB in P.E.B. Commentary No. 9 that transfers pursuant to a lease produce "proceeds. " The rationale of that commentary supports the inclusion of licenses as dispositions for the purposes of new section 9-315 as well.

You must understand that the ultimate decision as to who gets transferred collateral may involve a priority decision. In other words, *if* the security interest does *not* continue that it does not would be dispositive of a dispute. However, even where the security interest continues a particular transferee could prevail under the priority rules that are examined in Part VI.

The next problem explores the application of new section 9-315(a)(1).

Problem 9.6 (INTERACTIVE)

Donald Debtor is in the business of manufacturing automotive parts. Ready Lender has a security interest in Donald's equipment. The security agreement prohibits Donald from transferring any equipment without Lender's express written authorization. Without written authorization Donald sells a drill press to Byron Buyer. Ready Lender is aware that Donald has occasionally disposed of equipment and replaced it with newer equipment and has never objected to these dispositions.

Does Ready Lender's security interest in the drill press continue?

Suppose Ready Lender provided Donald with a document stating that "Lender authorizes the sale of the drill press to Buyer."

Would Ready Lender's security interest in the drill press continue?

When would Ready Lenders security interest in the drill press *not* continue?

For completeness note that new section 9-315(a)(1) refers to Article 2 section 2-403(2). A brief comment about section 2-403(2) is in order. When a person "entrusts" goods to a merchant in the business of selling goods of the kind entrusted there is a risk that the merchant will improperly transfer the goods to a buyer in ordinary course, as defined in revised section 1-201(b)(9) (essentially as a buyer who buys from a merchant who sells such goods without knowledge of the lack of authority on the part of the merchant to sell the goods).

For example, if the owner of a watch takes the watch to a jeweler for repairs and the jeweler not only repairs but sells watches and the jeweler wrongfully sells the watch to a retail customer (who most likely will meet the definition of a buyer in ordinary course) then the retail customer gets the owner's rights and in a dispute between the owner and the customer the customer would prevail.

In other words, section 2-403(2) shifts the risk of such improper transfers to the person who does the entrusting in the sense that the buyer from the merchant gets whatever rights the entrusting person had to the goods. By virtue of the incorporation of section 2-403(2) into new section 9-315, a secured party who entrusts collateral that consists of goods to a merchant in business of selling goods of the kind confers on the merchant the power to transfer the secured party's rights to a buyer-in-ordinary-course of the goods.

As will be seen in Part VI, there is a priority rule that also protects buyers in ordinary course and it is not clear what the embellishment of new section 9-315 adds.

2. Proceeds

Before Article 9 was enacted there were difficulties creating security interests in property that constituted proceeds of original collateral, meaning essentially property received when original collateral was disposed of. To illustrate, when inventory is sold, as it is expected to be (certainly if the debtor's business is viable), the debtor will receive property that in a sense replaces the inventory. This property may be other inventory, for example, a "trade in, " or it may be cash or some cash equivalent or even a promise to pay for the inventory that is itself secured, or it may be some combination of the foregoing. The trade in or cash equivalent or promise to pay or combination thereof, constitute proceeds.

Under the law prior to Article 9 there was no ready method to assure that a security interest would attach to proceeds. Even when a security interest in proceeds was allowed, for example, as to accounts receivables, unless there was a strict accounting by the debtor for collections on the accounts the arrangement might be deemed to be a fraud on creditors. *See* Official Comment 2 to new 9-205.

Former Article 9 greatly enhanced the extent to which proceeds could serve as collateral. Thus, former section 9-306(2) simply bestowed on a creditor a security interest in *identifiable* proceeds. Proceeds were identifiable when they could be *traced* to the original collateral. To this extent the security interest in proceeds arose by operation of law. Under former section 9-203(3) there was no need even to refer to proceeds in a security agreement to make the interest enforceable.

"Proceeds" was defined in former section 9-306(1) to include "whatever is received upon the sale, exchange, collection or other disposition of collateral or proceeds." That same section distinguished "cash, " defined as "money, checks, deposit accounts and the like," from "non-cash" proceeds. Cash proceeds could be difficult to trace sufficiently to make them "identifiable." However, former section 9-205 abolished the risk of fraud where the debtor is allowed to make regular payments and does not have to turn over the proceeds themselves or otherwise make a strict accounting of proceeds (unless so required by the security agreement).

The basic proceeds scheme of new Article 9 parallels that in former Article 9. Thus, new section 9-315(a)(2) provides quite simply that a security interest attaches automatically to any identifiable proceeds of collateral. There is no need for an agreement regarding proceeds and the interest is enforceable without the need to provide for a proceeds interest in the security agreement. *See* new section 9-203(f).

New Article 9, section 9-205, echoes former section 9-205 by providing that a security arrangement that does not require a debtor to account to the secured party for proceeds (unless so required by the security agreement) is valid and is not fraudulent as against other creditors. However, sound practice dictates that a creditor "monitor " or "police" collateral, including proceeds, to whatever extent is practicable.

An important point of clarification is in order. Although Article 9 relaxes the rules regarding the extent to which a debtor must account to a secured party for proceeds and a secured party is essentially given an enforceable security interest in identifiable proceeds, the property claimed as proceeds must be traceable to the original collateral and the secured party bears the burden of proving that the property claimed as proceeds are traceable to the original collateral and, hence, identifiable. *See* In re *Quisenberry*, 295 B.R. 855, 862 n. 3 (Bkcy N.D. Tex. 2003).

New Article 9 generally tracks former Article 9 on the matter of what constitutes proceeds. The essential proceeds' definitions have been moved and appear in more complete form in the general definitional section of new Article 9. "Proceeds" is defined in new section 9-102(a)(64). The definition in new section 9-102(a)(64) continues former section 9-306(1)'s focus on what comes in (is acquired) when original collateral is disposed of.

Under former section 9-306(2) proceeds meant property *received by the debtor* when collateral was disposed of. New section 9-102(a)(64) eliminates any such requirement thereby making clear, for example, that when collateral is sold by a debtor to a buyer and the buyer also sells the collateral then what is received by the buyer constitutes proceeds. For property to qualify as proceeds under new Article 9 it is necessary only that the property be traceable, directly or indirectly, to the original collateral. *See* Official Comment 13d to new 9-102.

New section 9-102(a)(64) omits a reference to "proceeds of proceeds" such as appeared in the definition of proceeds in former section 9-306(1). However, it would make little sense for a security interest not to continue in proceeds (assuming the ability to identify). Official Comment 13c to new section 9-102 states that "the idea of " proceeds of proceeds is captured in the revised definition of collateral and no change in meaning is intended. "Collateral" is defined in new section 9-102(a)(12) to mean essentially the property subject to a security interest or agricultural lien, including proceeds to which a security interest attaches under new section 9-315(a)(2).

You may explore the basics of the treatment of proceeds under new Article 9 through the following problem.

Problem 9.7 (INTERACTIVE)

Leslie Lender has a security interest in Danielle Debtor's "equipment, existing and after-acquired." The security agreement makes no mention of proceeds. The agreement does provide that Danielle is not to dispose of any equipment without the Leslie's express written consent. Danielle sells a drill press to Byron Buyer without Leslies's express written consent. Danielle receives cash in the amount of $1,000 and a check for $1,500. Danielle uses the cash to purchase a newer and less expensive drill press. She places the check in a cash drawer.

Does Leslie have an enforceable security interest in the *original* drill press?

Does Leslie have an enforceable interest in the *new* drill press as proceeds?

Does Leslie have a security interest in the check in the cash drawer?

It is useful to understand that property that cannot be reached as proceeds, for example, because the property is not identifiable as proceeds, sometimes may be reached more directly. The next problem illustrates how this is so.

Problem 9.8 (INTERACTIVE)

Assume the facts of Problem 9.7. Assume further, however, that Leslie Lender would be unable to show the new drill press is identifiable proceeds.

Could Leslie still have an enforceable interest in that drill press? If so, how?

As noted above, under new section 9-204(b)(2) a security interest cannot attach to a commercial tort claim, as defined in new section 9-102(a)(13), unless the tort claim is in existence at the time the security agreement is authenticated. A security interest, however, could attach to a later arising commercial tort claim as proceeds under new section 9-315(a)(2) if the claim arises out of loss or damage to the original collateral.

For example, if the original drill press (or other equipment) in the Problems 9.7 and 9.8 had been lost as the result of tortuous behavior by a third person then the tort claim arising from that behavior could be proceeds of the drill press.

New section 9-102(a)(64)(E) includes as proceeds insurance payable to the debtor or the secured party by reason of loss or damage to the original collateral. This inclusion is a carryover from a change made to former Article 9, section 9-306(1) in 1972 to reject court decisions holding that insurance proceeds were not proceeds within the meaning of Article 9 because the lost or damaged collateral had not been disposed of.

Former section 9-306(1) was amended in 1996 to specifically include within the definition of proceeds "payments or distributions made with respect to investment property." This amendment was intended to reject the decision in *Hastie v. FDIC*, 2 F.3d 1042 (10th Cir. 1993), holding that post-petition dividends on stock collateral are not proceeds under Article 9.

New section 9-102(a)(64) makes no specific reference to investment property. However, new section 9-102(a)(64)(B) states that proceeds includes "whatever is collected on, or distributed on account of, collateral." Official Comment 13a to new section 9-102 states that new section 9-102(a)(64)(B) "is broad enough to cover cash or stock dividends distributed on account of securities or other investment property" and reiterates that the section rejects the holding in *Hastie v. FDIC*, *supra*.

Of course, the quoted language of new section 9-102(a)(64)(B) is "broad enough" to cover income from collateral other than investment property. The question arises just how much beyond the traditional concept of proceeds (what is received when collateral is disposed of) the drafters have intended to go or courts will be willing to accept.

Until the uncertainty has been removed it may be advisable to describe with specificity the particular items of income that are intended to be included as original collateral thereby giving a secured party an enforceable interest in the property as after-acquired original collateral. As noted earlier, the use of specific descriptions generally is preferable wherever they are practicable.

A downside of the original collateral approach, considered in subpart A above, is that in bankruptcy a security interest created before bankruptcy is unenforceable under BRA § 552 as to property acquired after bankruptcy except where the property is proceeds. Moreover, what constitutes proceeds in bankruptcy under BRA § 552 ultimately is a federal question and new section 9-102(a)(64) will not necessarily control. *Cf*. Official Comment 13(a) to new section 9-102 (wherein the drafters make clear that new section 9-102(a)(64) rejects the *Hastie* decision only to the extent that decision relies on the Article 9 definition of proceeds).

However, describing particular property as original collateral does not preclude a claim to that property as proceeds. If proceeds is broadly interpreted and the claim is successful, so much the better for the secured party. If the proceeds claim fails, the secured party has an enforceable security interest in property acquired before bankruptcy (or all such property if the debtor does not file bankruptcy).

The case of *In re Stallings*, 290 B.R. 777 (Bkcy D Idaho 2003) offers a useful vehicle for exploring the points just made about proceeds and original collateral. At issue in that case were payments made to a debtor under a federal program to compensate persons who had suffered farming setbacks as the result of a chemical sprayed by the U.S. Bureau of Land Management where both the federal program and the payments post-dated the filing of the petition in bankruptcy. The court concluded that the payments constituted at best an expectation on the part of the debtors and could not be reached either as original collateral described as general intangibles or payments under government programs or as proceeds.

The program payments could not be reached as original collateral in bankruptcy because they were collateral (other than proceeds) acquired after bankruptcy was filed and BRA § 552 bars enforcement of a security interest in such collateral. The program payments could not be reached as proceeds because they did not stem from a loss or conversion of crops and rather were payments for crops not grown.

As for the expanded definition of proceeds in new Article 9 the court stated that "it is too much of an interpretive stretch to view the [program] payment, which can be seen as a gift from the government to effected [sic] farmers, as falling within the UCC definition of proceeds." *Stallings*, at footnote 6.

Similar problems may arise as to other parts of new section 9-102(a)(64) to the extent they include as proceeds property that does not replace the original collateral. Thus, under new section 9-102(a)(64)(D) claims arising out of the value of the loss, nonconformity, or interference with the use of, defects or infringement rights in, or damage to collateral constitute proceeds to the extent of the value of the collateral.

Once again, the Official Comments do not offer any guidance as to the scope of this provision. However, at least one court, in the case of *In re Wiersma*, 283 B.R. 294 (Bkcy D. Idaho 2002), applied the section quite literally in concluding that a breach of contract claim constitutes proceeds.

You may explore the foregoing discussion of the expansion of the concept of proceeds under new Article 9 in the next two problems.

Problem 9.9 (INTERACTIVE)

Ready Lender has a security interest in Debtor's prize racing greyhound, Black Streak. The security agreement describes the collateral as "Debtor's racing greyhound, Black Streak."

Why are Black Streaks winnings not proceeds in the historical sense of that term?

What is the argument that Ready Lender has an enforceable interest in Black Streak's winnings?

What is the argument that Black Streak's winnings are not proceeds under new Article 9?

If you were drafting the security agreement for Ready Lender what would you do to try to assure that Black Streak's winnings are covered?

Is there a downside to the original collateral approach?

Problem 9.10 (INTERACTIVE)

Danielle Debtor operates a gambling casino. Your client holds a security interest on Danielle's slot machines under a security agreement that describes the collateral as "Debtor's equipment, existing and hereafter acquired."

Are the quarters and silver dollars placed in the slot machines after-acquired original collateral?

Are the quarters and silver dollars covered by the security interest as proceeds?

How could you have assured coverage of the coins with a proper description in the security agreement?

As noted earlier, former Article 9, section 9-306(1) distinguished cash and non-cash proceeds. New Article 9 also distinguishes the two types of proceeds. Under new section 9-102(a)(9) "cash proceeds" means "money, checks, deposit accounts, or the like." New section 9-102(a)(58) defines noncash proceeds very simply to mean "proceeds other than cash proceeds." Cash proceeds may be more difficult to trace so as to make them "identifiable" and this is especially true of deposit accounts.

What results from the deposit of funds into a deposit account is a debtor-creditor relationship with the depositor as the creditor and the bank as the debtor. *See* B & S (cited in Chapter 3), Ch. 26.01. Technically, checks and other cash proceeds deposited in a bank account lose their identity. To deal with this problem secured parties typically have obligated debtors to deposit proceeds in separate accounts, *i.e.*, accounts in which only proceeds have been deposited.

But, on occasion even well intentioned debtors who have encountered serious financial distress will commingle proceeds with non-proceeds in deposit accounts that were supposed to be only for proceeds. Consequently, there has been a need for an analysis under which deposit accounts as to which commingling has occurred may still be *identifiable* proceeds.

Under former Article 9 attorneys and judges looked for assistance to equitable doctrines, including what has been referred to as the "lowest intermediate balance (LIB) of proceeds" analysis. There were two aspects to the LIB analysis. The first was that when proceeds had been commingled with non-proceeds (which, for convenience are referred to as the debtor's funds) the security interest in the proceeds continued into the account. Second, to make it possible to separate the proceeds and the non-proceeds portions of the deposit account, it was presumed that withdrawals from the account came first from the debtor's funds.

For example, if proceeds of $500 from the sale of inventory are deposited in a bank account having a balance of $500 consisting of non-proceeds and the debtor then withdraws $500, under an LIB of proceeds analysis the secured party would have a claim to the bank account in the amount of $500 on the theory that the $500 withdrawn from the account was the debtor's funds and not proceeds.

New Article 9 deals with the deposit accounts as proceeds cases in new section 9-315(b)(2). Under new section 9-315(b)(2) if proceeds that are not goods are commingled with other property they are identifiable "to the extent that the secured party identifies the proceeds by a method of tracing, including application of equitable principles, that is permitted under law other than this article with respect to commingled property of the type involved." Subsection (b)(2) does not in so many words embrace the LIB doctrine, but Official Comment 3 to new section 9-315 observes:

> [This provision] indicates when proceeds commingled with other property are identifiable proceeds and permits the use of whatever methods of tracing other law permits with respect to the type of property involved. Among the "equitable principles " whose use other law may permit is the "lowest intermediate balance rule. " *See* Restatement (2d) Trusts § 202.

It is important to understand that new section 9-315(b)(2), and the lowest intermediate balance of proceeds analysis, applies only where there has been commingling of non-goods proceeds with proceeds. Moreover, under new section 9-315(b)(2), the secured party bears the burden of proving that proceeds were deposited in a bank account. *See*, *e.g.*, *In re Quisenberry*, *supra*; *In re MJK Clearing, Inc.*, 286 B.R. 109 (Bkcy D. MN 2002) (creditor failed to prove that any funds had been deposited in debtor's bank account and that there was a *positive* balance of proceeds in the account).

You may consider the treatment of deposit accounts as proceeds by new Article 9 in the next problem.

Problem 9.11 (INTERACTIVE)

Assume the facts of Problem 9.7 (Leslie Lender has a security interest in Danielle's "equipment, existing and after-acquired." The security agreement makes no mention of proceeds. The agreement does provide that Danielle is not to dispose of any equipment without the Leslie's express written consent. Danielle sells a drill press to Byron Buyer without Leslie's express written consent. Danielle receives cash in the amount of $1,000 and a check for $1,500.   Danielle uses the cash to purchase a newer and less expensive drill press. She places the check in a cash drawer.) Assume further, however, these additional facts:

Danielle deposited the $1,500 check in a checking account in Second Bank;

At the time of the deposit the balance in the account is $4,000 all of which was from the deposit of non-proceeds;

Danielle defaulted owing Lender $2,000;

Leslie could not win in a priority dispute over the drill press with Byron Buyer (We will consider possible reasons in Part VI);

Before Leslie learned of the foregoing, Danielle withdrew $3,000 from the bank account;

Danielle took the cash and blew it at the dog track;

Just after the withdrawal there was an automatic deposit of $500 made by Second Bank to Danielle 's account to correct an earlier overcharge to the account;

There have been no other changes to the bank account balance.

How much of the bank account is subject to Leslie's security interest?

Suppose Danielle had withdrawn $4500 instead of $3000 just before defaulting. How much of the deposit account could Leslie reach now?

Suppose the facts were as originally stated in Problem 9.10, except that *none* of the $1,500 found its way into the account. How much of the deposit account could Leslie reach under this change in facts?

Recall from Chapter 4 (Scope of Article 9) that new Article 9 brings the creation of a security interest in a deposit account as original collateral within its scope. Be sure when analyzing deposit account situations to pay heed to whether a claim is made to a deposit account as original collateral or whether the account is being claimed as proceeds.

Insolvency proceedings can seriously complicate efforts to reach proceeds. Under former Article 9 the maze of rules in former 9-306(4) compounded the effects of insolvency proceedings, including bankruptcy. New Article 9 simply eliminates former section 9-306(4). Official Comment 8 to new 9-315 states:

> This Article deletes former Section 9-306(4), which dealt with proceeds in insolvency proceedings. Except as otherwise provided by the Bankruptcy Code, the debtor's entering into bankruptcy does not affect a secured party's right to proceeds.
>
> * * *

Consequently, under new Article 9, security interests in proceeds are enforceable in insolvency proceedings, other than bankruptcy, to the same extent that they are enforceable in the absence of such proceedings. Insofar as non-bankruptcy cases go, your task is to master only one set of rules -- the new Article 9 rules applicable to proceeds generally. However, where bankruptcy has ensued, the federal bankruptcy law applies and that law may qualify the new Article 9 rules. Given the frequency of bankruptcy filings today it is important that you have a sense of how bankruptcy can impact the Article 9 proceeds' rules.

It was noted above that BRA § 552's effect to render unenforceable security interests in collateral acquired after bankruptcy has been filed does not apply to proceeds. The controlling provision as to proceeds is BRA § 552(b)(1). Under it a security interest created pre-petition is enforceable as to proceeds acquired post petition is enforceable if the security agreement and the applicable nonbankruptcy law supports the claim. The applicable nonbankruptcy law in this case is Article 9. As you now know under that law a security interest attaches to identifiable proceeds and is enforceable without the need to provide for such an interest in the security agreement.

You may consider the treatment of property acquired after a bankruptcy petition has been filed in the next problem.

Problem 9.12 (INTERACTIVE)

Donald Debtor manufactures automobile parts. Second Bank has a security interest in Donald's inventory of automobile parts, existing and after-acquired, and the interest has been timely perfected. Donald has filed bankruptcy. Of the $30,000 inventory of automobile parts subject to Second Bank's security interest on hand, $10,000 of it was in existence prior to bankruptcy, $5,000 was acquired with proceeds from the sale of inventory in existence pre-petition and $15,000 was acquired post-petition with non-proceeds.

In which automobile parts does Second Bank have an enforceable security interest?

New section 9-315(a)(2) does not cover proceeds from property subject to an agricultural lien. Official Comment 9 to new section 9-315 indicates that whether an agricultural lien extends to proceeds of property subject to such a lien is not determined by Article 9 but is left to other law, specifically the statute creating the agricultural lien. The comment adds that if the proceeds are themselves farm products that would be subject to an agricultural lien then an agricultural lien could attach to the proceeds not as proceeds but by operation of the statute creating the agricultural lien. The difference is not unlike that between a security interest in property as proceeds or in property as after-acquired property. Recall Problem 9.8.

Many states, including Arizona, have liens that could qualify as agricultural liens. For example, ARS 33-901 creates a farm services lien for furnishing labor or machinery upon agricultural land. ARS 33-362 creates a landlord's lien that also could fall within new section 9-102(a)(5)'s definition of an agricultural lien. *See* *United States v. Globe Corp.*, 546 P.2d 11 (Ariz. 1976) and B & S (cited in Chapter 3), Ch. 25. It would be necessary to examine such statutes to discover whether proceeds are covered.

You may consider how proceeds of property subject to an agricultural lien are treated under new Article 9 in the next problem.

Problem 9.13 (INTERACTIVE)

Assume again the facts of Problem 9.1 (Exactly one year ago Danielle Debtor borrowed from Second Bank and signed a security agreement giving Second Bank an interest in Danielle's "crops growing on Debtor's farm in Pima County." Danielle has come to Ready Lender seeking another loan and has offered to Ready Lender a security interest in Danielle's current crop. The loan to Second Bank is still unpaid.)

Is the following statement true or false?

Second Bank has a security interest in the crops growing at the time of the loan and also in any monies generated by a sale of the crops growing at the time of the loan that are identifiable as monies generated by the sale of the crops growing at the time of the loan. Suppose Second Bank had no security interest but a local statute gave Second Bank a lien on Danielle's crops.

Would the monies generated by a sale of the crops be covered by Second Bank's lien?

Suppose Danielle put the monies into growing a new crop. Would Second Bank have an agricultural lien on the new crop?

D. The New Debtor Problem

As we saw in subpart C, under new section 9-315(a)(1) a security interest continues in transferred collateral unless the secured party authorized transfer of the collateral free of the security interest. Where there has been no such authorization the transferee takes the collateral subject to the security interest and the security interest is enforceable to the same extent as it was against the transferor unless, as is explored in Part VI, the transferee takes free of the security interest or otherwise has priority over the secured party under some special Article 9 rule governing such conflicts.

Under new section 9-102(a)(28), "debtor" is defined as "a person having an interest in the collateral . . . whether or not the person is the obligor." According to new section 9-102(a)(59), an "obligor" is a person that owes an obligation secured by a security interest. By these definitions, when collateral is transferred the transferee becomes the debtor and the transferor ceases to be the debtor but continues as the obligor.

Consequently, a transferee is a new debtor, but not as that term is used in new Article 9. Under new section 9-102(a)(56), a "new debtor" is a person who becomes bound under new section 9-203(d) on a security agreement entered into by someone else (who in the new Article 9 scheme, under new section 9-102(a)(60), is the "original debtor"). It is new debtors in this technical sense that is the subject of this subpart.

Under new section 9-203(d)(1), a person becomes bound as a debtor by a security agreement entered into by another person (the original debtor) and, hence, becomes a new debtor) if by operation of law other than of Article 9 or by contract the security agreement becomes effective to create a security interest in that person's property. Under new section 9-203(d)(2), a person becomes bound by a security agreement entered into by another person (the original debtor) and becomes a new debtor, if by operation of law other than Article 9 or by contract the person becomes generally obligated on the obligations of the original debtor, including the obligation secured under the security agreement, and the person acquires or succeeds to all or substantially all the assets of the original debtor.

Among the more important cases of a person becoming a new debtor by operation of law outside new Article 9 or by contract (or both) are those where a debtor changes from a sole proprietorship to a corporation or a corporate debtor is taken over by or merges with another corporation.

Under new section 9-203(e), the security interest created by the security agreement entered into by original debtor is enforceable against the new debtor without the need for any other agreement or authentication of the security agreement by the new debtor, as otherwise would be required by new section 9-203(b)(3)(A).

"New debtor" problems arose under former Article 9, but former Article 9 did not contain the rules explicitly provided by new Article 9 for dealing with the problems. Understanding the new Article 9 scheme for determining when persons become new debtors is essential to applying the new Article 9 rules governing *perfection* of security interests in the collateral of new debtors (Part V) and also the rules for resolving priority disputes between the creditors of original debtors and the creditors of new debtors (Part VI).

To explore the basics of the new Article 9 new debtor scheme, especially to the extent that new debtors are distinguished from transferees, consider the following problems.

Problem 9.14 (INTERACTIVE)

Jane Smith is a sole proprietor doing business as "Jane's Desert Treasures." Ready Lender has a security interest in Jane's inventory of jewelry, existing and after-acquired.

In which jewelry currently owned and later acquired does or will Ready Lender have an enforceable security interest?

Problem 9.15 (INTERACTIVE)

Without Ready Lender's authorization, Jane Smith in Problem 9.14 transfers an item of jewelry to John Doe who also is in the business of selling jewelry. John Doe also acquires an item of jewelry from Harold Brown.

Putting aside the possible impact of priority rules to be considered in Part VI, is the item of jewelry acquired by John Doe from Jane Smith subject to Ready Lender's security interest?

On what does a complete answer depend?

Does Ready Lender have a security interest in the item of jewelry acquired by John Doe from Harold Brown and added to Johns inventory?

What additional facts would be necessary to give Ready Lender a security interest in the item of jewelry acquired by John Doe from Harold Brown?

Problem 9.16 **(INTERACTIVE)**

Assume that Jane Smith in Problem 9.14 sells her business to John Doe and in connection with the sale Jane transfers all of her business assets, including all of her jewelry inventory, to John Doe and John Doe assumes all of Jane's obligations, including Jane's obligation to Lender.

Does Ready Lender now have an enforceable security interest in the item of jewelry that John Doe acquired from Harold Brown?

Suppose that instead of a sale to John Doe, Jane Smith had incorporated her sole proprietorship business under the name "Jane's Desert Treasures, Inc." and it was the corporation that acquired an item of jewelry from Harold Brown. Would Ready Lender have a security interest in the item of jewelry acquired from Harold Brown?

For completeness, ask yourself this question: Does Ready Lender has a security interest in jewelry transferred by Jane to the corporation?

E. Some Parting Thoughts about the Enforceability and Attachment of Security Interests

It is useful to note here that the foregoing discussion of attachment and enforceability of security interests may be collapsed into two basic questions: (1) To exactly what property does an otherwise enforceable security interest attach? and (2) Exactly what debt may be satisfied from the property to which a security interest has attached? In making these inquiries recall what is at stake in the enforceability inquiry. What is the impact on a creditor if a court concludes that the requirements for enforceability have been met? If the requirements have *not* been met? How does a putative secured creditor stand relative to other creditors and a trustee in bankruptcy depending on whether a security interest is enforceable or not?

You may explore these closing questions in the next problem.

Problem 9.17 **(INTERACTIVE)**

Leslie Lender lends Donald Debtor $10,000. There is an authenticated security agreement that describes the collateral as "All of Donald's equipment located at Donald's place of business." Donald's equipment located at its place of business is worth $20,000.

In what property does Leslie have an enforceable security interest?

Suppose instead of all its equipment, Donald had given Leslie a security interest in a drill press, serial number XYZ123, worth $10,000, and the security agreement so described the collateral.

In what property would Leslie have an enforceable security interest now?

Assume again that Donald gave Leslie a security interest in the drill press with the serial number XYZ123. Suppose Donald owned three drill presses, including a drill press with the serial number

XYZ123. Suppose further that the drill press with that serial number XYZ123 was stolen and the loss was not insured.

Can Leslie simply take one of the other two drill presses to satisfy the debt?

Who would care if Leslie did take a substitute drill press? Suppose in the case where Leslie Lender has a security interest only in the drill press with serial number XYZ123 and that drill press was stolen, Donald had an insurance policy covering any losses of Donald 's equipment and on which Donald is the named insured.

Does Leslie have a claim to the insurance proceeds covering the loss of the drill press serial number XYZ123?

Would your analyses or your answers to the questions posed in this problem change if the parties were doing business electronically and there was an enforceable security agreement satisfying the requirements of new section 9-203(b)?

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Part IV Creating an Enforceable Article 9 Security Interest

Chapter 10 The Need for Value and Debtor's Rights in the Collateral

A. The Need for Value and Debtor's Rights in the Collateral

As was true under former section 9-203(1), new sections 9-203(b)(1) and (b)(2) impose as conditions of enforceability and attachment of a security interest that the creditor have given value and that the debtor have rights in the collateral. In the typical case these conditions are readily met. However, there are certain nuances associated with the requirements that justify a closer look.

B. The Need for Value

Under new section 9-203(b)(1) a security interest is enforceable only when "value has been given." Often it will be clear that value has been given. When a seller sells goods or a lender lends money value has been given. But, suppose a creditor has not actually sold or lent or even bound itself to sell particular goods or to make a particular loan. Has value been given? Is value given if eventually the seller sells or the lender lends? If so, when? The definition of "value" in new Article 1, section 1-204 (replacing without substantive change section 1-201(44)) answers this and most other value questions.

You may test your understanding of the basic meaning of value in the next problem.

Problem 10.1 (INTERACTIVE)

Ready Lender enters into an agreement with Danielle Debtor under which Ready agrees to lend Danielle $10,000 and Danielle agrees to give Ready a security interest in Danielle's equipment. The security agreement provides that "if Lender makes further loans to Debtor these loans also shall be secured by the interest in Debtor's equipment." Lender lends Debtor $10,000. Two months later Ready lends Danielle another $10,000.

If Danielle has not paid anything on the first loan, what is the dollar amount of Ready's security interest in Danielle's equipment as of the date of the second loan?

Had Ready given value as to the second $10,000 loan as of the date the security agreement was authenticated?

Suppose the security agreement executed by Danielle had stated that "Lender agrees to lend

Debtor $10,000 now and, in addition, Lender agrees to lend Debtor up to $10,000 during the next six months, and the loan of $10,000 made on this date and any loans made during the next six months shall be secured by an interest in Debtor's equipment."

Would Ready have given value as to the second $10,000 loan at the time the security agreement was authenticated?

When does Ready's security interest as to the second $10,000 loan attach?

The last question in Problem 10.1 should bring to mind the discussion in Chapter 9 (The Specifics of Enforceability -- After-Acquired Property, Proceeds and Future Advances) of the difference between optional and obligatory future advance clauses. In that discussion, the concept of an advance made "pursuant to commitment," as defined in new section 9-102(a)(68), was introduced. Whether an advance has been made voluntarily or "pursuant to commitment," as defined in new section 9-102(a)(68), can be pivotal in resolving priority disputes involving future advances. However, the priority discussion is best deferred to Part VI.

There is another aspect of the definition of value in Article 1, section 1-204 that needs attention here and can be explored through the following problem.

Problem 10.2 (INTERACTIVE)

Leslie Lender lends $10,000 to Donald Debtor on open (unsecured) credit. Some weeks later Leslie demands and receives from Donald an interest in Donald's equipment to secure the loan.

Has value been given sufficient to allow the security interest in the equipment to include the earlier loan? Be sure to consult Article 1, section 1-204 before answering the question.

A note of caution is in order. Even though securing or satisfying an antecedent debt is value for purposes of the enforceability (and attachment) of a security interest under new section 9-203(b)(1), there may be problems in bankruptcy. As will be seen in Chapter 30 (Secured Party Versus Trustee in Bankruptcy), when value is given before a security interest is created the trustee may be able to avoid the security interest under BRA § 547 (the avoidable preference provision) leaving the creditor unsecured. Moreover, securing or satisfying an antecedent debt is not considered "new value" as that concept is defined in new section 9-102(a)(57). Certain priority rules considered in Part VI turn on whether new value has been given.

C. Debtor's Rights in the Collateral

Under former section 9-203(1)(c) a security interest was enforceable only if the debtor had rights in the collateral. New Article 9 section 9-203(b)(2) expands former section 9-203(1)(c) by requiring that the debtor have rights in the collateral "or the power to transfer rights in the collateral to a secured party." At one level the requirement imposed by this section is straightforward and rather intuitive. After all, you would not expect a debtor to be able to create an enforceable security interest in property in which the debtor has no rights. But, there is more to the requirement than first meets the eye.

Early on courts looked to title to decide whether a debtor could create a security interest. Title is an elusive concept and its role has been minimized in the UCC generally, *see* Article 2, section 2-401(1), and new Article 9, new section 9-202. So, courts began to invoke property law doctrine under which a person ordinarily has the right to transfer only the interest that person has in the property, but under certain circumstances the person has the *power* to transfer more. In particular, there was reference to the doctrine of "voidable title."

Reference to voidable title makes some sense because the classic instance of circumstances in which a transferor has power to transfer more rights than the transferor enjoys against the owner is that where a person who has *voidable* title transfers property to a bona fide purchaser for value (BFP). *Cf*. Article 2, 2-403(1). However, voidable title itself is not defined in the UCC and it has been left largely to the courts to decide when a person has voidable title and, hence, the power to transfer good title to a BFP. Consequently, tying a conclusion that a debtor has sufficient rights in property under Article 9 to enable the debtor to create a security interest in the property to voidable title did little to give content to the requirement that a debtor have such rights.

The drafters of new Article 9 concluded that specific rules for dealing with particular disputes as to whether a debtor had sufficient rights to enable the debtor to create a security interest would work better than a scheme in which courts are required to fashion outcomes from principles that do not always mesh well with Article 9 rules. An important example is new section 9-319 dealing with the rights of creditors of and purchasers from consignees and which, according to Official Comment 2 to new section 9-319 "to a considerable extent reformulates the former law." However, as will be apparent from the discussion that follows, courts so far have not limited their inquiry to such specific rules.

In considering the question of whether a debtor has sufficient rights in the collateral it is useful to be sensitive to the reality that conclusions about which debtors have what rights or what power to create security interests frequently reflect beliefs as to when debtors should (or should not) have the right or power given what is at stake. Normally what is at stake is whether a particular debtor in specific circumstances should be able to create a security interest that can subordinate the interests of competing parties, including those who might be thought to have stronger claims, at least in terms of historical conceptions of title. Stated differently, decisions as to what *is* true often are decisions about what *should* be true.

It also is important to note that the burden to prove a debtor has sufficient rights in the property to allow a security interest to attach is on the creditor asserting a security interest in the property in question. In *In re S.M. Acquisitions Co.*, 2004 WL 1151575 (N.D. Ill. 2004), for example, the federal district court reversed and remanded a determination by the bankruptcy court that a debtor had sufficient rights because of an absence of evidence indicating otherwise. In so doing, the district court explicitly placed the burden of proof on the creditor.

As noted above, outright ownership cases are clear. It also is true that an owner of property that is already subject to another lien has rights or power such as will allow a security interest to attach. An outstanding lien generally does not bar the creation of a new one. *See* new 9-401 and Chapter 25 (The Why and How of Priority). At the other extreme are cases in which a person has no present or contingent right of ownership whatsoever and such persons do not have rights within the meaning of Article 9. For example, a thief, pure and simple, has no rights or power to transfer such as will to allow a security interest to attach.

In between the extremes of ownership and a total absence of rights against the owner are all manner of cases as to which specific rules have been developed. Thus, a person who as between that person and the owner of property has title that is voidable may have the *power* to transfer good title to a BFP. Under Article 1, sections 1-201(b)(29) and (b)(30), a secured party is a purchaser. Because an interest to secure an antecedent debt is value under new section 1-204(2) (replacing Article 1, section 1-201(44)(b)), a secured party also may be a BFP and thereby have a lien that subordinates the rights of the true owner. The fact that a secured party may be a BFP means that a debtor who gives the secured party a security interest in goods can have rights sufficient to allow the security interest to attach to the goods. For example, a person who buys goods on credit (or with a bad check), leaving the seller unpaid, has sufficient rights in goods to allow a security interest that subordinates the unpaid seller's interest to attach.

In the case of *In re S.M. Acquisitions Co.*, 2004 WL 1151575 (N.D. Ill. 2004), a federal district court applying Illinois law concluded that unless the true owner has consented to the debtor's use of the property as collateral or is estopped to deny that the debtor has the power to do so, the debtor must have possession and title to the goods. The court noted that constructive as well as actual possession will suffice and that the latter exists when the debtor has essentially complete control over the goods. As for title, the court referred to Article 2, section 2-401, under which the parties to a contract for the sale of goods may agree when title passes and in the absence of such agreement title passes when the seller has completed performance with respect to the goods.

The insistence that the debtor have title is bothersome because passage of title has been given diminished importance under the UCC. Moreover, something less than the technical passage of title should suffice to allow a security interest to attach. It has been held that a person who is in possession of property and has contingent rights of ownership, in the sense that the parties to the transfer contemplate that title to the property will pass to the person in possession, also has rights in the property sufficient to create an enforceable security interest.

The "possession with contingent rights of ownership" test has been employed to give secured parties priority over consignment sellers or other sellers for resale. *See General Electric Credit Corp. v. Town & Country Mobile Homes, Inc.*, 574 P.2d 50 (Ariz. App. 1977). *See generally*, *Amfac Mortgage Corp. v. Arizona Mall of Tempe, Inc.*, 618 P.2d 240 (Ariz. App. 1980); *In re County Green Limited Partnership*, 438 F. Supp. 693 (D. Va. 1970). However, in the final analysis, it appears that determinations as to whether a particular debtor has sufficient rights in property to allow a security interest to attach will be decided largely on a case-by-case basis.

The case of *Arcadia Financial, Ltd v. Southwest-Tex Leasing Co.*, Inc., 47 UCC Rep. Serv. 2d 1371 (Tex. App. 2002), offers a good illustration of the difficulties courts may have in applying the foregoing concepts to determine whether or not a debtor has rights in collateral sufficient to allow a security interest to be created. The facts of *Arcadia Financial*, as often is true, are complicated. An auto leasing company (Southwest doing business as Advantage Rent-a-Car) sold used vehicles subject to a certificate of title law to a dealer, Lone Star, under an agreement whereby Lone Star would take possession of the vehicles for inspection and after accepting the vehicles Lone Star would pay for the vehicles and Advantage would provide Lone Star with the titles to the vehicles.

Lone Star had entered into an agreement with Arcadia under which Arcadia would finance the sales of vehicles on credit to Lone Star's customers and Lone Star would assign the contracts arising from the sales to Arcadia to secure the monies advanced to Lone Star. According to the agreement between Arcadia and Lone Star, Arcadia was not obligated to advance any funds until Lone Star provided certificates of title to Arcadia that Arcadia could use to obtain new titles showing its security interest in the vehicles.

As will be explained in Chapter 17 (Perfection of Security Interests in Vehicles Subject to Certificate of Title Legislation), Arcadia's security interest could be perfected only by having the security interest noted on the certificates of title covering the vehicles. Lone Star sold four vehicles to customers who purchased on credit. Lone Star had never paid Advantage for the vehicles and, therefore, Lone Star had not received the certificates of title covering the vehicles from Advantage and could not tender the certificates to Arcadia. Notwithstanding the requirement that Arcadia was not obligated to advance funds to Lone Star until the certificates of title were provided, Arcadia did in fact advance funds equaling the unpaid purchase prices of the vehicles sold by Lone Star.

Lone Star then went out of business and was unable to repurchase the sales contracts from Arcadia as provided for in their agreement. Arcadia demanded that Advantage turn the certificates of title to the vehicles over to Arcadia. Advantage refused and Arcadia sued Advantage for interfering with it contractual relations with Lone Star and the buyers from Lone Star and for conversion.

The lower court concluded that under the Texas Certificate of Title Law the sales by Advantage to Lone Star were void because the certificates of title were not transferred to Lone Star as required by the Certificate of Title Law. It further concluded that Lone Star had nothing to sell to its customers and the contracts with these customers created no rights in the vehicles or in the obligations of the customers to pay the unpaid sales prices in favor of Arcadia. In so doing, the trial court rejected Arcadia's argument that the Uniform Commercial Code, Article 2, sections 2-401 and 2-403 should have been applied and under the UCC title to the vehicles would have passed to Lone Star and the buyers from Lone Star.

The appellate court held that there was no need to resolve any conflict between the Texas Certificate of Title Law and the UCC because under its interpretation of the UCC, the outcome would be the same. The court then concluded that because passage of title to the vehicles was expressly conditioned on payment for them by Lone Star, under UCC Article 2, section 2-401, title never passed to Lone Star and Lone Star had nothing to sell to its customers. The appellate court further concluded that, for the same reason, Lone Star did not have rights in the vehicles sufficient to allow a security interest in the vehicles or the contracts arising from the sale of the vehicles to attach in favor of Arcadia under new section 9-203(b).

It should be apparent that the appellate court's analysis regarding the application of the UCC is erroneous. Advantage had reserved title to the vehicles pending payment by Lone Star, but under Article 2, section 2-401(1), such a reservation of title operates only to create a security interest. Further, although the sales by Advantage to Lone Star were voidable as between Advantage and Lone Star, under Article 2, section 2-403(1), a transferor with voidable title has the power to transfer title to a bona fide purchaser for value and, absent proof to the contrary, the buyers from Lone Star would take title to the vehicles free of Advantage's claim to the vehicles.

As explained above, Lone Star's voidable title would give Lone Star sufficient rights under new section 9-203(b) to allow the Arcadia's security interest to attach. Alternatively, Lone Star had possession of the vehicles with a contingent right of ownership that would give Lone Star rights sufficient to allow Arcadia's security interest to attach.

The controlling question should have been whose security interest, that of Advantage, created by its reservation of title, or that of Arcadia, created by Lone Star in its agreement with Arcadia, should have priority. The answer to this question turns on the application of priority rules that will be considered in Chapter 28 (Secured Party Versus Secured Party and Chapter 29 (Secured Party Versus Secured Party (Continued)).

Although the buyers from Lone Star appear not to have contested Advantage's claims to the vehicles, as will be explained in Chapter 27 (Secured Party Versus Buyers), it would seem the buyers from Lone Star would qualify as buyers in ordinary course under revised Article 1, section 1-201(b)(9) and as buyers in ordinary course could well have had a claim to the vehicles superior to that of Advantage.

Curiously, the court discussed buyer in ordinary course status only as to Arcadia and seemingly failed to note that under Article 1, section 1-201(b)(9) only a buyer of goods can be a buyer in ordinary course. Finally, to the extent that Arcadia had an enforceable security interest in the contracts of sale between Lone Star and its customers it is likely that Arcadia would be subject to the buyers' defense that they had been forced to defend their title to the vehicles. The question of the extent to which claims and defenses may be asserted by parties such as these buyers against assignees such as Arcadia are dealt with in Chapter 37 (Foreclosure as to Intangibles).

The important point made in this discussion of *Arcadia Financial* for purposes of the requirement that a security interest can attach only if the debtor has rights in the collateral sufficient to allow attachment is that, contrary to the court's holding, a debtor such as Lone Star, does have rights with respect to the collateral sufficient to allow a security interest to attach because persons with voidable title have such rights as do persons in possession with contingent rights of ownership.

The foregoing must be qualified insofar as the UCC expressly denies a debtor sufficient rights to allow a security interest to attach at the expense of a seller. Thus, new section 9-110 essentially makes a security interest arising under Article 2 (for example, by reserving title to goods) superior to that of a claim by a creditor of the buyer/debtor until the seller relinquishes possession of the goods. Moreover, although new section 9-110 apparently does not determine whether a seller may withhold delivery for non-payment under governing Article 2 sections, Official Comment 5 to new section 9-110 indicates that a buyer's creditor has no greater rights as to the goods prior to the time the seller gives up possession and may not prevent the seller from withholding delivery and looking to new section 9-110 to give it priority of the buyer's creditor. *See In re Kellstrom Industries, Inc.*, 282 B.R. 787 (Bkcy D. Del. 2002).

Thus, if Advantage in the *Arcadia* case had withheld delivery of the vehicles to Lone Star it could have relied on new section 9-110 to assure priority over Arcadia in the Arcadia case. However, once the seller relinquishes possession then new section 9-110 ceases to apply and the earlier discussion of when the debtor has rights in the collateral sufficient to allow a security interest to attach once again comes into play.

Subject to the special rules governing various consignments, bailees generally do not have rights in or power with regard to bailed goods sufficient to allow a security interest to attach. Likewise, lessees of goods in a true lease situation, *see* Article 1, section 1-201(b)(35) and Chapter 4 (Scope of Article 9), cannot create security interests that will subordinate the lessor's interest. An exception exists for a so-called "disguised conditional sale," that is, a security transaction parading as a lease. As to the differences between a true lease and a lease intended as security, *see* Article 1, section 1-203 (which now contains the discussion in former Article 1, section 1-201(37) dealing with the distinction).

Another type of bailment situation that has presented difficulties is that where goods have been sold on approval under Article 2, section 2-326. According to section 2-326(1), a sale on approval is one in which goods are delivered primarily for use and the buyer may return the goods even if they conform to the contract. Under section 2-326(2), goods sold on approval are not subject to the claims of creditors until the buyer has accepted the goods. In the case of *In re S.M. Acquisitions Co.*, 2004 WL 1151575 (N.D. Ill. 2004), the district court instructed the bankruptcy court on remand to determine, inter alia, whether goods asserted to be collateral had been sold on an acceptance basis and, if so, whether the debtor had accepted the goods.

On remand the bankruptcy court concluded that even if there was a sale on approval the debtor had accepted the goods. *See* In re *S.M. Acquisitions Co.*, 319 B.R. 55 (Bkcy N.D. Ill. 2005). The court's reasons for so concluding are less than entirely clear, but the decision seemed to turn on the totality of the circumstances. The court might usefully have referred to Article 2, section 2-327(1)(b), according to which the use of goods sold under a sale or acceptance contract does not constitute acceptance, but a buyer who fails to seasonably notify the seller of an election to return the goods will be deemed to have accepted.

It is worth noting, as discussed earlier, that the district court felt constrained by Illinois law to require that title have passed before the debtor could have rights sufficient to create an enforceable security interest but it did not explain the connection between acceptance and passage of title. That connection can be found in Article 2, section 2-327(1)(a), providing that in the absence of express agreement, title passes upon acceptance.

In ways that cannot be understood without referring to the specific provisions and comments thereto the expansion of the scope of Article 9 under new section 9-408 can impact a determination of when a debtor has rights in collateral. New section 9-408 is discussed in Chapter 4 (Scope of Article 9).

You may explore the foregoing discussion of when a debtor has sufficient rights in collateral to create a security interest in the following problems.

Problem 10.3 (INTERACTIVE)

Danielle Debtor owns a computer subject to a security interest held by Second Bank.

Does Danielle have rights in the computer sufficient to give Ready Lender an enforceable security interest in the computer?

Problem 10.4 (INTERACTIVE)

Cora Crook steals a computer from Owen Owner. Cora borrows from Second Bank. Second Bank takes a security interest in the computer. Assuming the other requisites of new section 9-203(b) are satisfied, is Bank's security interest enforceable?

Problem 10.5 (INTERACTIVE)

Leroy Lessor leases a computer to Lisa Lessee. Under Article 1, section 1-201(b)(35) and 1-203 the lease is not intended for security.

Does Lisa have sufficient rights in or power to transfer the computer to allow Ready Lender to take a security interest in the computer that could subordinate Leroy's rights?

Would your answer be different if the lease was a "disguised conditional sale"?

Problem 10.6 (INTERACTIVE)

Donald Debtor manufactures custom window awnings on a special order basis. Byron Buyer provides the raw materials needed by Donald to manufacture window awnings for Byron. The agreement between Donald and Byron provides, among other things, that Donald has possession of the raw materials only for the purpose of manufacturing the window awnings for Byron and that Donald has no rights in or title to the raw materials, contingent or otherwise. Donald borrows from Second Bank and gives Bank a security interest in the raw materials supplied by Byron.

Does Bank have an enforceable security interest in the raw materials?

Problem 10.7 (INTERACTIVE)

Bertram Buyer has entered into a contract to purchase tools used in Bertram's business from Easy Sale, Inc. Under the terms of the agreement entered into between Bertram and Easy Sale, Bertram may take possession of and use the tools without becoming obligated to pay for the tools until Bertram indicates he is satisfied with the tools (or Bertram fails to notify Easy Sale that he is returning the tools within a reasonable time).

Does Bertram have sufficient rights in the tools to create an enforceable security interest in favor of Northern Bank?

If not, at what point would Bertram have such rights?

Would your answers to these questions be different if Bertram were a reseller of tools such as acquired from Easy Sale and the tools were delivered to Bertram under an agreement providing that if Bertram sold the tools to third parties he would remit some portion of the proceeds to Easy Sale, but if Bertram did not sell the tools he would return them? Explain your answer.

Problem 10.8 (INTERACTIVE)

John borrows money from Second Bank. With Mary's permission, John signs a security agreement giving Bank an interest in a Jaguar owned by Mary to secure the debt.

Does Bank have an enforceable security interest in the Jaguar?

How can Bank best assure that it will have an enforceable security interest in the Jaguar?

Deciding who is the debtor can be tricky in situations involving a husband and wife, especially in community property states. Typically, there is joint management of community property and either spouse can encumber the property to secure community debts. But, deciding when property is community property and when a debt is a community debt is not always easy. It is generally advisable to get both spouses to sign a security agreement.

The next problem provides a glimpse of the difficulty.

Problem 10.9 (INTERACTIVE)

Wendy Wife in Arizona, a community property state in which spouses have joint management authority with respect to community property, owns an automobile as her separate property. At Harold Husband's request, Wendy agrees to give Second Bank a security interest in the automobile to secure a separate debt of Harold.

If only Harold signs the security agreement and Wendy does not sign or otherwise authenticate the security agreement, is the security interest enforceable?

What *should* Bank do to assure that its security interest is enforceable?

CASE COMMENTARY

In re Lexington Healthcare Group, Inc., 335 B.R. 570 (Bkcy D. Del. 2005)

Wells Fargo Bank v. Robex, Inc., 711 N.W.2d 732 (Iowa App. 2006) (Unpublished opinion)

Integrity Bank Plus v. Talking Sales, Inc., 2006 WL 212193 (D. Minn. 2006)

ACG Credit Co., LLC v. Gill, 876 A.2d 188 (N.H. 2005)

Mackela v. Bentley, 614 S.E.2d 648 (S.C. App. 2005)

In re Jeans, 326 B.R. 722 (Bkcy W.D. Tenn. June 28, 2006)

Vibbert v.PAR, *Inc*, 224 S.W.3d 317 (Tex. App. March 23, 2006)

Coffey v. Singer Asset Finance Co., L.L.C., 2007 WL 258962 (Tex. App. 2007)

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Show

Part IV Creating an Enforceable Article 9 Security Interest

Chapter 11 Enforceability And Attachment Of Security Interests In Consumer Transactions

A. Generally

Secured transactions involving consumers are commercial transactions but they are different in that consumers frequently lack bargaining power and often do not fully understand the nature and consequences of whatever bargain is struck. New Article 9 does somewhat more than former Article 9 to protect consumers. However, many consumer protections are in laws outside Article 9 and these laws can affect the operation of Article 9 rules where the debtor is a consumer. The purpose of this chapter is to explore the limitations on the enforceability of security interests in consumer cases found in Article 9 and in the law outside of Article 9.

B. The Article 9 Consumer Protections

As noted in Chapter 5 (Classification of Collateral), under new section 9-102(a)(23) goods are "consumer goods" if they are used or bought for use primarily for personal, family or household purposes. In Chapter 8 (The Specifics of Enforceability -- A Security Agreement Authenticated by the Debtor or Its Equivalent) we saw that a description of consumer goods by type, *i.e.*, as "consumer goods," was resisted by courts under former Article 9 in the belief that a more detailed description was necessary to compensate for the fact that most consumers had little understanding of secured transactions.

We also saw in Chapter 8 (The Specifics of Enforceability -- A Security Agreement Authenticated by the Debtor or Its Equivalent) that new Article 9 codifies the resistance to the use of a "consumer goods" description in a security agreement by providing in new section 9-108(e)(2) that a description only by type is insufficient as to consumer goods in a consumer goods transaction. A "consumer transaction," as defined in new section 9-102(a)(26), is one in which an individual debtor incurs an obligation for personal, family, or household purposes and the obligation is secured by an interest in collateral that is held or acquired primarily for personal, family or household purposes.

Where the collateral in a consumer transaction constitutes consumer goods the transaction will be a “consumer-goods transaction” as defined in new section 9-102(a)(24). As is made explicit in the definition in new section 9-102(a)(26), a “consumer transaction” includes a “consumer-goods transaction,” but the former is broader in that the collateral need not be consumer goods but rather need only be “held or acquired primarily for personal, family, or household purposes.”

The more inclusive definition applies to new section 9-108(e)(2) which, in addition to barring the use of a description by type as to consumer goods, provides that a description of investment property collateral as "investment property" or a "securities entitlement" or a "securities account" or "commodity account" likewise is insufficient in a consumer transaction.

The next problem gives you the opportunity to explore the limitations found in new section 9-108(e)(2) again.

Problem 11.1 (INTERACTIVE)

The facts of Problem 8.11, in Chapter 8 (The Specifics of Enforceability -- A Security Agreement Authenticated by the Debtor or Its Equivalent), were as follows: Byron Buyer runs a technology consulting business out of his home. Byron owns a refrigerator, a large screen television and a personal computer. Only the personal computer is used in Byron's business. Byron also has a securities account with Broker, Inc. Byron borrows from Ready Lender to pay some debts arising in connection with the consulting business and Byron gives Ready a security interest in the foregoing items of property.

Would a description such as "consumer goods" or "all the debtor's consumer goods" be sufficient as to the personal computer?

Would a description "consumer goods" or "all the debtor's consumer goods" be sufficient as to the refrigerator and television?

Would a description such as "debtor's securities accounts" be sufficient as to the account with Broker, Inc.?

Would your answers be different if Byron borrowed from Ready Lender to finance a vacation?

In Chapter 9 (The Specifics of Enforceability -- After-Acquired Property, Proceeds and Future Advances) you learned that there is another Article 9 limitation on the enforceability of a security interest where the debtor is a consumer. New section 9-204(b)(1) provides that a security interest does not attach under an after-acquired property clause to consumer goods, as additional security, other than to accessions, unless the debtor acquires rights in the consumer goods within ten days after the secured party has given value.

The "additional security" qualification is necessary to prevent new section 9-204(b)(1) from barring enforcement of a security interest taken by a seller in consumer goods that the seller has contracted to sell but that have not yet been made or acquired by the seller or a security interest of a lender in consumer goods that the debtor has not yet bought. In other words, the section is not intended to bar enforcement of a security interest in specific consumer goods that a seller has contracted to sell but have not yet been acquired or made by the seller or of a security interest in specific consumer goods that the debtor has not yet bought.

As explained in Chapter 9 (The Specifics of Enforceability -- After-Acquired Property, Proceeds and Future Advances), accessions, as defined in new section 9-102(a)(1), are goods that are attached or integrated into other goods so as to become part of other goods but not lose their identity, for example, a new engine in an automobile. As will be seen in Part VI there are special priority rules for dealing with accessions.

You may explore the application of new section 9-204(b)(1) in the next problem.

Problem 11.2 (INTERACTIVE)

Assume the original facts of Problem 11.1. Assume further, however, that the security agreement described the collateral as "consumer goods, existing and hereafter acquired" and also "securities accounts, existing and hereafter acquired." One month after the original loan and security agreement Byron acquired a stereo system for personal use and also opened another personal securities account with See-Trade, an online brokerage firm.

Is Ready Lender's security interest in the stereo system enforceable?

Is Ready's security interest in the new securities account enforceable?

Suppose that at the time Byron acquired the stereo system, Byron also purchased additional memory for his personal computer. Would Ready have an enforceable security interest in the computer memory?

C. Consumer Protections Outside Article 9

Consumer transactions in which after-acquired property security interests are created often involve so-called "series of sales." In these situations the debtor acquires several items on credit from the same seller. Frequently, there will be a general agreement providing that every item purchased becomes collateral for the debt associated with each item previously purchased and each previously-purchased item is collateral for the debt associated with the later-acquired items.

The following example will illustrate. Debtor purchases a refrigerator from Seller and Seller takes a security interest in the refrigerator to secure its unpaid price. Debtor signs a security agreement that provides that Seller will have a security interest in any appliances purchased later by Debtor from Seller to secure the debt owed on the refrigerator and the refrigerator will be security for the debts incurred in the purchase of the later items. A week later Debtor purchases a stove from Seller. The debt owed on the refrigerator will be secured by interests in the refrigerator and the stove and the debt owed on the stove will be secured by interests in the stove and the refrigerator.

Such arrangements are referred to as "cross collateral" security agreements because each item subsequently purchased becomes security for each item previously purchased (and vice versa). Cross collateralizing is not uncommon in the business world and there is nothing in Article 9 that directly prevents it. However, where the debtor is a consumer a cross collateral security arrangement may run into difficulty. Depending on the timing of the purchases, new section 9-204(b)(1) limiting the enforceability of security interests in after-acquired consumer goods could apply. But, law outside of article 9 also may limit the enforceability of the security interests without regard to the timing of the purchases.

Many of you will recall from contracts class the well-known case of *Williams v. Walker-Thomas Furniture Co*, 350 F.2d 445 (D.C. Cir. 1965). You likely will remember in general terms what happened in that case, but the opinion is worth reading again. You may do so by clicking on the case name.

Oversimplifying somewhat, the buyer-debtors in *Williams* had entered into series of sales agreements that provided for cross collateralizing. After having paid for many or most of the items purchased the debtors defaulted at which point the creditor repossessed *every* item. The court of appeals concluded that the agreements may have been unenforceable on grounds of *unconscionability*, especially as provided for in UCC

Article 2, section 2-302, and remanded for a determination of whether the cross collateralizing arrangements were unconscionable.

The decision and opinion in *Williams* generated much debate. Detractors complained that because cross collateral clauses are not expressly barred and implicitly are approved by the provision authorizing after-acquired collateral arrangements (now new section 9-204(a)) and the floating lien concept discussed in Chapter 9 (The Specifics of Enforceability -- After-Acquired Property, Proceeds and Future Advances), such clauses should not be denied effect as being unconscionable. However, these objections overlooked certain important features of the contracts at issue in *Williams.*

The contracts in *Williams* consolidated the debts incurred as to each item purchased and provided for single monthly payments on the consolidated debts. Moreover, under the contracts all of the items purchased served as collateral *until all of the consolidated debt had been paid*. It was these features of the contract that allowed the sellers to repossess every item when the debtors failed to make a monthly payment even though the debtors had paid more than the amount of the debts incurred for some or even most of the items.

A way to avoid unconscionability challenges in series of sales contracts is to provide that each monthly payment will be applied to the debt created by each item purchased in the order of purchase *and* when enough had been paid to satisfy the debt associated with a particular item the security interest in that item will be released. This type of payment and release arrangement is conveniently referred to as first-in-first-out (FIFO) secured financing.

You may explore the application of unconscionability doctrine in the next problem. The problem also illustrates the possible overlap of unconscionability doctrine with the Article 9 limitations examined in subpart B.

Problem 11.3 (INTERACTIVE)

Betty Buyer has entered into a contract with Sid Seller under which Sid agrees to sell furnishings and appliances "on time" and Betty signs an agreement under which each item becomes security for each item later-purchased and each later-purchased item becomes security for each earlier purchased item (*i.e.*, there is cross collateralizing of all the items purchased). In the description of the collateral section of the agreement "consumer goods" appears. The security agreement further provides that all the debt arising from the secured sales shall be consolidated and paid in equal monthly installments. The security agreement finally provides that in the event of a default at any time before the entire debt owing is paid Sid may retake all the items purchased. Betty then makes several purchases of personal use goods from Sid. Buyer first purchases a large screen television. A week later Betty purchases a stereo system. A month later Betty purchases a dishwasher and a refrigerator.

Is the description of the collateral sufficient to support enforceability and attachment of the security interests in the television, stereo system, dishwasher and refrigerator?

Suppose the agreement describes the collateral as "an Hitachi television, serial number xyz123," and a specific description of each later-purchased item is added to the basic agreement at the time each item is purchased. As to which items is there still an enforceability difficulty under Article 9?

If all of the later-purchased items were purchased within ten days of the purchase of the television, would there be an enforceability problem under Article 9.

If all of the later-purchased items were purchased within ten days of the purchase of the television, would there be an enforceability problem under the law outside Article 9?

How might the contracts be revised to avoid whatever objections to enforceability you have identified?

Cross-collateralizing and other "blanket" security arrangements have been the target of special statutes outside Article 9. These laws were inspired by a common belief that, in the consumer setting, blanket security arrangements can be especially oppressive because the goods often are worth much more to the debtor than they are to the creditor and the result is to give creditors undue "leverage." ARS § 44-5501 is such a law. ARS § 44-5501(C) provides:

> C. Neither the seller of consumer goods or services nor his assignee may take any other security for a consumer credit sale other than (1) a security interest in goods sold or as to which services have been rendered and (2) in the realty to which such goods may be affixed. If the seller or assignee elects not to retake the goods, but brings an action for the unpaid balance, the goods may not thereafter be retaken and are not subject to judicial process to enforce any judgment obtained therein.

ARS § 44-5501 is limited to consumer credit sales of goods and services. "Consumer credit sale" is not defined, but is generally understood to refer to personal, family and household credit. Under subsection (C) only security interests in goods that are the subject of a sale or as to which services have been rendered are enforceable. The language could be clearer, but the intent is that a security interest in other than the goods sold at the time the security interest attaches, for example, goods later sold by the same seller to the same buyer/debtor, is not enforceable (except to the extent that a separate security in these later purchased goods is created). For reasons that are not apparent the limitation applies only to sellers and assignees and not lenders.

We will come back to subsection (B) of ARS § 44-5501 in connection with foreclosure, but here you should be aware that it applies only to transactions where the sales prices is $1,000 or less. The question has been raised whether the dollar limit also applies to subsection (C). The argument that the dollar ceiling does apply is that ARS § 44-5501 is aimed at "low ticket" sales where the goods have relatively little resale value.

Another limitation on blanket security arrangements in the consumer setting is found in the Federal Trade Commission (FTC) Fair Credit Practices Rule in 16 CFR Part 444.2. This rule makes taking a non-purchase money security interest in household goods an unfair trade practice. The difference between purchase and non-purchase money security interests is explored at length in Chapter 18 (Perfection by Doing Nothing -- Automatic Perfection). As used in the FTC rule, "other than a purchase money security interest" essentially means that the credit did not enable the debtor to acquire the household goods involved. "Household goods" is defined in 16 CFR Part 444.1(i) to include clothing, furniture, appliances and personal effects, but to exclude electronic equipment other than one television and one radio.

Security arrangements that violate the rule technically are unfair trade practices that require action by the FTC, but the practical effect of the rule is to make the proscribed security interests unenforceable.

You may test your understanding of ARS § 44-5501(C) and the Fair Credit Practices Rule in the next two problems.

Problem 11.4 (INTERACTIVE)

Betty Buyer purchases an Amana refrigerator on credit from Sid Seller for $600. The refrigerator is bought for use in Betty's home. Betty signs a security agreement that gives Sid an interest in the Amana refrigerator to secure its unpaid price. The collateral is described as "one Amana refrigerator, serial number 125689, and a Maytag washer, serial number xx9210, and a Technics stereo, serial number xyz123." At the time Betty signs the security agreement, Betty already owns the Maytag washer and Technics stereo.

Are Sid's interests in the Maytag washer and Technics stereo enforceable under ARS § 44-5501?

Problem 11.5 (INTERACTIVE)

Assume the facts of Problem 11.4. Assume further, however, that Betty Buyer paid Sid Seller for the Amana refrigerator with cash borrowed from Friendly Finance Company and the security agreement described in Problem 11.4 named Friendly Finance Company as the secured party.

Does ARS § 44-5501(C) bar enforcement by Friendly Finance Company of the security interests in the Maytag washer and Technics stereo?

Would Friendly Finance Company be in trouble under the Fair Credit Practices Rule as to the Maytag Washer? In answering this question be sure to check the definitions of terms used in the rule.

Would Friendly Finance Company be in trouble under the Fair Credit Practices Rule as to the Technics stereo? Again, be sure to check the definitions of terms used in the rule.

The application of ARS § 44-5501 to a series of sales agreement such as that in Problem 11.3 is clouded by the fact that ARS § 44-5501(C) provides that a seller of consumer goods may not take a security interest in other than goods sold and all the goods in Problem 11.3 were sold by the seller. The Fair Credit Practices Rule more clearly applies to the security interests in the dishwasher and refrigerator to secure the debt incurred to buy the television because these security interests seem not to have enabled the debtor to acquire rights in the television within the meaning of the FTC rule.

There also is a bankruptcy provision, BRA § 522(f)(1)(B), under which certain non-purchase money, non-possessory interests may be avoided. That complicated provision is best treated in Chapter 30 (Secured Party Versus Trustee in Bankruptcy), but it is worth noting here that the FIFO approach to consolidated debt financing referred to above is a way to preserve the purchase money status of a security interest and reduce the likelihood that a BRA § 522(f) attack will be successful.

It also should be noted that new section 9-103(f) purports to preserve the purchase money status of security interests in cross-collateral arrangements, but that section does not apply in consumer goods transaction (separately defined in new section 9-102(a)(24)). As to the intended operation of new section 9-103(f) in non-consumer-goods transactions, see Official Comment 7 to new section 9-103.

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Part V Perfecting an Article 9 Security Interest

Chapter 12 Perfection Generally

A. Introduction

The ultimate concern for a secured party is to have *priority* against third parties, including a trustee in bankruptcy. As will be developed more fully in Part VI, priority is very much a zero sum game. One party wins and the others lose. Moreover, under Article 9, priority outcomes tend to be rule-driven with little room for considering "the equities" in particular cases.

The need for certainty in commercial dealings and the desire to reduce the effect of "off the record " activity are the reasons usually given for such a scheme. After you have examined the sometimes maddeningly complex priority rules in Part VI you can decide for yourself how much certainty those rules offer.

In any event, priority frequently is a function of perfection and the timing of perfection. New section 9-308(a) echoes former section 9-303 by providing that perfection of a security interest requires attachment and some appropriate further action. As to an agricultural lien there is perfection under new section 9-308(b) when the lien is "effective" under the statute creating the lien and some action to perfect has been taken.

As we saw in Part IV, under new section 9-203(a), a security interest attaches when it becomes enforceable. As noted in Chapter 7 (Overview of Enforceability and Attachment), although the actions leading to attachment or perfection can overlap in the sense that they need not occur in any particular order, perfection is a conceptually separate matter from attachment, even in the special case of perfection on attachment.

Typically the required action is to file a financing statement but taking possession of the collateral sometimes is necessary or advisable. As to certain collateral, specialized action, such as getting "control" of the collateral or complying with some law other than Article 9, is needed to perfect. In other cases a security interest may be perfected "automatically, " *i.e.*, by doing nothing. The action beyond attachment, if any, that is needed to perfect a security interest is the subject of this chapter.

Technically there is another decision that must be made before any required action to perfect is taken. A creditor must decide in which state whatever action that is required should be taken -- or, more accurately, a creditor must decide which state's law governs perfection and non-perfection and the effect of each. We first dealt with the governing law question in Chapter 6 (Choice of Law) and we will revisit it in this part in connection with particular modes of perfection.

Recall from the discussion in Chapter 6 (Choice of Law) that under Article 1, section 1-301(c)(8) (formerly revised Article 1, section 1-105(2)), where the Uniform Commercial Code applies, parties generally may not choose the law that will govern perfection of a security interest.

B. Modes of Perfection

1. Filing or Possession

As was true under former Article 9, to perfect a security interest under new Article 9 a secured party ordinarily must either file a financing statement or must take possession of the collateral. New 9-310(a), 9-312(a) and 9-313(a). Where perfection can be achieved by some other method, such as possession or control, then filing is not necessary, *see* new 9-310(b), and, as is explained below, filing is not effective as to security interests in certain collateral. Under new section 9-310(a), filing is the action required to perfect as to an agricultural lien.

In secured financing law there is a general abhorrence of "secret liens." Secret liens are interests in property to secure debts that are unknown to third parties who may act to their detriment in the belief that the property is free of liens. Public filing and changes of possession operate to give third parties notice that property is or may be subject to a lien. Perfection by filing is covered in Chapters 13 (Overview of Perfection by Filing) and 14 (The Nitty Gritty of Filing). Perfection by possession is the subject of Chapter 15 (Perfection by Possession (Including Documents of Title)).

2. Perfection by "Control"

Former Article 9 introduced the concept of "control" in connection with security interests in investment property. Control was the central mode of perfection as to investment property. New Article 9 continues the use of control as a step for perfecting a security interest in investment property, but it expands the control cases to include security interests in deposit accounts, letter of credit rights and electronic chattel paper. New 9-314(a). *See*, *e.g.*, *Sonic Engineering, Inc. v. Konover Construction Co. South*, 51 UCC Rep Serv. 2d 844 (Conn Super. Ct. 2003) (Control of a deposit account). Control as a mode of perfection is also referred to in Chapter 8 (The Specifics of Enforceability).

Perfection as to a security interests in certain property as to which control is proper also may be achieved by filing or possession (technically, by "delivery ") or sometimes without either. New 9-312(a) and 9-313(a). But, generally speaking, control is the superior mode of perfection. The perfection by control situations are dealt with in Chapter 21 (Perfection as to Investment Property) and Chapter 22 (Perfection as to Deposit Accounts, Letter of Credit Rights and Electronic Chattel Paper).

3. Perfection by Compliance with Non-Article 9 Law

There are two important situations in which a creditor must take action under a law other than Article 9 to perfect a security interest. The first involves security interests in vehicles other than those held for sale. Under certificate of title laws enacted in most jurisdictions, perfection of such security interests requires that the interest (lien) be noted on the certificate of title. Consequently, a secured party who takes an interest in a vehicle other than one held for sale must comply with the certificate of title law and have the lien interest noted on the vehicle's title. New 9-303 and 9-311(a)(2) and (d). We will revisit the "lien notation" scheme in detail in Chapter 17 (Perfection as to Goods Subject to Certificate of Title Legislation).

Another important situation where special action is required is that where federal laws operate to preempt or otherwise displace the perfection scheme of Article 9. In such cases, under new section 9-311(a)(1), the secured party must do as the federal law dictates. A clear example is that to perfect a security interest in a variety of aircraft collateral a creditor must go to the Federal Aviation Authority (FAA) in Oklahoma City, Oklahoma and, ultimately, must register the security interest in Ireland pursuant to procedures established by an international convention to which the United States is a party.

More complicated, and the subject of a continuing debate, is the extent to which federal law requires that security interests in intellectual property, including copyrighted materials, be perfected otherwise than by filing under Article 9. Perfection by complying with federal law is treated in Chapter 19 (Perfection Pursuant to Federal Law).

4. Automatic Perfection -- Perfection by Doing Nothing

Certain security interests may be perfected without doing anything. This type of perfection is often referred to as "automatic" perfection. The most common instance of automatic perfection is that for a purchase money security interest in consumer goods. New 9-309(1). The definition of "purchase money" in new section 9-103 expands that found in former section 9-107, but the essence continues to be that the credit enables a debtor to acquire rights in the collateral. Most consumer credit is purchase money.

The "exemption" from filing for purchase money creditors in the consumer context is premised on a belief that requiring all creditors who extend credit to file would place a burden on the filing system that is outweighed by the protection accorded to the relatively few creditors who take security interests in consumer goods after the debtor already owns them.

There are other less obvious cases of automatic perfection. New section 9-309 sets forth all the automatic perfection cases, which under Article 9 are referred to as "perfection on attachment." The subjects of "automatic " perfection, or perfection on attachment (perfection without doing anything), and the concept of purchase money security are addressed in greater detail in Chapter 18 (Perfection by Doing Nothing -- Automatic Perfection).

5. Perfection as to Proceeds

As we saw in Chapter 9 (The Specifics of Enforceability -- After-Acquired Property, Future Advances, Transferred Collateral and Proceeds and the New Debtor Problem), when collateral is transferred to another party or collateral is lost or destroyed or simply changes form proceeds result. As was also seen in that chapter, Article 9 is quite solicitous of secured parties when it comes to creating an enforceable interest in proceeds. There is no need for an agreement creating a security interest as to proceeds and a proceeds interest is enforceable without any reference to proceeds in the security agreement.

As for perfection, under new section 9-315(c) an interest in proceeds as to which a security interest attached is perfected automatically, that is, without a secured party doing anything. But, as was true under former Article 9, under new section 9-315(d) the perfection may not continue indefinitely and action to achieve *continuous perfection* may be necessary. Perfection as to proceeds is considered in Chapters 16 (Perfecting Security Interests in Proceeds and Other Later Acquired Property) and 24 (Continuing Perfection -- Changes as to the Use of the Collateral or in the Location of the Collateral or the Debtor; Security Interests in Proceeds).

6. Perfection as to Goods Affixed to Real Estate

Goods can be affixed to real estate in such a way as to give a party with an interest in the real estate an interest in the goods. Such goods are "fixtures." *See* new 9-102(a)(41) and Chapter 5 (Classification of Collateral). A clear example is a central air conditioning or heating system in a building. Security interests in fixtures can be perfected by filing or even by doing nothing (but probably not by possession). However, a creditor who perfects a security interest in a fixture risks losing out to certain real estate claimants unless the creditor makes a special filing called a "fixture filing.

"Perfection of security interests in fixtures and the matter of fixture filings are dealt with in Chapter 20 (Perfection as to Fixtures and Other Real Estate-Related Collateral). Perfection issues as to other real estate-related collateral, such as promissory notes secured by deeds of trust and timber to be cut, also are treated in Chapter 20. The priority issues are treated in Part VI.

The following problems allow you to explore the basics of perfection as set forth above.

Problem 12.1 (INTERACTIVE)

Jane Jones buys a stereo from Donald Dealer for use in her office. Jane promises to pay the $1200 purchase price in 12 equal monthly installments. Jane signs an agreement giving Donald Dealer an interest in the stereo to secured the unpaid purchase price. Before making a payment Jane's business folds and Jane defaults on her contract with Donald. It so happens that Jane owes Lisa Lender $2000. Lisa has obtained a judgment and a writ of execution pursuant to which the sheriff has seized and sold the stereo at a public sale for $800.

Who gets the $800? Hint: As is explained in detail in Chapter 26 (Secured Party Versus Lien Creditor), generally speaking, if Donald has not perfected its security interest in the stereo at the time of the levy (seizure of the stereo) by the sheriff then Lisa has priority, however, if Donald has perfected at the time of the levy then Donald has priority.

Problem 12.2 (INTERACTIVE)

Assume the same facts as in Problem 12.1 except that before the sheriff seizes the stereo Donald Dealer properly files a financing statement covering the stereo. Now who gets the $800?

Problem 12.3 (INTERACTIVE)

Assume the same facts as in Problem 12.1 except that Jane purchases the stereo for use in her home. Now who gets the $800?

Problem 12.4 (INTERACTIVE)

Assume the same facts as in Problem 12.2 except that the subject of the sale (the collateral) is a used Toyota. Who gets the $800 now?

Problem 12.5 (INTERACTIVE)

Assume the same facts as in Problem 12.2 except that the subject of the sale is an airplane that Jane intended to restore but which even in its dilapidated condition had to be registered. Who gets the $800 now?

Problem 12.6 (INTERACTIVE)

In each of the foregoing problems there is a winner and a loser and no pro rata distribution. True or false?

CASE COMMENTARY

In re *Sabol*, 337 B.R. 195 (Bkcy C.D. Ill. February 6, 2006)

In re *Snelson*, 330 B.R. 643 (Bkcy E.D. Tenn. 2005)

Vars v. Citrin, 470 F.3d 413 (1st Cir. 2006)

Stockman Bank of Montana v. AGSCO, Inc., 727 N.W.2d 742 (N.D. 2007)

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Part V Perfecting an Article 9 Security Interest

Chapter 13 Overview Of Perfection By Filing

A.   Generally

There are some important situations as to which filing a financing statement either is not permitted or is not advisable. However, filing is the action most commonly required to perfect a security interest and filing a financing statement is necessary to perfect an agricultural lien. *See* new 9-310(a).

The action of filing a financing statement may be conveniently separated into three inquiries. The first is *what* to file? The second is *when* to file whatever must be filed? The third is *where* to file whatever is required to be filed? As was true under former Article 9, the short answers to these questions under new Article 9 are that a secured party should file a document (or record) called a financing statement in the proper filing office and the filing should be done as soon as possible.

Understanding that filing as a mode of perfection is a two-sided coin is imperative. On the one side, filing is a step that perfects an interest in collateral against the claims of others to that collateral. On the other side, filing is the scheme by which third parties learn about the existence of interests in property that they are contemplating taking an interest in to secure a debt.

Stated differently, where to file and where to search are flip sides of the same coin. The governing rules may be understood (although not necessarily satisfactorily explained) as attempts to balance the burdens imposed upon filing parties and searching parties.

B. What to file

As was true under former Article 9 initial filings are made using a form called a "UCC 1." This form also may be used to continue and to amend initial filings. The contents of a UCC 1 are rather skimpy, at least by contrast to real estate recording instruments.

The reason is that Article 9 employs a "notice filing" scheme under which searchers are given only enough information to know that certain property of a particular debtor *may* be subject to a security interest. Under the notice-filing scheme it is incumbent on a searcher to make further inquiry to get the details of a possible security interest. *See* Official Comment 2 to new 9-502.

New Article 9 limits further the information that former Article 9 required to be included in a financing statement. For example, under former Article 9, section 9-402(1), a financing statement had to include the debtor's address, a requirement that makes sense because, as is explained as third parties below, a third party must go through the debtor to obtain specifics about a security interests that the third party is put on notice of by financing statement. *See* subpart D (1) of Chapter 14 (The Nitty Gritty of Filing) *infra*. However, the debtor's address is not included within the contents explicitly mandated by new sections 9-502, 9-503 or 9-504 for a financing statement to be sufficient under new Article 9.

Interestingly, as is explained in subpart C of Chapter 14 (The Nitty Gritty of Filing), a filing officer is required to reject a financing statement that does not include the debtor's address and a financing statement that is rejected for this reason is not effective (although if the financing statement is accepted by the filing officer it very probably will be effective).

To facilitate electronic filing new Article 9 eliminates the need for the debtor's signature and refers at various places to "records" rather than financing statements. *See* new 9-502(a) and Official Comment 3 to new 9-502. The specifics of what must be contained in a financing statement are dealt with at length in Chapter 14 (The Nitty Gritty of Filing).

New section 9-521 contains a set of "safe harbor" forms that if properly completed must be accepted for filing by an office that accepts written records. There is a revised UCC 1 adapted to the requirements of new Article 9. To see what it looks like, click here.

Optimal protection against real estate parties of security interests in fixtures requires a "fixture filing." For a financing statement to be effective as a fixture filing the statement must indicate that it is to be filed in the real estate records, provide a description of the real estate to which the goods have or will be attached and, if the debtor does not have an interest of record, include the name of a record owner of the real estate. New 9-502(b).

Generally speaking, the description of the real estate is adequate if it reasonably identifies the real estate within the meaning of new section 9-108(a), as discussed in Chapter 8 (The Specifics of Enforceability -- A Security Agreement Authenticated by the Debtor or Its Equivalent). Optionally, a state may require that the description of the real estate be sufficient to satisfy the local law governing descriptions in real estate mortgages, including a legal description. New 9-502(b)(3) and Official Comment 5 to new 9-502.

The additional requirements for a fixture filing also apply to filings covering "as extracted collateral " (minerals and the like) and timber *to be cut* (but not timber that has already been cut). New 9-502(b). These additional requirements, and a provision under which a mortgage recording may be sufficient as to real estate-related collateral, are explored further in Chapter 14 (The Nitty Gritty of Filing).

Under former section 9-402(8), a financing statement that substantially complied with the requirements imposed by the UCC was effective. New section 9-506 is similar but it goes beyond the prior section to explicitly deal with the use of computers in filing offices and to address the "new debtor" problem discussed in Chapter 9 (The Specifics of Enforceability -- After-Acquired Property, Future Advances, Transferred Collateral and Proceeds and the New Debtor Problem).

The substantial compliance rule most often was invoked in disputes regarding the debtor's name and further discussion of the rule is best deferred to Chapter 14 (The Nitty Gritty of Filing) where the central role of the debtor's name in the operation of the filing system is explored.

As noted above, a major change from former Article 9 to new Article 9 is that the debtor's signature is not required. This change is designed to facilitate electronic ("paperless") filing. The elimination of the signature requirement does not mean that any and all filings are effective. New Article 9 spells out who is entitled to file a financing statement (or other record) and specifies that an initial filing must have been authorized by the debtor. *See* new 9-509(a).

New section 9-509(b) provides that by authenticating a security agreement (or becoming bound to it) a debtor (or new debtor) authorizes the filing of an initial financing statement and any amendment. The reach of new section 9-509(b) is worthy of comment.

It would seem that the scope of the authorization to file a financing statement is limited by the description of the collateral in the security agreement authenticated by the debtor. Thus, authentication of a security agreement containing a relatively specific description of the collateral should not authorize the filing of a financing statement that uses a much broader description (especially not a "super generic" description, as discussed below). The authorization scheme is considered at greater length in Chapter 14 (The Nitty Gritty of Filing).

New Article 9 provides for civil liability for unauthorized filings, spells out the effect of unauthorized filings and contains procedures for removing unauthorized filings. In so doing new Article 9 tracks laws in many states, including Arizona, strictly regulating recordings affecting real estate. *See* B & S (cited in Chapter 3), Ch. 13.

New Article 9 also adds a provision, new section 9-518, that allows a person who believes a filing is inaccurate or was wrongfully filed to file a correction statement. However, under new section 9-518(c) a correction statement does not affect the effectiveness of the filing with respect to which the correction statement was filed. *See* Official Comment 2 to new section 9-518. And, the drafters have taken the position that Article 9 cannot provide a satisfactory or complete solution to problems caused by misuse of the Article 9 filing system. *See* Official Comment 3 to new section 9-518.

Nonetheless, at least one state has enacted a non-uniform version of new section 9-518 that adds specific remedies for fraudulent and unauthorized filings. *See* Vernon's Texas Code Annotated, § 9.5185. Remedies for unauthorized filings and other failures to comply with Article 9 are dealt with in Chapter 38 (Remedies for a Secured Parties Failure to Comply with Article 9).

The modifier "initial" is intended to distinguish first filings from amendments, continuation statements and an "initial financing statement in lieu of a continuation statement." *See* new 9-102(a)(39) (defining "financing statement") and new 9-102(a)(27) (defining "continuation" statement). The distinction is important in applying the transition rules of Part 7 of new Article 9.

As noted in Chapter 12 (Perfection Generally), and discussed further in the next subpart, in the end perfection is about priority and most priority disputes are decided according to some variation on the first-in-time rule. Consequently, the date and time that the financing statement was received for filing often can be critical. This information is provided by the filing officer. *See* new 9-523(a).

C. When to File

The *when* to file question is relatively easily answered. A financing statement should be filed as soon as possible meaning as soon as a client gets serious about extending secured credit to a debtor who is seeking such credit and the debtor has authorized the filing. The Article 9 filing scheme facilitates early filing. It does so insofar as it does not require that the agreement itself be recorded -- or even have been executed -- and by conditioning filing only on the debtor's willingness to authorize a filing. *See* new 9-502(d) and Official Comment 3 to new 9-502.

The reason for filing as soon as possible is that priority is largely a function of timing with the first-to-file often having priority. *See* Part VI. Early filing does not, however, assure priority over all other parties. The logic of the first-to-file priority scheme necessarily means that if another party is already on record when a creditor files then that other party is likely to have priority.

Because of the importance of timing in the Article 9 priority scheme there must be a rule for determining when a party is of record so as to establish that party's position for purposes of priority. Generally speaking, as was true under former section 9-403(1), a filing is effective when a financing statement is tendered together with any required fees. However, new Article 9 attempts to limit the wide discretion to accept or reject filings that filing officers had under former Article 9. *See* new 9-516 and 9-520(a). The specifics of the new Article 9 scheme as to when a filing is effective are complicated and best left for discussion in Chapter 14 (The Nitty Gritty of Filing).

A filing does not last forever. A financing statement is effective for five years at which time it lapses unless it has been properly continued. Consequently, there is another "when" to file question, namely, when it is necessary to make a further filing beyond the initial filing.

The need for another filing also can arise because of changes in circumstances that cause a financing statement to become misleading to searchers. These questions are dealt with at length in Chapters 23 (Continuing Perfection -- The Need to Reperfect (Or Refile) and 24 (Continuing Perfection -- Changes as to the Use of the Collateral or in the Location of the Collateral or the Debtor; Security Interests in Proceeds).

D. Where to File

Recall that there is a flip side to the where to file question, namely, where to search. The question of where to file (or where to search) actually involves two questions. The first is in which state a filing should be made. The second is where in the appropriate state the filing should be made.

1. Which State

As was discussed briefly in Chapter 6 (Choice of Law), the state in which to file a financing statement is the state whose law governs perfection and nonperfection (as distinguished from the effect of perfection or nonperfection).

Under former Article 9 the law of the state where the collateral was located (the "situs rule") was the state in which to file (or search) as to most tangible collateral, but filings as to accounts and general intangibles and mobile goods (goods that "normally" were used in more than one jurisdiction) had to be made in the state where the debtor was located (on the theory that intangibles had no situs and the situs of mobile goods was at best uncertain).

The choice of law rules provided in new Article 9 are intended to make answering the question in which state to file (and in which state to search) easier. As we saw in Chapter 6 (Choice of Law), the "general rule" is that the law of the state where the debtor is located governs perfection and non-perfection. Consequently, under new section 9-301(1) the state in which to file (and search) normally is the state where the debtor is located.

Under new Article 9, the law of the state where the collateral is located (the situs rule) governs perfection and nonperfection of possessory security interests, new section 9-301(2), and security interests in real estate-related collateral. *See* new 9-301(3) and 9-301(4). Under new section 9-302 a location of the collateral rule also governs as to the jurisdiction in which to file an agricultural lien. New section 9-301(3)(C), providing that the law of the state where the collateral is located governs *the effect of* perfection and nonperfection as to nonpossessory security interests (as distinguished from perfection and nonperfection) pertains to priority rather than perfection as such. *See* Official Comment 7 to new 9-301.

A location of the debtor choice of law rule means there must also be rules for determining where a debtor is located. These rules are found in new section 9-307. The place to begin is new section 9-307(b). The location rules of former section 9-103(3)(d) turned on whether a debtor was in business or not and did not distinguish individual from organizational debtors.

By contrast, new Article 9 divides debtors into individual debtors and organizational debtors. Under new section 9-307(b)(1) an *individual* debtor is located at the debtor's principal place of residence. Therefore, the state in which to file as to a consumer debtor or an individual business debtor is the state of the debtor's principal residence.

Under new section 9-307(b)(2), an *organizational* debtor is located at its place of business if the organization has only one place of business. New section 9-307(a) defines "place of business" as "a place where a debtor conducts its affairs." Under new section 9-307(b)(3), an organizational debtor that has more than one place of business is located at its chief executive office.

As was true under former Article 9, "chief executive office" is not defined. Official Comment 2 to new section 9-307 indicates that the chief executive office is "the place where the debtor manages the main part of its business operations or other affairs."

General partnerships and various unincorporated entities fall within the general definition of "organization" found in Article 1, section 1-201(b)(25) (formerly Article 1, section 1-201(28)). Under the location of the debtor rules for organizations, a general partnership debtor doing business in one state is located at its place of business, but if the partnership has more than one place of business it is located at its chief executive office. *See* Official Comment 2 to new 9-503.

Corporations are included within the general definition of an organization in Article 1, section 1-201(b)(25), but new Article 9 specially defines a "registered organization" in new section 9-102(a)(70). The gist of the definition is that if an organizational entity must be registered to exist then it is a registered organization. Under the definition, limited partnerships and corporations are registered organizations.

New section 9-307(e) provides that "a registered organization that is organized under the law of a State is located in that State." Consequently, a financing statement filed against a corporate debtor should be made in the state of incorporation. Likewise, the place to file as to a limited partnership is the state where the partnership is organized. Under new section 9-307(f), new Article 9 defers to federal law to decide where a debtor organized under federal law is located.

Under new section 9-307(c), new section 9-307(b) applies only where a debtor's residence, place of business, or chief executive office, as applicable, is located in a jurisdiction whose law generally requires information concerning the existence of a nonpossessory security interest to be made generally available in a filing or other registration system as a condition of priority of the security interest over a lien creditor. Where this condition of applicability of new section 9-307(b) is not met, the debtor is located in the District of Columbia.

According to Official Comment 3 to new section 9-307, as to a debtor who is a foreign national located in another country it is not enough that the law of that country includes a filing or registration system. It must also be the case that under this generally applicable foreign law filing is necessary to perfect, *i.e.*, to get priority over a lien creditor. The law in many countries that have some form of filing or registration system, or which are moving to such systems, Mexico being a leading example, is likely to be less than clear on the matter of lien creditor priority. Consequently, a creditor may be well advised to file or record as required in the foreign country and also file in the District of Columbia.

It should be kept in mind that the new Article 9 rules that determine where a debtor is located, and more generally, the rules governing perfection and non-perfection of a security interest, are applicable only where the Uniform Commercial Code (UCC) governs a transaction. As explained in Chapter 6 (Choice of Law), in international transactions it is quite possible that the parties will choose the applicable law or the applicable law must be determined under choice of law rules and in either case it could happen that a law other than the UCC governs perfection and non-perfection (and other aspects of a transaction as well).

As noted earlier, security interests in real estate-related collateral often are subject to separate rules. Under new sections 9-301(3) and (4), a situs rule determines the law governing perfection and, hence, the place to file. Therefore, the state in which to file a "fixture filing" or to perfect a security interest in timber to be cut or minerals and other "as extracted " collateral is the state where the collateral is located. As also noted above, under new section 9-302 there also is a location of the collateral rule for agricultural liens.

Given that it sometimes can be difficult to choose the correct state in which to file, it would be natural for parties to attempt to make the choice in the security agreement. However, as noted in Chapter 6 (Choice of Law), for the most part, under the latest version of Article 1, section 1-301(c)(8) (formerly revised section 1-105(2)), parties may not choose the law governing perfection under Article 9.

2. Where in a State

As for *where* to file *in the state whose law governs*, the answer under former Article 9 depended on which of three alternatives to former section 9-401(1) had been adopted and further on whether the collateral involved required local or central filing. Local filing was done in the recorder's office of the county where the debtor was located. Local filing usually meant filing locally in the personal property records, but it also could mean filing in the real estate records. Central filing was filing in some central office, typically that of the Secretary of State.

New Article 9 works a significant change as to the rules governing the place to file within the state whose law governs. Under new section 9-501(a), central filing has become the general rule. The occasions for local filing are vastly more limited (although not any less important where required). Moreover, under new section 9-501(a)(1), local filing now means only filing in the real estate records in the office designated for the filing or recording of a mortgage.

Local filing is required to perfect security interests in "as extracted collateral," as defined in new section 9-102(a)(6), timber to be cut and security interests in fixtures IF the protection of a "fixture filing" is sought. *See* new 9-501(a)(1) and Chapter 20 (Perfection as to Fixtures and Other Real Estate-Related Collateral).

Under new section 9-501(a)(2), as to *all* other cases, including filings to perfect security interests in a fixture simply as goods (not a fixture filing) and timber that has already been cut, filing is central, meaning in a centrally-designated office, typically, the Office of the Secretary of State. *See, e.g.,* ARS 47-9501(A)(2). New section 9-501(a)(2) also requires central filing as to agricultural liens even though, as noted above, under new section 9-302 the jurisdiction in which to file is that where the collateral is located.

Specialized filing rules apply under new section 9-501(b) to security interests in the property of a transmitting utility. In Arizona, for example, a filing in such cases is to be made in the Office of the Secretary of State. ARS 47-9501(B).

There was a rule in former Article 9 that provided a degree of forgiveness to a creditor who filed in the wrong place. That rule was found in former section 9-401(2). Proper application of the rule was the subject of considerable debate. There appears to be no comparable rule in new Article 9. Perhaps it is assumed that under the new filing scheme such a rule will be unnecessary.

The following problems explore the basics of perfection by filing under Article 9.

Problem 13.1 (INTERACTIVE)

Sid Seller owns an appliance store in the City of Tucson, Pima County, Arizona. Betty Buyer resides in Tucson. Sid sells a new stereo system to Betty on credit. Betty buys the stereo for use in her home. The unpaid price of the stereo is secured by an interest in the stereo. For reasons that will be explored in Part VI, Sid prefers not to rely on automatic perfection.

In which state must Sid file to perfect the security interest in the stereo under new Article 9?

What language of new sections 9-301(1) and 9-307(b) supports your answer?

Where in the appropriate state should Sid file?

What language of new section 9-501(a)(2) supports your conclusion?

Problem 13.2 (INTERACTIVE)

Lisa Lender is a New York bank. Lisa lends to Donald Debtor who is in the business of manufacturing automobile parts. Donald is a sole proprietorship doing business exclusively in the City of Tucson, Pima County, Arizona. Donald also resides in Tucson. To secure the loan, Lisa takes a security interest in Donald's inventory of automobile parts and equipment used in manufacturing the parts.

In which state must Lisa file to perfect its security interest in Donald's inventory and equipment under new Article 9?

Where in the appropriate state must Lisa file to perfect its security interest in Donald's inventory and equipment under new Article 9?

Problem 13.3 (INTERACTIVE)

Suppose that the debtor in Problem 13.2 was an Arizona corporation, Donald’s, Inc., with its chief executive office located in Tucson, Arizona *and* that Donald’s is engaged in selling automobile parts in Arizona, California and New Mexico.

On the facts of Problem 13.2 changed to make the debtor an Arizona corporation selling automobile parts in Arizona, California and New Mexico with its chief executive office located in Tucson, Arizona, in which state must Lisa Lender file to perfect its security interest in Donald Inc.'s inventory under new Article 9?

What language of new section 9-307 supports your answer?

Problem 13.4 (INTERACTIVE)

Suppose the facts of Problem 13.2 as changed to make the debtor an Arizona corporation selling automobile parts in Arizona, California and New Mexico with it chief executive office in Tucson, Arizona, were further changed in that Lisa Lender's security interest was in accounts generated by the sale of automobile parts (rather than the inventory itself).

Where must Lisa file under new Article 9 if the collateral is accounts and the debtor, Donald's Inc., is an Arizona corporation with its chief executive office in Tucson, Arizona?

Problem 13.5 (INTERACTIVE)

Suppose the facts are that the debtor is a general partnership, Donald and Donald, doing business in Arizona, California and New Mexico, Donald and Donald's chief executive office is in San Diego, California, and Lisa Lender has a security interest in accounts generated by the sale of inventory in the three states.

Where would Lisa have to file under new Article 9 to perfect its security interest in the accounts?

Would the answer be the same if the collateral were inventory rather than accounts?

Would the answer change if Donald and Donald did business only in Arizona.

Could the parties specify the law governing perfection (the state in which to file) in their security agreement?"

Problem 13.6 (INTERACTIVE)

Sid Seller operates a retail store in Phoenix, Arizona. Sid sells to Betty Buyer supplies to be used in Betty's farming operations conducted on Betty's farm in Marana (Pima County), Arizona. Betty is an individual. The supplies are sold on credit. The unpaid price of the supplies is secured by an interest in the supplies.

How should the supplies be classified?

As we have seen, the usual place for filing as to ordinary goods and intangibles is in the state where the debtor is located and in the Secretary of State's Office. Does your determination as to how the supplies should be classified require a different place of filing under new Article 9?

Note that Sid in such circumstances could have an agricultural lien as defined in new section 9-102(a)(5). Agricultural liens are within the scope of *new* Article 9 under new section 9-109(a)(2). *See* Chapter 4 (Scope of Article 9).

Where must Sid file to perfect an agricultural lien? Would your answer be different if Betty resided in California?

Problem 13.7 (INTERACTIVE)

Second Bank, a New York bank, lends to Light It Up, Inc., a light bulb manufacturing business incorporated in Arizona and engaged in selling light bulbs exclusively in Arizona. To secure the loan Second Bank takes an interest in Light It Up's equipment, including a drill press in Light It Up's manufacturing plant in Tucson, Arizona. The drill press is attached to the floor of Light It Up's building in such a way as to give the holder of a real estate mortgage on the building an interest in the drill press (and, therefore, under new section 9-102(a)(41), the drill press is a fixture).

Will a filing in the Arizona Secretary of State's Office perfect the security interest in the equipment, including the drill press, under *new* Article 9?

As noted in the text, to gain whatever protection Article 9 provides against real estate parties Second Bank may wish to file a "fixture filing" (a specialized filing defined in new section 9-102(a)(40)). If Second Bank wishes to gain the additional protection of a fixture filing, where in Arizona should Second Bank file?

What section of new Article 9 governs the place to make a fixture filing within a state?

Would your answer to the question of where to file a fixture filing change if Light It Up's's building were located in San Diego, California? If so, how?

Problem 13.8 (INTERACTIVE)

Lisa Lender lends to Donald Debtor, an individual residing in Orange County, California, and takes a security interest in timber owned by Donald that is standing on land located on Mount Lemmon, in Pima County, Arizona. Lisa and Donald are aware that the timber will be cut and removed under a contract of conveyance.

In which state must Lisa file to perfect the security interest under new Article 9?

Where in Arizona must Lisa file?

Suppose the timber is a stand of virgin pine that there are no plans to remove? May Lisa perfect its security interest in the timber under Article 9?

What if the timber has already been cut when Lisa's security interest attaches. Where should Lisa file to perfect its security interest in the cut timber?

Problem 13.9 (INTERACTIVE)

Donna Debtor creates a security interest in favor of Ready Lender. Donna authenticates a security agreement describing the collateral as "Debtor's inventory and accounts, existing and thereafter acquired."

Does Ready Lender have authority to file a financing statement indicating that the collateral is "Debtor's inventory, accounts and equipment, existing and after-acquired"? Before answering the question you may wish to consult new section 9-509(b).

As noted in the text, a creditor should file as soon as possible (for reasons of priority) and new section 9-502(d) indicates that a financing statement may be filed before a security agreement has been authenticated. When would a filing made before a security agreement has been authenticated be authorized?

Problem 13.10 (INTERACTIVE)

Second Bank located in Tucson, Arizona is about to lend to Donald Debtor, an individual who resides and does solar electric installations in Rocky Point, in the State of Sonora, Mexico. To secure the loan, Donald has authenticated a security agreement giving Second Bank a security interest in Debtor's solar engineering equipment. The State of Sonora has recently implemented a registration system under which all nonpossessory security interests must be registered in a state registry in Hermasillo, Mexico, the capitol of the State of Sonora. Second Bank has registered its security interest in the registry in Hermasillo, Mexico.

Is Second Bank’s security interest perfected?

What action would you advise Second Bank to take?

Before answering these questions, you may wish to consult new section 9-307(c).

CASE COMMENTARY

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Part V Perfecting an Article 9 Security Interest

Chapter 14 The Nitty Gritty Of Filing

A. The Filing System and the Debtor's Name

1. How the System Works

Understanding the perfection by filing scheme requires knowing a fair amount about the filing system and how it actually works. In Chapter 13 (Overview of Perfection by Filing) we saw that Article 9 employs a notice filing scheme according to which third parties are given only enough notice to lead them to inquire further. It was explained in that chapter that new Article 9 further reduces the formal requirements regarding the contents of a financing statement.

Thus, under new section 9-502, a financing statement must contain only the debtor's name, the secured party's name and a description of the collateral. Even though a third party must go through the debtor to obtain the specifics of a security interest, *see* subpart D (1) below, the debtor's address is not required for a financing statement to be sufficient (although, as explained further in subpart C a filing officer is required to reject a financing statement that does not contain the debtor's address). We also saw in Chapter 13 that to facilitate electronic filing the debtor's signature is no longer required.

The debtor's name is the key to filing and searching under Article 9. The filing office assigns each financing statement a file number and indexes the statement using the debtor's name. A list of file numbers corresponding to any financing statements that have been filed against a debtor is indexed according to the debtor's name. A search under the debtor's name will lead a searcher to the financing statements indexed under that name. *See* new 9-519(c).[1]

To illustrate, where the correct name for a debtor is "John Smith" any financing statements using that name will be indexed alphabetically with the names beginning with "S." According to the proposition that searching is the flip side of filing, a searcher contemplating extending credit to this debtor should search (or request a search) under the name "Smith." Filing offices must have the capability for retrieving statements filed under the name "Smith."

Financing statements could be indexed otherwise than according to the debtor's name. For example, the secured party's name could be used instead of the debtor's. More interesting, as we will discover in Chapter 17 (Perfection as to Goods Subject to Certificate of Title Legislation), certificate of title legislation uses the vehicle identification number and the federal copyright office uses the description contained in a copyright registration.

For reasons that will appear in Chapter 20 (Perfection as to Fixtures and Other Real Estate-Related Collateral), certain real estate-related filings may be done using a record owner's name or the secured party's name or even a description of the real estate, *in* addition to the debtor's name. However, the debtor's name remains central to the Article 9 filing (and searching) scheme.[2]

For the system to work both the secured party and the searcher must use the same name. If the secured party uses one name and a searcher another the scheme will break down. As it happens, deciding upon the correct name can be more difficult than might be expected. Naming conventions produce complications that can be compounded by the relative ease with which a name can be changed. The name change issues are deferred until Chapter 23 (Continuing Perfection -- The Need to Reperfect (Or Refile)). Here it is important to come to grips with the reality that most persons, natural and artificial, have legal names and also may go by and be known to others by names that are not legal names.

2. Choosing the Correct Name for the Debtor

In the earlier example ("John Smith") it was assumed that the correct name to use on the financing statement was "Smith." But, why the last name? What effect does the first name have on the indexing? What if the debtor is a corporation and not an individual? What if the debtor is a business and uses a trade name? How are secured parties and searchers to know what to do? The answer to these questions is that there are rules for deciding which name is the debtor's correct name for purposes of the filing system.

Under former section 9-402(7), a financing statement sufficiently showed the name of the debtor if it gave the individual, partnership or corporate name of the debtor, whether or not it added trade names or the names of partners. New section 9-503 provides a more elaborate set of rules for determining the debtor's name.

a. Corporate and Other Organizational Debtors

New sections 9-503(a)(1), (a)(2) and (a)(3) deal with certain specifically identified organizational debtors, including especially debtors who are registered organizations. Under new section 9-503(a)(1), "a financing statement sufficiently provides the name of [a debtor who is a registered organization] *only if* the financing statement provides 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. [Emphasis added.]

"Jurisdiction of organization" is defined in new section 9-102(a)(50) to mean, with respect to a registered organization, the jurisdiction under whose law the organization is organized. Consequently, the name to use for a corporate debtor or a debtor who is a limited partnership or a limited liability company is the name appearing on the public record recognizing the creation of the debtor entity.

b. Trade Names

New sections 9-503(b) and (c) deal with the use of trade names. New section 9-503(b)(1), indicates that the use of a trade name does not render a financing statement ineffective. New section 9-503(c), more importantly, provides that a trade name is not sufficient. Together these sections adopt what had become the prevailing view under former Article 9 that a trade name is neither necessary nor sufficient although a trade name may be added without adverse effect. *See, e.g.*, *In re Wardcorp., Inc.*, 133 B.R. 210 (Bkcy S.D. Ind. 1990).

c. Individual Debtors

New section 9-503(a)(4) deals with individual debtors and with organizational debtors not covered in new sections 9-503(a)(1), (a)(2) or (a)(3). New section 9-503(a)(4)(B) acknowledges that certain debtors do not have names. However, it is difficult to imagine an individual debtor who has no name.

Under new section 9-503(a)(4)(A), if an individual debtor has a name the financing statement sufficiently shows the debtor's name only if the individual name is used. Thus, under new section 9-503(a)(4)(A) the name to use for a consumer debtor is the debtor's individual name. The same is true for a sole proprietorship.

The simple sounding rule governing what name to use for an individual is, however, more easily stated than applied. The difficulty is two-fold: An individual may use or be known by a name other than the individual's complete legal name including, a nickname; and, new section 9-503(a)(4)(A) gives precious little guidance as to when a financing statement sufficiently provides an individual debtor's name. *See* Warner, Using the Strong-Arm Power to Attack Name Errors Under Revised Article 9, American. Bankruptcy Institute J., Oct. 2001, at 22.

Under new section 9-506(c), dealt with more fully in subpart A (3) below, a financing statement is effective even though it fails sufficiently to provide the debtor's name if the financing statement would be disclosed under a search using the debtor's correct name. Consequently, the ultimate test of whether the name used in a financing statement is sufficient is whether the financing statement would turn up in a search under the debtor's correct name. But, that test requires deciding what is a debtor's correct name, i.e., the name required by new section 9-503(a).

The question as to an individual debtor is whether new section 9-503(a)(4)(A) requires the use of the debtor's legal name. This question was answered in the negative in the case of In re *Erwin*, 50 UCC Rep. Serv. 2d 933 (Bkcy D. Kan. 2003). In *Erwin*, a bankruptcy court, applying Kansas law, held that a financing statement using the name "Mike Erwin" was effective to perfect a security interest created by a debtor whose legal name was "Michael A. Erwin." Under this decision, a name other than the debtor's legal name sufficiently provides the name of an individual debtor within the meaning of new section 9-503(a)(4)(A).

The decision also means that the correct name for purposes of applying new section 9-506(c) can be a name other than the debtor's legal name, specifically, on the facts of *Erwin*, "Mike Erwin" (or perhaps some other variation on the debtor's legal name). The court acknowledged that the effect of its decision was to place on searching creditors the burden of coming up with a name or names that the debtor Michael A. Erwin might use or be known as.

The court in *Erwin* did not actually decide whether a financing statement that gave the debtor's name as "Michael A. Erwin" would sufficiently provide the debtor's name under new section 9-503(a)(4)(A), but its reasoning suggests that if such a financing statement would not be disclosed in a search under the name "Mike Erwin" then the financing statement would have failed to sufficiently provide the debtor's name.

What this means is that a filing creditor must decide that a name other than the debtor's legal name must be used (or whether it should file under multiple names in the hope that one of them will be sufficient). To this extent, although the *Erwin* decision on its face appears to shift the burden from the filing to the searching creditor this may not be so.

In direct contrast to In re *Erwin* is the decision in the case of In re *Kinderknecht*, 308

B.R. 71 (B.A.P. 10th Cir. 2004). There a bankruptcy appellate panel, also applying Kansas law, reversed a bankruptcy court decision that had agreed with Erwin and concluded that a financing statement using the name "Terry J. Kinderknecht" did not perfect a security interest created by a debtor named "Terrance Joseph Kinderknecht." For the *Kinderknecht* court, even though new section 9-503(a)(4)(A) does not expressly so require, only the debtor's legal name is sufficient to satisfy that section.

As the court notes, reading "individual name" as it appears in new section 9-503(a)(4)(A) to mean the debtor's legal name is consistent with new sections 9-503(b)(1) and (c) providing, as explained in subpart A (2)(b) above, that a trade name is neither necessary nor sufficient as to an organizational debtor. That reading also finds support in Official Comment 2 to new section 9-503 indicating that only one name should be sufficient and in the fact that the recommended (but not mandated) form in new section 9-521 requires the debtor's exact legal name.

Perhaps most importantly, as the court also notes, reading new section 9-503(a)(4)(A) to require that a financing statement filed against an individual debtor must give the debtor's legal name makes the task of deciding which name to use in a financing statement and under which name to conduct a search easier.

However, equating individual name with legal name does not make the decision as to which name to use quite as easy as the court in *Kinderknecht* suggests. In *Kinderknecht* that the debtor's legal name was "Terrance Joseph Kinderknecht" was not in dispute. That will not always be so, especially where new section 9-503(a)(4)(A) is understood to mandate the use of the debtor's legal name.

By contrast to a registered organization there is no uniformly agreed upon source for determining an individual's legal name. Although resorting to a debtor's birth certificate or passport or social security registration may not always be convenient, one or more of these documents may emerge as the authoritative source of an individual debtor's legal name.

There also will be the question whether the debtor's complete legal name is necessary or whether something less will suffice. Thus, "Terrance Kinderknecht" and "Terrance J. Kinderknecht" are not nicknames in the usual sense of that term but neither is what the parties in Kinderknecht agreed was the debtor's legal name. Should either or both nonetheless suffice to satisfy new section 9-503(a)(4)(A)? Given the relative frequency of the use of abbreviated names on bank accounts and other legal documents the answer arguably should be in the affirmative.

The importance of this last question is diminished somewhat by the fact, as noted earlier, that a financing statement that does not sufficiently provide the debtor's name may still be effective under new section 9-506(c). Thus, on the facts of *Kinderknecht*, the financing statement using the name "Terry Kinderknecht" would not have been disclosed by a search under the debtor's legal name. Therefore, the court did not have to decide whether the financing statement would have been effective if it would have turned up in a search using the debtor's legal name. As is explained more fully in subpart A (3) below, new section 9-506(c) should save a financing statement under those circumstances.

Of course, the central question for an Article 9 attorney is what creditors should be advised to do with regard to individual debtors in light the uncertainties associated with the meaning of the phrase sufficiently provides the debtor's name in new section 9-503(a)(4)(A). The not altogether satisfying answer to this question is that until the meaning of the section has been definitively clarified by the drafters of Article 9, individual state legislatures or the agencies charged with administering the filing systems, or the courts, the wisest course of action for a filing creditor is to use the debtor's full legal name, determined by reference to some authoritative document such as a birth certificate and also provide names that the debtor is known by or has used, such as a nickname.

As for searching parties, they also should use the debtor's legal name, again determined by reference to some authoritative document, and also have a search conducted using other names that the debtor may be known by as well. The extent to which a creditor, either as a filing or searching party, takes these precautions will depend on that creditors assessment of the need to do so given what is at stake. The greater the dollar amount involved the more cautious a creditor will wish to be.

d. Partnership Debtors

Certain organizational debtors, such as partnerships, may not have names. Under new section 9-503(a)(4)(B) if the debtor does *not* have a name the financing statement sufficiently shows the name of the debtor only if "the names of the partners, members, associates, or other persons comprising the debtor" are used. To illustrate, if a partnership does not have a name then the names of all the general partners must appear on the financing statement. New section 9-503(e) expressly provides that more than one debtor's name may appear on a financing statement (in which case the financing statement will be indexed under each name on the financing statement).

General partnerships may have names under assumed name or a partnership statute such as the Revised Uniform Partnership Act (RUPA). Where this is so then under new section 9-503(a)(4)(A) the partnership name should be used.

It should be noted that the fact that a general partnership has a name does not make it a registered organization to which the rule of new section 9-503(a)(1) would apply. As seen in Chapter 13 (Overview of Perfection by Filing), an organization is a "registered organization" only if the definition in new section 9-102(a)(70) is satisfied. For the most part, only limited partnerships and other such limited liability entities qualify as registered organizations. *See* Official Comment 2 to new 9-503. A limited partnership will have a name and as noted above under section 9-503(a)(1) it is that name that must be used in the financing statement.

e. Who Is the Debtor

The rules governing the name to use in a financing statement require knowing who is the debtor. It is that debtor's name that must appear on the financing statement. Ordinarily who the debtor is will be clear. But, as defined in new section 9-102(a)(28), a debtor is the person who owns the collateral. Consequently, the debtor may be someone other than the person who is the "obligor" (defined separately in new section 9-102(a)(59)) on the secured debt.

General partnerships can incur debts and own property and be debtors under Article 9. However, the general partners, who may be ultimately liable for partnership debts secured by partnership property, are not debtors as defined in new Article 9. Nonetheless, under new section 9-503(a)(4)(B), if the partnership does not have a name then the names of the general partners, who are not debtors under new Article 9, must appear on the financing statement.

In Chapters 8 (The Specifics of Enforceability -- A Security Agreement Authenticated by the Debtor or Its Equivalent) and 9 (The Specifics of Enforceability -- After-Acquired Property, Future Advances, Transferred Collateral and Proceeds and the New Debtor Problem), we saw that there can be similar difficulties deciding who is the debtor as the person who must authenticate a security agreement.

3. Errors in the Debtor's Name

It is necessary now to backtrack to the opening proposition that *both* filing and searching are done using the debtor's name. Suppose a creditor uses the required name but makes a mistake of some kind as to the name.

Under former section 9-402(8) a financing statement that substantially complied with the requirements of Article 9 was effective even though it contained minor errors so long as the errors were not seriously misleading. Technically, a creditor was protected under former section 9-402(8) only as to minor errors but that limitation received relatively little attention. Decisions interpreting former section 9-402(8) indicated that an error was seriously misleading if it was such as to prevent a searcher who conducted a proper search from discovering the financing statement.

New section 9-506 is the successor to former section 9-402(8). Under new section 9-506(a), a financing statement substantially satisfying the requirements of Part 5 (Filing) of new Article 9 is effective even if it has minor errors or omissions, unless the errors or omissions make the financing statement seriously misleading. New section 9-506(b) indicates that a financing statement that fails sufficiently to provide the name of the debtor as required by new section 9-503(a) is seriously misleading except as otherwise provided in new section 9-506(c).

Under new section 9-506(c) an error in the debtor's name is not be seriously misleading if, despite the error, the financing statement would be discovered in a search of the records of the filing office under the debtor's correct name, using the filing office's standard search procedures.

New section 9-506, by its terms, requires that a financing statement substantially comply with Part 5 and that the error be minor. However, insofar as the debtor's name is concerned, these requirements appear to be subsumed into the more general requirement that a financing statement not be seriously misleading. So, new section 9-506(c) is the key section with respect to errors as to the debtor's name and it will be helpful to quote the language of that provision. New section 9-506(c) provides:

> If a search of the records of the filing office under the debtor's correct name, using the filing office's standard search logic, if any, would disclose a financing statement that fails sufficiently to provide the name of the debtor in accordance with Section 9-503(a), the name provided does not make the financing statement seriously misleading.

By this language, a financing statement's effectiveness is to be tested by reference to the debtor's correct name, meaning the name that satisfies new section 9-503(a). Where the correct name of the debtor is clear, as would be the case as to a registered organization whose name appears on the public record, the application of new section 9-506(c) should be reasonably straightforward.

Thus, if there is an error in the debtor's name such that the financing statement does not sufficiently provide the debtor's name as required by new section 9-503(a), the financing statement is still effective to perfect a security interest created by the debtor if the financing statement would turn up in a search done under the debtor's correct name using the standard search procedure of the particular filing office.

For example, if debtor's legal name is Super Fine Products, Inc. and the financing statement uses the name Super Fin Products, Inc. the error in the name is harmless so long as the financing statement would be disclosed by a search conducted under the name Super Fine Products, Inc. using the standard search procedure of the particular office in which the filing was made.

The situation is less clear where the debtor's correct name is uncertain. As discussed in subpart A (2)(c), the problem is especially acute where individual debtors are concerned. The court in the case of In re *Kinderknecht*, 308 B.R. 71 (B.A.P. 10th Cir. 2004), explored in subpart A (2)(c), held that where a debtor is an individual the correct name is the debtor's legal name. Because the financing statement in that case did not use the debtor's legal name the financing statement failed to sufficiently provide the debtor's name as required by new section 9-503(a) as a matter of law.

The courts holding also meant that the financing statement could be saved by new section 9-506(c) only if a search under the debtor's legal name would disclose the financing statement. The evidence offered by the trustee in bankruptcy established that the financing statement did not show up in a search under the debtor's legal name in the particular filing office using that offices search procedures so the failure of the secured party to use the debtor's legal name could not be forgiven under new section 9-506(c).

The court in *Kinderknecht* was not faced with the question of whether the financing statement would have been effective if it would have been found using the debtor's legal name. New section 9-506(c) indicates that even if a financing statement does not sufficiently provide the debtor's name, *i.e.*, does not use the name required by new section 9-503(a), the financing statement can still be effective to perfect a security interest if a search under the correct name, using the search procedures of the particular filing office, would disclose the financing statement. Thus, in *Kinderknecht*, if the financing statement would have been found using the debtor's legal name then the financing statement would have been effective even though the financing statement did not give the debtor's legal name.

It is important to understand that *Kinderknecht* did not, and could not properly, decide that a financing statement that failed to use the debtor's legal name was fatally defective irrespective of whether it would have been found in a search done under the debtor's legal name. As is illustrated by the cases requiring the application of new section 9-506(c), the likelihood that a financing statement using a nickname or some other variant of the legal name will be found is diminished by the fact that most filing offices have been computerized and the search procedures of these offices may well not generate variations of the name given by the searching party such as will locate the financing statement. But, it certainly is conceivable that a financing statement that uses a name other than the debtor's legal name will turn up in a search done using the debtor's legal name.

It also should be understood that, as was explained in subpart A (2)(c), not all courts have held that individual name means the debtor's legal name. In the case of In re *Erwin*, 50 UCC Rep. Serv. 2d 933 (Bkcy D. Kan. 2003), also considered in subpart A (2)(c), it was held that a name other than the debtor's legal name, such as a nickname, can sufficiently provide an individual debtor's name. Where the language "sufficiently provides" is given such a meaning it is the name other than legal name that is the correct name for purposes of applying new section 9-506 and a financing statement giving the debtor this other name can be effective even though a search conducted under the debtor's legal name would not disclose the financing statement.

Even if courts were to agree that the correct name for an individual debtor is the debtor's legal name will suffice the difficulties of ascertaining that name and deciding whether something less than the complete legal name will suffice remain. These difficulties were considered in subpart A (2)(c). Of course, not all cases involving individual debtors will pose such difficulties.

In *Pankratz Implement Co. v. Citizen National Bank*, 33 Kan.App.2d 279 (Kan. App. 2004), for example, the court held that a financing statement giving the debtor's name as "Roger House" rather than the debtor's legal name of "Rodger House" did not sufficiently provide the debtor's name as required by new section 9-503(a)(4)(A). The decision turned on evidence that a search in the filing office where the financing statement was filed under the name Rodger House using the particular filing offices search procedures would not disclose the financing statement.

In determining that "Rodger House" and not "Roger House" was the correct name to use in applying new section 9-506(c) the court relied on the decision in *Kinderknecht* that the debtor's legal name is required as to an individual debtor. However, *Pankratz* was not a case involving the use of a nickname or some variation on the debtor's legal name. Rather, the secured party had attempted to use a name that would have satisfied the legal name requirement and then misspelled the name. The new section 9-506(c) question was whether the financing statement containing the misspelled debtor's name would be found in a search under the name correctly spelled and the evidence established that it would not.

On appeal to the Kansas Supreme Court, the secured party in *Pankratz* argued that there was only a minor error in the name and that there was no need to test the name used under new section 9-506(c). In *Pankratz Implement Company v. Citizens National Bank*, 130 P.3d 57 (Kan. 2006) the court rejected the argument, concluding that under 9-506(b) an error in the debtor's name is seriously misleading essentially as a matter of law and the filing can be saved only if the financing statement would be disclosed in a search employing the standard search logic of the particular filing office using the correct name as provided for in new section 9-506(c).

In its opinion the court emphasized that standard search logic as used in new section 9-506(c) means the formal search logic of the particular office and does not include any alternative searching process that the filing office might provide, for example, during a transition from former Article 9 to new Article, or that might be available through sources other than the particular filing office.

New section 9-506(d) makes clear that the correct name for the debtor in new debtor situations is the name of the new debtor. As explained in Chapter 9 (The Specifics of Enforceability -- After-acquired Collateral, Future Advances, Transferred Collateral and Proceeds, and the New Debtor Problem), under new section 9-102(a)(56), a "new debtor" is a person who becomes bound as a debtor under a security agreement executed by another person.

It is worth noting that although information such as the debtor's address would aid searchers in determining whether a party to which the searcher is contemplating extending credit is or is not the debtor named in a financing statement turned up in a search, under new Article 9 a financing statement need not include the debtor's name to be sufficient under new sections 9-502 or 9-503.

The next several problems illustrate the basic rules governing the requirement that a financing statement provide the debtor's name.

Problem 14.1 (INTERACTIVE)

An individual whose name as it appears on her birth certificate is "Donna Joann Smith." owns and operates a business as a sole proprietorship. Donna does business under the name "Donna's Desert Treasures." Donna is known to her customers and to many of her suppliers as Donna Smith. She maintains a bank account for personal and business use under the name Donna J. Smith.

What name does new section 9-504(a)(4)(A) require be used in a financing statement under new

Article 9?

What name would you advise a secured party to use in the financing statement on the facts of Problem 14.1? Donna Smith? "Donna's Desert Treasures"? Donna's legal name? Explain.

So, what is Donna's legal name? "Donna Smith"? "Donna's Desert Treasures"? Explain.

Under what name should a potential lender conduct a search on the facts of Problem 14.1?

How would the financing statement be indexed (under what letter)?

Problem 14.2 (INTERACTIVE)

Assume the facts of Problem 14.1, but assume further that Donna Smith, a sole proprietor in Problem 14.1, has incorporated her business under the name "Donna's Desert Treasures, Inc."

What name is a secured party be required to use in the financing statement under new Article 9?

What language of new section 9-503 supports your conclusion?

What name should a lender search under (or request a search under)?

Where do you find the correct name for a corporation (or least confirm it)?

What if the corporate name is "Desert Treasures, Inc." and the corporation does business under the name "Donna's Desert Treasures"? This might happen, for example, if Donna Smith, the sole proprietor, were bought out by a corporation called "Desert Treasures, Inc." What name should be used in the financing statement under this change of facts?

Would the financing statement be indexed in the Ds or Ts?

Problem 14.3 (INTERACTIVE)

Donna Smith in Problem 14.1 recently took on a partner, Jane Jones. The partnership does not have a name but continues to do business as "Donna's Dessert Treasures." What name (or names) should appear on the financing statement under new Article 9? What name should be used in the financing statement if Donna and Jane had filed a statement of partnership authority under the section of the RUPA set out below?

§ 29-1023. Statement of partnership authority

A. A partnership may file a statement of partnership authority that:

1. Shall include:

(a) The name of the partnership.

(b) The street address of its chief executive office and of one office in this state, if there is one.

(c) The names and mailing addresses of all of the partners or of an agent appointed and maintained by

the partnership for the purpose of subsection B of this section.

(d) The names of the partners authorized to execute an instrument transferring real property held in the name of the partnership.

Problem 14.4 (INTERACTIVE)

Donna Smith, Joe Jones, and Mary Brown are engaged in a joint land development venture but they have never registered as a partnership or other legal entity.

What name or names do you use on the financing statement? Under what name or names should a potential lender search?

Problem 14.5 (INTERACTIVE)

Jane Jones, an individual, purchases property on credit and gives the creditor an interest in the property to secure its unpaid price. Jane's close friend, Donna Smith, cosigns the debt instrument.

Who is the debtor for purposes of deciding what name to use in the space for the debtor's name on the financing statement?

Problem 14.6 (INTERACTIVE)

Jane Jones operates a technology consulting business out of her home. She has incorporated her business under the name "J & J, Inc." Jane purchases a computer from Selma Seller on credit secured by an interest in the computer.

What name should you use on the financing statement?

On what does the decision as to what name to use in the financing statement depend?

Suppose, as is likely, that the J & J, Inc. is buying the computer. What name should Selma use on the financing statement?

What name should Selma use if Jane Jones is acquiring the computer for use by J & J, Inc.?

Suppose Jane bought the computer for personal use in her home. What name should Selma use now?

What name should Selma use if Jane Jones were a sole proprietorship acquiring the computer for use in her business?

Problem 14.7 (INTERACTIVE)

Wilma Wife purchases a stereo system from Dan Dealer on credit and Dan takes an interest in the system to secure the unpaid purchase price. Wilma then gives the stereo to Harvey Husband as a gift. Whose name should appear on the financing statement?

Suppose Wilma simultaneously purchases the stereo and executes a deed of gift to Harvey.

Whose name should appear on the financing statement? Who should sign or otherwise authenticate the security agreement? What would you advise?

Suppose the facts are that Wilma Wife purchases a stereo in a community property state such as Arizona (putting aside any simultaneous or subsequent transfer to Harvey Husband). What name (or names) should be used on the financial statement?

Whose name should go on the financing statement if Wilma acquires the stereo as separate property and gifts the stereo to Harvey?

Problem 14.8 (INTERACTIVE)

Second Bank lends to Donna Smythe, a sole proprietorship doing business as "Donna's Desert Treasures." Donna Smythe signs a security agreement giving Bank an enforceable security interest in Donna Smythe's equipment. Second Bank submits a financing statement showing the debtor's name as "Donna Smith." The filing office indexes the statement under the name on the financing statement.

Is Second Bank's security interest perfected under new Article 9? Please explain your answer.

As earlier noted, as to an individual debtor, the debtor's last name is used for indexing a financing statement. Consequently, a financing statement must make clear which is the last and which is the first name. New section 9-516(b)(3)(C) indicates what *should* happen if there is uncertainty as to which is the first and which is the last name.

You may consider the matter further and apply new section 9-516(b)(3)(C) in the next problem.

Problem 14.9 (INTERACTIVE)

Second Bank lends to John Paul and obtains an enforceable security interest. The financing statement submitted by Second Bank does not make clear which is the debtor's first name and which is the last.

What happens now?

The proper question is what *should* happen given that the financing statement fails to indicate which is the first and which is the last name. What answer is given by new section 9-516(b)(3)(C)?

B. Information In Addition to the Debtor's Name

1. Generally

In Chapter 13 (Overview of Perfection by Filing) we saw that under new section 9-502(a), in addition to the debtor's name, a financing statement must provide the secured party's name and indicate the collateral covered by the financing statement. Keep in mind the observation made earlier that the filing system reflects an attempt to balance the obligations (and hence burdens) imposed on filing parties and the information available to searching parties and what action it takes to get the information.

An additional reality is explored here, namely, the burdens imposed on parties who have properly filed to respond to inquiries from searching parties. For reasons that probably are apparent, a description of the collateral probably is the most important information in addition to the debtor's name that must be included in a financing statement.

2. Indication of the Collateral

At first glance there would seem to be no mystery about why a description is required. How else would a potential lender know what is subject to a perfected security interest? But, recall that Article 9 employs a "notice filing " scheme. Under that scheme searchers are only put on inquiry notice that another party *may* have a security interest in property the searcher is considering as collateral.

Consequently, Article 9 does not require a description that allows a potential creditor (or a court) to know with precision what is subject to a claimed security interest and a perfected one at that. To this extent the description of the collateral in the financing statement need not be as precise as that required for a security agreement.

Former sections 9-402(1) and (3) essentially required a description of collateral by item or type. A description by type employed the classification of collateral that emerged from former sections 9-105, 9-106, 9-109. Thus, a financing statement might describe intangible collateral as "accounts," as defined in former section 9-106, or goods as "equipment" as defined in former section 9-109(2). A description "by item" was a description of a specific item (or items) of property, for example, by serial number.

As noted in Chapter 8 (The Specifics of Enforceability -- A Security Agreement Authenticated by the Debtor or Its Equivalent), in simple situations, especially those involving one or two items, a description by specific item in both the security agreement and the financing statement was both practicable and desirable. Even though the clear intent of the notice filing scheme employed by former Article 9 was that descriptions in financing statements need only put a searcher on inquiry notice, the requirement that a financing statement describe collateral by item or type occasionally caused problems as to descriptions that were quite specific but technically were not by item or type. *See In re Cilek*, 115 B.R. 974 (Bkcy W.D. Wis. 1990) (concluding that a describing collateral as all the motorcycles of a specified brand financed by the creditor was not sufficient).

New section 9-502(a)(3) provides that a financing statement is sufficient only if it "indicates the collateral covered by the financing statement." The section thereby eliminates the "by item or type " requirement of former section 9-402. Of course, except as explained below, the new provision does not bar the use of such descriptions in a financing statement.

New section 9-504 adds two of what the drafters refer to as "safe harbors" to the description requirement. *See* Official Comment 2 to 9-504. The first such safe harbor is that new section 9-504(1) incorporates new section 9-108. We examined new section 9-108 as it affects the adequacy of descriptions in security agreements in Chapter 8 (The Specifics of Enforceability A Security Agreement Authenticated by the Debtor or Its Equivalent). We there noted that the gist of new section 9-108(b) is that a description is adequate to the extent that it permits an objective determination of the property subject to the security interest.

New section 9-108 specifically authorizes the use of descriptions by item and also, except in certain consumer situations and as to commercial tort claims, descriptions by type. *See* new 9-108(b)(3) and 9-108(e) and Chapter 8 (The Specifics of Enforceability A Security Agreement Authenticated by the Debtor or Its Equivalent) and Official Comment 5 to 9-108. Thus, under new section 9-504(1) an "indication" of collateral that satisfies the "description" requirement of new section 9-108 is sufficient under new section 9-502(a)(3).

However, something less than is necessary to satisfy the description requirement of new section 9-108 may be sufficient as an "indication" of the collateral. In particular, new section 9-108(c) bars the use in security agreements of super generic descriptions such as all the debtor's personal property" or "all the debtor's assets." But, under new section 9-504(2) such super generic descriptions are explicitly authorized for a financing statement. This is the other intended safe harbor.

Interestingly, new section 9-504 read together with new section 9-108(e) appears to leave open the possibility that a description by type in a financing statement of consumer goods or investment property would not be sufficient in a consumer transaction. Thus, new section 9-504(2) supercedes the super generic description limitation in new section 9-108(c), but it otherwise incorporates new section 9-108, including the limitation on descriptions by type as to consumer goods and investment property in consumer transactions, without qualification. The same problem may exist as to a commercial tort claim, as defined in new section 9-102(a)(13) because of new section 9-108(e)(1) under which a description of such collateral by type is not sufficient. *See* Official Comment 5 to 9-108.

You may explore the indication of the collateral requirement in new sections 9-502(a)(3) and 9-504 in the next two problems.

Problem 14.10 (INTERACTIVE)

Dan Debtor is a retailer of motorcycles. Ready Lender finances a substantial part of Dan's inventory. Dan sells several brands of motorcycles. Ready finances only motorcycles acquired from Honda. Ready files a financing statement describing the collateral as "all Honda motorcycles for which Ready Lender provides financing."

Is Ready's security interest perfected under *former* Article 9? Would the security interest be perfected under *new* Article 9?

Problem 14.11 (INTERACTIVE)

Southwestern Bank lends to Delia Debtor to finance a personal vacation. Southwestern takes a security interest in Delia's stereo system used in Delia's home. Delia signs a security agreement describing the stereo system by make, model and serial number. Southwestern files a financing statement describing the collateral as "Consumer Goods."

Is Southwestern 's security interest in the stereo system perfected under *new* Article 9? Before answering you should consult not only new section 9-504 but also new sections 9-102(a)(26) and 9-108(e)(2).

Suppose the financing statement described the collateral as "all Debtor's personal property." Is the security in the stereo system perfected under *new* Article 9?

Even though a financing statement is not required by new section 9-502 to contain the debtor's address, as is explained in subpart C below, a filing officer is supposed to reject a financing statement that does not contain the debtor's address and secured parties should, and routinely will, include the debtor's address (and that of the secured party as well) in any filing. Where the debtor has more than one address, for example, where an individual debtor owns a business, the question could arise as to which address should be included in the financing statement.

The answer lies in the reason for including the debtor's address, namely, to allow a third party to obtain the specifics of a security interest. As explained in subpart D (1) below, a third party cannot go directly to a creditor who has filed a financing statement for information, but must go through the debtor. Consequently, any address at which a third party may contact the debtor for the purpose of getting specifics should be sufficient.

Because the debtor's address is required only to allow searchers to seek details regarding a secured transaction, the debtor's address is not necessary to a sufficient indication of the collateral under new sections 9-108 and 9-504. In *In re Grabowski*, 277 BR 388 (Bkcy S.D. Ill 2002), for example, a creditor challenged an earlier filed financing statement on the ground that the statement gave the address of the debtor's farm equipment business rather than the debtor's residence address where it engaged in a farming operation and kept a farming equipment that was claimed both by the creditor raising the challenge and the creditor who had filed earlier.

The argument of the creditor making the challenge was that by giving the debtor's business address, the earlier filed creditor had not sufficiently described the farming equipment and had misled searchers because they reasonably could believe the equipment covered by the financing statement was only that used in the debtor's farm equipment business and not its farming operation. The challenge was rejected because the debtor's address was not a required part of the description of the collateral, the very general description of the collateral contained in the financing statement satisfied new section 9-504(2) (authorizing super-generic descriptions that would not pass muster in a security agreement), the debtor's business address was included only to enable third parties to contact the debtor and the debtor could in fact be contacted at the business address regarding farm equipment used in the debtor's farming operation.

A word of caution is in order. It is not uncommon to use the location of the collateral in describing the collateral in the *security agreement*. If a security agreement describes the collateral as that located at the debtor's address, then the debtor's address could limit what is covered by the security interest. Moreover, if a financing statement uses the debtor's address to describe the collateral it is at least arguable that this presents a different situation than that in *Grabowski*, *supra*, and that the security interest is perfected only as to collateral located at that address.

Two closing thoughts about descriptions in financing statements are in order. Despite the breadth of the authorization found in new Article 9, a financing statement that indicates property to which a security interest has not attached cannot perfect a security interest in that property. *See* Official Comment 2 to new 9-504. Moreover, as noted in Chapter 13 (Overview of Perfection by Filing), new section 9-509(b) to the contrary notwithstanding, authentication of a security agreement describing the collateral in relatively narrow terms, arguably, does not authorize the filing of a financing statement indicating the collateral in very broad terms, including the use of a super-generic description.

The next problem illustrates these final points.

Problem 14.12 (INTERACTIVE)

Northeastern Bank lends to Dan Debtor and takes a security interest in Dan's inventory, existing and after-acquired. The security agreement describes the collateral as "all Honda motorcycles for which financing is provided by Northeastern Bank." Northeastern files a financing statement covering "all Debtor's inventory, existing and after-acquired."

Does Northeastern have a perfected security interest in Dan's inventory of Yamaha motorcycles?

Should the "composite document" doctrine aid the Northeastern here?

Was Northeastern authorized to file the financing statement covering all of Dan's inventory?

3. Name of the Secured Party or a Representative of the Secured Party

Former section 9-402(1) required that a financing statement contain the name of the secured party and an address of the secured party from which information concerning the security interest could be obtained. New section 9-502(a)(2) requires the name of the secured party (or a representative) but under this section no address need be provided.

One might think the point of naming the secured party is to allow searchers who are only put on inquiry notice by a financing statement to seek further information from the secured party. That is certainly the impression created by former section 9-402(1). Such is not the case, however.

As will be seen in subpart C below, the failure to include the address of the secured party in the financing statement will justify a rejection of the statement by a filing officer. *See* new 9-516(b)(4). But, under new Article 9, the inclusion of the address of the secured party is not aimed at facilitating further inquiry by creditors who learn of the filing. Rather, as is explained in subpart D below, Article 9 does not contemplate direct inquiry by a searcher to a secured party and the reason for the address of the secured party is that it enables other creditors to send to the secured party notification required by certain priority rules.

So, what then is the purpose of requiring the name of the secured party in a financing statement? The answer seems to be that being named as the secured party in a financing statement confers certain rights and imposes specific responsibilities. New Article 9 is somewhat clearer on this point insofar as it refers to a "secured party of record." *See* new section 9-511. The rights and duties of a secured party of record are considered in later chapters.

C. When a Filing is Effective

As was generally true under former section 9-403(1), under new section 9-516(a) "communication of a record to a filing officer and tender of the filing fee or acceptance of the record by the filing office constitutes filing." However, this general rule is subject to important qualifications. The starting place is new section 9-520(a) under which a filing office must refuse to accept a filing that is defective under new section 9-516(b) but must accept a filing that is not defective under new section 9-516(b). Despite this statement of what should happen a filing may be rejected when it should be accepted and may be accepted when it should be rejected. There must be rules for dealing with these variations of what should happen.

To begin with a filing can be effective only if it satisfies new section 9-502, including especially a correct name for the debtor. To illustrate, suppose a corporate debtor whose name is "Desert Solar, Inc." and who does business under the name "Super Solar," borrows from First Bank and gives First Bank a security interest in its inventory, existing and after-acquired, to secure the loan. Suppose further that First Bank submits a financing statement that is otherwise complete and proper under new section 9-502 but uses as the name for debtor "Super Solar, Inc." Whether the financing statement is accepted or rejected it is not effective to perfect First Bank's security interest because "Super Solar, Inc." is not the correct name for Desert Solar, Inc. under new section 9-503(a)(1) (and most likely would not be saved under new section 9-506(c)).

Suppose, however, that First Bank submits a financing statement that uses the correct name for the debtor, "Desert Solar, Inc.," but fails to include a mailing address for the debtor. The financing statement satisfies new section 9-502, but it is defective under new section 9-516(b), specifically, new section 9-516(b)(5)(A), which requires a mailing address for the debtor. Under new section 9-520(a) the filing office should reject the financing statement. If the filing office does reject the financing statement, the rejection is proper and under new section 9-516(b) "a filing does not occur with respect to a record that a filing office refuses to accept because [of a reason stated in new section 9-516(b)]."

If the filing office accepts the financing statement even though it should have been rejected the filing is effective under new section 9-520(c), which provides that "a filed financing statement satisfying Section 9-502(a) and (b) is effective, even if the filing office is required to refuse to accept it for filing under [new section 9-520(a)]." So, First Bank's financing statement, which uses the correct name for the debtor but fails to include the debtor's mailing address is effective to perfect First Bank's security interest (and, as will be seen further in Chapter 26 (Secured Party Versus Lien Creditor; Future Advances; Bankruptcy)) protects First Bank against a trustee in bankruptcy.

There is an exception to the rule that a financing statement that was accepted even though it should have been rejected is effective if it satisfies new section 9-502, namely, that new section 9-338 applies where the financing statement provides information that is *incorrect* under new section 9-516(b)(5), but that exception does not apply where, as is hypothesized, the financing statement is missing an address for the debtor rather than that it contains an incorrect mailing address for the debtor. *See* Official Comment 2 to new 9-520.

Suppose, however, that the financing statement submitted by First Bank uses the correct name for the debtor and provides a mailing address for the debtor, and is otherwise complete, but the mailing address is incorrect. In such a case, the financing statement is *not* defective under new section 9-516(b)(5) and the filing office is obligated to accept the financing statement. More than likely the financing statement will be accepted because there is no reason why the filing office would know the mailing address is incorrect and the filing office has no obligation to verify such information. *See* Official Comment 3 to new 9-516 and Official Comment 2 to new 9-520. As noted above, under new section 9-520(c) a filed financing statement that satisfies new section 9-502 is effective (even if the financing statement should have been rejected).

However, a financing statement that contains information required by new section 9-516(b)(5) that is incorrect could mislead a searching party and the exception to the general rule in new section 9-520(c) referred to above can apply. Suppose, for example, that a party, Ready Lender, does a search using the name "Desert Solar, Inc."

and it finds the financing statement filed by First Bank. Suppose further that Ready Lender concludes because of the incorrect mailing address that the debtor named in the financing statement is not Desert Solar, Inc. and lends to Desert Solar. If Ready Lender's actions are reasonable then Ready Lender is protected (can have priority over First Bank) under new section 9-338, according to which "a security interest or agricultural lien [that] is perfected by a filed financing statement providing information described in Section 9-512(b)(5) which is incorrect at the time the financing statement is filed: (1) . . . is subordinate to a conflicting security interest in the collateral to the extent that the holder of the security interest gives value in reasonable reliance upon the incorrect information."

That Ready Lender's actions could be seen as reasonable may seem a stretch, but as explained in Official Comment 3 to new section 9-520 the requirement of a mailing address for a debtor is intended to assist the searching party to weed out "false positives" by eliminating debtors who are not the one to whom the searcher wishes to extend credit. On the other hand, Official Comment 2 to new section 9-338 indicates that situations where a purchaser is protected by new section 9-338 are likely to be rare.

In the unlikely event that a filing office *rejects* the financing statement submitted by First Bank the rejection is wrongful because there was no ground for rejection under new section 9-516(b). However, the filing is effective under new section 9-516(d), providing that "a record that is communicated to the filing office with the tender of the filing fee, but which the filing office refuses to accept for a reason *other than* one set forth in [new section 9-516(b)]" [emphasis added] the filing is effective.

Once again, there is an exception for reliance purchasers. Specifically, new section 9-516(d) states that a filing that is effective even though it was wrongfully rejected is not effective "as against a purchaser of the collateral which gives value in reasonable reliance upon the absence of the record from the files." For example, if the financing statement submitted by First Bank did not show up in a proper search by a party Ready Lender who then lends to Desert Solar in reasonable reliance on the absence of the financing statement from the system then the financing statement would not be effective against Ready Lender.

The exception to new section 9-520c for accepted filings and that in new section 9-516(d) for wrongfully rejected filings require that a purchaser have done a proper search. *See* Official Comment 2 to new 9-338 and Official Comment 3 to new 9-516. Moreover, the general rules of both new sections 9-520(c) and 9-516(d) are that the filings are effective to perfect a security interest and protect the filing party against a trustee in bankruptcy (who is not a purchaser).

The foregoing rules tend to favor the filing party but many of the difficulties that give rise to the problems the rules address can be avoided if the filing party uses care to be sure that required information is included and is accurate. Moreover, the filing party can respond to wrongful rejections in that the filing office is obligated to notify the filing party of a rejection. There is one case where such care by the secured party is not an answer. It can happen that a party submits a financing statement that uses the correct name for the debtor and is otherwise complete under new section 9-502 and does *not* omit information required by new section 9-516(b) and does not provide information required by new section 9-516(b)(5) that is incorrect but the filing office misfiles (incorrectly indexes) the financing statement.

New section 9-517 provides that such a filing is effective. In so doing Article 9 has placed the risk of a mistake by the filing office on the searching party even though as between the filing party and the searching party the latter is in a better position to detect such a mistake by following up to be sure the filing was accepted and correctly indexed. Of course, even though new section 9-517 favors the filing party it is good practice to follow up a submission and not rely on the Article 9 allocation of risk to protect the filing party's interest.

The operation of new sections 9-520(a) and (c) and 9-516(a), (b) and (d) and their interaction with new sections 9-502 and 9-506 may be explored in the next two problems.

Problem 14.13 (INTERACTIVE)

Western Bank lends to Widget Corp., Inc., a widget manufacturer incorporated in Arizona. Widget Corp. is doing business as "Super Widgets." Western obtains a security interest in Widget Corp.'s inventory of widgets, existing and later acquired. Western presents for filing a financing statement that names the debtor as "Super Widgets, Inc." The financing statement is otherwise complete and proper.

If the financing statement is *rejected* (which is unlikely, right?) is the financing statement effective?

If Western Bank's filing were *accepted* (which is more likely since a filing office would not know the correct name), would it be effective?

If the financing statement was accepted and the day after the financing statement was submitted by Western Bank, Widget Corp., Inc. filed for bankruptcy would Western Bank be perfected (and protected against the trustee in bankruptcy)?

Problem 14.14 (INTERACTIVE)

Assume the facts of Problem 14.13. Assume further that the name used in the financing statement is "Widget Corp., Inc." but there is no mailing address for the debtor.

If the filing is tendered with the required filing fee and is accepted is the filing effective to perfect Western Bank's security interest?

If the financing statement is rejected is it nonetheless effective?

Suppose that the financing statement contains a mailing address for the debtor but the address is incorrect. If Western's filing is rejected is it effective as against Friendly Finance Company who conducted a proper search under the name "Widget Corp., Inc."?

Assume again that Western Bank submitted a financing statement using as the debtor's name "Widget Corp., Inc." and the financing statement provided a mailing address for the debtor, but the address is incorrect. Assume further that the financing statement is accepted for filing and the financing statement was disclosed to Friendly Finance who then lent to Widget Corp., Inc. Could Western Bank (who as will be seen in Part VI has priority under a first-to-file priority rule), end up being subordinated to Friendly Finance?

Is the financing statement containing an incorrect mailing address for the debtor effective to protect Western Bank against a trustee in bankruptcy?

Is the financing statement containing an incorrect mailing address for the debtor effective to protect Western against Ready if the financing statement is *rejected*?

Suppose finally that Western Bank submits a financing statement using as the debtor's name "Widget Corp., Inc." and containing a correct mailing address for the debtor, but the filing office indexes the filing under the name "Super Widgets, Inc. " Is the filing effective to achieve perfection and protect Western Bank against Friendly Finance who does a search under the name "Widget Corp., Inc." and then lends to Widget Corp., Inc. in reliance on the absence from the filing system of the financing statement filed by Western Bank?

The difficulties associated with rejections and acceptances just considered were compounded under former Article 9 because filing officers were under no specific obligation to make their decisions known in a timely fashion. As noted earlier, new article 9 speaks to this problem in new section 9-520(b) by requiring a filing office to notify a filing party of any rejection and the reason for the rejection within two business days after the filing office receives the financing statement.

Section 9-519(h) more generally imposes a similar two-day time limit on the performance of all responsibilities regarding filing, indexing and searching and reporting information to searchers. This limitation may help alleviate the difficulty created by the fact that a financing statement is effective when communicated to the filing office but may not show up in a search for some time. The lag time, sometimes referred to as the basket phenomenon, should be less of a problem under new Article 9 because of the time limits imposed by new sections 9-520(b) and 9-519(h).

However, the difficulties for filers and searchers created by delays in action by filing officers and by the basket phenomenon have not been eliminated. Noticeably absent from either section 9-520(b) or 9-519(h) is provision for a remedy for injury caused by failures of filing officers to act within the prescribed time limits. New section 9-524 excuses certain delays by a filing officer, but does not indicate what remedy exists for an unexcused delay.

The immediate question for a creditor (or you as an advisor thereto) is how a creditor can best assure that it will not unknowingly extend credit when there is an earlier filed financing statement covering the collateral in which the creditor contemplates taking a security interest. This question is explored in the next problem.

Problem 14.15 (INTERACTIVE)

Eastern Bank is lending Delia Debtor $20,000 and has been given a security interest in Delia's inventory. If nothing else has happened would you advise Eastern it is safe to close today and disburse the loan funds?

Is there action that Eastern (or you on behalf of Eastern) should take the results of which would assist Eastern in knowing when it is safe to disburse the loan funds? Explain.

Could such action have been taken early enough to permit Eastern to close and disburse the loan funds today?

Are the answers to the questions about when it is safe for Eastern to disburse funds clearer under new Article 9 than they would have been under former Article 9?

You should be aware of the fact that an earlier filed financing statement shows up in a properly conducted search does not mean your client cannot close a secured credit deal. There are ways to "undo" the priority (including obtaining a termination of the earlier filing or a subordination agreement) and in a proper case there may be enough collateral to assure satisfaction of your client's claim even if it has a lower priority than that of another party. These possibilities are considered in Part VI.

D. The Incompleteness of the Filing System and What It Means to Creditors

In subpart C we considered several ways in which the Article 9 filing system might be viewed as being incomplete. The problem of the "basket phenomenon," which as explained above has been addressed in new Article 9 but not entirely obviated, is one illustration. The fact that financing statements can be effective even if they are rejected for filing or are accepted even though they defective in a way that should have led to a rejection obviously can cause problems for searching creditors. But, perhaps the most telling incompleteness is one that results from the nature of the notice filing system itself.

1. Incompleteness Attributable to the Notice Filing Scheme

Under the "notice filing" scheme, the required public record need only put third parties on notice that they may be at risk and must make further inquiry. However, Article 9 does not contemplate that third parties should go directly to a secured party for information needed to fully assess the risk. As we saw, the secured party's address is not required for a financing statement to be effective and the absence of the secured party's address is a basis for rejection by a filing officer only because such information is needed to allow a new creditor to send notification required by certain special priority rules.

The question then is just how does a third party obtain complete information. The short answer is that third parties must make requests for information through the debtor. New section 9-210 provides the particulars of this scheme of indirectness. New section 9-210 is long and involved. It is best understood by thinking through its application to specific situations.

You can get a sense of the basics of the scheme by considering the next problem.

Problem 14.16 (INTERACTIVE)

Your client, Southwestern Bank, is considering lending to Dan Debtor and taking an interest in a valuable drill press that Dan has offered as collateral.

What is the first step Southwestern should take under *new* Article 9?

Suppose an otherwise complete financing statement describing the collateral as "Debtor's equipment, existing and after-acquired" shows up in a search. Now what? Explain by reference to new section 9-210.

As will be explored in Chapter 38 (Remedies for a Secured Party's Failure to Comply with Article 9), a third party has only that recourse for failure of a secured party to comply with a proper request for information as is spelled out in new section 9-625, including damages.

2. Other Ways In Which the System is Incomplete

There are other respects in which the filing system might be viewed as being incomplete. For example, the filing system does not reveal whether pro-offered collateral actually exists. Nor does it assure a creditor that the collateral is not in the possession of another creditor who has perfected by taking possession, *see* Chapter 15 (Perfection by Possession (Including Documents of Title)), or automatically, *see* Chapter 18 (Perfection by Doing Nothing -- Automatic Perfection), or whether a security interest perfected outside Article 9 (pursuant to a certificate of title law, Chapter 17 (Perfection as to Goods Subject to Certificate of Title Legislation), or federal law, Chapter 19 (Perfection Pursuant to Federal Law)) exists. Consequently, a creditor should confirm that the collateral exists and is not in the possession of another creditor.

Where automatic perfection is a possibility (explained in Chapter 18 (Perfection by Doing Nothing -- Automatic Perfection)), a creditor must investigate for "secret liens." Where the collateral requires perfection outside Article 9, state and federal registries (and as explained in Chapter 19 (Perfection Pursuant to Federal Law), as to certain aircraft collateral, even international registries) must be checked.

One non-obvious way in which the Article 9 filing system is incomplete is its treatment of unauthorized or even fraudulent filings. As explained in Chapter 13 (Overview of Perfection by Filing), new section 9-518 allows the filing of a correction statement, but such a filing does not affect the effectiveness of the filing that is the subject of the correction statement and the drafters have decided that a more complete remedy is better left to the law outside Article 9 and the courts.

There are other risks against which the Article 9 filing system does not protect. The risks include the possibility that the sheriff is in possession of the collateral pursuant to a valid writ and levy or that the debtor has filed bankruptcy. A creditor should make sure the collateral is not in the possession of the sheriff and should check for bankruptcy filings wherever a particular debtor could file. Learning whether a debtor has filed bankruptcy is a task complicated by the jurisdiction and venue rules of the federal bankruptcy statute. These rules are beyond the scope of these materials and understanding them may require the assistance of a bankruptcy expert.

You may explore the foregoing aspects of the incompleteness of the filing system in the next problem.

Problem 14.17 (INTERACTIVE)

Assume again the facts of Problem 14.16.

What should Southwestern Bank do besides filing a financing statement right away, even before getting details of an outstanding security interest under new section 9-210?

E. The Life of a Financing Statement

Even properly filed and complete financing statements are not effective forever. Generally, a financing statement will *lapse*, cease to be effective, after a designated period of time unless further action is taken. Under former 9-403(2) as adopted in Arizona the period was six years. Under new section 9-515(a), which has been adopted without modification in Arizona, the period is five years. To be effective beyond the five-year period a *continuation statement* must be timely filed. New 9-515(c), (d).

On the other hand, a financing statement that has not lapsed *is* effective to perfect a security interest *even if* the debt has been paid unless a *termination statement* has been filed. New 9-513. These important realities about the life of a financing statement are best left for complete discussion in Chapter 23 (Continuing Perfection -- The Need to Reperfect (Or Refile)) and in Part VI.

CASE COMMENTARY

In re James Baker, __ F.Supp.2d __, 345 B.R. 261 (D. Colo. 2006)

Planned Furniture Promotions, Inc. v. Benjamin S. Youngblood, Inc., 374 F. Supp. 2d 1227 (M.D. Ga. 2005)

In re Snelson, 330 B.R. 643 (Bkcy E.D. Tenn. 2005)

Semmelman v. Mellor, 2006 WL 90094 (D. Minn. 2006)

Federal National Mortgage Association v. Okeke, 2006 WL 355241 (S.D. Tex. 2006)

First National Bank of Izard County v. Garner, 86 Ark. 213, 167 S.W.3d 664 (Ark. App. 2004)

Pankratz Implement Co. v. Citizens National Bank, 130 P.3d 57 (Kan. 2006)

Sunflower Bank, N.A. v. Kindsvater, 144 P.3d 81 (Kan. App. 2006) (Unpublished opinion)

In re Millivision, Inc., 474 F.3d 4 (1st Cir. 2007)

[1] For reasons set forth in Chapter 23 (Continuing Perfection The Need to Reperfect (or Refile)), the indexing scheme requires that subsequent filings affecting the initial financing statement be linked to the financing statement. Real estate-related filings that are made in the real estate records are indexed under the name of the debtor and, if the debtor is not an owner of record of the real estate, also under the owner of record's name. *See* Chapter 20.

[2] Some states allow searches generally to be conducted under both the debtor's name and a file number, but many, including Arizona, do not. There are commercial services that provide both filing and searching assistance, for a fee. If you have a paid subscription, you can search the filings in some states using Lexis or WestLaw. These services may assist you in using the right name but in the end it is your responsibility. Some searching can be done online without charge. The Office of the Arizona Secretary of State web site supports online searching. The URL is: http://azsos.gov/business_services/filings.htm.

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2011-08-22 update

Part V Perfecting an Article 9 Security Interest

Chapter 15 Perfection By Possession (including Documents of Title)

A. Generally

Security interests in some collateral may or must be perfected by possession. Recall that perfection is about giving notice to third parties so as to prevent secret liens. A public filing gives such notice (at least constructively). Theoretically, a change of possession also serves to give notice of a possible interest that should lead a potential creditor to inquire further. The theory may break down in application, especially insofar Article 9 does not expressly define the meaning of possession and whether or not there is possession of collateral in particular situations has not always been clear. *See* Official Comment 3 to new 9-313.

Difficulties have arisen where the collateral is in the possession of some third party rather than the secured party. As will be seen below, new Article 9 distinguishes between possession by third parties generally and possession by bailees holding under a document of title. The latter cases are separately treated in subpart E. As it happens, Article 9 treats both perfection and priority issues in such cases in the same sections so priority matters that might otherwise be left to Part VI are treated in subpart E.

Fully understanding possession as a mode of perfection requires knowing when possession is an alternative to filing, when perfection by possession is not possible at all and when only possession will perfect. It also is important to understand why possession works or does not work. A review of Chapter 5 dealing with the classification of collateral would be helpful here.

Not unexpectedly, a secured party who takes possession of collateral assumes certain responsibilities with regard to the care of the collateral. Although these responsibilities do not directly impact the effect of possession to perfect a security interest, they may influence a creditor's decision to rely on possession.

In the Chapter 13 (Overview of Perfection by Filing) discussion of filing we saw that the first question to answer is which state's law governs perfection (and the effect of perfection and non-perfection and priority). There is such a choice of law issue with regard to perfection by possession as well. We begin with that question.

B. Choice of Law

As was touched on in Chapter 6 (Choice of Law) and developed more fully in Chapter 13 (Overview of Perfection by Filing), former Article 9 employed a "situs rule" as to goods and quasi-goods and under that rule the law of the state where such collateral was located governed perfection of a security interest in that collateral.

As was seen in Chapter 13 (Overview of Perfection by Filing), under new section 9-301(1), the "general" choice of law rule under new Article 9 is that the law of the state where the debtor is located governs perfection. But, as also pointed out in Chapter 13, this general rule is subject to numerous important exceptions, including the law governing perfection by possession.

Thus, under new section 9-301(2) so long as collateral is located in a jurisdiction perfection and nonperfection of a *possessory* security interest in such collateral is governed by the law of that jurisdiction. In other words, new Article 9 employs a situs rule as to security interests perfected by possession.

Under new section 9-316(c), if the collateral leaves a jurisdiction the law of that jurisdiction ceases to govern and a security interest will be continuously perfected in the jurisdiction to which the collateral is removed only if the security interest is perfected under the local law of that jurisdiction. What this means is that if a secured party relying exclusively on possession for perfection has perfected by possession in State A and the collateral is moved to State B then the security interest continues to be perfected in State B only if State B allows perfection by possession as to the particular collateral and the secured party has sufficient possession in State B to perfect under the law of State B.

Moreover, under new section 9-316(c) there is no "grace period" during which perfection of the security interest continues to be perfected until the secured party perfects under the law of the state to which the collateral has been moved.

The matter of continuous perfection is considered fully in Chapters 23 (Continuing Perfection -- The Need to Reperfect (Or Refile) and 24 (Continuing Perfection -- Changes as to the Use of the Collateral or in the Location of the Collateral or the Debtor; Security Interests in Proceeds).

You may test your understanding of the basics of the new Article 9 choice of law rules in perfection by possession cases in the next three problems.

Problem 15.1 (INTERACTIVE)

Delia Debtor is an individual residing in Arizona. Delia gives a security interest in a valuable painting to Lisa Lender who also is an individual residing in Arizona. Lisa takes possession of the painting in Arizona. Which state's law determines whether the security interest in the painting is perfected under new Article 9?

Problem 15.2 (INTERACTIVE)

Assume the facts of Problem 15.1. Assume further, however, that Lisa Lender resides in New Mexico and Delia Debtor delivers the painting to Lisa in New Mexico. Would your answer to the question posed in Problem 15.1 be the same or different?

Problem 15.3 (INTERACTIVE)

Assume the facts of Problem 15.1. Assume the facts of Problem 15.1. Assume further, however, that Lisa Lender moves to California and takes the painting with her. Which state's law determines whether the security interest in the painting is perfected under new Article 9?

If the security interest were perfected under Arizona law but not under California law would Lisa have some time period within which to perfect in California?

C. Collateral as to Which Perfection by Possession is Permissible, Mandatory or Not Possible

1. Goods and Quasi Goods

New section 9-313(a) generally tracks former section 9-305 by listing negotiable documents, goods, instruments, money and tangible chattel paper as collateral a security interest in which may be perfected by possession. That only *tangible* chattel paper is listed reflects the fact that new Article 9 distinguishes tangible from electronic chattel paper. *See* Chapters 5 (Classification of Collateral) and 22 (Perfection as to Deposit Accounts, Letter of Credit Rights and Electronic Chattel Paper).

All of the listed collateral is property that the law recognizes as being possessable or pledgeable. In Chapter 5 (Classification of Collateral), such property was referred to as goods or quasi goods by contrast to pure intangibles.

2. Instruments and Money

Security interests in all the property listed in former section 9-305 also could be perfected by filing except for a security interest in an instrument, which could be perfected only by possession (except where the instrument was part of chattel paper or proceeds). *See* former section 9-304(1). New Article 9 makes an important change here. Under new section 9-312(a) a security interest in an instrument may be perfected by filing.

It is important to be aware that perfection by possession is the *preferred* mode of perfection as to instruments, negotiable documents, and certain investment property because a security interest in such property perfected by filing may be subordinated to the rights of certain transferees of such property. *See* new sections 9-330 and 9-331. The risks associated with filing where possession is possible are explored more fully in Part VI.

"Money" is defined in Article 1, section 1-201(b)(24) to mean "a medium of exchange currently authorized or adopted by a domestic or foreign government." Under new Article 9 a security interest in money as original collateral (as distinguished from proceeds) may be perfected *only* by possession. *See* new 9-312(a) (omitting money from the property as to which filing is possible) and new section 9-312(b)(3) (providing that a security interest in money may be perfected only by possession).

3. Certificate of Title Cases

Under former Article 9 there were doubts about whether a security interest in a vehicle covered by a certificate of title could ever be perfected by possession. New sections 9-311(b) and 9-313(b) make it clear that a security interest in collateral covered by a certificate of title may be *re-perfected* by possession but may not be perfected *initially* by possession. The difference will be clearer after Chapter 17 (Perfection as to Goods Subject to Certificate of Title Legislation), dealing with perfection of security interests in vehicles covered by certificates, has been completed.

4. When Perfection by Possession Is Not Possible

As was noted in Chapter 5 (Classification of Collateral), in certain cases perfection by possession is not permitted at all. A review of new section 9-313 will reveal that security interests in pure intangibles, property that is not in law possessable or pledgeable, such as accounts, general intangibles, deposit accounts, electronic chattel paper, health care receivables and uncertificated securities, may not be perfected by possession.

5. Certificated Securities and Delivery

New section 9-313(a) provides for perfection of a security interest in certificated securities by *delivery*. Perfection of security interests in investment property (and delivery as a mode of perfection as to such property) is treated separately in Chapter 21 (Perfection as to Investment Property).

You may explore the meaning of possession and when perfection by possession is possible (or not) under new Article 9 in the next problem.

Problem 15.4 (INTERACTIVE)

As to which of the collateral listed below is perfection by possession possible, mandatory, advisable or not possible?

(a) Gold ingots in a safe deposit box;

(b) A general checking account in a bank;

(c) An account in a bank represented by a negotiable CD;

(d) Debtor's collection of John Kennedy silver dollars;

(e) A Lexus automobile used in Debtor's business;

(f) Accounts generated by the sale of Debtor's inventory of goods.

As to that collateral as to which perfection by possession is not possible (the deposit account, the Lexus automobile and the accounts), what should a creditor do to perfect?

D. What Constitutes Possession

1. Generally

Article 9 does not directly define possession and it has not always been clear in particular situations whether or not a secured party has possession sufficient to achieve perfection by possession. *See* Official Comment 3 to new 9-313. The ostensible purpose of a change of possession (as with filing) has been to avoid secret liens by giving to third parties constructive notice of the possible existence of a security interest.

Theoretically, then, there must be such a change of possession -- a transfer of property to the secured party or at least a divestment of possession by the debtor -- such as will give notice to third parties. In practice, however, something less will be enough achieve perfection by possession.

If the debtor transfers physical possession of the collateral to the secured party (pursuant to an agreement) then there is possession sufficient to perfect a security interest by possession. However, transfer of actual physical possession to the secured party is not always possible or practicable. Consequently, "constructive" possession has sometimes been enough. Just when this is so has not always been apparent. Most of the litigation and commentary has dealt with agency and other such third party possession cases.

2. Possession through a third party

All agree that a debtor cannot be the secured party's agent for possession and that leaving the collateral with the debtor under an agreement by the debtor to hold the collateral for the secured party is not possession by the secured party. On the other hand, possession by a person who is a general agent of the secured party and not an agent of the debtor results in possession by the secured party.

A clear case is that where the collateral is in the physical possession of an employee of the secured party. *See* Official Comment 3 to new 9-313. Situations where a third party who is not the exclusive agent of either the debtor or the secured party is in physical possession of the collateral have generated the most controversy.

Former section 9-305 was understood by some courts and commentators to mean that perfection as to collateral in the possession of a third party was effected when the third party was given notice of the secured party's security interest. As is explained in subpart E (2) below, under new Article 9, a security interest in collateral that is in the possession of a third party who has issued a non-negotiable document of title covering the collateral is perfected when the third party receives notification of the security interest. However, this is a limited and special case. Where collateral is held by a third party who has not issued a document of title covering the collateral, notice will not suffice to achieve perfection under new Article 9.

New section 9-313(c) deals with cases where collateral that is not certificated securities or goods covered by a document of title (see subpart E below) is in possession of a person other than the debtor or the secured party. New section 9-313(c) provides that a secured party has possession in the specified cases when the person in possession "authenticates a record acknowledging that it holds [or will hold] possession of the collateral for the secured party." Essentially, as contrasted with notice to the third party of the secured party's security interest, new section 9-313(c) requires that the third pary enter into an agreement with the secured party acknowledging that the third party has possession for the benefit of the secured party.

Recall from Chapter 8 (The Specifics of Enforceability -- A Security Agreement Authenticated by the Debtor or Its Equivalent) that "authenticate," as defined in new section 9-102(a)(7), clearly contemplates an expression of an intent to adopt a record that identifies the authenticating party. By requiring an authenticated acknowledgment, new Article 9 rejects the position of former Article 9 that receipt of notification of the secured party's interest by a person in possession of the collateral is enough to give the secured party possession. *See* Official Comment 4 to 9-313.

Among the most important instances of possession of collateral by a third party is that where collateral is held in escrow, for example, where the collateral is in the possession of a title company. In the case of *In re Cadiz Properties, Inc.*, 278 B.R. 744 (N.D. Tex. 2002), the court concluded that a security interest in securities was perfected when an escrow agent took possession of the securities. In so doing, the court relied upon *In re Copeland*, 531 F. 2d 1195 (3rd Cir. 1976), a case decided under former Article 9 in which the court concluded that a security interest in securities in the possession of an escrow agent was perfected under former section 9-305.

As it happens, in *Copeland* there was an agreement by the escrow agent that it held the collateral for the secured party, but the court did not indicate it was the agreement and not simply notice to the escrow agent of the security interest that effected perfection of the security interest. Although the facts of *Cadiz Properties* would support a conclusion that the escrow agent had acknowledged that it held the collateral for the secured party's benefit, the court made no mention of new section 9-313(c) requiring such an agreement.

The next three problems allow you to explore the basic operation of new section 9-313(c).

Problem 15.5 (INTERACTIVE)

Ready Lender lends to Donald Debtor and takes a security interest in Donald's equipment and a negotiable certificate of deposit (CD). Ready not only files a financing statement covering the equipment but also enters into an agreement with Donald under which Donald agrees to hold the CD for Ready and not draw on it without Ready 's written permission.

Is the security interest in the CD perfected by possession?

Would there nonetheless be perfection of Ready 's security interest in the CD under new Article 9 on the facts of Problem 15.5?

Is filing as to the security interest in the negotiable CD advisable?

Problem 15.6 (INTERACTIVE)

First Bank lends to Delia Debtor. Delia gives First Bank a security interest in a negotiable promissory note that is in the possession of Title Company who is acting as a collection agent for Delia.

Can the security interest in the note be perfected by possession without Title Company transferring the note to First Bank?

How can First Bank perfect by possession without Title Company transferring possession of the note to First Bank?

Is there a way other than possession that First can perfect a security interest in the note under new Article 9?

What is the risk associated with any alternative mode of perfection?

Problem 15.7 (INTERACTIVE)

Northern Bank lends to Donald Debtor. To secure the loan Northern is considering taking a security interest in a valuable coin collection that has been pledged to Lisa Lender to secure an earlier loan. Lisa is not likely to give up possession of the coin collection to Northern (at least not while Donald's debt to Lisa remains unpaid).

May Northern still perfect the security interest in the coins by possession? Would it be enough under new Article 9 that Northern notified Lisa of its security interest?

What would you advise Northern to do to perfect a security interest by possession in the coin collection pledged to Lisa? Is Lisa likely to cooperate sufficiently to make this possible?

Could Northern file a financing statement covering the coin collection under new Article 9?

Would the value of the coin collection be relevant to whatever advice you give to Northern?

Although not apparent from the language of new section 9-313(c), there remains the question of whether a person in possession of collateral is so closely associated with the debtor that possession by that person does not constitute possession by the secured party even if the required authenticated acknowledgment is given. Official Comment 3 to 9-313 indicates that when a person is in possession of collateral under an escrow arrangement and that person is acting as an agent for both the debtor and the secured party then an authenticated acknowledgment can give the secured party possession sufficient to achieve perfection of a security interest in the collateral.

However, the comment implies that it generally is for the courts to decide whether or not a person is so closely connected or controlled by the debtor that the debtor has effectively retained possession even though the person has agreed to hold collateral on behalf of the third party. *In re Rolain*, decided under former Article 9, presented an interesting instance of the question left to the courts by new section 9-313(c). To check out the decision, click *here*.

The next problem explores further the treatment of third party possession situations.

Problem 15.8 (INTERACTIVE)

Assume the facts of Problem 15.5 (Ready Lender lends to Donald Debtor and takes a security interest in a negotiable certificate of deposit (CD) to secure the loan. Ready not only files a financing statement covering the equipment but also enters into an agreement with Donald under which Donald agrees to hold the CD for Ready and not draw on it without Ready's written permission. Assume further that the agreement between Donald and Ready provides that the CD will be delivered to Donald's attorney who will hold the CD for Ready. Is the security interest perfected by possession? Is the security interest perfected by possession?

The resemblance of the facts to *In re Rolain* set forth above is intentional. Was there enough in that case to give the secured party possession under new section 9-313(c)? What is lacking on the facts of Problem 15.8 that was present in *Rolain* and that is important under new section 9-313(c)?

Could perfection by possession by the secured party fail on the facts of *Rolain* or Problem 15.8 even if the facts are modified to satisfy new section 9-313(c)? *See* Official Comment 3 to new section 9-313.

As will be explored more fully in Chapter 20 (Perfection as to Fixtures and Other Real Estate-Related Collateral), the requirement that a third party authenticate an acknowledgment that it holds the collateral for the secured party is important in situations where a security interest is taken in a note secured by a deed of trust or a mortgage and the note is in the possession of a third party, such as a title company. As will be seen in the next subpart, new Article 9 separates out for special treatment in new section 9-312 cases in which goods are held by a bailee under *any* document of title, negotiable or not.

E. Document of Title Situations

As noted above, the perfection of security interests in goods held by a bailee under a document of title is governed by special rules. As you should remember from property class, a bailment is an arrangement whereby one person (the bailor) places goods in the possession of another party (the bailee) under a contract that specifies the terms of the bailment, such as the duration of the bailment, any charges imposed on the bailor, and the conditions under which the bailee must deliver the goods back to the bailee (or some other person designated by the bailor).

The bailment contract will be more or less detailed, and more or less formal, depending on whether the bailment is between commercial parties or between acquaintances. Whether or not the bailee issues a receipt for the goods also will depend on the degree of formality of the arrangement.

Carriers (*e.g.*, railroads and ships) and warehouses are commercial bailees who issue documents of title covering goods in their possession. Carriers issue bills of lading. Warehouses issue warehouse receipts. Bills of lading and warehouse receipts both are documents of title that constitute both a receipt for the goods and a contract between the parties to the bailment. The documents of title may be negotiable or non-negotiable and the difference is important to perfection. Much of the law governing documents of title, including that dealing with negotiability of documents, is found in Article 7, but perfection is the subject of Article 9.

The rules governing perfection as to goods held by a carrier that has issued a bill of lading or a warehouse that issued a warehouse receipt are the same. For practical reasons, a security interest in a bill of lading covering goods often is perfected temporarily without filing or possession as to the bill of lading. *See* new sections 9-312(e) and (f). Consequently, it is useful to focus here on warehouse situations.

1. Negotiable document of title cases

According to Article 7, section 7-104(1)(a), a warehouse receipt is negotiable if by the terms of the receipt the goods that it covers are deliverable to a bearer of the receipt or to the order of a named person. The "bearer or order " language is basic to negotiability not only of documents of title but instruments as well.

As was seen in Chapter 5 (Classification of Collateral), a negotiable document of title may be considered quasi goods in the sense that it is possessable or pledgeable. This is so because the rights represented by the document are embodied (or "merged") into the document. A special attribute of a negotiable document is that it must be surrendered to get the goods covered by the document. For this reason, persons in control of negotiable documents also control the goods covered by the documents. To this extent, a negotiable document takes on a life of its own and persons dealing with the goods held by the issuer of the document do so by taking action as to the document.

A security interest in goods in a warehouse may be perfected by filing a financing statement *as to the goods themselves*. The fact that the goods are held under a negotiable warehouse receipt does not prevent such perfection. However, because a negotiable document of title becomes a surrogate for the goods themselves new section 9-312(c)(1) provides that a security interest *in goods* held under a negotiable document of title may be perfected by perfecting a security interest *in the document*.

Furthermore, under new section 9-312(c)(2), a creditor who has perfected a security interest *in the document* has priority over a creditor who perfects by filing *as to the goods if* the filing as to the goods takes place *after* the goods are transferred to the bailee who issues the document of title. New section 9-312(c)(2) thereby trumps the usual first-in-time priority rule that will be discussed in Part VI. Former section 9-304(2) was to the same effect.

Especially because of the special priority rule in new section 9-312(c)(2), a creditor holding a security interest in goods held by a warehouse under a negotiable warehouse receipt should perfect its interest in the goods by perfecting a security interest in the receipt and not by perfecting as to the goods themselves. But, of course, the creditor should check the records for filings that pre-date the issuance of the document of title.

The next question is how a creditor perfects a security interest in a negotiable warehouse receipt. Under former section 9-304(1), a security interest in a negotiable document of title could be perfected by filing a financing statement covering the document. New section 9-312(a) preserves this option. However, filing a financing statement is not the only way to perfect a security interest in a negotiable warehouse receipt. Consistently with the proposition that negotiable documents are quasi goods, under new section 9-313(a), as was true under former section 9-305, a security interest in a negotiable document can be perfected by taking possession of the document.

As a result, a creditor with a security interest in a negotiable document has a choice to take possession of or to file as to the document. However, the fact is that perfection of a security interest in a negotiable document of title by possession is preferable to perfection of that interest by filing. The reason that perfection by possession is preferable is traceable to new section 9-331(a) and certain provisions of Article 7. Under new section 9-331(a), a person who has become a holder of a negotiable document of title by due negotiation has "priority over an earlier security interest, even if perfected, to the extent provided in Article 3, 7, and 8."

Article 7, sections 7-501(1) and (2), provide that a negotiable document of title that was issued "to bearer " is negotiated by delivery of the document and a document of title issued "to order" is negotiated by delivery together with a proper indorsement. If the person to whom the document is negotiated takes delivery of the document for value and without notice of any claim to the document on the part of any party then, under Article 7, section 7-501(4), the document has been "duly negotiated." Under Article 7, section 7-502(1), a holder to whom a negotiable document has been duly negotiated acquires title to the document and the rights given by the document against the issuer to control delivery of the goods.

In combination, new section 9-331(a) and the foregoing provisions of Article 7 essentially give to a person to whom a negotiable document of title has been duly negotiated a claim to the document of title, *and the goods it covers*, that is superior to the claims of other parties. A secured party who perfects a security interest in a negotiable document of title by taking possession more likely than not will do so by due negotiation and as a result will have priority over an earlier security interest in the document perfected by filing.

That the secured party in possession will enjoy the rights and priority conferred by new section 9-331(a) and Article 7 is the more likely because new section 9-331(c) provides that filing a financing statement "does not notice of a claim or defense" to a holder under new section 9-331(a).

Under Article 7, section 7-503(1), a secured party who had perfected security interest in the goods before they were deposited in the warehouse and who did not acquiesce in the procurement of the document of title of title can defeat the rights conferred under Article 7, section 7-502(1). This means that a debtor acting alone or in collusion with another creditor cannot put goods subject to a perfected security interest into the possession of a bailee who issues a negotiable document of title covering the goods and negotiate the document so as to subordinate the claim of the secured party.

Moreover, as discussed earlier, new section 9-312(c)(2) gives priority to a secured party who has perfected a security interest in a negotiable document only against another secured party who perfected as security interest in the goods *after* they were delivered to the bailee.

In summary, a security interest in goods held by a bailee who has issued a negotiable document of title covering the goods may be perfected by filing a financing statement covering the goods, but a security interest in such goods also may be perfected by perfecting a security interest in the document of title. A secured party who perfects an interest in the document by possession (and to whom the document is duly negotiated) has priority over a secured party who perfects by filing as to the document. A secured party who perfects a security interest in a negotiable document of title by either filing or possession has priority over a secured party who perfects a security interest in the goods *after* they were delivered to the bailee.

A secured party who perfects a security interest in a negotiable document by possession (and to whom the document is duly negotiated) might gain priority over a secured party who filed as to the goods *before* the goods were delivered to the bailee by asserting rights under Article 7. However, a secured party in possession of a negotiable document will have priority only if the secured party who filed as to the goods somehow acquiesced in the delivery of the goods to a bailee who issued the negotiable document of title (and thereby created a risk that due negotiation of the document could produce superior rights for a holder of the document).

As explained in Chapter 12 (Perfection Generally) priority is often very much a function of perfection. The relationship between perfection and priority is especially clear as to negotiable documents of title because Article 9 treats both matters in the same section. *See* new 9-312(c)(2) as discussed above. However, do not lose sight of the fact that this chapter is about perfection by possession and the principal message is that a security interest in goods held under a negotiable document of title can (and should) be perfected by perfecting an interest in the document by taking possession of the document.

One last point about negotiable documents of title should be made here. Because such documents take on a life of their own and parties deal with the goods held under such documents by taking action as to the documents there is a risk that a creditor may forget that ultimately it is the goods that are the security. Some major frauds have been perpetrated through the use of documents covering empty warehouses. The message to an Article 9 practitioner is apparent. Make certain the goods are in the warehouse (as well as being sure there are no filings against the goods that were made before the goods were placed in the warehouse).

To test your understanding of the rather heady material covered in this subpart consider the next problem.

Problem 15.9 (INTERACTIVE)

Southern Bank lends to Delia Debtor and takes a security interest in Delia's current crop of oats that is about to be harvested. Southern files a financing statement covering the oats. Delia, without the permission of Southern or any acquiescence on the part of the Southern, harvests the oats and delivers them to Grain Elevator for storage. Grain Elevator issues a warehouse receipt providing that the oats are deliverable to bearer. Delia borrows from Ready Lender and gives Ready an interest in the oats to secure the loan. Ready perfects a security interest in the warehouse receipt by filing a financing statement covering the receipt. Delia later borrows from Friendly Finance Company and gives Friendly an interest in the oats to secure the loan. Friendly asks for and receives delivery of the warehouse receipt. Friendly is not aware of the interests of Southern or Ready. Delia defaults on all three loans.

If the oats are worth enough to satisfy only one of the three loans who would you rather be representing, Southern, Ready or Friendly? Be sure to read the pertinent sections of new Article 9 very carefully.

Who would you rather represent if Southern filed its financing statement after the oats were delivered to Grain Elevator? Why?

If you had been representing Ready Lender or Friendly Finance Company, what steps in addition to those necessary to perfection of their security interests would you have advised them to take?

2. Non-negotiable Documents of Title

In sharp contrast to negotiable documents of title, non-negotiable documents are not quasi goods and possession of them does not confer on the party in possession any special claim to the goods they cover. Non-negotiable documents need not be surrendered to the bailee to get possession of the goods. It follows that a security interest in goods held under a non-negotiable document of title may *not* be perfected by perfecting a security interest in the document.

As is true in the case of negotiable documents of title it is possible to perfect a security interest in goods held under a non-negotiable document of title by filing *as to the goods* themselves. *See* new section 9-312(d)(3). However, under new sections 9-312(d)(1) and (2), it also is possible to perfect a security interest in goods in the possession of a bailee held under a non-negotiable document of title by having the document issued in the name of the secured party or by receipt of notification by the bailee of the security interest.

The occasions for use of non-negotiable documents of title are matters that are largely beyond the scope of these materials. One case deserves attention here because it exists primarily for security purposes. It can happen that a creditor does not feel comfortable relying on filing as to goods because of concerns about the debtor's trustworthiness but, for practical reasons, the creditor cannot take possession of the goods. This could be the case where the goods, for example, are inventory. In such a case a creditor may set up a "field warehouse."

A field warehouse is just what the name suggests, namely, a field warehouse that is set up "in the field," meaning on the debtor's premises. This can be done by putting a lock on a yard or room or whatever or by putting a fence around the inventory. There are companies that are in the business of setting up field warehouses. To allow the debtor access to the inventory the field warehouse company issues a non-negotiable document of title and the secured party can regulate the debtor's access to the inventory with "delivery orders."

As noted above, under new sections 9-312(d)(1) and (2), a security interest in the inventory can be perfected by having the document issued to the secured party *or* by receipt by the warehouse company of notification of the security interest *or* by filing a financing statement as to the goods. Again, perfecting a security interest in the document would serve no useful purpose (and Article 9 seems not to provide any method for doing so) because the interest in the goods is not "locked up " in the document.

Historically, creditors have used one or the other of the two methods described: they have had documents of title issued in their names or relied on notifying the bailees of their interest. However, many field warehouses are rather loosely run even to the point that the on site "custodian" may be an employee of the debtor. As a result there may be a question of whether the warehouse is "in possession " sufficiently to satisfy the predicate of new section 9-312(d). Consequently, in such cases a secured party is well advised to file a financing statement covering the goods.

The question then is why bother with a field warehouse. The answer is that such an arrangement is not really about perfection but rather about "policing the collateral."

The next problem illustrates the new Article 9 rules governing perfection of a security interest in goods held under a non-negotiable title in the context of field warehousing.

Problem 15.10 (INTERACTIVE)

Northern Bank lends to Donald Debtor. Northern takes a security interest in Donald's inventory of lumber. The lumber is stacked in Donald's lumberyard. Northern contracts with Field Warehouse Co. to put up a fence inside Donald's lumberyard and at all times keep inside the fence lumber that has a value of at least twice the amount of the outstanding balance owing on the loan debt. Field Warehouse Co. issues a non-negotiable document of title covering the inventory of lumber in the name of Northern and provides Northern with blank delivery orders that may be issued to Donald allowing Donald to take and sell lumber kept in the enclosed area of the lumberyard. Field Warehouse Co. hires Donald's yard foreman as custodian of the enclosed area and give the yard foreman a key to the gate to the enclosed area.

Is Northern's security interest perfected?

What *should* Northern do to perfect its security interest? Why?

F. Responsibilities of a Secured Party in Possession

Under former section 9-207(1), a secured party who took possession had a duty of reasonable care as to the collateral. New section 9-207(a) imposes such a duty on a secured party in possession (other than in certain specialized cases referred to in new section 9-207(d) where there is no recourse against the debtor in the event the debt is not paid). Be aware that creditors who have gained possession of collateral by "repossession" also have the responsibilities set forth in new section 9-207. *See* Chapter 34 (Getting Possession of the Collateral).

Generally speaking, the duty of care requires secured parties to avoid acting so as to undermine the value of the collateral or facilitating foreseeable actions of third parties that result in a loss or damage to the collateral. *See*, *e.g.*, *Nevada National Bank v. Huff*, 582 P.2d 364 (Nev. 1978). The extent to which a secured party has a duty to act affirmatively to preserve the value of collateral was unclear under former Article 9 and continues to be so under new Article 9. It is true, as was the case under former Article 9, that the reasonable expenses incurred in holding the collateral are chargeable against the collateral. *See* new 9-207(b)(1).

Under new section 9-207(c)(2), money or funds received from the collateral must be applied to reduce the secured obligation unless they are remitted to the debtor. Under new section 9-207(c)(1), proceeds of collateral may be held as additional security unless the proceeds are money or funds in which case the proceeds again must be applied to reduce the secured debt.

As was also the case under former section 9-207, under new section 9-207(b)(4) a secured party may use the collateral for the purpose of preserving it. A secured party also may use collateral as permitted by a court order or, except as to consumer goods, to the extent the debtor has so agreed. New section 9-207(c)(3) permits a secured party to repledge the collateral.

A qualification in former 9-207(2)(e) to the effect that a secured party in possession could create a security interest in the collateral only if doing so did not impair the debtor's right of redemption has been eliminated as being implicit in new section 9-623 (the section that creates the right to redeem). *See* Official Comment 5 to new 9-207. The right of redemption, which is essentially the right of a debtor to recover collateral by paying the amount of the debt owing, is dealt with in Chapter 33 (A Secured Party's Options on Default).

The rights and responsibilities imposed by Article 9 may be dispensed with or changed by agreement, but only within certain limits. In particular, under new Article 1, section 1-302(b) (formerly section 1-102(3)), the duty of care imposed by new section 9-207(a) may not be disclaimed by agreement. However, the parties may determine by agreement standards of care that are not manifestly unreasonable.

New section 9-207(b)(4)(C) excludes consumer goods cases from those in which the parties may agree on the right of the secured party to use the collateral. And, new 9-602(1) appears to limit the extent to which the rules of new section 9-207(b)(4)(C) regarding use or operation of the collateral may be altered by agreement entered into in connection with a default. *See* Official Comment 2 to new 9-602.

You may explore some of the issues associated with the secured party's rights and responsibilities when the secured party is in possession of the collateral in the next two problems.

Problem 15.11 (INTERACTIVE)

Western Bank has a security interest in a certificate of deposit (CD) owned by Delia Debtor. Western has taken possession of the CD. The interest rates on the certificate of deposit are variable and are tied to market rates of interest.

If interest rates begin to decline is Western required to act in response? Examine new section

9-207 carefully. *Cf. Citibank, N.A. v. Data Lease Financial Corp.*, 828 F.2d 686 (11^{th} Cir. 1987).

May Western treat the interest paid on the CD as additional collateral? Again, examine new section 9-207 carefully.

Problem 15.12 (INTERACTIVE)

Assume the facts of Problem 15.11.

May Western Bank pledge the certificate of deposit to secure a debt of its own? Examine new section 9-207 carefully. *Cf. McRae v. Vogler*, 536 P.2d 509 (Or. 1975).

CASE COMMENTARY

In re *Clayson*, 341 B.R. 137 (Bkcy W.D.N.Y March 24, 2006)

Ace Equipment Sales, Inc. v. H.O. Penn Machinery Co., Inc., 871 A.2d 402 (Conn. App. 2005)

Thompson v. First State Bank, 709 N.W.2d 307 (Minn. App. 2006)

Ronald V. Odette Family Limited Partnership v. Agco Finance, LLC, 129 P.3d 95 (Kan. App. 2005)

In re Commercial Money Center, Inc., 350 B.R. 465 (B.A.P. 9th Cir. 2006)

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Part V Perfecting an Article 9 Security Interest

Chapter 16 Perfecting Security Interests in Proceeds and Other Later Acquired Property

A. Generally

In Chapter 9 (The Specifics of Enforceability -- After-Acquired Property, Future Advances, Transferred Collateral and Proceeds and the New Debtor Problem) we saw that under new Article 9, section 9-315(a)(2), as was true under former Article 9, a secured party is *given* an interest in identifiable proceeds without the need for an agreement as to proceeds. We also saw that under new section 9-203(f) a security interest in proceeds is enforceable without regard to whether the requirements applicable to original collateral have been met. Consequently, a security interest (but not an agricultural lien -- except as the statute creating it so provides) attaches to proceeds as soon as property constituting identifiable proceeds of original collateral comes into existence.

As for perfection, again as was true under former Article 9, under new section 9-315(c) a security interest in identifiable proceeds is perfected at the moment of attachment without the need for further action *so long as* the security interest in the original collateral is perfected. To this extent a security interest in identifiable proceeds is perfected *automatically*.

There is an issue as to how long the perfection in proceeds conferred by Article 9 continues. Under former section 9-306(3)(d), except as to specified cases, perfection of a security in proceeds would continue beyond ten days only if action to perfect the security interest as if the proceeds were original collateral was taken.

New sections 9-315(d) and (e) retain the basic scheme of former Article 9 but extend the period of conferred protection to twenty days. The situations in which no action need be taken to continue the perfection in proceeds beyond the twenty-day period and actions that must be taken to continue perfection in other cases are considered in Chapter 24 (Continuing Perfection -- Changes as to the Use of the Collateral or in the Location of the Collateral or the Debtor; Security Interests in Proceeds).

In Problems 9-6 to 9-10 in Chapter 9 (The Specifics of Enforceability -- After-Acquired Property, Future Advances, Transferred Collateral and Proceeds and the New Debtor Problem) the question was whether and as to which property the secured party had an enforceable security interest. Each of those problems has been revised to raise the question whether or not, and under what circumstances, any enforceable security interest the secured party may have is perfected. You may put aside for now the question of how long any perfection would continue without further action.

Problem 16.1 (INTERACTIVE)

Leslie Lender has a security interest in Danielle Debtor's "equipment, existing and after-acquired." Leslie files a financing statement covering "All Debtor's Equipment." The security agreement makes no mention of proceeds. The agreement does provide that Danielle is not to dispose of any equipment without the Leslie's express written consent. Danielle sells a drill press to Byron Buyer without Leslie's express written consent. Danielle receives cash in the amount of $1,000 and a check for $1,500. Danielle uses the cash to purchase a newer and less expensive drill press. She places the check in a cash drawer.

Does Leslie have a perfected security interest in enforceable security interest in the $1,500 check?

Does Leslie have a perfected security interest in the new drill press?

Problem 16.2 (INTERACTIVE)

Assume the facts of Problem 16.1. Assume further, however, that Leslie Lender would be unable to show the new drill press is identifiable proceeds.

Could Leslie still have a perfected security interest in that drill press?

Would your answer be the same if Leslie had filed a financing statement indicating that the collateral is the drill press (that Danielle eventually sold to Byron Buyer)?

Problem 16.3 (INTERACTIVE)

Ready Lender has a security interest in Donald's prize racing greyhound, Black Streak. Ready has filed a financing statement covering "Black Streak."

Does Ready have a perfected security interest in Black Streak's winnings?

If Ready Lender decides to go the original collateral route what should Ready do to be sure the security interest in the winnings as original collateral is perfected?

Problem 16.4 (INTERACTIVE)

Delia Debtor operates a gambling casino. Your client holds a security interest on Delia's slot machines under a security agreement that describes the collateral as "Debtor's equipment, existing and hereafter acquired. " Your client has filed a financing statement covering equipment.

Does your client have a perfected security interest in the quarters and silver dollars placed in the slot machines?

If your client decides to go the original collateral route what should your client do to be sure the security interest in the coins as original collateral is perfected?

Problem 16.5 (INTERACTIVE)

Assume the facts of Problem 16.2 (Leslie Lender has a security interest in Danielle Debtor's "equipment, existing and after-acquired." The security agreement makes no mention of proceeds. The agreement does provide that Danielle is not to dispose of any equipment without the Lender's express written consent. Danielle sells a drill press to Byron Buyer without Leslie's express written consent. Danielle receives cash in the amount of $1,000 and a check for $1,500. Danielle uses the cash to purchase a newer and less expensive drill press; Danielle places the check in a cash drawer). Assume the following additional facts:

Danielle deposits the $1,500 check in a checking account in First Bank; At the time of the deposit the balance in the account is $4,000 all of which was from the deposit of non-proceeds; Danielle defaulted owing Leslie $2,000; Leslie could not win in a priority dispute over the drill press with Byron Buyer (we will consider possible reasons in Part VI); Before Leslie learned of the foregoing, Danielle withdrew $3,000 from the bank account; Danielle took the cash and blew it at the dog track; Just after the withdrawal there was an automatic deposit of $500 made by First Bank to Danielle's account to correct an earlier overcharge to the account; There have been no other changes to the bank account balance.

We saw in Chapter 9 (The Specifics of Enforceability -- After-Acquired Property, Future Advances, Transferred Collateral and Proceeds and the New Debtor Problem) that under the Lowest Intermediate Balance (LIB) of proceeds analysis Leslie would have a security interest in $1,500 of

Danielle's bank account. (If you do not see how this is so you should review the treatment of Problem 9.11 in Chapter 9.)

Is Leslie's security interest in Danielle's bank account perfected?

B. Proceeds in Bankruptcy

As has been noted bankruptcy is viewed as the "acid test" of whether you have done your job properly in representing a secured creditor. It has been noted that security interests in original collateral that are not perfected on the date of bankruptcy are at risk of being avoided by a trustee under BRA § 544(a) leaving the creditor unsecured. Perfection is every bit as essential as to security interests in proceeds.

Indeed, perfection is the more important insofar as security interests in collateral acquired after a petition in bankruptcy is filed are unenforceable except where the collateral is proceeds. *See* BRA § 552 and Chapter 9 (The Specifics of Enforceability -- After-Acquired Property, Future Advances, Transferred Collateral and Proceeds and the New Debtor Problem).

The interaction of BRA § 544(a) and BRA § 552 and complexities introduced by BRA § 547 (avoidable preferences) as to certain commercial collateral, such as inventory and accounts, and the proceeds thereof, will be explored at length in Chapter 30 (Secured Party Versus Trustee in Bankruptcy).

CASE COMMENTARY

In re *Clayson*, 341 B.R. 137 (Bkcy W.D.N.Y March 24, 2006)

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Part V Perfecting an Article 9 Security Interest

Chapter 17 Perfection As To Goods Subject To Certificate Of Title Legislation

A. Generally

New section 9-102(a)(10) defines "certificate of title" essentially as a certificate of title issued pursuant to a statute requiring that a security interest be indicated on the title in order for the security interest to be perfected. As we saw in Chapter 12 (Perfection Generally), under new section 9-311(b) filing a financing statement is neither necessary nor sufficient to perfect a security interest in goods subject to a certificate of title statute requiring as a condition of perfection that the security interest be indicated on the certificate of title.

Rather, under new section 9-311(a)(2), to perfect a security interest in goods subject to a certificate of title statute requiring "lien notation" (for the most part vehicles operated on a highway) a secured party must comply with the demands of the statute for getting its security interest noted on the certificate of title covering the goods. *See, e.g.*, A.R.S. § 47-9311(A), pointing to Title 28 of the Arizona Revised Statutes (Arizona's motor vehicle code).

Subject to certain qualifications as to timing and choice of law, the operative principle is that if the security interest is noted on a certificate of title covering the goods then the security interest is perfected but if the security interest is not so noted (the certificate is "clean") then the security interest is not perfected. As discussed further below, under new section 9-311(d), perfection of a security interest in goods held for sale or lease by a debtor engaged in selling such goods is outside the lien notation scheme and the usual modes of perfection provided for in new Article 9 apply.

Perfection by lien notation typically requires a secured party to apply for a title indicating its security interest to the agency responsible for administering the certificate of title statute. In most states, including Arizona, there is no need to submit the security agreement and an application signed by the debtor is enough.

Perfection by lien notation typically requires a secured party to apply for a title indicating its security interest to the agency responsible for administering the certificate of title statute. In most states, including Arizona, there is no need to submit the security agreement and an application signed by the debtor is enough.

Most states, including until very recently Arizona, have employed a "title holder" scheme according to which the certificate of title is issued to the debtor and the security interest is noted on the title. To view a sample of a certificate of title, this one as employed in Arizona (until any change in the system as is discussed below is made), click here. You will see the place for lien notation on the title.

In 2003, Arizona made two important changes to its certificate of title system. The first is that no longer are certificates of title to be issued to the vehicle owners. Rather they go to the secured party and a "new" certificate cannot be issued to the vehicle owner until the secured debt has been satisfied (or the secured party has consented in writing or electronically to the transfer of title). A.R.S. § 28-2132(D).

Second, paper certificates of title will be replaced by electronic certificates of title. Initially the use of an electronic title will be voluntary, but this could change if the electronic title scheme is deemed successful. A.R.S. § 28-2064. The administrative burden imposed on secured parties associated with holding certificates of title is what led to certificate of title laws under which the title was issued to the vehicle owner. That burden seemingly would be reduced in an electronic certificate of title system.

The switch to a "lien holder" scheme undoubtedly will reduce the risk of fraud resulting from the issuance of paper titles to vehicle owners while the secured debt remains unpaid. The use of electronic titles could further reduce the risk of fraud as a person taking an interest in a vehicle subject to a security interest will not be relying on the physical state of a paper title. It is not entirely clear whether paper titles will be replaced entirely or whether electronic titles will be used only when a vehicle is subject to a security interest and a paper title will be issued when the debt secured by the vehicle is paid.

As is explored in Chapter 24 (Continuing Perfection – Changes as to the Use of the Collateral or the Location of the Collateral or the Debtor; Security Interests in Proceeds), exactly how an electronic certificate of title system will interface with the new Article 9 sections dealing with goods covered by certificates of title, many of which appear to contemplate the issuance of paper titles, is not clear.

Two other matters that will be considered more fully in later chapters warrant mention here. First, some certificate of title statutes provide that a transfer of a vehicle is not effective without a transfer of a certificate of title covering the vehicle and such provisions may impact the operation of Article 9 provisions designed to protect certain buyers against certain security interests. *See* Chapter 27 (Secured Party Versus Buyer). What effect such provisions in certificate of title statutes actually have, in turn, may depend on whether the certificate of title statute involved provides that in the event of a conflict between the certificate of title statute and Article 9 the latter should control.

Second, how a certificate of title statute affects disputes between or among persons having an interest in a vehicle generally depends on whether a certificate of title covering a vehicle actually has been issued. Problems can arise where a certificate of title is not applied for or issued even though the parties contemplated that an application be made and a title issued. This can happen when a party who had responsibility for making an application, for whatever reason, does not do so.

The point is that it should always be clear who has responsibility for making an application for a certificate of title and, ultimately, the creditor the perfection of whose security interest depends on lien notation should make sure that a certificate of title noting the creditor's security interest is in fact issued. There is less of a problem in "lien holder" states than in "title holder" states, but problems can and do arise even in lien holder states. *See* Chapter 24 (Continuing Perfection – Changes as to the Use of the Collateral or in the Location of the Collateral or the Debtor; Security Interests in Proceeds) and Chapter 27 (Secured Party Versus Buyer).

B. Goods As To Which Lien Notation Is Required

Certificate of title statutes differ from state to state and the differences have meant that Article 9 and a specific certificate of title law may not mesh very well. The Uniform Motor Vehicle Certificate of Title Act (UMVCTA), which has been adopted in many states, is aimed at producing greater harmony among the statutes, but differences persist.

It is enough here to understand that a creditor first must decide if the goods in which it seeks to take and perfect a security interest are within the scope of a particular certificate of title law, in which case lien notation and not filing is necessary to perfect, and the creditor then must comply with the specific requirements of that particular certificate of title statute.

Because of the differences among the statutes it is risky to generalize about when lien notation rather than filing is required. However, for the most part, certificate of title laws cover vehicles that must be registered for use on a state's highways. An important exception in Arizona is that mobile homes must be titled and security interests in them perfected by lien notation. In many states, including Arizona, trailers must be registered and titled.

Boat trailers and boats pose interesting issues. At least in Arizona, a boat trailer must be titled, but a boat, even a powerboat, need not be titled (although it must be registered with the Game and Fish Department). The result is a difference in the perfection requirements for boats and boat trailers. As to the latter, but not the former, lien notation is necessary. The difference in perfection requirements for boats and trailers will be revisited in the context of automatic perfection. *See* Chapter 18 (Perfection by Doing Nothing -- Automatic Perfection).

A more important generalization, referred to above, is that both Article 9 and the many certificate of title statutes except from the lien notation scheme security interests in goods held for sale or lease by a person in the business of selling such goods, *i.e.*, inventory. *See* new 9-311(d).

Therefore, to perfect a security interest in a dealer's inventory of cars and trucks, for example, a creditor must file a financing statement even though security interests in cars and trucks not held as inventory are subject to the lien notation requirements. If goods are subject to a certificate-of-title statute and the debtor is in the business of leasing but not of selling such goods then lien notation is required. *See* Official Comment 4 to new 9-311.

C. Choice of Law

Under new section 9-303(c), the law of a state issuing a certificate of title covering goods governs perfection and non-perfection. Somewhat curiously, new section 9-303(a) indicates that there need be no nexus between the debtor or the goods and the state issuing a certificate of title covering the goods. The rule stated in new section 9-303(a) means that a secured party, theoretically, is free to choose to apply for a certificate of title in any state and this freedom of choice, again theoretically, can pose problems for searchers who must locate the state system in which to conduct a search.

The difficulty for searchers is compounded by the fact that a security interest in a vehicle is indexed according to the vehicle identification number (VIN) and it is not possible to search for all outstanding security interests created by a particular debtor simply by requesting a search under the debtor's name.

However, certificates of title are issued in conjunction with registering a vehicle for use on a state's highways. Consequently, in practice a secured party reasonably will apply for a certificate of title from the state where a vehicle will be kept and used, most often the state of the debtor's residence, and it is that state's law that governs perfection and non-perfection.

For example, if a seller of new cars in Tucson, Arizona sells a vehicle to a buyer who resides in Tucson and the parties expect the buyer to keep and use the car in Arizona then the dealer should comply with the Arizona certificate of title statute. If, on the other hand, the buyer is from Albuquerque, New Mexico and the car will have to be registered in New Mexico for use in New Mexico, then the dealer should apply for a New Mexico title.

The case of *In re Custer*, 50 UCC Rep. Serv. 2d 608 (Bkcy N.D. Iowa 2003), illustrates how the flexibility in the certificate of title system, especially where the debtor holds the title (*i.e.*, a title holder statute is involved, as discussed in subpart F below) can create problems. In *Custer*, a South Dakota dealer sold a vehicle to an Iowa purchaser. It appears that at the time of the sale the vehicle was owned by a California party who had obtained a South Dakota title for the vehicle. The California party released its interest in the vehicle and the dealer obtained a South Dakota title in its name.

The dealer prepared the title so that the debtor could obtain an Iowa certificate of title on which the security interest (that had been assigned to the entity that actually financed the purchase) could be noted. However, the debtor delayed applying for the Iowa certificate of title so long that the security interest was not timely perfected and the security interest was avoidable by the trustee in a bankruptcy proceeding commenced by the debtor shortly after the debtor returned to Iowa.

The avoidance of security interests that are not timely perfected is the subject of Chapter 26 (Secured Party Versus Lien Creditor; Future Advances; Bankruptcy) and Chapter 30 (Secured Party Versus Trustee in Bankruptcy).

As will be explored further below and more fully in Chapter 24 (Continuing Perfection -- Changes as to the Use of the Collateral or in the Location of the Collateral or the Debtor; Security Interests in Proceeds), most problems arise when vehicles are moved from one state to another and a certificate of title is issued by the state to which a vehicle is moved, raising the question of which state's law governs perfection and non-perfection.

D. The Timing and Duration of Perfection

Under new section 9-303(b), goods are covered by a certificate of title from the time a valid application and required fee are tendered to the appropriate authorities. The drafters of new Article 9 intend that perfection should date from the time goods are covered by a certificate of title (assuming a security interest is noted on the title) and that perfection of the security interest will continue so long as the goods are covered by the certificate of title (or until the certificate of title ceases to be effective under the law of the state issuing the title, for example, because a certificate of title has been issued by another state). *See* Official Comment 3 to 9-303.

However, the certificate of title statute of a state issuing a title in fact governs the timing and duration of perfection of a security interest and the law of some states, including Arizona, contains a "relation back" provision under which perfection dates from the time a security agreement is properly executed if the secured party duly applies for a certificate of title within some prescribed period of time, ten days under the Arizona statute and the UMVCTA.

These relation back periods can cause problems for searchers and the drafters have urged that they be eliminated. *See* Official Comment 6 to new 9-303 and Official Comment 5 to new 9-311. But, until the recommended change is made the relation back period in a governing certificate of title statute will control.

E. Exclusivity of Lien Notation Scheme

The lien notation scheme is largely exclusive in that possession by the creditor of the certificate of title itself will not perfect a security interest in the covered vehicle. *See* new section 9-311(b). *Cf*. Noble v. Bonnett, 557 P.2d 248 (Ariz. 1978). Under former Article 9 it was unclear whether possession (or "repossession ") of the vehicle could perfect a security interest in a covered vehicle.

New Article 9 makes clear that possession will re-perfect, for example, where a vehicle has been moved to another state without permission and the creditor repossesses the vehicle, but possession will not serve to perfect a security interest in the first instance. *See* new sections 9-311(b), 9-313(b), 9-316(d) and Official Comment 7 to new 9-311.

It is important to note that under new section 9-311(b) lien notation in compliance with a certificate of title law is the equivalent of filing insofar as priority over a lien creditor is concerned (which is the basic test of perfection under Article 9). *See* Official Comment 6 to new 9-311.

As was discussed in Chapter 10 (The Need for Value and Debtor's Rights in the Collateral), certificate of title laws may impact security interests in vehicles subject to a certificate of title law otherwise than as to the permissible means of perfecting such security interests. Specifically, although conditioning transfer of a certificate of title to a buyer on payment, under UCC Article 2, section 2-401, does not prevent title from passing to the buyer and operates only to create a security interest, it could happen that the certificate of title law itself alters this UCC rule.

Thus, a certificate of title law could make a sale not accompanied by a transfer of the certificate of title completely void (as opposed to simply voidable), thereby qualifying the general rule of alienability provided for in new section 9-401 and considered in Chapter 25 (The How and Why of Priority). The Texas certificate of title law at issue in the case of *Arcadia Financial, Ltd v. Southwest-Tex Leasing Co., Inc.*, 47 UCC Rep. Serv. 2d 1371, 78 S.W. 3d 619 (Tex. App. 2002), discussed in Chapter 10 in connection with the requirement that a debtor have rights in collateral in order for a security interest to attach under new section 9-203, appeared to so provide. Where a certificate of title law does provide that a sale not accompanied by a certificate of title is void, the further issue arises as to whether the UCC or the certificate of title law governs. There was a provision in the Texas certificate of title law under which in the event of a conflict the UCC was to control.

The point here is that certificate of title laws must be carefully examined to determine whether or not they make transfer of a certificate of title a condition of the passage of title (or other interest such as will support a security interest) and, if so, whether the certificate of title law trumps the UCC rules regarding the passage of title of a vehicle subject to a certificate of title law (and rights in such vehicles).

Making receipt of a certificate of title a condition of an effective transfer of a vehicle also can be problematic to the extent that a state moves to an electronic certificate of title scheme. The ultimate effect of the change will depend somewhat on whether paper titles are replaced entirely by electronic certificates of title or whether a paper title is issued when the debt secured by a vehicle is paid. But, either way, as discussed in Chapter 27 (Secured Parties Versus Buyers), conditioning an effective transfer on receipt of a certificate of title could conceivably prevent a buyer from becoming a buyer in ordinary course entitled to the special priority given to such buyers under new section 9-320(a).

F. Incompleteness of the Lien Notation Scheme

Fraudulent acquisition of a "clean title," a certificate of title on which a security interest is *not* noted, is much less likely today than it once was. This is so because of widespread sharing among motor vehicles departments of computerized information and because of various bond requirements. However, fraud involving doctored titles or claims of lost titles is still possible, especially where debtors are given control of certificates of title, as is true in so-called "title holder" states. *Cf.* Official Comment 6 to new 9-303.

By agreement between the debtor and secured party or as dictated by a particular certificate of title statute, secured parties may have possession of certificates of title and the risk of fraud is reduced by these "lien holder" schemes. But, because of the costs associated with lien holding, in most states debtors have been given possession of certificates of title. Moreover, while infrequent, mistakes by motor vehicles department personnel leading to the issuance of a clean title where a secured party has duly applied for a title noting a security interest are not unknown.

If a creditor or buyer extends value in reliance on the clean title, the question that arises is who as between the original creditor and a later creditor or buyer should prevail in the event of a dispute. In *Doherty v. Obregon*, 433 P.2d 52 (Ariz.App. 1967), decided under an earlier version of Arizona's certificate of title law, the court held in favor of the original creditor on the ground that creditor had duly complied with the certificate of title law and had done all that it could do to perfect its security interest. The rationale of the *Obregon* decision is sound and may well be applied should such a dispute arise under new Article 9.

It is desirable to give some degree of protection to non-dealer buyers, such as is provided for in new section 9-337 and discussed in Chapter 24 (Continuing Perfection -- Changes as to the Use of the Collateral or in the Location of the Collateral or the Debtor; Security Interests in Proceeds). However, even with the changes in the certificate of title lien notation system aimed at reducing the risk of mistake or fraud the message to creditors and buyers is that they should not rely on the physical appearance of a certificate of title and should check with the motor vehicles department to be sure there are not any outstanding encumbrances. *Cf. Wallace Imports, Inc. v. Howe*, 673 P.2d 961 (Ariz. App. 1983) (Distinguishing *Obregon*).

As explained above, some states, including Arizona, have adopted electronic certificate of title legislation according to which no paper title is issued until any security interest has been satisfied (or the secured party consents in writing or electronically to the transfer of title). One may expect the risk of an *Obregon*-type situation arising to be further reduced by such a system but, again, fraud or error leading to the issuance of a "clean" paper title before a security interest has been satisfied will still be possible.

In *Obregon* the dispute was between parties both of whom were relying on certificates of title issued by the same state. It also can happen that certificates of title are issued by more than one state. The new Article 9 scheme contemplates that there be only one certificate of title covering goods at any one time and that it will be clear which state's law governs perfection and non-perfection. However, because of fraud and the lack of complete coordination among state agencies responsible for administering certificate of title statutes from state to state, more than one certificate of title covering the same goods may be issued and be outstanding. *See* Official Comment to 6 to 9-303.

Deciding which state's law governs perfection in these rare but not unheard of cases requires applying new sections 9-316(d) and (e) and the examination of these sections is best left to Chapter 24 (Continuing Perfection -- Changes as to the Use of the Collateral or in the Location of the Collateral or the Debtor; Security Interests in Proceeds). And, again, the interface between the new Article provisions, especially those dealing with situations involving "clean" titles, and electronic certificate of title laws has yet to be clarified.

The next five problems will help you get a handle on the certificate of title lien notation scheme exception to perfection under Article 9 itself.

Problem 17.1 (INTERACTIVE)

Delbert Dealer, an Arizona automobile dealer, sells a new automobile to Betty Buyer, an Arizona resident, in Arizona. The automobile is purchased for use on the Arizona highways. Betty pays $2,000 down and agrees to pay the balance over four years. Betty gives Delbert an interest in the automobile to secure the unpaid price.

How should Delbert perfect its security interest?

If Delbert submits an application for a certificate of title nine days after the purchase contract is signed is the security interest perfected and, if so, as of what date?

Do your answers differ depending on whether former or new Article 9 applies?

Would your answer to the question of how Delbert should perfect its security interest change if Delbert knows Betty is just passing through Arizona and resides and will use the vehicle in California?

Which state's law, that of Arizona or that of California, governs perfection if Delbert applies for and obtains a California certificate of title?

Does it make any difference to perfection and the timing of perfection whether Arizona or California law governs?

Problem 17.2 (INTERACTIVE)

Dupe You, Inc. is a seller of new automobiles. Dupe You is an Arizona corporation doing business in Phoenix, Arizona and San Diego, California. Dupe You acquires a fleet of new automobiles to add to its inventory. The purchase is financed by Southwestern Bank, which takes a security interest in the automobiles to secure the unpaid price of the fleet of automobiles.

How should Southwestern Bank perfect its security interest in the fleet of automobiles under new Article 9?

By way of review of important material covered in Chapter 13 (Overview of Perfection by Filing), where should Southwestern Bank file its financing statement? Would filing be proper if the facts of Problem 17.2 were that Dupe You was an automobile rental agency that leased but did not sell automobiles (except to dispose of and replace automobiles that were leased)?

Problem 17.3 (INTERACTIVE)

Lisa Lender lends to Donald Debtor in Arizona. Donald delivers the certificate of title for his Honda automobile to Lisa as security for the loan.

Is the security interest in the Honda perfected under new Article 9?

Would your answer change if Lisa took possession of the Honda?

Problem 17.4 (INTERACTIVE)

Western Bank finances the purchase of an automobile by Donna Debtor in Arizona. Western duly applies to the Arizona Motor Vehicle Department for a certificate of title noting Western's security interest. Such a title is issued to Western. Subsequently, Donna is able, through fraud or mistake, to acquire a paper title on which Western's security interest is not noted. Donna sells the vehicle to Delbert Dealer in Arizona and Delbert pays an amount unadjusted for the amount of the security interest. Donna defaults on the loan to Western. Western tracks the vehicle to Delbert and demands that Delbert satisfy the loan debt or turn the vehicle over to Western.

Who wins this dispute?

As noted above, under contemporary certificate of title systems disputes such as that in Problem 17.4 generally should not arise. However, what should a creditor such as Delbert Dealer do to be safe?

Problem 17.5 (INTERACTIVE)

Delia Dealer in Arizona sells to Byron Buyer a new cabin cruiser boat and boat trailer that are to be kept and used in Byron's business in Arizona. Delia takes an interest in the boat and boat trailer to secure the unpaid purchase price of each.

How should the security interests be perfected under new Article 9?

G. Vehicle Financing As A Three-Party Transaction

It is useful here to anticipate some complexity that often exists as to an already not uncomplicated perfection scheme. That complexity arises because vehicle financing, whether the debtor is a dealer and the vehicles are inventory (in which case a financing statement is required) or the debtor is a person other than a dealer holding a vehicle for sale (in which case lien notation is required), often is a three-party transaction.

In a three-party transaction there will be two debtors and two creditors. For example, if you buy an automobile on credit from a retailer and the retailer takes a security interest in the vehicle then you are the debtor and the retailer is the secured creditor. But, quite likely the dealer has borrowed from a lender who finances the dealer's acquisition of inventory, including the vehicle you have purchased on credit. Consequently, the dealer is a creditor as to you but a debtor as to the lender.

There are many variations on three-party transactions. Recall from Chapter 4 (Scope of Article 9) that under new section 9-109(a)(3) sales of contracts are treated as secured transactions. The details determine what each creditor must do to perfect its security interest. New section 9-310(c) tracks former section 9-302(2) by providing that if a security interest is perfected when it is assigned then no further action is needed to perfect the interest against creditors of and transferees from the debtor who created the security interest.

The effect of this section is that where a creditor has been assigned an already perfected security interest the assignee-creditor need not take further action to perfect the assigned security interest. The perfection continues even where the assignee's name is different from that of the assignor because, as was explained in Chapter 14 (The Nitty Gritty of Filing), although the secured party's name must appear on the financing statement it is the debtor's name that is important for indexing and searching and the secured party's name is required only to allow the notification required by certain priority rules discussed in Part VI to be sent. *See* Official Comment 4 to new 9-310. *See also, In re Hergert*, 275 B.R. 58 (Bkcy D. Idaho 2002).

However, the assignee-creditor is excused from further action only where the assigned security interest was in fact perfected at the time of the assignment. Moreover, whether the assignment of a security interest is effective and whether the assigned security interest is perfected are separate matters. It should also be noted that new section 9-310(c) refers to the need to file a financing statement. As discussed earlier, under new section 9-311(c) lien notation in compliance with a certificate of title statute is the equivalent of filing.

The foregoing discussion of new section 9-310(c) assumes that there has been an assignment of a security interest. It could happen that a different secured party enters the picture by taking its own security interest in a vehicle already subject to a security interest held and perfected by lien notation by another creditor. In such a case, new section 9-310(c) presumably would not apply.

Thus, in the case of *In re Morgan*, 291 B.R. 795 (Bkcy E.D. Tenn. 2003), a creditor who took a security interest in a vehicle in connection with refinancing a loan that had enabled the debtor to purchase the vehicle delayed having its security interest noted on a certificate of title covering the vehicle for two years and until after the debtor filed bankruptcy.

The court held that under the state certificate of title law there was no perfection of the refinancing creditor's security interest until another title noting its security interest was issued. It further held that although the proceeds of the refinancing loan had been used to satisfy the secured debt of a creditor who had timely perfected the refinancing creditor could not be subrogated to the claim of the other creditor because the state certificate of title law did not allow for any such subrogation.

The net result was that perfecting the security interest after bankruptcy had been filed violated the automatic stay and was void and, therefore, the security interest was avoidable by the trustee in bankruptcy. The extent to which a trustee may avoid a security interest not perfected on the date of bankruptcy and the automatic stay are matters dealt with in Chapter 26 (Secured Party Versus Lien Creditor; Future Advances; Bankruptcy).

You may test your understanding of the three-party financing arrangements in the next problem.

Problem 17.6 (INTERACTIVE)

Delbert Dealer in Problem 17.1 borrows from Friendly Finance Company. Delbert assigns to Friendly the contract of sale involved in Problem 17.1.

Is Friendly protected against a trustee in bankruptcy if *Betty Buyer* files bankruptcy? Recall that protection against a trustee in bankruptcy turns on perfection.

Is Friendly protected against a trustee in bankruptcy if *Delbert* files bankruptcy?

What advice would you give to Friendly if you were advising Friendly as to bankruptcy risks?

Other issues arising in three-party transactions, including the extent to which defenses against an assignor/debtor may be raised against an assignee/secured party are considered in Chapter 37 (Foreclosure as to Intangibles).

CASE COMMENTARY

In re Judith Baker, 430 F.3d 858 (7th Cir. 2005)

In re James Baker, 345 B.R. 261 (D. Colo. 2006)

In re Snelson, 330 B.R. 643 (Bkcy E.D. Tenn. 2005)

In re Jeans, 326 B.R. 722 (Bkcy W.D. Tenn. June 28, 2006)

Genesee Regional Bank v. Palumbo, 9 Misc.3d 823 (N.Y. Supreme Court 2005)

Vibbert v.PAR, Inc., 224 S.W.3d 317 (Tex. App. March 23, 2006)

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2011-08-22 update

Part V Perfecting an Article 9 Security Interest

Chapter 18 Perfection By Doing Nothing -- Automatic Perfection

A. Generally

As you will recall, filing is the usual step required for perfection. *See* Chapter 12 (Perfection Generally). But, as was also pointed out in that chapter, perfection is achieved in certain cases by doing nothing, *i.e.*, automatically. The most familiar case of perfection on attachment is that for purchase money security interests in consumer goods under new section 9-309(1). This exception to filing and possession, and its components, purchase money security interest and consumer goods, are explored and explained at length in subpart B below.

Other instances of automatic perfection, also found in former Article 9, include a security interest temporarily perfected without delivery in instruments or certificated securities, a security interest in proceeds perfected for 20 days if the security interest in the original collateral is perfected (as discussed in Chapter 16 (Perfecting Security Interests in Proceeds and Other Later Acquired Property)), an assignment of accounts that does not involve a significant part of the outstanding accounts of the assignor, a security interest arising under Article 2 or 2A or Article 4, and an assignment for the benefit of creditors of the assignor.

New Article 9 makes certain changes to the former Article 9 scheme by providing for perfection on attachment as to (1) sales of payment intangibles and promissory notes (which, as discussed in Chapter 4 (Scope of Article 9), were outside the scope of former Article 9), (2) certain security interests in letters of credit, (3) security interests in investment property created by a broker, and (4) security interests created by the assignment of a health-care insurance receivable to a provider.

Automatic perfection for security interests in beneficial interests in trusts, which was not part of former Article 9 as enacted in many states, including Arizona, has been eliminated by new Article 9. The change in the treatment of assignments of beneficial interests in trusts was made because of an increased use of such interests as collateral. The proper way to perfect a security interest in a beneficial interest in a deed of trust is dealt with in Chapter 20 (Perfection as to Fixtures and Other Real Estate-Related Collateral). Temporary perfection for certain collateral such as instruments and documents of title has not been eliminated but rather moved to new section 9-312.

There were differing rationales for the situations where filing was not required ranging from the fact that the transaction was not really a financing transaction or the transaction was so out of ordinary course that a creditor might not think about perfecting its interest to transactions in which the creditor was relying on possession for perfection and there was a need to allow a debtor or other party temporary access to the collateral to accomplish a transfer of the collateral.

As was noted in Chapter 17 (Perfection as to Goods Subject to Certificate of Title Legislation), perfection by compliance with a certificate of title law is the equivalent of filing a financing statement. *See* new 9-311(c). Such is not the case as to automatic perfection and, as will be seen in Part VI (Priority), relying on automatic perfection poses a risk in consumer goods cases that can be avoided only by filing a financing statement.

B. Automatic Perfection as to Purchase Money Security Interests in Consumer Goods

1. In general

Perhaps the most important instance of automatic perfection is that for a purchase money security interest in consumer goods. Under former section 9-302(1)(d) there was perfection on attachment as to a purchase money security interest in consumer goods other than a security interest in a vehicle required to be registered or in a fixture as to which a creditor desired the protection against real estate parties achieved by making a fixture filing.

New section 9-309(1) tracks former section 9-302(1)(d) in substance, but rather than state the rule in terms of an exception to filing, new section 9-309(1) provides that a purchase money security interest in consumer goods, other than one that is subject to a statute or treaty (such as a certificate of title law), is perfected on attachment.

The exemption from filing for purchase money creditors in the consumer context is premised on a belief that requiring all creditors who extend such purchase money credit to file would place a burden on the filing system that is outweighed by the protection accorded to the relatively few creditors who take interests in consumer goods after the debtor already owns them. The exemption from filing for purchase money security interests in consumer goods is made *even though* the effect is to create the possibility of a secret lien.

2. When a Security Interest is a Purchase Money Security Interest

The distinction between purchase and non-purchase money interests is important throughout the law of secured financing and in bankruptcy and whether a security interest is or is not purchase money can be controlling as to matters other than automatic perfection. Here the question is whether there is a purchase money security interest in goods such as will result in automatic perfection.

Under new section 9-103(b)(1), a security interest is a purchase money security interest in goods to the extent that the goods are purchase money collateral with respect to the security interest. "Purchase money collateral," under new section 9-103(a)(1), means goods or software that secure a "purchase-money obligation" with respect to the collateral. New section 9-103(a)(2), in turn, defines a "purchase-money obligation" as an "obligation incurred as all or part of the price of the collateral or for value given to enable the debtor to acquire rights in or the use of the collateral if the value is in fact so used."

Thus, for a security interest to be a purchase money security interest in goods under new section 9-103 the goods must secure a purchase money obligation and this means that the obligation must have been incurred to secure the price of the collateral or the value must have been given by the creditor to enable the debtor to acquire rights in the collateral and the value must have been in fact so used.

The classic instance of a purchase money security interest in goods historically has been a conditional sales contract, *i.e.*, a contract under which the seller takes an interest in the goods sold to secure the unpaid purchase price of the goods and that instance of a purchase money security interest is captured in new section 9-103(a)(2).

The other type of purchase money credit is that involving a loan that enables the debtor to acquire rights in the collateral. Under new section 9-103(a)(2), a loan results in a purchase money security interest only to the extent the loan ("the value") actually is used to acquire the goods. To help assure that loan proceeds are actually used to acquire goods, lenders should be advised to make checks payable to the seller of the goods (or the debtor and seller).

3. The Requirement that the Goods be "Consumer Goods"

As was true under former section 9-302(1)(d), for there to be perfection on attachment under new section 9-309(1) there must be a purchase money security interest in goods that are consumer goods. As discussed in Chapter 5 (Classification of Collateral), under new section 9-102(a)(44) "goods" essentially means things that are moveable when a security interest attaches and under new section 9-102(a)(23) goods are "consumer goods " if they are used or bought for use primarily for personal, family, or household purposes.

Article 9 separately defines a "consumer transaction" as one in which the secured obligation was incurred by an individual for personal, family or household purposes. *See* new 9-102(a)(26). However, the automatic perfection rule requires only that the collateral be consumer goods and not that the secured obligation have been incurred for a consumer purpose.

You may explore the basics of perfection on attachment for a purchase money security interest in consumer goods under new section 9-309(1) in the next three problems.

Problem 18.1 (INTERACTIVE)

Donald Debtor borrows from Southern Bank to acquire appliance parts from Stella Seller. Donald gives Southern an interest in the appliance parts that Donald will acquire from Stella and in appliance parts that Donald already owns. Donald uses the proceeds of the loan from Bank to acquire the appliance parts from Stella.

Which of Southern's security interests are purchase money under new Article 9?

Suppose that Donald acquired the appliance parts from Stella on credit and used the loan from Southern to take a vacation. Would your answer be different?

Problem 18.2 (INTERACTIVE)

Donna Debtor acquires a computer from Sid Seller on credit and gives Sid an interest in the computer to secure its price. Donna runs a consulting business out of her home. Donna uses the computer both in her business and to play electronic games.

Is Sid's interest in the computer perfected without the need for Sid to file a financing statement?

Would answer to the question be more certain if the security agreement contained a covenant that Donna would use the computer only for personal use?

Problem 18.3 (INTERACTIVE)

Assume the basic facts of Problem 18.2. Assume, however, that Donna Debtor borrowed from Lisa Lender to acquire the computer and gave Lisa an interest in the computer to secure the loan.

Under what further assumptions may you conclude that Lisa's security interest in the computer is perfected automatically under new Article 9?

What specific action would you advise Lisa to take to help assure that its security interest is perfected without filing? Why?

It is important to understand what automatic perfection means to third parties. You may explore this point in the next problem.

Problem 18.4 (INTERACTIVE)

Assume the basic facts of Problem 18.2. Assume further that Donna Debtor acquired the computer primarily to play electronic games. Suppose that after acquiring the computer from Sid Seller, Donna goes to Lisa Lender for a loan and offers Lisa an interest in the computer as collateral.

How can Lisa protect herself against any competing interest that might be asserted by Sid?

As noted earlier, certificate of title laws can impact the availability of automatic perfection. Take another look at the language of new section 9-309(1) and then consider the next problem.

Problem 18.5 (INTERACTIVE)

Assume the facts of Problem 17.5 in Chapter 17 (Perfection as to Goods Subject to Certificate of Title Legislation) (Delia Dealer in Arizona sells to Byron Buyer a new cabin cruiser boat and boat trailer that are to be kept and used in Byron's business in Arizona. Delia takes an interest in the boat and boat trailer to secure the unpaid purchase price of each) except that Byron buys the cabin cruiser and boat trailer for personal use.

As to which items of property is Delia's security interest perfected without doing anything?

Recall the rationale for the automatic perfection of purchase money security interests in consumer goods set out above. Is this a case where the rationale breaks down?

In Part VI (Priority), it will be seen that there is a risk for a creditor who relies on automatic perfection under new section 9-309(1) and to protect against that risk a creditor may be advised to file even where automatic perfection is possible. For now just make a note that there is such a risk.

C. Automatic Perfection of a Security Interest in Software

Software is an increasingly important source of collateral. The question arises whether a security interest in software can be perfected automatically. Under new section 9-309(1), as set forth above, a security interest can be perfected automatically only where the software constitutes consumer goods and the security interest is purchase money.

As discussed in Chapter 5 (Classification of Collateral), software constitutes goods under new section 9-102(a)(44) if it is embedded into a computer in such a way that it would customarily be considered part of the computer or by acquiring a computer a person acquires a right to use the software in connection with the computer in which the software is embedded.

Software satisfying the definition of ''goods'' in new section 9-102(a)(44), for example, a computer operating system, can be ''consumer goods'' if it is used or bought for use primarily for personal, family or household purposes under new section 9-102(a)(23). However, for there to be automatic perfection not only must the software be consumer goods but the security interest must be a purchase money security interest.

Former Article 9 did not specifically address the question of whether or when a security interest in software could be or was purchase money. New section 9-103(c) indicates that a security interest in software is a purchase-money security interest to the extent that: (1) the security interest also secures a purchase-money obligation incurred with respect to goods in which the secured party holds or held a purchase-money security interest; (2) the debtor acquired its interest in the software in an integrated transaction in which it acquired an interest in the goods; and (3) the debtor acquired its interest in the software for the principal purpose of using the software in the goods.

According to Official Comment 5 to new section 9-103, the circumstances under which a security interest in goods may be accompanied by a purchase money security interest in software are limited. Specifically, there will be a purchase money security in software only where the software was acquired by the debtor in an integrated transaction in which the debtor acquired the goods and the software together and the debtor acquired the software for the principal purpose of using the software in the goods.

It seems, therefore, that any time (a) software is goods under new section 9-102(a)(44), (b) the secured party has a purchase money security interest in the computer in which the software is embedded, and (c) there is a security interest in the software that secures the obligation incurred in acquiring the software and also in acquiring the computer, then the security interest in software is a purchase money security interest. New section 9-103(b)(3) confirms this conclusion.

Note that because of the requirement that there be an integration of the software with the computer for a security interest in the software to be purchase money it also seems that if there is a purchase money security interest in software then, as discussed in Chapter 5 (Classification of Collateral), the software constitutes goods under new section 9-102(a)(44). If the software is used or bought for use for personally, family or household purposes, then under new section 9-102(a)(23) the software will be consumer goods and there can be automatic perfection of the security interest in the software under new section 9-309(1).

The question of when a security interest in software can be perfected automatically may be explored in the next problem.

Problem 18.6 (INTERACTIVE)

Byron Buyer acquires a computer for personal use that is "bundled" with a suite of software from Stella Seller. Byron agrees to pay 10% down and the balance in 12 equal monthly installments and gives Stella a security interest in the computer and software suite to secure the purchase price of the system. Two weeks later Byron acquires from Stella graphics software for personal use that Byron also acquires on credit giving Stella an interest in the graphics software to secure its price and also to secure the price of the earlier acquired computer and software suite.

In what property does Stella have a purchase money security interest?

In what property would the security interests be perfected automatically under new section 9-309(1?

Is the security interest in the graphics software even enforceable?

In Chapter 11 (Enforceability and Attachment of Security Interests in Consumer Transactions) it was noted that cross collateralizing and refinancing or consolidation of debts can threaten the status of a security interest as a purchase money security interest. The loss of purchase money status also can affect priority and enforceability of a security interest in bankruptcy. *See* Chapters 26 (Secured Party Versus Lien Creditor) and 30 (Secured Party Versus Trustee in Bankruptcy). Oversimplifying somewhat, new sections 9-103(e), (f), and (g), applicable to other than consumer-goods transactions, generally provide that the purchase money character of security interest will be preserved in situations where it would be lost because of cross collateralizing and consolidation and refinancing.

New section 9-103(h) provides that the rules applicable to other than consumer-goods transactions in new sections 9-103(e), (f), and (g) do not apply in consumer-goods transactions and rather courts are to fashion appropriate rules and should not be influenced by new sections 9-103(e), (f), and (g) in doing so. Consumer-goods transaction is defined in new section 9-102(a)(24) essentially as a consumer transaction in which the collateral is consumer goods.

CASE COMMENTARY

First National Bank v. Lubbock Feeders, L.P., 183 S.W.3d 875 (Tex. App. 2006)

In re Commercial Money Center, Inc., 350 B.R. 465 (B.A.P. 9th Cir. 2006)

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Part V Perfecting an Article 9 Security Interest

Chapter 19 Perfection Pursuant To Federal Law

A. Generally

As noted in Chapter 12 (Perfection Generally), perfection of security interests in certain collateral must be accomplished by complying with laws outside Article 9. We examined in Chapter 17 (Perfection as to Goods Subject to Certificate of Title Legislation) the important case of perfection by "lien notation" of security interests in goods covered by certificate of title laws. The other major category of cases where Article 9 does not govern perfection is that where compliance with federal law is required. *See* new sections 9-310(b)(3) and 9-311(a)(1).

As with certificate of title cases two questions must be answered. The first is whether federal law and not Article 9 governs perfection. The second is what is necessary to comply with a federal law that has displaced Article 9. When federal law supercedes Article 9 it may do so as to every aspect of a security arrangement from creation and enforceability to perfection, priority and foreclosure. However, this chapter, and most of the debate as to when federal law rather than Article 9 governs, is concerned only with the question of whether perfection may be achieved under Article 9 or must be accomplished by action under federal law.

As was seen in Chapter 12 (Perfection Generally), the general rule of new Article 9 is that a security interest may be perfected only by filing a financing statement in the proper place. Thus, the perfection question, for the most part, becomes a question of whether a security interest in particular property may be perfected by filing a financing statement under Article 9 or whether perfection may be accomplished only by complying with the requirements of federal law.

B. When Compliance with a Federal Statute is Required

1. The Governing Provisions

Under the Supremacy Clause of the Article VI of the United States Constitution, federal law may displace state law to the extent that the federal law, explicitly or implicitly, preempts state law. Unfortunately, determining when and to what extent federal law has preempted state law is a difficult task at best.

As to Article 9, the question is when a federal law providing for the federal registration of interests in personal property has preempted the Article 9 rules governing the perfection of security interests in such property. Former Article 9, sections 9-104(a) and 9-302(3)(a) offered little guidance for deciding whether a particular federal law scheme displaced the Article 9 perfection scheme as a matter of preemption and there was some indication that federal law governed even where there was no preemption as such. *See* *National Peregrine, Inc. v. Capitol Federal Savings and Loan Ass'n*, 116 B.R. 194 (C.D. Cal. 1990), discussed further below.

It is clear that the drafters of new Article 9 intend that Article 9 yield to federal law only when and to the extent that federal law has preempted Article 9. Thus, new section 9-109(c)(1) provides that new Article 9 "does not apply to the extent that a statute, regulation or treaty of the United States *preempts* [Article 9]." [Emphasis added.] *See* Official Comment 8 to new 9-109 (rejecting the "voluntary step back" approach taken in *National Peregrine*, *supra*).

As to the specific matter of the perfection of a security interest, new section 9-311(a)(1) states that "the filing of a financing statement is *not necessary or effective to perfect* a security interest in property that is subject to . . . a statute, regulation, or treaty of the United States *whose requirements for a security interest's obtaining priority over the rights of a lien creditor with respect to the property preempt Section 9-310(a)*." [Emphasis added.]

The effect of new section 9-311(a)(1) is that the perfection rules of new Article 9 apply unless a federal law not only provides for federal registration of a security interest in personal property but federal registration is a condition of priority of the security interest over the rights of a lien creditor. According to Official Comment 2 to new section 9-311, new section 9-311(a)(1) uses the lien creditor language rather than the word "perfection" because the essence of perfection tends to be that a security interest is protected against lien creditors, including a trustee in bankruptcy, and federal laws posing preemption issues may use language other than "perfection."

The difficult reality facing Article 9 practitioners is that although the test of displacement of Article 9 by federal law may be relatively easily stated it is anything but easily applied to particular federal laws. Most federal laws do not make clear by their language whether federal registry of an interest in personal property is a condition of and results in priority of the interest over the rights of a lien creditor. The remainder of this chapter examines court decisions under former Article 9 dealing with particular federal statutes and inquires whether the cases would be decided the same way under new Article 9.

2. Perfecting Security Interests in Particular Property Subject to Federal Statutes

a. Perfecting Security Interests in Civil Aircraft

There was general agreement under former Article 9 that to perfect a security interest in or other lien on civil aircraft (or parts thereof) a creditor had to register the security interest or lien with the Federal Aviation Administration in Oklahoma City, Oklahoma. *See e.g.*, *Danning v. Pacific Propeller, Inc. (In re Holiday Airlines Corp.)*, 620 F.2d 731 (9th Cir.), *cert. denied*, 449 U.S. 900 (1980).

The controlling provisions of the Federal Aviation Act, 49 U.S.C. §§ 44107-11, do not in so many words indicate that the effect of recording a security interest with the FAA in Oklahoma City, Oklahoma is to give the recording creditor priority over a lien creditor. However, there is language in sections 44108(a) and (b) indicating that a recording is necessary to make a security interest effective against persons other than the debtor or who have actual notice of the security interest and that no other recording is needed to make the security interest effective against all persons.

The language of these sections supports a conclusion that the Article 9 filing requirements have been preempted as contemplated by new section 9-311(a)(1). Official Comment 2 to new section 9-311 specifically identifies the federal aviation statute as the type of statute to which new section 9-311(a)(1) applies. Consequently, under new Article 9 it will be necessary to perfect a security interest in aircraft (or aircraft engines or propellers) by complying with federal law and filing an Article 9 financing statement is neither necessary nor effective under new sections 9-311(a)(1) and 9-311(b).

Until March of 2006, compliance with federal law to perfect a security interest in aircraft meant registering the security interest with the Federal Aviation Authority (FAA) in Oklahoma City, Oklahoma. Effective on March 1, 2006, the United States became a party to the Cape Town Convention. See 49 U.S.C. subtitle VII, Pt. A and the FAA regulations, 14 C.F.R. §§ 1 et seq., implementing the Convention. A copy of the Convention and Protocol may be found at http://www.unidroit.org/english/conventions/c-main.htm.

The details of the Convention and Protocol are beyond the scope of these materials but the essence is that to perfect security interests in aircraft and engines and documents related thereto that fall within the scope of the Convention a creditor must go to the FAA and obtain a code that enables the creditor to register a security interest in an international electronic registry in Dublin, Ireland. Thus, the FAA is the exclusive entry point but perfection requires registration pursuant to the Convention in Ireland. Consistent with the proposition that filing and searching are flip sides of the same coin, searching for security interests in covered aircraft now requires searching the international registry.

A multiplicity of questions regarding the details of compliance with the Convention and implementing federal registration, priority of conflicting security interests and how the new scheme interfaces with federal bankruptcy law undoubtedly will arise. A useful overview of the new scheme has been provided by Frank L. Polk in "Cape Town and Aircraft Transactions in the United States," Air and Space Lawyer (Winter 2006), available from Westlaw at 20-WTR Air & Space Law. 4.

In the case of *In re AvCentral, Inc.*, 289 B.R. 170 (Bkcy D. Kan. 2003), it was held that a security interest in aircraft acquired by the debtor to be "parted out" had to be perfected by recording the security interest with the FAA. In so holding, the court did not decide the question of whether a security interest attaching to aircraft parts of an already disassembled aircraft (other than engines or propellers or spare parts held by an aircraft carrier) would be subject to the federal recording scheme or had to be perfected by filing a financing statement under Article 9 of the UCC.

Presumably, the decision in *AvCentral* will continue to be good law after the effective date of the Cape Town Convention, but confirming that this is so and determining the steps necessary to achieve perfection as to such collateral as was involved in the case will require examining the Convention and implementing federal legislation.

b. Perfecting Security Interests in Copyrighted Property

Perfection of security interests in copyrighted property was the subject of considerable debate under former Article 9. In *National Peregrine, Inc. v. Capitol Federal Savings and Loan Ass'n*, 116 B.R. 194 (Bkcy C.D. Cal. 1990), Judge Kozinski, a Ninth Circuit Court of Appeals judge sitting by designation in a bankruptcy proceeding, concluded that both as a matter of voluntary deference of Article 9 and preemption a security interest in a copyright or copyrighted materials could be perfected only by recording the security interest in the U.S. Copyright Office.

In so holding the court in *National Peregrine*, relying essentially on 17 U.S.C. § 205, concluded that a federal recording was necessary to achieve priority over a lien creditor and, hence, a trustee in bankruptcy. *National Peregrine* has been understood to mean that the need to record federally applies not only to copyrighted materials as such but also to accounts generated by the sale or licensing of copyrighted materials. However, the court's opinion in *National Peregrine* did not indicate whether its holding applied to all copyrighted materials, whether the copyrights had been registered by the owners in the U.S. Copyright Office or not, or whether only security interests in copyrighted materials as to which copyrights had been registered had to be recorded in the Copyright Office.

The distinction matters because, although registration gives a copyright owner certain enforcement advantages not enjoyed by owners who have not registered their copyrights, 17 U.S.C. § 411(a), copyright protection exists under federal law whether or not a copyright has been registered, 17 U.S.C. §§ 102(a), 408(a), and many copyrights are never registered. Beyond this, registration is a pre-condition to the ability of a creditor to record a security interest in the U.S. Copyright Office.

Registration results in an identification number being assigned to a copyright, 17 U.S.C. § 409, and recordings of all transfers, including security transfers, are indexed using the identification number (and not the owner's name). 17 U.S.C. § 205(a). Consequently, there is no way to record an interest against an unregistered copyright and, as considered further below, if security interests in all copyrights must be made federally a creditor would first have to require a debtor-copyright owner to register all its copyrights.

National Peregrine was followed in *In re AEG Corp.*, 161 B.R. 50 (BAP 9th Cir. 1993) and in *In re Avalon Software, Inc.*, 209 B.R. 517 (Bkcy D. Ariz. 1997). The courts in these cases concluded that federal filing was necessary even where a debtor-copyright owner had *not* registered its copyrights. The court in *Avalon Software* acknowledged that a security interest may not be recorded in the U.S. Copyright Office unless and until a copyright is registered, but it insisted that it is the responsibility of the secured party to be sure that the debtor has registered all copyrights (as to copyrighted materials in existence at the time the security interest is created and as to copyrights arising later and those involving modifications and derivatives of the original copyrighted works).

More recently, in *In re World Auxiliary Power Co.* *(AKA Aerocon Engineering, Inc. v. Silicon Valley Bank)*, 303 F.2d 1120 (9th Cir. 2002), the Court of Appeals for the Ninth Circuit upheld the decisions of a bankruptcy court and a federal district court concluding that a security interest in *unregistered* copyrights need *not* be recorded in the U.S. Copyright Office and may be perfected by filing a financing statement under Article 9. To view the opinion click on the case name.

In so holding the court of appeals affirmed the decision and analysis in *National Peregrine* regarding registered copyrights, including the conclusion that a federal recording is necessary to achieve priority over a lien creditor and, hence, a trustee in bankruptcy, but the court of appeals rejected the holdings in *AEG Corp.* and *Avalon Software, supra,* to the extent that those decisions made recording federally necessary as to unregistered copyrights.

In its opinion, the court of appeals in *World Auxiliary Power* agreed with Judge Kozinski in *National Peregrine* that federal recording is required as to registered copyrights both as a matter of voluntary deference by Article 9 to federal law and as a matter of preemption. As noted above, new Article 9 has rejected the voluntary deference approach and Article 9 is displaced only to the extent that there is preemption. Therefore, only the preemption aspect of *World Auxiliary Power* is viable under new Article 9. Nonetheless, it is clear, at least in the Ninth Circuit, that a filing under new

Article 9 is effective to perfect a security interest in unregistered copyrights and only security interests in registered copyrights need be recorded in the U.S. Copyright Office.

The credit industry undoubtedly will hale the decision in *World Auxiliary Power* as a major victory. As the court of appeals notes, the vast majority of copyrights are not registered and as to these copyrights creditors may perfect their security interests by taking the relatively simple step of filing a financing statement under Article 9 and need not go the costly and time-consuming route of requiring a debtor-copyright owner to register its copyrights and to record their security interests in the U.S. Copyright Office. Of manifest importance, filing under Article 9 will perfect security interests in unregistered copyrights and protect the security interests in unregistered copyrights against trustees in bankruptcy.

However, the decision in *World Auxiliary Power* does not relieve a creditor of the responsibility of recording a security interest in registered copyrights in the U.S. Copyright Office. Moreover, the decision does not satisfactorily dispose of the question of what happens when a debtor-copyright owner registers a copyright a security interest in which has been perfected by filing under Article 9. It would seem that perfection achieved by filing under Article 9 ceases when a copyright is registered. Consequently, a secured party will have to establish procedures to monitor a debtor-copyright owner's behavior with regard to copyright registration.

Nor does the decision in *World Auxiliary Power* adequately address the problem that arises if a debtor gives a security interest in unregistered copyrights to a creditor who perfects by filing and the debtor then gives a security interest in the same copyrights to a subsequent creditor who requires the debtor to register the copyrights and who records its security interest in the U.S. Copyright Office. If perfection by filing ceases when a copyright is registered, it follows that the creditor who recorded with the U.S. Copyright Office would have priority.

The court of appeals dismisses the problem by labeling it "double dealing" and fraud, which the court declines to try to prevent by requiring federal recording as to security interests in unregistered copyrights. But, of course, there need be nothing fraudulent about the debtor's behavior in such a situation. Debtors regularly offer as collateral property already subject to a security interest and it is the fact that they do so, and that such subsequently created security interests are effective, that makes necessary the extensive and often complex set of priority rules in Article 9.

A related question is what happens if a debtor-copyright owner who has given a security interest in unregistered copyrights that is perfected by filing later registers the copyrights and then files bankruptcy. The answer again would seem to be that the security interest is not perfected and is avoidable by a trustee in bankruptcy. A creditor could include in its security agreement a provision barring later security interests, but under new section 9-401 such a provision would not render ineffective a later-created security interest and, rather, would have the effect only of making the creation of a later security interest by the debtor a default.

Neither is there necessarily anything improper about a subsequent creditor requiring a debtor-copyright owner to register its copyrights. Indeed, realistically, determining whether particular copyrights have been registered is not so simply accomplished as the court of appeals' opinion suggests. It would seem that simply asking a debtor would not provide complete assurance and the best way to know is to require a debtor to provide evidence of registration that a creditor must then confirm by doing a search in the U.S. Copyright Office.

Given that both creditors who are acting to perfect their security interests and creditors who engage in a search for outstanding security interests before lending against copyright collateral may end up in the U.S. Copyright Office, it is reasonable to ask why it would not make more sense to require all recordings to be made in one rather than in two places, such as is the result of the decision in *World Auxiliary Power*.

In the last analysis, the important question is what lenders who take security interests in copyrights and copyrighted material and accounts generated by the sale or license of such property must or ought to do both to be sure that there are no outstanding interests that could have priority and to perfect any interests that lenders take so as to protect their security interests against the claims of other parties, including a trustee in bankruptcy.

Under new section 9-311(a)(1) and *World Auxiliary Power*, to perfect a security interest in registered copyrights a creditor must record the interest in the U.S. Copyright Office. Under new section 9-311(b), *only* a recording in the U.S. Copyright Office will perfect a security interest in registered copyrights (but federal recording is the equivalent of an Article 9 filing to the extent that filing is material under new Article 9). Because recording federally is the exclusive mode of perfection as to registered copyrights, a lender who is contemplating taking a security interest solely in *registered* copyrights need search only in the U.S. Copyright Office.

On the other hand, under new section 9-311(a)(1) and *World Auxiliary Power*, recording a security interest in *unregistered* copyrights in the U.S. Copyright Office will *not* perfect the security (indeed recording technically is not possible as to unregistered copyrights). To perfect a security interest in unregistered copyrights a lender *must* file a financing statement under Article 9 and need not (may not) record federally and such a lender need search only the Article 9 filing system.

A word of caution is in order. Copyrighted materials, other than software bundled with computers so as to make the software goods under new section 9-102(a)(44), most likely will be general intangibles and both the security agreement and financing statement should so describe the copyrighted materials (describe the materials by item). Although revenues generated by the sale or license of the materials may be proceeds under new section 9-102(a)(64), it may be wise to specifically refer to such revenues as accounts (and this is true of revenues from materials as to which copyrights have been registered as well).

The foregoing may be seen as a summary of what creditors lending against copyrighted materials *must* do under *World Auxiliary Power* and new Article 9. What such creditors *should* do may be quite different. As was explained, knowing whether a copyright is registered or not is no trivial matter. As also explained, perfection by filing in an unregistered copyright would seem to end if the copyright is later registered, putting the secured party at risk as against a later creditor who perfects a security interest by recording in the U.S. Copyright Office and a trustee in bankruptcy.

Consequently, to be safe a creditor probably should search both the Article 9 system and the U.S. Copyright Office (something that can be done only using copyright identification numbers and not a debtor's name) and a creditor should file an Article 9 financing statement and record its security interest in the U.S. Copyright Office, something it can do only if it requires the debtor-copyright owner first to register the copyright. Given the cost and time involved, the extent to which a creditor will be so thorough will depend upon how much is at stake.

Stated another way, the decision in *World Auxiliary Power* may not change what thorough creditors would do or should do, but it will protect those who choose not to be so thorough. The decision also will protect those who do choose to be thorough during the time it takes to complete the process of getting copyrights registered and recorded, especially against a trustee in bankruptcy.

c. Perfecting Security Interests in Patents

The perfection of security interests in patents may pose an interesting test of the changes made by new Article 9. The Lanham Act, the federal statute governing patent assignments, in 35 U.S.C. § 261, provides that "an assignment, grant or conveyance shall be void as against any subsequent purchaser or mortgagee for a valuable consideration, without notice, unless it is recorded in the U.S. Patent and Trademark Office within three months from its date or prior to the date of such subsequent purchase or mortgage."

Judge Kozinski, in *National Peregrine*, discussed above, concluded that perfection of a security interest in a patent required recording the interest in the U.S. Patent and Trademark Office. According to Judge Kozinski, holding otherwise would produce a dual filing system under which protection against lien creditors, including trustees in bankruptcy, would be achieved by filing under Article 9 but protection against purchasers, including other secured parties, would require recording in the U.S. Patent and Trademark Office.

To avoid a dual filing situation and reach the result that it was necessary to file federally, despite the incompleteness of the priority scheme provided for in 35 U.S.C. § 261, Judge Kozinski argued that perfection and priority are distinguishable matters. Under Judge Kozinski's analysis it is possible for a federal law to establish a federal recording system that displaces the Article 9 *filing system*, but leave the consequences of recording a security interest federally to the Article 9 *priority* rules.

As noted earlier, under new section 9-311(a)(1), the Article 9 filing scheme is displaced only where the federal statute preempts not only the Article 9 place of filing rules but further that the effect of a federal filing is to give a security interest priority over the rights of a lien creditor. Consequently, new section 9-311(a)(1) does not allow for the distinction between perfection and priority argued for by Judge Kozinski in *National Peregrine*. Of course, preemption is a federal question and a court might adopt Judge Kozinski's distinction between perfection and priority as a matter of federal law so as to require that to perfect a security interest in a patent the security interest must be recorded in the U.S. Patent and Trademark Office.

However, the need to make a choice between what new Article 9 intends and a federally imposed preemption result has been avoided, at least for now, and at least as to patents, by the Ninth Circuit Court of Appeals decision in *In re Cybernetics Services, Inc.*, 252 F.3d 1039 (9th Cir. 2001). In that case, it was held that the Lanham Act, in particular, 35 U.S.C. § 261, deals only with ownership interests and does not allow for or require that a security interest be recorded in the U.S. Patent Office and Trademark Office for the security interest to be perfected and protected against either a lien creditor or another secured party. Under this decision, a security interest in a patent may be perfected only by filing a financing statement under Article 9.

The Ninth Circuit's interpretation of 35 U.S.C. § 261, especially the word "purchaser," seems a bit strained, as does the court's insistence that transfers are divided into those involving ownership interests and those involving licenses (with the result that security interests somehow become license interests). However, insofar as the decision is that of an appellate court, the decision provides greater certainty and guidance on the matter of perfecting a security interest in a patent than exists as to copyrights.

d. Perfecting Security Interests in Trademarks

In *In re Together Development Corp.*, 227 B.R. 439 (Bkcy D. Mass. 1998), the court held the filing of a notice of a security interest in a trademark in the U.S. Patent and Trademark Office was *not* effective to perfect the security interest. The court concluded that the Lanham Act, 15 U.S.C. § 1060, does not provide for recording security interests, as distinguished from ownership interests, in trademarks in the U.S. Patent and Trademark Office. The secured party should have filed a financing statement under Article 9.

As with *Cybernetics Services*, discussed above, the decision rests on a distinction between security transfers and outright assignments of ownership interests. As was also true in *Cybernetics Services*, the court viewed security interests in copyrights as a different matter.

It should be noted that security interests in trademarks present special drafting and enforcement problems. A mark cannot be transferred "in gross," that is, separately from the business with which it is associated. 15 U.S.C. § 1060. Consequently, the security agreement should be structured so as to effectively create a security interest in the debtor's business that allows the creditor to sell the business on default.

Doing so likely will require that security interests be created specifically in all of the debtor's business property and that these interests be properly perfected. For example, the security agreement should cover good will as a general intangible and equipment and inventory as tangible collateral, in addition to creating a security interest in the trademark.

e. Trade Secrets

Trade secrets can be valuable collateral. There are several problems with using trade secrets as collateral. One is that there is no legal protection for a trade secret once the secret is out. Persons who steal a trade secret and persons to whom the secret is communicated with awareness of the theft may be criminally or civilly liable, but the secret is otherwise available to the public. Consequently, a creditor must be sure the debtor is taking every precaution to maintain the secrecy of a trade secret.

Another problem is classifying the trade secret for purposes of describing it in a security agreement and financing statement. One would think that describing the collateral as the "debtor's trade secrets" would be sufficient and it may be. More generally, a trade secret would seem to be a general intangible under new section 9-102(a)(42) and, hence, describing the collateral as "debtor's general intangibles" should also be sufficient.

Insofar as the theft or other unauthorized appropriation of a trade secret gives rise to an action in tort that action, by analogy to insurance proceeds, should be proceeds of the trade secret under new section 9-315(a)(2), as discussed in Chapter 9 (The Specifics of Enforceability – After-Acquired Property, Future Advances, Transferred Collateral and Proceeds and the New Debtor Problem).

As explained in Chapter 16 (Perfecting Security interests in Proceeds and Other Later Acquired Property), so long as the security interest in the trade secret as original collateral was perfected the interest in the tort action as proceeds would be perfected automatically for twenty days under new section 9-315(c) and would continue to be perfected beyond the twenty-day period under the "same place" filing rule of new section 9-315(d)(1). *See* Chapter 24 (Continuing perfection – Changes as to the Use of the Collateral or in the Location of the Collateral or the Debtor; Security Interests in Proceeds).

Some uncertainty arises from the fact that the basic legal protection for trade secrets is misappropriation and it may be that a secured party who takes a security interest in a trade secret is getting a security interest in a "commercial tort claim," which as explained in Chapter 4 (Scope of Article 9) is covered by new Article 9. If the collateral constitutes a commercial tort claim then under new section 9-108(e)(1) a description by type in a security agreement is not adequate and greater specificity is required. A more serious problem for the secured party is that under new section 9-204(b)(2), as discussed in Chapter 9 (The Specifics of Enforceability -- After-acquired Collateral, Future Advances, Transferred Collateral and Proceeds, and the New Debtor Problem), a security interest cannot attach to a commercial tort claim as after-acquired property and the secured party would have to rely on its ability to reach any such tort claim as proceeds.

The final point about trade secrets is that they may be used to produce copyrighted or patented property. Consequently, a secured party will want to have an interest in any such resulting patents or copyrights. Whether or not the resulting property constitutes proceeds, even under the expanded definition of proceeds in new section 9-102(a)(64), is a nice question. *See* Chapter 9 (The Specifics of Enforceability – After-Acquired Property, Future Advances, Transferred Collateral and Proceeds and the New Debtor Problem).

The copyrighted or patented property likely would be covered by a description in a security agreement that includes existing and later-acquired general intangibles, but there is the problem of perfection discussed above. A filing under Article 9 is sufficient to perfect a security interest in a patent, but recording the security interest in the U.S. Copyright Office may be necessary as to copyrighted property, at least if the copyright is registered.

f. Domain Names

In the age of electronic commerce domain names are valuable assets because a name that readily identifies the debtor's business allows web surfers to get quickly and easily to the debtor's web site without the need to do a search that undoubtedly will result in multiple hits that may include the sites of competitors. Even in the age of such powerful search engines as Google, for businesses that depend on their web presence for success, a domain name may be among the most valuable assets the business owns.

In *Network Solutions, Inc. v. Umbro International, Inc.*, 529 S.E.2d 80 (Va. 2000), the court held that the contractual right arising when a domain name is registered by a debtor is not subject to garnishment. In so holding, the court rejected the view that domain names constitute a new form of intellectual property and concluded that the contract with the registering entity was a contract for services that was not within the scope of the Virginia garnishment statute. The question arises as to what effect, if any, this decision has on the creation and perfection of a security interest in a domain name. The short answer would seem to be that the decision has no effect.

In *Network Solutions*, the court was interpreting the Virginia garnishment statute. Whether its conclusion that the contract with a registering entity is a contract for services withstands the test of time remains to be seen. But, Article 9 clearly covers contract rights. The question is whether the contract right is an "account" under new section 9-102(a)(2) or a "general intangible" under new section 9-102(a)(42).

Although the new Article 9 definition of "account" is expanded so as not to be limited to a right to payment for goods or services, new section 9-102(a)(2) still limits accounts to rights to payment. Therefore, the contract right is a general intangible under new section 9-102(a)(42) and should be treated accordingly. A security agreement describing the collateral as "existing and later-acquired general intangibles" would create an enforceable security interest in existing and later-acquired domain names and filing a financing statement under Article 9 covering general intangibles would perfect the security interest.

This, however, is not the end of the story. Domain names may be bought and sold and otherwise transferred, but only with the cooperation of the registering entity. Thus, domain name contracts may be understood to include the functional equivalent of a "no assignment" clause. New section 9-408(a) provides that a term in an agreement between an account debtor (here the registering entity) that relates to a general intangible and which prohibits, restricts or requires the consent of the account debtor to an assignment or transfer of the general intangible is ineffective to prevent the creation of a security interest in the general intangible.

However, new section 9-408(d) provides that if an agreement relating to a general intangible contains a term that is rendered effective by new section 9-408(a), then a security interest in the general intangible is not enforceable against the account debtor, does not impose any duty or obligation on the account debtor, does not require the account debtor to recognize the security interest, does not entitle the secured party to use or assign the debtor's rights under the agreement and does not entitle the secured party to otherwise enforce the security interest in the general intangible.

The official comments to new section 9-408 make clear that section 9-408(d) means what it says and acknowledge that *outside* of bankruptcy the value of any general intangible is a function of the extent to which the account debtor is willing to cooperate. Therefore, a secured party taking an interest in a domain name should attempt to get an agreement from the registering entity that it will cooperate with the secured party in the event of a default by the debtor (or that the registering entity will give the secured party an opportunity to cure any failures of the debtor to perform its contractual obligations, *e.g.*, to renew a domain name registration when necessary.

In bankruptcy, BRA § 365 could render the no-assignment clause completely ineffective and the secured party could obtain the rights under the domain name contract.

Two other points should be made regarding domain names. Often a domain name will be of little or no value except as it is associated with an ongoing business. To this extent, a domain name is like a trademark and, as indicated above, a domain name ought to be viewed as part of a business rather than a separate asset. Certain domain names may have value independently of a given business and could be important to the success of a bankruptcy reorganization. But, a creditor should carefully investigate for the possibility that a debtor's acquisition of a domain name violates the Anti-Cybersquatting Consumer Protection Act, 15 U.S.C. § 1125(d) or poses an untoward risk of trademark infringement.

You may test your understanding of the heady matter of the need to perfect by compliance with federal law in the next five problems.

Problem 19.1 (INTERACTIVE)

Donald Debtor, a sole proprietorship, is engaged in the sale of printer ribbons. Donald borrows from Western Bank and gives Western a security interest in Donald's inventory of printer ribbons, existing and after-acquired, a 1999 Acura used exclusively in Donald's business and a Cessna aircraft that Donald uses to travel to business meetings and to escape to an island retreat.

What must Western do to perfect the security interests in each of the items of collateral under new Article 9?

What sections of new Article 9 support your answer?

Problem 19.2 (INTERACTIVE)

Super Soft, Inc. is an Arizona corporation that is in the business of developing computer software for managing inventory from purchasing through manufacture to sale to collection and accounting on disposition. Super Soft 's research and development and manufacturing and sales office is located in Tucson, Arizona. The software Super Soft developed is called "SureThing." Super Soft registered its copyright on SureThing with the United States Copyright Office. To finance its expanding business operations, Super Soft borrowed money from Southwestern Bank. To secure the credit, Super Soft authenticated a security agreement granting Southwestern a security interest in Super Soft's personal property consisting of Super Soft's inventory of software, accounts generated by the sale or license of the software, and computer equipment. The security agreement contained an "after-acquired" property clause that covered all of the collateral. Southwestern filed a UCC-1 financing statement with the Arizona Secretary of State that described the collateral as "all of Debtor's inventory, accounts, and equipment." Subsequently to entering into the security agreement with Southwestern Super Soft developed a software product called "AnotherThing." Super Soft did not register its copyright on AnotherThing.

As to which items of collateral can it be said with confidence that Southwestern's security interests are perfected?

If Southwestern were your client, what you have advised Southwestern to do to perfect its security interests in the collateral described in the security agreement in the problem?

Where should someone contemplating lending to Super Soft in Problem 19.2 search for outstanding security interests on the collateral referred to in that problem?

Would a search in both offices be conducted under Super Soft 's name?

Problem 19.3 (INTERACTIVE)

Suppose that the collateral in Problem 19.2 included a patent and a trademark.

Must the security interest in the patent be recorded in the U.S. Patent and Trademark Office to protect the interest against lien creditors and other secured parties?

Must the security interest in the trademark be recorded in the U.S. Patent and Trademark Office to protect the interest against lien creditors and other secured parties?

What should Southwestern Bank do to perfect its security interest in the patent? In the trademark?

Problem 19.4 (INTERACTIVE)

Suppose the collateral in Problem 19.2 included a trade secret.

May the security interest in the trade secret be perfected by filing a financing statement under Article 9?

How should the collateral be described?

What further steps would you advise Southwestern Bank to take to "secure" its interest in the trade secret?

Problem 19.5 (INTERACTIVE)

Suppose the collateral in Problem 19.2 includes the domain name "SuperSoft.com."

May the security interest in the domain name be perfected by filing a financing statement under Article 9?

What further steps would you advise Southwestern Bank to take to "secure" its interest in the domain name?

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Part V Perfecting an Article 9 Security Interest

Chapter 20 Perfection As To Fixtures And Other Real Estate Related Collateral

A. Fixtures

Under new section 9-109(d)(11), new Article 9 does not apply to the creation or transfer of an interest in or lien on real estate except to the extent that provision is made for the treatment of fixtures. The same was true of former Article 9. *See* Chapter 4 (Scope of Article 9). Recall from Chapter 5 (Classification of Collateral) that under new section 9-102(a)(41) fixtures are goods that have been affixed to real estate so that under real property law a person who has or acquires an interest in the real estate also has an interest in the goods.

Because fixtures are goods, under new section 9-501(a)(2), a security interest in a fixture may be perfected by filing a UCC 1 in the Article 9 records and as to a purchase money security interest in a fixture that constitutes consumer goods perfection is automatic. Perfection achieved in either of these ways will protect a secured party against other Article 9 secured parties, most buyers, lien creditors and trustees in bankruptcy according to the priority rules governing disputes with such parties under Article 9. *See* Official Comment 4 to new 9-501 and Chapter 32 (Fixtures Priorities).

However, because fixtures are goods in which real estate parties acquire an interest by taking an interest in the real estate to which the goods are attached to gain the most protection possible against real estate parties as to goods that *are* fixtures, a secured party must make a "fixture filing." *See* new 9-334 and Chapter 32 (Fixtures Priorities).

As defined in new section 9-102(a)(40), a "fixture filing" means a financing statement that in addition to satisfying the usual requirements for sufficiency discussed in Chapter 13 (Overview of Perfection by Filing) also contains information necessary to facilitate filing in the real estate records and to give notice to real estate parties. Specifically, under new section 9-502(b), a fixture filing is a financing statement that satisfies new section 9-502(a) (for a regular filing) and, in addition, indicates that it covers fixtures and that it is to be filed in the real estate records, provides a description of the real estate to which the collateral is related sufficient under local law to give constructive notice of a mortgage and, if the debtor does not have an interest of record, provides the name of a record owner of the real estate.

As for the place of filing, under new section 9-301(3)(A), the law of the state where the fixtures are located, necessarily meaning where the real estate is located, and not the state where the debtor is located, governs perfection and is the state in which to file. Under new 9-501(a)(1)(B), if a financing statement is filed as a fixture filing "and the collateral is goods that are or are to become fixtures," then the filing must be made in the office designated for the filing or recording of a mortgage on real property.

The quoted language from new section 9-501(a)(1)(B) in the previous paragraph is very important. It means that a fixture filing is effective to perfect a security interest in goods that are fixtures and such a filing will protect the Article 9 party against other secured parties, buyers, lien creditors and a trustee in bankruptcy. *See* 9-308(a), 9-310(a) and 9-501(a)(1)(B). It also means, however, that a fixture filing does *not* perfect a security interest in goods that are not fixtures. *Cf*. Official Comment 4 to new 9-501.

Deciding whether particular goods are affixed to real estate so as make them fixtures under local law outside Article 9 can be difficult at best. In *Gomez v. Dykes*, 359 P.2d 760 (Ariz. 1961), the court applied a three-part test in deciding that a trailer house located on a farm sold pursuant to a real estate sales contract was not a fixture.

The test offered is as follows:

(1) There must be an annexation to the realty or something appurtenant thereto;

(2) The chattel must have adaptability or application as affixed to the use for which the real estate is appropriated; and,

(3) There must be an *intention* of the party to make the chattel a permanent accession to the freehold.

The court in *Gomez* noted that the modern tendency is to give the intention of the parties the greatest weight. Since the trailer house belonged to a hired hand of the seller and not the seller, there could not have been an intention to make the trailer house part of the real estate. The emphasis on the parties' intent is somewhat odd given that whether or not goods affixed to real estate are fixtures can impact the rights of persons who are not parties to an agreement. But, since the dispute in *Gomez* was between the parties to the sales contract it was convenient to look to the intent of the parties.

The court in *Gomez* also had to decide whether manure located on the farmland was a fixture or not. The court concluded that manure dropped by animals fed off the land constituted fixtures but manure brought onto the land or dropped by animals not fed off the land was personalty. According to the court, "the reason for this rule is the strong public policy to keep that which has never become a true part and parcel of the land freely alienated from same. By the same token, if the animals have not been fed with the products of the land, the land has not been impoverished, and consequently, the animals' owner owes no duty to leave the manure to replenish the land."

The uncertainty as to when goods are fixtures clouds decisions about how to perfect an Article 9 security interests in goods that might not be or might not become fixtures. The result is that it can be risky to rely exclusively on a fixture filing because goods may turn out not to be fixtures.

You may test your understanding of the matter of perfecting security interests in fixtures under new Article 9 in the next two problems.

Problem 20.1 (INTERACTIVE)

Donna Debtor is a sole proprietor doing business in Tucson, Arizona. Sid Seller sells a drill press to Donna to be used by Donna in her manufacturing operations. Sid takes an interest in the drill press to secure its price. The drill press will be welded to the floor of Donna's plant located in Pima County, Arizona in such a way as to give a purchaser of the plant an interest in the drill press.

How *may* Sid file to be perfected under new Article 9?

How *should* Sid perfect? Will a fixture filing protect Sid's security interest in the drill press against Article 9 (personal property) parties?

If Sid files only a fixture filing and the drill press turns out not to be a fixture is Sid's security interest perfected under new Article 9?

Problem 20.2 (INTERACTIVE)

Assume the facts of Problem 20.1. Assume further, however, that Donna Debtor bought the drill press for use in her home and Sid Seller did not file anywhere.

Is Sid's security interest perfected under new Article 9?

Is the security interest perfected given the change in facts if the drill press is *not* a fixture?

What is the downside of relying on automatic perfection where the drill press *is* a fixture?

If the drill press is not a fixture need Sid worry about real estate parties?

B. Notes Secured by Deeds of Trust or Mortgages

When a person lends to another and takes an interest in real estate to secure the debt there will be a promissory note (typically negotiable in form) that names the lender as the payee and also an agreement creating an interest in the real estate to secure the note. In many states the agreement creating the interest in the real estate will be a mortgage. In such a case, the borrower is a mortgagor and the lender is a mortgagee. In most western states, the agreement creating the interest in the real estate will be a deed of trust and the lender will be the beneficiary on the deed of trust.

The mortgagee or beneficiary on a deed of trust has a right to payment secured by an interest in real estate. The secured right of payment has value and may be used as collateral by the mortgagee or beneficiary on a deed of trust when the mortgagee or beneficiary on the deed of trust becomes a borrower. The person taking an interest in the secured right to payment will require the mortgagee or beneficiary on the deed of trust to assign the promissory note and the mortgage or deed of trust. The use of the interest of a beneficiary has been referred to as "a collateral assignment of a beneficial interest in a deed of trust."

Under former Article 9 there was some disagreement as to whether such security arrangements were governed by Article 9 or by real estate law and, more specifically, whether the lender's interest in the collateral, consisting of the right to payment embodied in a promissory note secured by an interest in real estate, had to be perfected under Article 9 or under real estate law. The consensus view under former Article 9 was that the interest of beneficiary on a deed of trust or mortgagee on a mortgage was personal property and perfection of a security interest in such property required compliance with Article 9. *Rodney v. Arizona Bank*, 836 P.2d 434 (Ariz. App. 1992), offers a good illustration of that view.

In *Rodney* the beneficiary on a deed of trust borrowed from Arizona Bank and gave the bank a security interest in the borrower's interest as the beneficiary on a deed of trust and subsequently borrowed from Rodney and gave Rodney an interest in the borrower's interest as the beneficiary on a deed of trust. Arizona Bank proceeded under Article 9 on the assumption that the collateral was personalty and Rodney proceeded under real estate law on the assumption that the collateral was realty. The question on the borrower's default was whether Arizona Bank or Rodney had properly perfected. The court concluded that Article 9 governed the perfection of a security interest in the secured right to payment of a beneficiary on a deed of trust.

New Article 9 adopts the prevailing view under former Article 9. *See* new 9-109(d)(11)(A) and Official Comment 6 to new 9-308. New section 9-308(e) provides that "perfection of a security interest in a right to payment or performance also perfects a security interest in a security interest, mortgage, or other lien on personal or real property securing the right." In other words, the note is primary and the security follows the debt.

In an attempt to minimize the "separation" of the mortgage or deed of trust from the note, new section 9-203(g) provides that "the attachment of a security interest in a right to payment or performance secured by a security interest or other lien on personal or real property is also attachment of a security interest in the security interest, mortgage, or other lien."

Together, new sections 9-203(g) and 9-308(e) mean, for example, that a creditor who takes a security interest in a note secured by a deed of trust gets an enforceable interest in the deed of trust and if the creditor perfects its interest in the note the creditor is automatically perfected as to the beneficial interest in the deed of trust.

The question then is what may or must a creditor do to perfect its security interest in a promissory note. A promissory note almost certainly will meet the definition of an instrument in new section 9-102(a)(47) (essentially requiring a writing that is transferred in the usual course of business by delivery). In earlier chapters, it was pointed out that under new sections 9-312(a) and 9-313(a) a security interest in an instrument can be perfected by filing and it is no longer the case, as was true under former Article 9, that a security interest in an instrument can be perfected only by possession. It follows that a security interest in a promissory note may be perfected by filing or by possession.

However, perfection by possession of a security interest in a promissory note is preferable. The reason is that notes typically are negotiable and negotiation of a note to a holder-in-due-course could result in subordination of the interest of a secured party who perfects by filing as to the note. *See* new section 9-331(a). Therefore, a creditor who takes a security interest in a note secured by a deed of trust or mortgage may perfect its interest in the note by filing but should perfect the interest by getting possession of the note.

The meaning of possession, especially as to collateral in the possession of a third party was considered at length in Chapter 15 (Perfection by Possession (Including Documents of Title)) and it would be a good idea to review that material now. As explained in Chapter 15, in cases where no document of title has been issued it no longer is enough for a secured party to notify a third party in possession of collateral of the secured party's interest and under new section 9-313(c) the third party must authenticate a record acknowledging that it is holding for the secured party.

Article 9 does not speak directly to the resolution of disputes involving creditors *of the obligor on the secured note* (the mortgagor on a mortgage or grantor on a deed of trust). To get as much protection as possible against creditors of the mortgagor or grantor under a deed of trust (the obligor on the secured note) a secured party should record an assignment of the interest of the debtor in the real estate records as well as perfect a security interest in the note secured by a deed of trust or mortgage. Certain matters clearly are outside the scope of Article 9. For example, the questions of who an obligor on a note must pay to discharge the obligation (and the security) is governed by Article 3 and the who has the power to release the real estate security is left to local real estate law. *See* Official Comment 6 to new 9-308.

You may test your understanding of the Article 9 scheme for perfecting a security interest in the beneficial interest in a deed of trust on real estate or a real estate mortgagee's interest in the next two problems.

Problem 20.3 (INTERACTIVE)

Southern Bank is about to lend to Donald Debtor. Donald is the payee on a negotiable promissory note secured by a deed of trust on real estate. Southern Bank is taking Donald's interest in the note and deed of trust as collateral.

What should Southern do to perfect its security interest? How *may* Southern perfect its security interest in the note under new Article 9? What *should* Southern do to perfect its security interest in the note?

Problem 20.4 (INTERACTIVE)

Assume the facts of Problem 20.3. What should Southern Bank be advised to do to perfect its security interest where the note is held by a title company for collection?

C. Standing Timber and As-Extracted Collateral

As explained in Chapter 5 (Classification of Collateral), standing timber is real estate unless it constitutes “goods” within the meaning of new section 9-102(a)(44). To acquire a “perfected” interest in standing timber that does not constitute goods a creditor must obtain a mortgage or deed of trust on the real estate and have the mortgage or deed of trust properly recorded in the office where real estate records are kept. Standing timber constitutes "goods" under new section 9-102(a)(44) if "is to be cut and removed under a conveyance or contract of sale."

As explained in Chapter 8 (The Specifics of Enforceability -- A Security Agreement Authenticated by the Debtor or Its Equivalent), a security interest in timber to be cut is enforceable and attaches only if the security agreement includes "a description of the land concerned" as required by new section 9-203(b)(3)(A). Moreover, standing timber is expressly excluded from the definition of "farm products" under new section 9-102(a)(34). *See* Official Comment 4(a) to new 9-102. Therefore, the collateral should be described in the security agreement as standing timber or standing timber to be cut (or as particular trees).

Timber to be cut is the opposite of fixtures in that it is realty that qualifies as goods rather than goods an interest in which arises under real property law. However, a financing statement filed to perfect a security interest in timber to be cut must meet the special content requirements of new section 9-502(b) for a fixture filing, discussed in subpart A above.

The requirements of new section 9-502(b) are that the financing statement indicate that it covers timber to be cut and that it is to be filed in the real estate records and there must be a description of the real estate on which the timber is standing that would be sufficient to give constructive notice of a mortgage under the law of the state where the trees are located if the description were contained in a record of a mortgage and, if the debtor does not have an interest of record, the name of a person with an interest of record must be provided.

The reason for these special requirements as to the contents of the financing statement is that under new section 9-501(a)(1)(A), a security interest in timber to be cut can be perfected only by filing a financing statement "in the office designated for the filing or recording of a mortgage on the related real property."

Under new section 9-301(3)(B) the law of the state where the trees are located (which will be the state where the real estate on which the timber stands is located) governs perfection and is the state within which to file.

The reason that perfection of a security interest in timber to be cut requires filing or recording in the real estate records is that parties with interests in real estate can have interests in timber and timber to be cut. Unlike disputes as to fixtures and growing crops, as to which specific Article 9 rules apply, see new section 9-334 and Chapter 32 (Fixtures Priorities), there are no new Article 9 rules dealing with conflicts involving timber to be cut as such.

That courts will struggle with fashioning outcomes for such conflicts is illustrated by the case of *Feliciana Bank & Trust v. Manuel & Sessions, L.L.C.*, 943 So.2d 736 (Miss.App. 2006), in which the court never really recognizes that new Article 9 priority rules should be consulted.

As explained in Chapter 5 (Classification of Collateral), once timber has been cut it no longer is timber *to be cut* but rather constitutes "goods" pure and simple within new section 9-102(a)(44) because it constitutes "things that are moveable when a security interest attaches." As to cut timber, filing a UCC 1 that does not include a description of the real estate will suffice. Moreover, the filing should be made in the Secretary of State's Office in the state where the debtor is located, as required by new sections 9-301(1) and 9-501(a)(2).

This means the choice of law and place of filing rules for ordinary goods apply once the timber to be cut has been cut. Consequently, a filing made as to the timber as timber to be cut ceases to be effective once the timber has been cut and there is no time within which to refile under new sections 9-316(a) and (b). *See* Official Comment 3 to new 9-501.

You may explore the new Article 9 rules for perfecting a security interest in timber to be cut in the next problem.

Problem 20.5 (INTERACTIVE)

Danielle Debtor lives on a farm in Pinal County, Arizona. Danielle raises cotton on the farm, which is on the Pinal Parkway (Arizona Highway 77). Danielle also owns a two-acre plot of land adjacent to the farm on which there is a stand of mesquite trees. Danielle has entered into a contract under which the mesquite trees will be cut and removed during the next calendar year. Danielle borrows from Second Bank and gives Second Bank a security interest in Danielle's current crop of cotton and the mesquite trees.

What must the security agreement include to make the security interest in the mesquite trees enforceable?

How should Second Bank perfect its security interest in the in the mesquite trees?

Would a financing statement that is sufficient as to contents and filed in the right office to perfect the security interest in the mesquite trees also perfect the security interest in the cotton crop?

Would perfection as to the security interest in the mesquite trees achieved by a filing properly as to these trees continue after the trees are cut?

2. As-extracted collateral

Under new Article 9, oil, gas, and other minerals that have not been extracted from the ground are treated as real property to which Article 9 does not apply. Upon extraction, minerals will become personal property (goods) and are eligible to serve as collateral under new Article 9. The definition of "as-extracted collateral" in new section 9-102(a)(6) is intended to capture this distinction. *See* Official Comment 4(c) to new 9-102.

Under the definition in new section 9-102(a)(6), accounts arising out of the sale of minerals at the wellhead or minehead also are "as-extracted collateral." There is a parallel to timber to be cut in that as-extracted collateral is minerals (and certain accounts) only to the extent removal from the ground is contemplated. If removal is not contemplated, then the minerals are part of the real estate.

Financing involving as-extracted collateral is complicated and largely beyond the scope of these materials. The examples offered by Official Comment 4(c) to new section 9-102 are helpful in deciding what is (and what is not) as-extracted collateral. Under new section 9-301(4), the law of the state where the wellhead or minehead is located governs and that is the state in which to file. Under new section 9-501(a)(1)(A), the filing must be made locally in the real estate records.

As explained above, the choice of law and place of filing rules for goods apply once the timber has been cut and a filing made as to the timber as timber to be cut ceases to be effective. By contrast, a security interest in as-extracted collateral attaches only when the collateral has been extracted and a filing made properly before extraction is effective after extraction.

Case Commentary

Feliciana Bank & Trust v. Manuel & Sessions, L.L.C., 943 So.2d 736 (Miss.App. 2006)

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Part V Perfecting an Article 9 Security Interest

Chapter 21 Perfection As To Investment Property

A. Interface between Article 8 and Article 9

Corporate securities and other such investment property can be important sources of collateral. As noted in Chapter 8 (The Specifics of Enforceability -- A Security Agreement Authenticated by the Debtor or Its Equivalent) and Chapter 12 (Perfection Generally), the drafters of the UCC have struggled with the question of whether all matters pertaining to investment property should be placed in Article 8 or whether the regulation of security interests in such property should be in Article 9. Underlying the question are changes in the way investment property is held and traded.

The drafters incorrectly predicted a movement away from certificated securities to a system comprised of "certificateless" (uncertificated) securities in which corporate equity holdings and other interests were represented electronically and not by stock certificates. What actually happened is that, for the most party, only governmental securities and certain mutual funds have become certificateless. Individual stock certificates continue to exist. However, there has been a major move to an indirect holding system in which brokers and other intermediaries hold "jumbo certificates" in which individuals have interests.

New Article 9 governs perfection of security interests in investment property but, as was the case under former Article 9, applying the perfection provisions of new Article 9 requires reference to many definitions and key concepts found in Article 8, as well as those in Article 9. New section 9-102(a)(49) defines "investment property" to include a range of securities and related property and also commodities property. However, the definitions of specific types of investment property are found in Article 8. *See* Article 8, sections 8-102, 8-301, 8-501 and Official Comment 6 to new 9-102.

This chapter focuses on security interests in securities, securities accounts and securities entitlements because such property is more likely to be encountered in Article 9 practice. A thorough treatment of the subject of investment property, including the trading and security practices associated with such property, is beyond the scope of these materials. To reduce the risk of becoming lost in a maze of definitions and concepts, many of which are found in Article 8, the discussion of perfection that follows is not complete in all particulars. However, be aware that a practitioner who regularly deals with security interests in investment property is responsible for knowing the many nuances of both Article 8 and Article 9.

B. New Article 9

1.Control as the Primary Mode of Perfection

Former Article 9 adopted "control," as defined in Article 8, section 8-106, as the central mode of perfection of a security interest in investment property. New Article 9 once again makes control, as given meaning in Article 8, the primary method of perfecting a security interest in investment property. Thus, under new section 9-314(a) a security interest in investment property may be perfected by control under new section 9-106(a) and new section 9-106(a) defines control by reference to Article 8, section 8-106.

Under new section 9-312(a), a security interest in investment property, other than one created by a broker or other securities intermediary, as defined in Article 8, section 8-102(a)(14), also may be perfected by filing a financing statement covering the investment property. Under new section 9-313(a), a security interest in a certificated security may be perfected by delivery of the security under Article 8, section 8-301(a). New section 9-309(10) provides that a security interest in investment property created by a broker or other securities intermediary is perfected on attachment, *i.e.*, automatically, but may not be perfected by filing. *See* Official Comment 4 to new 9-312.

As will be explored more fully in Part VI, under new section 9-328(1), a secured party having control of investment property has priority over a security interest held by a secured party who does not have control, including a secured party who has taken delivery under Article 8, section 8-301, but does not have control under new section 9-106(a).

2. Control of a Certificated Security

This chapter focuses on perfecting security interests in securities, securities accounts and security entitlements. As noted earlier, most equity interests in securities are embodied in a certificate (albeit today often a "jumbo" certificate). As it happens, most investment property today consists of securities entitlements, that is, interests and rights in securities held by someone else, typically a broker, and perfecting a security interest in a security entitlement is of particular concern. Nonetheless, the concept of "control" may best be understood as it applies to certificated securities.

Control of a certificated security depends on whether the security is in bearer or in registered form. A security is in bearer form when it is transferable without the need for an indorsement by the bearer of the certificate (or action by the issuer of the certificate). A security is in registered form when the person entitled to the certificate is specified in the certificate (and a transfer of the security may be registered on the books of the issuer). Transfer of a registered security requires an indorsement by the person named in the certificate (or action by the issuer).

Control of a certificated security in *bearer* form and, hence, perfection of a security interest in the certificate under new sections 9-314(a) and 9-106(a), is achieved when the certificate is delivered to the secured party as required by section 8-106(a). Control of a certificated security in *registered* form and, hence, perfection of a security interest in the security under new sections 9-314(a) and 9-106(a), is achieved when either of two sets of conditions are satisfied.

The first set of conditions is that the security has been delivered to the secured party *and* the certificate has been indorsed to the secured party (or in blank). The second is that the security is delivered to the secured party *and* is registered in the name of the secured party by having the security issued to the secured party or by having the issuer register a transfer of the security to the secured party. These conditions of control are spelled out in section 8-106(b).

Delivery is a requirement of control as to a certificated security whether the security is in bearer or registered form. "Delivery" of a certificated security occurs under Article 8, section 8-301(a) when the secured party gets possession of the security certificate or another person gets possession of the certificate on behalf of the secured party or acknowledges that it previously acquired possession of the certificate and it holds the certificate on behalf of the secured party. Possession by "another person" who is a securities intermediary results in delivery only if the security is in registered form and has been specially indorsed to the secured party by an effective indorsement.

Note that the essence of delivery as to a certificated security is possession by or on behalf of the secured party. Note also that possession by another on behalf of the secured party may be accomplished without the need for an authenticated record acknowledging that the possession is for the secured party's benefit as is required for perfection by possession of other than investment property under new section 9-313(c). Note finally that a secured party may get possession of a security by delivery without also getting control where, for example, a registered security has not been properly indorsed.

3. Control of an Uncertificated Security

Control of an uncertificated security and, hence, perfection of a security interest in such a security under new sections 9-314(a) and 9-106(a), is achieved when the secured party takes delivery of the security or when the issuer has agreed that it will comply with instructions given by the secured party without the need for further assent by the registered owner, as provided for in Article 8, section 8-106(c).

Delivery as to an uncertificated security occurs under Article 8, section 8-301(b), when the issuer registers the secured party as the owner at the time of original issue or by registration of transfer *or* another person, other than a securities intermediary, either becomes the registered owner on behalf of the secured party or, having previously become the registered owner, acknowledges that it holds for the secured party.

4. Control of a Security Entitlement

As indicated above, as a practical matter, because of the way most investment property is held today, perfection of a security interest in a security entitlement may be of greatest interest. Security entitlements are indirect interests, *i.e.*, interests in securities held by a securities intermediary, typically a broker. A security entitlement is distinguishable from a securities account in that the latter refers to all of the investment positions held through a given account rather than particular investment positions held through that account. *See* Official Comment 6 to new 9-102.

Perfection by control of a security interest in a security entitlement is somewhat analogous to perfection by control of a security interest in an uncertificated security, as discussed in the previous paragraph; however, control cannot be accomplished by delivery as to a security entitlement. A secured party has control of a security entitlement and, hence, has perfected a security interest in such investment property under new sections 9-314(a) and 9-106(a), in any one of three situations provided for in Article 8, section 8-106(d).

The first situation is that the secured party has become the entitlement holder (the person identified in the records of the securities intermediary as having a security entitlement against the intermediary). The second is that the securities intermediary has agreed that it will comply with entitlement orders originated by the secured party without further consent by the entitlement holder. The third is that another person has control of the security entitlement on behalf of the secured party or, having previously acquired control, the person acknowledges that it has control on behalf of the secured party.

5. Control of a Securities Account

As noted above, a securities account refers to all of the investments positions held through a given account. The term is included in the definition to facilitate transactions in which a debtor wishes to create a security interest in all of the investment positions held through a particular account rather than in specific positions carried in the account. *See* Official Comment 6 to new 9-102.

Under new section 9-106(c), a secured party having control over all security entitlements in a securities account has control over the securities account.

6. Duration of Perfection by Control

New Article 9 expressly addresses the question of when perfection by control commences and how long it continues. Under new section 9-314(c) a security interest in investment property is perfected by control under new section 9-106(a) from the time the secured party obtains control. Under the same section a secured party remains perfected by control until the secured party does not have control and (1) in the case of a certificated security the debtor has or acquires possession; (2) in the case of an uncertificated security the issuer has registered or registers the debtor as the owner; or (3) as to a security entitlement the debtor is or becomes the entitlement holder.

You may test your grasp of the basics of the complex matter of perfecting security interests in investment property in the next problem.

Problem 21.1 (INTERACTIVE)

Northern Bank is about to lend to Delia Debtor. Delia has offered as collateral government securities held in uncertificated form, stock certificates as to which Delia is the registered owner, and a securities entitlement held by Delia against Bonnie Broker.

How *may* Northern perfect its security interests in such property?

How *should* Northern perfect its security interests?

Exactly what must Northern do to so perfect its security interest by control as to the *uncertificated* securities?

Exactly what must Northern do to so perfect its security interest by control as to the *certificated* securities?

Exactly what must Northern do to so perfect its security interest by control as to the *security entitlement*?

If Delia's securities account with Bonnie Broker includes several security entitlements and Northern has taken a security interest in the securities account, what must Northern do to get control of the securities account?

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Part V Perfecting an Article 9 Security Interest

Chapter 22 Perfection as to Deposit Accounts, Letter of Credit Rights and Electronic Chattel Paper

A. Generally

As noted in Chapter 21 (Perfection as to Investment Property), former Article 9 made control as the preferred mode of perfection of a security interest in investment property. Under new Article 9, control is a means of perfecting security interests in collateral other than investment property. As to certain collateral, control is the only way a security interest can be perfected.

New section 9-314(a) provides that a security interest in investment property, a deposit account, a letter-of-credit right, or electronic chattel paper may be perfected by control of the collateral. Investment property is dealt with in Chapter 21 (Perfection as to Investment Property). The other types of collateral as to which control is proper or required are treated separately below. "Control" is defined separately for each type of collateral.

It should also be understood that control can serve to render a security interest enforceable without the need for an authenticated security agreement. On this point you should review Chapter 8 (The Specifics of Enforceability – A Security Agreement Authenticated by the Debtor or Its Equivalent).

B. Deposit Accounts

As was seen in Chapter 4 (Scope of Article 9), under former Article 9 security interests in deposit accounts were covered only as proceeds and security interests in deposit accounts as original collateral were outside the scope of former Article 9. Consequently, a creditor had to perfect such interests pursuant to law outside Article 9.

As also noted in Chapter 4 new Article 9 makes a major change as to security interests in deposit accounts. Under new 9-109(d)(13), a security interest in a deposit account as original collateral, other than in a consumer transaction, is covered by new Article 9.

In Chapter 5 (Classification of Collateral), it was seen that as defined in new section 9-102(a)(29) a deposit account is essentially a general bank account. Under the definition investment property and accounts evidenced by an instrument are not deposit accounts but, contrary to former Article 9, a certificate of deposit that is not an instrument may be a deposit account.

Because deposit accounts are pure intangibles, possession is not a permissible mode of perfection of a security interest in a deposit account. As a rule, filing is a proper way to perfect a security interest in a pure intangible, *see* Chapter 12 (Perfection Generally), but under new section 9-312(b)(1) a security interest in a deposit account may be perfected by filing only where the deposit account is proceeds. A security interest in a deposit account *as original collateral* must be perfected by control.

Under new section 9-104(a), a secured party has control of a security interest in a deposit account where:

(1) The secured party is the bank at which the account is maintained;

(2) The bank has agreed in an authenticated record to comply with the secured party's instructions without further assent by the debtor; or,

(3) the secured party becomes a "customer" with respect to the account.

Article 4, section 4-104(a)(5) indicates that "customer" means "a person having an account with a bank or for whom a bank has agreed to collect items, including a bank that maintains an account at another bank." There is control under new section 9-104(b) even if the debtor has a continuing right to withdraw funds from the account. Under new section 9-314(b), perfection of a security interest in a deposit account by control dates from the time the secured party obtains control and continues only so long as the secured party has control.

In *Sonic Engineering, Inc. v. Konover Construction Co. South*, 51 UCC Rep Serv. 2d 844 (Conn Super Ct 2003) the court concluded that a secured party had obtained control of a deposit account pursuant to an agreement between the secured party and the bank despite the fact that the debtor had access to the deposit account.

As will be seen in Part VI, a security interest in a deposit account perfected by control has priority over a security interest in the deposit account that is proceeds and is perfected by filing.

For a helpful article explaining the many intricacies associated with deposit accounts as collateral, *see* Markell, *From Property to Contract and Back: An Examination of Deposit Accounts and Revised Article 9*, 74 Chicago Kent L. Rev. 963 (1999).

C. Electronic Chattel Paper

As explained in Chapter 5 (Classification of Collateral), there are two kinds of chattel paper, tangible and electronic. Tangible chattel paper is a form of quasi-goods a security interest in which may be perfected by filing or by possession.

What would amount to electronic chattel paper could exist under former Article 9 but would fall within the definition of general intangibles in former section 9-106 and a security interest in such collateral would have to be perfected by filing.

New Article 9 separately defines electronic chattel paper in new section 9-102(a)(31) and electronic chattel paper is excluded from the definition of general intangibles in new section 9-102(a)(42). However, because electronic chattel paper is a pure intangible a security interest in it may be perfected by filing. Under new section 9-314(a) a security interest in electronic chattel paper also may be perfected by control.

Control as to electronic chattel paper is governed by new section 9-105. The essence of new section 9-105 is that there is control as to electronic chattel paper if the chattel paper is created, stored and assigned in such a manner that:

(1) there is a single authoritative copy of the record or records of which the chattel paper consists that is unique and identifiable;

(2) the authoritative copy identifies the secured party as the assignee of the record or records;

(3) the authoritative copy is maintained by the secured party;

(4) the authoritative copy cannot be duplicated or altered without the participation of the secured party;

(5) any copy that is not the authoritative copy is readily identifiable as being unauthorized; and

(6) any revision of the authoritative copy is readily identifiable as being authorized or unauthorized.

Under new section 9-105, control of electronic chattel paper turns generally on the existence of a single *authoritative* copy of the electronic record or records of which the electronic chattel paper consists and the fact that copies and revisions are not possible, or at least not practically so, without the secured party's participation. Determining just when the conditions of "control" as to electronic chattel paper have been met is a matter that largely has been left by new Article 9 to business practices and developing technologies. *See* Official Comment 4 to new 9-105.

Control requires that there be more than an agreement between the secured party-assignee and the assignor that the latter will not change the designated assignee without the secured party's consent. However, there can be control even when the mechanisms employed do not eliminate entirely the possibility that the secured party's interest could be subverted by the wrongful conduct of a person acting on the secured party's behalf. *See* Official Comment 4 to new 9-105.

Under new section 9-314(b), perfection by control of a security interest in electronic chattel paper dates from the time the secured party obtains control and continues only so long as the secured party has control.

As will be seen in Chapter 29 (Secured Party Versus Secured Party (continued)), under new section 9-330, certain purchasers of chattel paper can get priority over a security interest in chattel paper perfected by filing. Consequently, the preferred method of perfecting a security interest in electronic chattel paper is by control and for tangible chattel paper perfection by possession is advisable.

It has been observed that the electronic chattel paper provisions of new Article 9 represent a major innovation aimed at removing existing legal barriers to electronic commerce. *See* Winn, *Electronic Chattel Paper under Revised Article 9: Updating the Concept of Embodied Rights for Electronic Commerce*, 74 Chicago Kent L. Rev. 1055 (1999). In her article, Professor Winn also explores the interesting questions posed by the reality that much electronic chattel paper will result from the conversion of tangible chattel paper to electronic chattel paper.

D. Letter of Credit Rights

Former Article 9 looked to Article 5 for assistance in defining interests in letters of credit. New Article 9 separately defines a "letter of credit right" in new section 9-102(a)(51). Under this definition "letter-of-credit right" means a right to payment and performance under a letter of credit as defined in Article 5, section 5-102(a)(10). The right of a beneficiary to demand payment or performance is excluded from "letter of credit right" as defined in new section 9-102(a)(51).

The reason for the exclusion is that new Article 9 adopts the distinction between an assignment of a letter of credit and a transfer of a letter of credit. New Article 9 deals only with assignments (for security) of letter of credit rights. Transfers of a beneficiary's rights are governed by Article 5. *See* Official Comment 5(e) to new 9-102 and new 9-109(c)(4) (recognizing the independent and superior rights of a transferee beneficiary under Article 5, section 5-114(e)).

Under new Article 9, sections 9-312(b)(2) and 9-308(d), except insofar as a letter of credit right constitutes a supporting obligation (as defined in new section 9-102(a)(77)), a security interest in a letter of credit right may be perfected only by control.

The distinction between an assignment of a letter of credit right and a transfer of a letter of credit referred to above carries over to the definition of control as to a letter of credit right. Under new section 9-107 control as to a letter of credit right is accomplished through an agreement by which the issuer or nominated person consents to an assignment of the proceeds of a letter of credit to the secured party. Proceeds as used in new section 9-107 means the beneficiary of a letter of credit's right to receive payment under a letter of credit. *See* Article 5, section 5-114(a) and Official Comment 4 to new 9-107.

As with other perfection by control situations other than those involving investment property, perfection by control of a security interest in a letter of credit right begins when control is obtained and continues until control is relinquished. New 9-314(b).

Perfection of a security interest in the above-discussed collateral and the essence of the concept of control as a means of perfecting a security interest in such collateral can be gained by working through the next problem.

Problem 22.1 (INTERACTIVE)

Southwestern Bank wishes to lend to Donald Debtor on a secured basis. Donald has offered the following as collateral:

(a) A general bank account in Southwestern Bank;

(b) A negotiable certificate of deposit;

(c) An interest in a written contract for the sale of equipment that evidences both the debt for the price of the equipment and a security interest in the equipment;

(d) An interest in a contract such as that in (c) that is in electronic form;

(e) A security interest in Donald's right to payment under a letter of credit (that is not a supporting obligation); and

(f) A certificated security in bearer form.

As to which items of collateral *may* Southwestern perfect its security interest by filing?

How *should* Southwestern perfect its security interests in each item of collateral?

Exactly what must Southwestern do to perfect its security interest in negotiable CD and the tangible chattel paper in the preferred manner?

Exactly what must Southwestern do to perfect its security interest in the certificated security in bearer form in the preferred manner?

Exactly what must Southwestern do to perfect its security interest in the general bank account?

Exactly what must Southwestern do to perfect its security interest in the letter of credit right?

Exactly what must Southwestern do to perfect its security interest in the electronic chattel paper in the preferred manner?

Is an authenticated security agreement required for enforceability and attachment of the security interests perfected in the preferred manner?

CASE COMMENTARY

In re Clayson, 341 B.R. 137 (Bkcy W.D.N.Y March 24, 2006)

Counseller v. Ecenbarger, Inc., 834 N.E.2d 1018 (Ind. App. 2005)

Madisonville State Bank v. Citizens Bank, 184 S.W.3d 835 (Tex. App. 2006)

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Part V Perfecting an Article 9 Security Interest

Chapter 23 Continuing Perfection -- The Need To Reperfect (Or Refile)

A. Generally

1. An Overview

This chapter and the next deal with the important reality that perfection generally does not continue indefinitely. Often it will be necessary to take action to continue perfection. Knowing when action is necessary and what action to take and when to take it requires a command of the rules governing perfection in the first instance and also an understanding of the rules governing the duration of perfection.

Perfection achieved by properly filing a financing statement can end if the financing statement lapses or is terminated. Moreover, when there is a change in the circumstances under which the particular action taken was effective to perfect, such as a change in the debtor's name or location, third parties may be mislead and reperfection or refiling may be required. Perfection also may cease because it was conferred only for a limited period. This happens where temporary perfection is given for a specific limited purpose. *See* new sections 9-312(f), (g) and (h).

More importantly, as seen in Chapter 16 (Perfecting Security Interests in Proceeds and Other Later Acquired Property), perfection as to certain types of proceeds does not continue beyond the twenty-day period of perfection automatically conferred by new sections 9-315(c) and 9-315(e) unless the secured party acts to timely reperfect.

Ideally, when a creditor acts to reperfect the result will be *continuous* perfection in the sense that the filing or perfection dates from the time of the original filing or other action to perfect was taken. Former Article 9 employed the concept of continuous perfection without defining it. New section 9-308(c) explicitly provides that a security interest (or agricultural lien) is perfected continuously if it is originally perfected in one manner under this article and it is later perfected in another manner under this article without an intervening period when it was unperfected.

2. The New Article 9 Transition Rules

For a period of time after the effective date of new Article 9, July 1, 2001, there was an important question of what would happen to a security interest created and perfected under former Article 9. The transition rules of Part 7 of new Article 9 were included to deal with this question. These rules are complicated and sometimes difficult to understand. It will be a rare case today that a transition issue arises, but it is useful to be aware of the Part 7 rules, not only to deal with such a rare case but also because many of the reported decisions applying new Article 9 were entered during the transition period and the rules were referred to by the courts.

B. The Life of a Financing Statement

1. Lapse of a Financing Statement

As was true under former Article 9, section 9-403(2), a filing may *lapse* under new Article 9 unless it is timely continued. Under new section 9-515(a), a regular initial financing statement is effective for five years after the date of filing. Some states, including Arizona, modified former Article 9 to extend the period to six years, but Arizona has gone with the five-year period in connection with its adoption of new Article 9.

Where the debtor is a transmitting utility if the financing statement so indicates a filing is good until terminated and a mortgage serving as a fixture filing is effective until the mortgage is released or satisfied of record. New 9-515(f) and (g). Under new Article 9, as to public finance transactions or manufactured-home transactions, if the financing statement so indicates a filing is good for a period of thirty years. New 9-515(b). However, as to most filings, the five-year period governs and as was true under former Article 9 action is needed to continue the effectiveness of the filing beyond that period.

As also was the case under former Article 9, to continue the effectiveness of a financing statement beyond the five-year period applicable to the vast majority of filings a secured party must timely file a *continuation statement*, as provided for in new section 9-515(d).

To be effective as a continuation statement a filing must indicate that it is a continuation statement and identify the filing it is intended to continue. New Article 9 so provides by defining a continuation statement in new section 9-102(a)(27) as an *amendment* of a financing statement that identifies the initial financing statement to which the continuation statement relates and indicates that it is a continuation statement. There is a "safe harbor " form in new section 9-521(b) to assist secured parties to file the appropriate record.

Under new section 9-515(d) a continuation statement may be filed *only* within six months before the expiration of the five-year period specified in section 9-515(a). A continuation statement that is not filed during the window of time provided in new section 9-515(d) must be rejected by a filing officer, *see* 9-516(b)(7), but even if the statement is accepted for filing it is not effective to continue the original filing. *See* new 9-510(c).

Under new section 9-515(e), a timely filed continuation statement continues the effectiveness of the original filing (or an earlier continuation statement) for five years beyond the time the original financing statement or continuation period would have lapsed.

As explained in Chapters 13 (Overview of Perfection by Filing) and 14 (The Nitty Gritty of Filing), under new Article 9 the controlling question as to any filing is whether the filing has been properly authorized. New section 9-509(b) provides that a debtor authorizes a secured party to file an initial financing statement “and an amendment” when the debtor authenticates the *security agreement*. The authorization to file a continuation statement is limited to an amendment that does not change the information in and rather simply continues the effectiveness of the original financing statement. Amendments that make substantive changes to a financing statement, for example, adding collateral, require separate authorization. *See* new New 9-512.

As noted above, if a continuation statement is not timely filed the financing statement "lapses." Under new section 9-515(c), when a filing lapses a security interest becomes unperfected and is deemed never to have been perfected as against a purchaser (which includes a secured party) of the collateral for value. Former Article 9 also contained such a "retroactive" non-perfection scheme but a secured party was at risk as to lien creditors as well as purchasers. Under new section 9-515(c), there is retroactive non-perfection only as to a purchaser and not a lien creditor (including a trustee in bankruptcy).

To illustrate new section 9-515(c), if a security interest that is perfected by filing has priority over another security interest according to the usual filing rules, *see* Part VI, but the filing as to the first security interest is not timely continued then the later security interest may have priority. For example, if the later secured party acquired its interest and perfected in the five-year period during which the first filing was effective but the first filing was allowed to lapse then the secured party who filed first cannot rely on the lapsed filing to establish priority.

A careful reading of new section 9-515(c) reveals that if a party is not relying on the lapsed filing for perfection and priority, but is "otherwise perfected" so as to give that party priority (for example, by having filed another financing statement that is first in time), the retroactive non-perfection rule of new section 9-515(c) does not operate to subordinate the party whose filing has lapsed.

Under former Article 9 a new financing statement could not serve the purpose of a continuation statement -- even if the financing statement was filed in the six-month period preceding the lapse of the original filing -- because it did not properly identify the initial financing statement (or earlier continuation statement). *See, e.g., In re Halyard Drilling Co.*, 840 F.2d 596 (8th Cir. 1985); *In re Hays*, 47 B.R. 546 (Bkcy N.D. Ohio 1985). New section 9-515(c) and the definition of a continuation statement in new section 9-102(a)(27) codify these decisions.

Thus, under new Article 9, a new financing statement will not operate as a continuation statement. However, a new financing statement could "otherwise perfect" within the meaning of new section 9-515(c) and that filing could give a party priority despite the fact that the lapse of its initial filing results in retroactive non-perfection based on the lapsed filing.

Decisions under former Article 9 further made clear that a continuation statement filed before the beginning of the six-month period for filing a continuation statement or after the end of that period was not effective as a continuation statement. New section 9-510(c) is to the same effect. Under former section 9-403(2), if a debtor filed bankruptcy the period for filing a continuation statement was "tolled." That protection has been dropped from new Article 9. It is now incumbent on a secured party to properly continue the effectiveness of a filing during bankruptcy. The BRA was amended in 1994 to make clear that filing a continuation statement during bankruptcy does not violate the automatic stay.

Given the critical importance of the timely filing of a continuation statement and the dire consequences of a failure to do so, including retroactive non-perfection of a security interest against a purchaser under new section 9-515(c), there arises the question of who as between the client and the client’s attorney is obligated to make sure that a continuation statement is timely filed.

This question is the subject of *Barnes v. Turner*, 606 S.E. 2d 849 (Ga. 2004). To examine the decision click on the case name. Oversimplifying somewhat, the majority in *Barnes* concluded that where continued financing is reasonably contemplated an attorney has a duty either to file a continuation statement or to advise the client that such a statement must be timely filed and an attorney who fails to do either may be liable for malpractice.

Although not at issue in *Barnes*, the court's reasoning could apply as well to a situation where an attorney fails to advise a client that a termination statement should be filed to avoid subordination of the client's security interest to a creditor who could have priority under the first-to-file priority rule in new section 9-322(a)(1). Termination statements are discussed in the next subsection. The first-to-file rule is considered in Chapter 28 (Secured Party Versus Secured Party).

2. Termination of a Financing Statement

Under new section 9-513(d), an otherwise effective financing statement ceases to be effective when a "termination statement" is filed. As defined in new section 9-102(a)(79) a termination statement is an amendment to a financing statement that identifies the financing statement and indicates that the amendment is a termination statement or that the identified financing statement is no longer effective. The rules governing when and how termination statements must be filed are somewhat complicated.

Under former section 9-404(1), in consumer goods cases a secured party was required to file a termination statement within a month (or within ten days after a debtor made a written demand) after the debt had been paid (assuming there was no commitment to make further advances). In other cases a secured party was only obliged to provide the debtor with a termination statement and had to do so only on written demand by the debtor after no debt or commitment to make a future advance was outstanding and there was no time within which a secured party had to act in other than consumer goods cases. If a secured party failed to file or provide a termination statement as required by former section 9-404(1), the financing statement continued to be effective but the secured party was liable to the debtor for $100 and actual damages.

New section 9-513, in more elaborate and structured terms, tracks former section 9-404(1). Thus, under new sections 9-513(a) and (b), in consumer goods cases, a secured party is required to file a termination statement within a month (or within twenty days after receiving an authenticated demand from the debtor) after the debt has been satisfied and there is no commitment to make a future advance.

Under new section 9-513(c), in other than consumer goods cases, if the debt has been satisfied and there is no commitment to make a future advance, a secured party must send the debtor a termination statement within twenty days after receiving an authenticated demand from the debtor. Further under new section 9-513(c), where the financing statement covers accounts or chattel paper that has been sold a secured party is required to provide a termination statement only where the account debtor or other obligated person has discharged its obligation and in consignment cases only where the consigned goods are no longer in the debtor's possession.

New sections 9-513(a)(2) and (c)(4) add to the other situations in which a secured party is required to file a termination statement the case where the debtor did not authorize the filing of a financing statement. As to "bogus filings," *see* Official Comment 3 to 9-513 and Chapter 14 (The Nitty Gritty of Filing).

Under new section 9-513, as was true under former section 9-404(1), if a secured party fails to file a termination statement as required by new Article 9 the financing statement continues to be effective. A party who is aggrieved by the failure (which may include persons other than the debtor) is left to the remedies provided for in new section 9-625, including actual damages and statutory damages. *See* Chapter 38 (Remedies for a Secured Party's Failure to Comply with Article 9).

You may explore the basics of the lapse and continuation statement and termination statement scheme of new Article 9 in the next two problems.

Problem 23.1 (INTERACTIVE)

On November 1, Year 0, Central Bank (CB) took an interest in Donna Debtor's accounts receivable, existing and after-acquired, to secure a $50,000 loan to Debtor. The agreement signed by Donna provided that her accounts would secure any future advances that CB should choose to make to Donna. On November 2, Year 0, CB properly filed a financing statement covering Donna's accounts receivable. On October 1, Year 5, Southern Bank (SB) lent Donna $25,000. To secure the loan SB took an interest in Donna's existing and later-acquired accounts. SB properly filed a financing statement covering Donna's accounts on October 2, Year 5. As of the date of the SB loan, Donna had paid off the entire balance owing on the debt to CB. On October 15, Year 5, CB lent Donna $25,000. CB immediately filed a financing statement covering Donna's accounts receivable. On November 30, Year 5, Donna defaulted on its outstanding debts, including those owed to CB and SB. On that date Donna's accounts were worth $25,000.

SB gets the $25,000 under new Article 9, right? Explain why. (Your analysis will be aided by drawing a time line that captures the situation chronologically. An example of such a timeline is set forth below after the questions.)

What should CB have done to avoid being subordinated?

Why did CB's filing on October 15, Year 5 not continue the effectiveness of CB's initial filing on November 2, Year 0?

If CB had filed a continuation statement on May 15, Year 5, would its filing on November 2, Year 0 have continued to be effective (not have lapsed)? If CB had filed a continuation statement on October 15, Year 5, when would its November 2, Year 0 filing have lapsed?

What could (should) SB have done to avoid any risk of being subordinated to CB's interest?

Would Donna be entitled to request and receive a termination statement on the stated facts of Problem 23.1?

If instead of lending the $25,000 on October 15, Year 5 and filing a financing statement on October 15, Year 5, CB had lent the $25,000 and filed on September 15, Year 5, would SB get the $25,000? Assume again that CB failed to timely file a continuation statement.

Assume further that instead of SB making a loan on October 1, Year 5 that Donna suffered a levy on that date. Would CB be deemed to be unperfected against the lien creditor?

Suppose that CB filed a malpractice action against its attorney based on the fact that no continuation statement was filed. What issues are raised by such an action and how are they likely to be resolved?

If CB had timely filed a continuation statement, could SB successfully sue its attorney for malpractice? Explain your answer.

Problem 23.2 (INTERACTIVE)

Assume the facts of Problem 23.1. Assume further that on the date that Donna Debtor paid the debt owed to CB, Donna sent CB an authenticated demand that CB send her a termination statement.

Would CB be required to send a termination statement to Donna?

If so, how long would CB have to provide the termination statement?

Suppose CB failed to comply with Donna's demand. Would the financing statement continue to be effective? What recourse, if any, would Donna have against CB?

C. The Effect of Name Changes, Transfers that Result in Name Changes and New Debtor Situations

In the remainder of this chapter and Chapter 24 (Continuing Perfection -- Changes as to the Use of the Collateral or in the Location of the Collateral or the Debtor; Security Interests in Proceeds), we look at specific changes that may (or may not) require action essentially because a change may somehow be misleading to potential creditors (searchers). You will discover that the code drafters have sought to strike a balance (not necessarily always a good balance or an obviously reasonable one) between imposing additional burdens on filers or on searchers. We start with name changes, transfers of collateral that result in name changes, and new debtor situations.

1. Changes to the Debtor's Name

It should be clear why name changes may require refiling. If it is not, you should review carefully the materials dealing with the operation of the filing system in Chapter 14 (The Nitty Gritty of Filing). Name changes sometimes are "simple," meaning that the debtor continues as the debtor but the debtor's name changes. At other times not only is there a name change but a debtor other than the original debtor becomes involved, thereby presenting the ''dual" and "new" debtor cases dealt with in subpart B below.

a. "Simple" name changes

Under former section 9-402(7) if a name change was seriously misleading then to be perfected as to collateral acquired more than four months after the name change, a secured party was required to file a financing statement under the corrected name. Note that the original filing was effective as to collateral owned by the debtor or acquired by the debtor within four months after the name change and also was effective as to collateral acquired by the debtor more than four months after the change if the name change was not seriously misleading.

New Article 9 continues to treat "simple" name changes as they were treated under former section 9-402(7) but the rules are broken out into several sections. New section 9-507(b) provides a general rule according to which in other than new debtor cases, and except as provided otherwise in other sections, a financing statement containing information that has become misleading continues to be effective.

Under new section 9-507(c)(1), if the debtor's name changes so that the name becomes seriously misleading the financing statement continues to be effective as to collateral in existence at the time of the change and also collateral acquired up to four months after the change. However, under new section 9-507(c)(2), to be perfected as to collateral acquired more than four months after the change the secured party must file an *amendment* that renders the filing not seriously misleading within the four-month period following the name change.

As explained in Chapter 14 (The Nitty Gritty of Filing), under new section 9-506 name changes are seriously misleading unless a financing statement would be found in a proper search under the search process employed by a particular filing office.

If a secured party timely files an amendment (*i.e.*, files an amendment before the end of the four-month period) then the security interest is continuously perfected -- meaning perfection dates back to the original filing. What happens if a secured party attempts to amend a financing statement after the four-month period has expired is not entirely clear.

One might reasonably expect that the corrected financing statement would operate to perfect a security interest in collateral acquired more than four months after the change but that the perfection is not continuous and rather dates from the filing of the amendment. However, new section 9-507(c)(2) states:

> [T]he financing statement is not effective to perfect a security interest in collateral acquired by the debtor more than four months after the change, unless an amendment to the financing statement which renders the financing statement not seriously misleading is filed within four months of the change.

Read literally, this language means that the financing statement that has become seriously misleading cannot be corrected by an amendment made outside the four-month period. It is conceivable, however, that courts will read new section 9-507(c)(2) to mean that a financing statement is not effective to continuously perfect a security interest unless an amendment is filed within the four-month period, but that a late amendment operates to perfect the security interest from the date it is filed.

You may test your understanding of the new Article 9 rules governing "simple" name changes in the next problem.

Problem 23.3 (INTERACTIVE)

Jane Smith is a sole proprietor doing business as "Jane's Desert Treasures." Ready Lender has a security interest in Jane's inventory of trinkets, existing and later-acquired. The security interest was properly perfected by filing on January 2nd. On that date Jane's inventory consisted of 1000 trinkets. On March 1st of the same year, Jane married and changed her name to Jane Jones. Jane acquires 1000 more trinkets on May 15th of the same year. On July 30th of the same year Jane acquired 2000 additional trinkets.

In which of the trinkets in Jane's inventory of trinkets does Ready Lender have perfected security interests without taking action beyond the January 2nd filing?

If Ready Lender does not have perfected security interests in all of the trinkets in Jane's inventory, what action must Ready Lender take to assure that it will have perfected security interests in all of the trinkets?

What action must Ready Lender take to assure that the security interests are *continuously* perfected from the date of the original filing (January 2nd)?

If Ready Lender does not file an amendment at all, then Ready Lender is unperfected as to the trinkets acquired on July 30. If Ready Lender files an amendment to the initial filing on July 10 is Ready Lender perfected as to trinkets acquired more than four months after the name change?

b. Transfer and "new debtor" cases

i. Transfer cases

Name changes often get mixed together with cases involving transfers of collateral. It is helpful to know that some transfers involve third parties who are strangers as to the security agreement authenticated by the transferor while other transfers involve persons who have become bound by the original security agreement, persons who are referred to as "new debtors" in new Article 9. The two types of transfers may be governed different rules.

In Chapter 9 (The Specifics of Enforceability -- After-Acquired Property, Proceeds and Future Advances) we saw that under new section 9-315(a)(1), a security interest continues in transferred collateral unless the secured party authorizes the collateral to be disposed of free of the security interest. Our concern here is with perfection and continuing perfection.

Under the last sentence of former section 9-402(7), a security interest that continued in transferred collateral was perfected by a filing made prior to the transfer and no further action by the secured party was necessary. This rule is preserved in new section 9-507(a), which provides "a filed financing statement remains effective with respect to collateral that is sold, exchanged, leased, licensed, or otherwise disposed of and in which a security interest or agricultural lien continues, even if the secured party knows of or consents to the disposition."

The effect of new section 9-507(a) is that *if* a security interest continues in collateral transferred to a third party then a financing statement filed against the transferor prior to the transfer that perfected a security interest in the transferred collateral continues to perfect the security interest in the collateral in the hands of the transferee without further action by the secured party. Note that under this rule searchers must investigate the origin of property offered as collateral to discover whether the person offering that collateral acquired the property subject to a security interest created by another person.

An important qualification to the foregoing conclusions with respect to transferred collateral is in order. As will be seen in Part VI, some special priority rule may apply to protect the transferee despite the rules under which a security interest continues in the transferred collateral and is perfected without further action by the secured party.

The next problem illustrates new Article 9's treatment of transfer cases.

Problem 23.4 (INTERACTIVE)

The facts of Problem 23.3 were as follows: Jane Smith is a sole proprietor doing business as "Jane's Desert Treasures." Ready Lender has a security interest in Jane's inventory of trinkets, existing and later-acquired. The security interest was properly perfected by filing on January 2nd. On that date Jane's inventory consisted of 1000 trinkets. On March 1st of the same year, Jane married and changed her name to Jane Jones. Jane acquires 1000 more trinkets on May 15th of the same year. On July 30th of the same year Jane acquired 2000 additional trinkets. Suppose that in Problem 23.3 Jane Smith transferred a trinket to John Doe on February 15th.

Is the trinket acquired by John Doe from Jane Smith subject to Ready Lender's security interest?

What must you know to answer the question whether the trinket transferred to John Doe on February 15th is subject to Ready Lender's security interest?

Is any security interest that Ready Lender has in the trinket acquired by John Doe from Jane Smith perfected?

Is your answer to this question affected by Jane's marriage and name change on March 1st?

ii. New debtor cases

It is possible for a security interest created by one person to attach to property owned or acquired by another person. This happens when a person becomes a new debtor by becoming bound to a security interest created by the original debtor. Recall from Chapter 9 (The Specifics of Enforceability -- After-acquired Collateral, Future Advances, Transferred Collateral and Proceeds, and the New Debtor Problem) that a person is a new debtor, as defined in new section 9-102(a)(56), when that person becomes bound to a security agreement authenticated by another person under new section 9-203(d). Here we are concerned with the question of whether and to what extent a filing against the original debtor is effective to perfect a security interest in property owned by or acquired by a new debtor.

Under new section 9-508(a), subject to the qualifications for name changes dealt with in subsection (b), a financing statement filed against the original debtor is effective against the new debtor as to property subject to the secured party's security interest under the security agreement authenticated by the original debtor to the same extent the financing statement is effective against the original debtor.

Under new section 9-508(b)(1) where the difference between the name of the original debtor and that of the new debtor is such that the financing statement filed against the original debtor would be seriously misleading under new section 9-506 the filing against the original debtor is effective only as to property subject to the security interest that is owned by the new debtor when the person becomes a new debtor and property acquired by the new debtor within four months of that time.

To be perfected as to property acquired after the end of the four-month period new section 9-508(b)(2) requires the secured party to file an initial financing statement providing the name of the new debtor is filed before the expiration of the four-month period.

The resemblance of new section 9-508(b)(2) to new section 9-507(c)(2) governing "simple" name changes should be apparent. Both provisions require a secured party to take action to continue perfection of a security interest in collateral acquired more than four months after a misleading name change. However, under new section 9-508(b)(2) the secured party must file *an initial financing statement* against the new debtor, whereas under new section 9-507(c)(2) a secured party must file an *amendment* to the original financing statement.

The requirement in new section 9-508(b)(2) that the initial financing statement be filed within four months after the new debtor becomes bound poses the question raised by new section 9-507(c)(2), namely, whether making the required filing outside the four-month period is enough to perfect the security interest in the collateral acquired more than four months after the new debtor becomes bound from the time the later filing is made. The argument that a tardy filing does not result in continuous perfection but does perfect from the date of the filing may be stronger as to new section 9-508(b)(2) than it is as to new section 9-507(c)(2) because the former involves an initial financing statement and not an amendment to the original filing.

Under new section 9-508(c), new section 9-507(a) and not new section 9-508 governs the effectiveness of a filing against the original debtor as to collateral transferred by the original debtor to the new debtor. It would seem that the result would be the same under either section but requiring the application of new section 9-507 places all transferred collateral under the same rule.

As noted earlier, what actually would happen in a dispute between a secured party and a new debtor could turn on the application of some priority rule that will be examined in Part VI.

To explore the treatment of the "new debtor" situation under new Article 9 (without regard to the priority rules of Part VI), consider the next problem.

Problem 23.5 **(INTERACTIVE)**

The facts of Problem 23.4 were that Jane Smith from Problem 23.3 transferred a trinket to John

Doe on February 15th. Assume further that John Doe, the transferee from Jane, acquired a trinket from Harold Brown on February 20th.

Does Ready Lender have a security interest in the trinket acquired by John Doe from Harold Brown?

Under what circumstances would Ready Lender have a security interest in the trinket acquired by John Doe from Harold Brown on February 20th?

Assume that John Doe became a new debtor on February 14th, in which case Ready Lender would have a security interest in the trinket acquired by John Doe from Harold Brown, would Ready Lender also have a security interest in trinkets owned by John Doe at the time of the acquisition of the trinket from Harold Brown?

Again assuming that John Doe became a new debtor on February 14th, is any security interest that Ready Lender has in trinkets John Doe owns at the time of the acquisition of the trinket from Harold Brown perfected?

Is any security interest that Ready Lender has in the trinket acquired by John Doe from Harold Brown on February 20th perfected?

Would any security interest that Ready Lender has in trinket acquired by John Doe from Harold Brown be perfected if the trinket were acquired on July 15th?

Assume that Ready Lender filed an initial financing statement naming John Doe as the debtor on February 15th. From what date is the filing effective?

If John Does acquires another trinket from Jane on July 20th is any security interest in that trinket perfected?

New debtor situations arise where a sole proprietorship (or partnership) whose property is subject to a perfected security interest incorporates after creating the security interest or a corporation that has created a security interest is acquired by or merges with another corporation. You may consider the former type of new debtor case in the next problem.

Problem 23.6 (INTERACTIVE)

Jane Smith in Problem 23.3 incorporates under the name "Jane's Desert Treasures, Inc." As part of the incorporation process, Jane transfers all of her inventory and equipment to the corporation. At the time of the incorporation, Jane owed Western Bank $50,000 secured by an interest in Jane's inventory and equipment, existing and later-acquired. Western Bank had properly filed under the name "Jane Smith" a financing statement describing the collateral as Jane's equipment and inventory. Under applicable state law the corporation is obligated to pay the debt owed to Western Bank by Jane.

Will the original financing statement provide continuing perfection of the security interest in the inventory and equipment transferred to the corporation by Jane?

Will the original financing statement provide *continuing* perfection as to inventory and equipment acquired by the corporation two months after incorporation? Will there be *continuous* perfection under the filing made against Jane as to inventory and equipment acquired by the corporation six months after incorporation? What does *continuous* perfection mean in this context?

2. Changes other than to the Debtor's Name

As the foregoing discussion makes clear changes in the debtor's name may require a refiling because Article 9 filings are indexed according to the debtor's name and information in a filing may become misleading as the result of a change. The question is whether changes to other information required by new section 9-502, specifically, the name of the secured party and the description of the collateral, require refiling.

Changes to the collateral that affect the description of the collateral can be accomplished only by an amendment to the financing statement under new section

9-512(a) by a person authorized to file such an amendment, which under new section 9-509(d) means a secured party of record as defined in new section 9-511(a). An amendment under new section 9-512 is a filing that identifies the initial financing statement to which the amendment pertains so, by definition, a refiling is necessary. It is worth noting under new section 9-512(c) an amendment that adds collateral is effective only from the date of the amendment.

The situation is different regarding changes that affect the name of the secured party given in a financing statement. It is possible for one secured party to be substituted for another, but this requires an amendment that, as noted above, is a filing. However, more likely a change as to who is the secured party will come about as the result of an assignment or a merger or acquisition that is accompanied by or is functionally equivalent to an assignment.

Under new section 9-310(c), a refiling is not needed to continue the perfected status of a security interest when the security interest is assigned. Note that this is so even though the public record does not accurately name the secured party.

As was stressed in Chapter 17, (Perfection as to Goods Subject to Certificate of Title Legislation), it is important for the assignee to be sure the security interest being assigned has been properly perfected as new section 9-310(c) provides only that a perfected security interest continues to be perfected when the security interest is assigned without the need for further action. It also is important to note that new section 9-310(c) provides for continuing perfection only as to creditors and transferees of the original debtor.

Moreover, if there is a transfer or a change under which a new debtor becomes involved then the rules regarding the need to refile, as discussed above, come into play. Finally, it is worth noting that because new Article 9 no longer requires an address for the secured party a change in the secured party's address does not affect perfection. *See, e.g., In re* Hergert, 275 B.R. 58 (Bkcy D Idaho 2002).

CASE COMMENTARY

Planned Furniture Promotions, Inc. v. Benjamin S. Youngblood, Inc., 374 F. Supp. 2d 1227 (M.D. Ga. 2005)

In re Snelson, 330 B.R. 643 (Bkcy E.D. Tenn. 2005)

Borley Storage and Transfer Co., Inc. v. Whitted, 271 Neb. 84, 710 N.W.2d 71 (Neb. 2006)

Sunflower Bank, N.A. v. Kindsvater, 144 p.3d 81 (Kan. App. 2006)

Retenbach Constructors, Inc. v. CM Partnership, 639 S.E.2d 16 (N.C. App. 2007)

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2011-08-22 update

Part V Perfecting an Article 9 Security Interest

Chapter 24 Continuing Perfection -- Changes as to the Use of the Collateral or in the Location of the Collateral or the Debtor; Security Interests in Proceeds

A. Relocation of the Debtor or the Collateral Within a State

Under former Article 9 difficulties could arise where a security interest was properly perfected by a local filing and the debtor's residence or the use or location of the collateral changed. For example, if a creditor properly perfected a security interest in farm equipment by filing in the county of the debtor's residence as required by former section 9-401(1)(a) (Second Alternative) and the debtor moved to another county, later creditors could be misled in that a search of the records in the county to which the debtor had moved would not disclose the filing. Nevertheless, under former section 9-401(3), the filing in the county from which the debtor had moved continued to perfect the security interest (until the filing lapsed or was terminated). Such problems largely go away under new Article 9 because there is local filing under new section 9-501(a) only as to certain real estate related collateral.

A second question under former Article 9 was what should happen if a secured creditor relied on automatic perfection as to a purchase money security interest in consumer goods and subsequently the debtor began using the collateral in the debtor's business. The change was potentially misleading in that filings as to consumer goods were local but those as to equipment were central. Former Article 9 did not expressly answer the question, but there was a consensus that a new filing was not needed.

A third question arising under former Article 9 was whether a financing statement properly filed to perfect a security interest in inventory was effective to perfect the security interest if the debtor began using the collateral in its business rather than holding it for sale. Again there was no answer provided by former Article 9, but there was wide agreement that the original filing was effective.

More generally, there was a "rule " that if a filing was proper under the circumstances extant at the time a security interest attached then the filing continued to be effective despite a change in circumstances that would have required a different filing initially.

makes sense and the rule should apply under new Article 9 as well. Note that the rule protects the secured party only where the initial filing is proper. However, there were exceptions to this general rule. These exceptions are explored in this chapter.

B. The Effect of Relocation of the Debtor or Collateral from One State to Another

1. Generally

Determining the effect of a relocation of the debtor or the collateral on continued perfection requires a complete understanding of the rules governing perfection *as an initial matter* because a change in location of the debtor or the collateral can mislead potential creditors only where the debtor's location or the location of the collateral governed perfection before the change. To illustrate, if the location of the collateral or the debtor requires central filing in State A and the collateral or the debtor moves to State B and the location of the debtor or the collateral in State B would require a central filing in State B then the move is misleading to potential creditors.

As a first step, you should review the discussion in Chapters 6 (Choice of Law), 13 (Overview of Perfection by Filing), 15 (Perfection by Possession (Including Documents of Title)) and 17 (Perfection as to Goods Subject to Certificate of Title Legislation) as to various choice of law rules. While doing so you should note that under new Article 9 the law of the state where the debtor is located is the general choice of law rule governing perfection, but that there are significant qualifications to this rule.

2. Relocation of the Debtor from One State to Another

Relocation of the debtor is a potential problem only in situations where the debtor's location determines the law governing perfection meaning, for the most part, the state in which a financing statement must be filed. Under former Article 9 the law where the debtor was located governed perfection only as to security interests in pure intangibles and mobile goods and security interests in chattel paper that were perfected by filing rather than possession. Where a debtor relocated to another state a creditor had four months from the date of the relocation to reperfect a security interest in the collateral.

The four-month period was designed to give a creditor time to learn that a debtor had moved and to reperfect in the state to which the debtor had relocated (although it was a good question whether creditors realistically could be expected to act within the time allowed even if they attempted to monitor a debtor's whereabouts (for example, by noting changes of address on payments), which they obviously should do. If a creditor failed to reperfect within the four-month period perfection was not continuous and the security interest was deemed unperfected as against a person who became a purchaser after the debtor relocated.

New Article 9 retains the scheme requiring a secured party to reperfect within four months after a debtor relocates in a situation where the debtor's location governs perfection of a security interest. As was seen in Chapter 13 (Overview of Perfection by Filing), the "general rule" of new Article 9, under new section 9-301(1), is that the law of the state where the debtor is located governs perfection and non-perfection (*i.e.*, dictates the state in which a creditor should file). The new Article 9 rules for dealing with situations where a debtor *relocates* are found in new section 9-316.

New section 9-316(a) indicates how long a security interest perfected in one state continues to be perfected in another state on the happening of certain events, including a relocation of the debtor. Under new section 9-316(a)(2), perfection continues for four months after the debtor relocates. This four-month "grace period " is a carryover from that in former Article 9. It should be noted that new section 9-316(a) deals with events other than relocation of the debtor. Thus, under new section 9-316(a)(1) perfection ends when a financing statement lapses or otherwise ceases to be effective in the state where the financing statement was filed.

Under new section 9-316(a)(3), perfection continues for one year after a transfer of collateral to a person in another state who becomes a debtor (either as a result of the transfer or by becoming bound to the security agreement entered into by the transferor, *i.e.*, becomes a "new debtor").

Of special importance is the fact that the rules found in new section 9-316(a) apply only where perfection and nonperfection are governed by the law where the debtor is located. The prefatory language of new section 9-316 refers to "a security interest perfected pursuant to the law of the jurisdiction in Section 9-301(1) . . . ." In particular, where the law of the jurisdiction that has issued a certificate of title covering goods governs perfection and nonperfection then the four-month rule does not apply. Certificate of title situations are considered in subpart B(3)(b) below.

New section 9-316(b) specifies what a secured party must do to continue perfection beyond the periods stated in new section 9-316(a) and what happens if a secured party fails to act timely to continue perfection. Under new section 9-316(b), if a security interest is reperfected in the jurisdiction whose law governs because of a change *and* reperfection is accomplished in the new jurisdiction before the end of the earliest of any applicable stated period, then perfection is continuous from the date the security interest was perfected in the state from which the debtor relocated (or action resulting in a new debtor was taken). However, under new section 9-316(b), as was also true under former section 9-103(3)(e), if the security interest is not reperfected before the end of the earliest of any applicable stated period, then the security interest is *deemed* never to have been perfected against a purchaser for value of the collateral.

The rules in new section 9-316(b) mean that if a secured party delays action to reperfect beyond the time periods provided for in new section 9-316(a) -- in the case of a relocation of the debtor, within four months after the change in the debtor's location -- then the security interest can be subordinated by a creditor who takes a security interest in the collateral, even one who does so during the time the security interest was perfected.

As was true under former Article 9, new section 9-316(b) requires *perfection* under the law of the jurisdiction that governs because of the change. A move by a debtor to another state (or a transfer of collateral) often will be unauthorized and constitute a default, giving a secured party the option to repossess the collateral rather than refile in the new jurisdiction, at least as to tangible collateral. As to reperfection by refiling, recall that under new section 9-509(b), execution of a security agreement authorizes a secured party to file a financing statement. Similarly, under new section 9-509(c), a transferee of collateral in which a security interest continues under new section 9-315(a)(1) authorizes the security party to file a financing statement covering the collateral.

You may test your understanding of the new Article 9 rules governing relocation of a debtor in the next three problems.

Problem 24.1 (INTERACTIVE)

Donald Debtor resides in and does business as a sole proprietorship in Tucson, Arizona. Donald borrows from Western Bank and gives Western a security interest in Debtor's accounts, existing and later-acquired. Western files a financing statement covering accounts in the Secretary of State's office in Arizona.

Is Western's security interest in the accounts perfected under new Article 9?

If Donald later moves to Albuquerque, New Mexico, but continues to do business in Tucson, will the security interest still be perfected under new Article 9? If Western's security interest is perfected after the move to New Mexico, for how long is it perfected?

What must Western do to assure *continuous* perfection after that period of time?

Problem 24.2 (INTERACTIVE)

Southwestern Bank lends to Super Stuff, Inc. and takes a security interest in Super Stuff's accounts, existing and later-acquired. Super Stuff is incorporated in Arizona but does business in New Mexico and California as well as Arizona. Southwestern perfects its security interest by filing a financing statement covering accounts in the Secretary of State's office in Arizona. At the time of the loan, Super Stuff's chief executive office is in Phoenix, Arizona.

Is Southwestern's security interest in Super Stuff's accounts perfected under new Article 9?

Subsequently, Super Stuff moves its chief executive office to Albuquerque, New Mexico. Does Southwestern's security interest continue to be perfected? If so, for how long?

Problem 24.3 (INTERACTIVE)

Assume the facts of Problem 24.2 but that the debtor, Super Stuff, is a general partnership. Subsequent to Southwestern Bank's filing in Arizona, Super Stuff moves its chief executive office to Albuquerque, New Mexico.

Do your answers to the questions posed in Problem 24.2 change?

If Southwestern's filing in Arizona does not lapse and is not terminated but Southwestern does not re-perfect in New Mexico within the four-month period after Super Stuff relocates to New Mexico what happens?

As noted earlier, new section 9-316 also deals with transfer and new debtor cases. Consider the next two problems.

Problem 24.4 (INTERACTIVE)

Delia Debtor, an individual residing in Tucson, Arizona, purchases a stereo for use in her business on credit from Sid Seller. Sid takes an interest in the stereo to secure the unpaid price of the stereo. Sid perfects by filing in Arizona. The security agreement executed by Delia provides that the stereo may not be removed from Tucson without the express written consent of Sid. Without Sid's knowledge, Delia moves to San Francisco, California.

Does Sid's security interest continue to be perfected after Delia moves to California?

If Sid's security interest is perfected in California without further action by Sid, for how long is it perfected?

What action must Seller take to achieve continuous perfection beyond that period of time after Delia's move to California?

What happens if Sid does not take the required action to continue perfection?

Now, suppose instead of moving to California, Delia sold the stereo to Teresa Transferee in San Francisco, California. Would Sid's security interest be perfected in California?

If Sid's security interest is perfected in California, for how long is it perfected?

What happens to Sid's security interest if Sid does not reperfect in California before the shorter of the two time periods provided for in new section 9-316(a) expires?

Problem 24.5 (INTERACTIVE)

Assume the original facts of Problem 24.4. Assume further, however, that Delia Debtor bought the stereo for personal use and Sid Seller did not file. Would these changes in the facts alter your answers to the question of how Delia's move to California affects the perfection of Sid's security interest in the stereo? Assume again the foregoing facts (that Sid took a security interest in the stereo sold to Delia, that Delia bought for personal use and that Sid did not file a financing statement) but that instead of moving to California, Delia sold the stereo to Teresa Transferee in

California.

Would the argument made earlier in this problem that Sid's security interest never became unperfected under new section 9-316(b) continue to be persuasive?

3. Movement of Collateral from One State to Another

As discussed earlier, movement of the collateral affects perfection only where the law governing perfection and nonperfection depended initially on the location of the collateral (rather than the location of the debtor). The situations where location of the collateral (a "situs rule") governs perfection and nonperfection are conveniently divided into cases involving collateral other than goods covered by a certificate of title and those involving goods covered by a certificate of title.

a. Collateral Other Than Goods Covered by a Certificate of Title

As was noted in Chapter 15 (Perfection by Possession (Including Documents of Title)), under new section 9-301(2), the law of the state where the collateral is located governs perfection and nonperfection as to security interests that are perfected by possession. The location of the collateral rule applies only where a security interest in the collateral can be perfected by possession under new section 9-313(a). As discussed in Chapter 15, perfection by possession is possible only as to collateral that falls into what have been referred to as the goods and quasi goods categories. Included in these categories are goods, instruments, money, certificated securities, and tangible chattel paper.

What happens when collateral a security interest in which has been perfected by possession in one state is then moved to another state is governed by new section 9-316(c). The operation of new section 9-316(c) may be illustrated by examining movement of goods other than goods covered by a certificate of title.

Consider the next three problems.

Problem 24.6 (INTERACTIVE)

The facts of Problem 15.1 in Chapter 15 (Perfection by Possession (Including Documents of Title) were as follows: Delia Debtor is an individual residing in Arizona. Delia gives a security interest in a valuable painting to Lisa Lender who also is an individual residing in Arizona. Lisa takes possession of the painting in Arizona. As seen in that problem, Arizona law governs perfection of Lisa's security interest because under new section 9-301(2), the law of the location of the collateral governs perfection as to a possessory security interest.

Is the security interest in the painting perfected? If so, for how long?

Problem 24.7 (INTERACTIVE)

The facts of Problem 15.2 in Chapter 15 were that Lisa Lender had taken a security interest in a painting and had taken possession of the painting but Lisa resided in New Mexico and took possession of the painting in New Mexico. As was seen in that problem, the law of New Mexico governs perfection because the law of the location of the collateral governs perfection under new section 9-301(2).

Is the security interest in the painting perfected?

Problem 24.8 (INTERACTIVE)

In Problem 15.3 in Chapter 15 the facts were that Lisa Lender took possession of a painting in Arizona and then moved to California taking the painting with her. It was seen that the law of California governs perfection of the security interest in the painting because the law of the location of the collateral governs perfection as to a possessory security interest under new section 9-301(2).

If the security interest was perfected by possession in Arizona, does the security interest in the painting remain perfected when Lisa moves to California?

If the security interest in the painting was perfected by possession under Arizona law and also is perfected by possession under California law, is the security interest in the painting *continuously* perfected?

If the security interest in the painting was perfected by possession under Arizona law but would not be perfected by possession under California law, would Lender have some time period within which to perfect in California? *See* new section 9-316(c).

Generally speaking, the law regarding perfection by possession of the jurisdiction to which collateral is moved will be the same as the law of the jurisdiction from which the collateral was moved and the security interest will be perfected in the jurisdiction to which the collateral is moved. There could, however, be differences in the law as between the two jurisdictions, especially where the collateral is physically in the possession of a third party. As to such third-party-possession cases new section 9-313(c) and Chapter 15 (Perfection by Possession (Including Documents of Title)) should be consulted.

In the rare case where a security interest is perfected by possession under the law of the jurisdiction from which the collateral was moved but is not so perfected under the law of the jurisdiction to which the collateral is moved under new section 9-316(c) there is no grace period during which action to perfect the security interest in the state to which the collateral is moved will result in continuous perfection.

It should be kept in mind that the rules just discussed regarding changes in possession apply to security interests in collateral other than goods covered by a certificate of title. The next subsection deals with security interests in goods covered by a certificate of title.

b. Goods Covered by a Certificate of Title Law Requiring Perfection by Lien Notation

The question here is what happens to perfection when goods, especially vehicles, in which security interests have been perfected by "lien notation" are moved to another state that also issues a certificate of title under a law requiring that a security interest be noted on the title for it to be perfected. As noted in subpart B(2), in other than certificate of title situations, specifically, where perfection and nonperfection are governed by the law of the jurisdiction where the debtor is located as per new section 9-301(1) then different rules apply.

Generally speaking, under former Article 9, the law of a state issuing a certificate of title requiring lien notation governed perfection and nonperfection until four months after a vehicle covered by the certificate of title was registered in another state or until the certificate of title was surrendered. But, exactly what should happen when the state to which a vehicle was moved issued a "clean title" (one on which a security interest had not been noted), especially if the certificate of title issued by the state from which the vehicle had been moved was surrendered, was not at all clear.

New Article 9 undertakes to resolve the uncertainties existing under former Article 9. It does so primarily by making clear that although problems tend to arise only where goods covered by a certificate of title issued by one state are moved to another state, the critical event is not the relocation of the collateral, as such, but rather the fact that goods cease to be covered by a certificate of title issued by one state and become covered by a certificate of title issued by another state.

As noted in Chapter 17 (Perfection as to Goods Subject to Certificate of Title Legislation), under new Article 9, section 9-303(c), the law of a state that has issued a certificate of title covering goods governs perfection of a security interest in those goods. Moreover, under new section 9-303(b), goods are covered by a certificate of title from the time of an application for a certificate of title and a tender of any required fees until the certificate ceases to be effective under the law of the issuing state *or* the goods become covered by a certificate issued by another state.

Assume, for example, a security interest in a vehicle that is covered by a certificate of title issued by State A. Under new section 9-303(c) the law of State A governs perfection and nonperfection. If the security interest is noted on the title issued by State A then the security interest is perfected. *See* new 9-311(b) and Chapter 17 (Perfection as to Goods Subject to Certificate of Title Legislation). Under new section 9-303(b) the vehicle is covered by the certificate of title issued by State A so long as the certificate is effective under the certificate of title law of State A and under new section 9-303(c) State A's law governs perfection and nonperfection so long as the vehicle is covered by the certificate of title issued by State A.

Now, suppose that State B issues a certificate of title covering the vehicle. Normally this will happen only when the vehicle is taken from State A to State B and registered in State B. However, as we saw in Chapter 17 the application of the choice of law rule of new section 9-303(c) is not dependent on any nexus of the goods with a state issuing a certificate of title. Under new section 9-303(a) it is enough to trigger the choice of law rule of new section 9-303(c) that a state has issued a certificate of title that covers the goods.

In any event, under new section 9-303(c), as soon as the vehicle in the example is covered by the certificate of title issued by State B the law of State B governs perfection and nonperfection. Under new section 9-303(b) the vehicle is covered by the certificate of title issued by State B from the time the application for the title was made and any required fees were tendered. Further, under new section 9-303(b), the vehicle ceased to be covered by the certificate of title issued by State A when the vehicle became covered by a certificate of title issued by State B and the law of State A no longer governs perfection and nonperfection.

The question here is whether the security interest in the vehicle continues to be perfected when State B issues a certificate of title covering the vehicle and the vehicle is no longer covered by the title issued by State A. It might appear that if, for example, the security interest were not noted on the State B title that the security interest would not be perfected under the law of State B (which we may assume requires lien notation). However, State B's law includes other provisions of new Article 9 that we have yet to examine, namely, new sections 9-316(d) and (e).

Technically, new sections 9-316(d) and (e) operate in situations other than those where a security interest was originally perfected by lien notation, but it is difficult to envision today a case where perfection in goods subject to a certificate of title law would be perfected in any other way. Moreover, on the facts of the example we have been considering the security interest was perfected in State A by having the security interest noted on the State A title.

Under new section 9-316(d), except as qualified in new section 9-316(e), if a state issues a certificate of title covering goods in which there is a security interest that is perfected when the goods become covered by that certificate of title, then the security interest continues to be perfected until the security interest would have become unperfected under the law of the *other* jurisdiction had the certificate of title not been issued and the goods not have become covered by the later certificate of title.

If, as could happen, the law of the state issuing the *earlier* title provides that if another state issues a certificate of title covering the vehicle then a security interest becomes unperfected then a security interest becomes unperfected as a matter of applying the law of the state issuing the *earlier* title as required by new section 9-316(d). *See*

Example 8 in Official Comment 5 to new 9-316.

In the example we have been using, if perfection ceased under the law of State A, for whatever reason, then according to new section 9-316(d) the security interest does not "remain" perfected and is perfected only if the security interest was noted on the certificate of title issued by State B, in which case the security interest is perfected under new section 9-311(b) as adopted in State B.

As noted above, new section 9-316(d) is subject to new section 9-316(e). Under new section 9-316(e) a security interest becomes unperfected as against a purchaser of the goods for value and is deemed never to have been perfected as against such a purchaser if the security interest is not perfected by lien notation under new section 9-311(b) or re-perfected by repossession under new section 9-313(b) before the end of the shorter of the following two periods:

(1) the time when the security interest would have become unperfected under the law of the state under which it was perfected

or

(2) the end of four months after the goods are covered by the certificate of title.

The meaning of new sections 9-303, 9-316(d) and 9-316(e) together can be understood by applying them to the earlier example. In that example, a security interest in a vehicle was perfected under the law of State A by having the security interest noted on a certificate of title covering the vehicle. The vehicle is then taken to State B and State B issues a certificate of title covering the vehicle. Under new sections 9-303 and 9-316(d), the security interest perfected in State A continues to be perfected in State B as long as perfection does not cease under the law of State A.

This result obtains even though the law of State B governs perfection and nonperfection when State B issues a certificate of title covering the vehicle and even if the security interest is not noted on the title issued by State B and to that extent is not perfected under the law of State B. This is an important point because it protects the secured party against the claims of lien creditors and a trustee in bankruptcy.

However, new section 9-316(d) is qualified by new 9-316(e). Under new section 9-316(e) for a security interest to be perfected against a purchaser of the vehicle for value the secured party must act to reperfect under the law of State B, either by having a lien noted on the title issued by State B or by repossessing the vehicle (thereby reperfecting by possession) *and* the lien notation or repossession must occur before the security interest becomes unperfected under the law of State A or the end of the four-month period from the time of the issuance of the State B title, whichever is earlier.

If the security interest is not perfected or reperfected within the time allowed by new section 9-316(e) the security interest will be deemed unperfected against a purchaser for value of the vehicle who purchases the vehicle any time after the vehicle becomes covered by the State B title.

The case of *In re Custer*, 50 UCC Rep. Serv. 2d 608 (Bkcy ND Iowa 2003), presents an interesting fact situation within which the application of new sections 9-316(d) and (e) might have been explored but was not. In *Custer*, a South Dakota dealer sold a vehicle to an Iowa purchaser under an installment contract that created a security interest in the vehicle. The contract contained a notice that the contract would be assigned to a creditor that actually financed the purchase. The vehicle was delivered to the debtor/buyer on April 26, 2002. The dealer applied for a South Dakota title and the title was issued in the dealers name on May 10, 2002.

The dealer then provided the debtor with the South Dakota title so that the debtor could obtain an Iowa certificate of title on which the security interest could be noted. However, the debtor delayed applying for the Iowa certificate of title and it was not until May 31, 2002 that an Iowa title noting the security interest was issued. In the meantime, on May 9, 2002, the debtor filed bankruptcy.

The court noted that if the security interest had been perfected within twenty days after the debtor took possession then under new section 9-317(e) and BRA § 546(b), even if the perfection occurred after bankruptcy was filed, something that BRA § 362(b)(3) would allow, the trustee could not have avoided the security interest. The court concluded, however, that because the security interest had not been perfected within the twenty-day period, new section 9-317(e) and BRA § 546(b) did not apply, the perfection on May 31, 2002 violated the automatic stay and was ineffective because BRA § 362(b)(3) did not permit such perfection.

Further, because the security interest was unperfected it could be subordinated by a lien creditor under new section 9-317(a)(2) and, consequently, the trustee could avoid the security interest under BRA § 544(a). As to the avoidance of security interests by a trustee under BRA § 544(a), *see* Chapter 26 (Secured Party Versus Lien Creditor; Future Advances; Bankruptcy).

Insofar as the courts analysis rests on the assumption that the security interest was not perfected until May 31, 2002, its application of the controlling new Article 9 sections and the corresponding sections of the BRA is correct. Moreover, the court correctly concluded that under new section 9-303(c) Iowa law governed perfection and non-perfection of the security interest.

However, if the security interest was noted on the South Dakota title and, therefore, was perfected under South Dakota law on May 10, 2002, then under new sections 9-316(d) and 9-316(e), as enacted in Iowa, the security interest would continue to be perfected under Iowa law unless it became unperfected under South Dakotas certificate of title law.

If the security interest was perfected under South Dakota law and did not cease to be perfected under Iowa law then the security interest would have been perfected before the end of the twenty-day period after the debtor received possession and the creditor should have had the benefit of new section 9-317(e) and BRA §§ 546(b) and 362(b)(3).

Moreover, because a trustee is a lien creditor and not a purchaser for value within the meaning of new section 9-316(e), the creditor would have been protected even if there was no perfection in Iowa by having the security interest noted on the Iowa title within four months after the issuance of the Iowa title.

Although it is increasingly unlikely that a certificate of title will not have a security interest created and perfected in another state noted on it, the issuance of "clean titles" through fraud or mistake is still possible. Clean titles are thought to be particularly problematic as to non-dealer buyers of vehicles and former Article 9 offered special protection to non-dealer buyers in clean title situations. New Article 9 also protects non-dealer buyers but it does so to a lesser extent than did former Article 9.

Thus, under new section 9-337(1), a non-dealer buyer of goods who gives value and receives delivery of the goods without knowledge of an outstanding security interest perfected in another state after a certificate of title that does not show the outstanding security interest *or* contain a statement that the goods may be subject to a security interest not shown on the title takes free of that security interest. The addition of the qualification that a non-dealer buyer is subject to (does not take free of) a perfected security interest if a certificate of title contains a statement to the effect that there may be an outstanding security interest not shown on the certificate diminishes the protection that was given to non-dealer buyers under former Article 9.

New Article 9, unlike former Article 9, includes some protection for secured parties in clean title situations. Thus, under new section 9-337(2) a secured party who, without knowledge of an outstanding security interest properly, perfects a security interest by lien notation after the issuance of a clean title or a title that does not contain the requisite disclaimer, has priority over a party who holds a security interest perfected in another state.

As explained in Chapter 17 (Perfection as to Goods Subject to Certificate of Title Legislation), the risk of fraud resulting in clean title difficulties is less where a certificate of title law provides that the title shall be issued to and held by the secured party until the secured debt is paid (i.e., in lien holder states). However, a determined debtor still may exploit differences in state laws to obtain a clean title and clean titles also can be issued by mistake. Therefore, so long as paper titles are used new section 9-337 will continue to be important.

As also explained in Chapter 17, some states are replacing paper titles with electronic titles. It remains to be seen how such a change will impact the incidence of fraud. If the electronic titles are employed only to the extent that a vehicle is subject to a security interest and a paper title is issued when the secured debt is paid or when the state agency charged with issuing titles receives satisfactory evidence that the debt has been paid, a debtor could defraud the state agency into issuing a clean paper title (and, again, mistakes are sometimes made).

You may test your understanding of the not uncomplicated scheme governing the continuation of security interests in goods covered by certificate of title statutes in the next two problems.

Problem 24.9 (INTERACTIVE)

Western Bank finances Donald Debtor's purchase of a vehicle in Arizona. On January 2nd, Western takes a security interest in the vehicle and timely submits the application and fee needed to obtain an Arizona certificate of title covering the vehicle. Arizona issues a certificate of title on which the security interest is noted. On February 2nd, without getting Western's consent, as mandated by the security agreement, Donald moves to California and applies for a California title and a California certificate of title covering the vehicle is issued. Three months later, on May 2nd, Donald files bankruptcy. May the trustee in bankruptcy avoid Western's security interest in the vehicle under BRA section 544(a) (assume that a trustee may avoid a security interest that is not perfected on the date of bankruptcy)?

Now, assume these additional facts: At the time of the application for the California title Donald surrendered the Arizona title and under Arizona law surrender of an Arizona title in connection with an application for a certificate of title in another state causes a perfected security interest to become unperfected. May the trustee in bankruptcy now avoid Western's security interest in the vehicle under BRA section 544(a) (assume that a trustee may avoid a security interest that is not perfected on the date of bankruptcy)?

What further information is required to decide whether a trustee could avoid Western Bank's security interest under BRA section 544(a) after the Arizona title is surrendered and the California title is issued?

If the Arizona title had not been surrendered (and no other event that would have ended perfection under Arizona law took place) then Western Bank's security interest would be perfected on May 2nd. Why so?

But, the Arizona title was surrendered and as a result Western Bank's security interest was no longer perfected under Arizona law. Why is this not the end of the inquiry?

Problem 24.10 (INTERACTIVE)

Assume the facts of Problem 24.9 qualified as follows:

- February 2nd: Donald obtained a California title but the Arizona title was not surrendered and perfection under Arizona law continued under new section 9-316(d);

- February 2nd: Western Bank's security interest was not noted on the California title;

- May 2nd (three months after the California certificate of title was issued): Rather than filing bankruptcy , Debtor sold the vehicle to Hot Deals, a dealer in used motor vehicles;

- Western does not learn what has happened to the vehicle until five months after the issuance of the California title (July 2nd).

Is Hot Deals subject to Western's security interest? Assume, as will be explained further in Part VI, the answer to the question turns on whether Western's security interest is perfected.

Assume again the facts of Problem 24.9 as qualified above -- Donald obtained a California title but the Arizona title was not surrendered, perfection under Arizona law did not cease when the California title was issued, and Western Bank's security interest was not noted on the California title -- but assume further that Western Bank learns what has happened to the vehicle and repossesses the vehicle from Hot Deals one week after the sale by Donald Debtor to Hot Deals (which is thirteen weeks after the California title was issued).

Is Hot Deals subject to Western Bank's security interest?

Suppose that Donald Debtor sold the vehicle to Byron Buyer who is a buyer other than a person in the business of selling vehicles. What would happen in such a case?

C. Continuous Perfection as to Proceeds

1. Generally

As explained in Chapter 9 (The Specifics of Enforceability -- After-Acquired Property, Proceeds and Future Advances), under new section 9-315(a)(2), a security interest attaches to proceeds, as defined in new section 9-102(a)(64), that are identifiable as proceeds (i.e., traceable to the original collateral) without the need for action directed to the proceeds by the secured party. As for perfection, we saw in Chapter 16 (Perfecting Security Interests in Proceeds and Other Later Acquired Property) under new section 9-315(c) a security interest in proceeds is perfected automatically if the security interest in the original collateral was perfected.

However, as was stressed in Chapter 16, under new Article 9 a security interest in proceeds becomes unperfected after twenty days unless certain conditions are met. A secured party of course will wish to assure that perfection as to proceeds continues beyond the twenty-day period and is continuous in the sense that it dates from the time of perfection of the security interest in the original collateral.

2. The Conditions under which a Security Interest in Proceeds Is Continuously Perfected

Under new section 9-315(d)(2), as was true under former section 9-306(3)(b), a security interest in proceeds that are identifiable cash proceeds continues to be perfected beyond the period of automatic perfection without further action by the secured party. "Cash proceeds" are defined in new section 9-102(a)(9) as "money, checks, deposit accounts or the like." The rule for cash proceeds of investment property in former section 9-306(3)(c) has been eliminated, presumably because it was deemed unnecessary.

New section 9-315(d)(1) retains the "same place filing" rule of former section

9-306(3)(a). Under new section 9-315(d)(1), if a filed financing statement covers the original collateral, the proceeds are collateral in which a security interest may be perfected by filing a financing statement in the office where the financing statement covering the original collateral was filed and the proceeds were not acquired with cash proceeds, then the security interest in the proceeds is perfected beyond the twenty days (until the filing lapses or is terminated).

Therefore, for example, a security interest in accounts that are proceeds of inventory subject to a security interest perfected by filing is perfected continuously from the date of filing as to inventory because a filing as to the accounts as original collateral would be made in the same place as the filing as to the inventory.

Certain additional observations about the "same place filing" rule under new section 9-315(d)(1) are in order. Under former section 9-306(3)(a), if proceeds were acquired with cash proceeds then the "cash interval" limitation would be triggered and there would be continuous perfection as to the proceeds only if "the description of collateral in the financing statement indicate[d] the types of property constituting proceeds."

Thus, for example, if inventory collateral was sold for cash and the cash was used to purchase equipment, the security interest in the equipment would be continuously perfected under the same place filing rule only if the financing statement described the collateral as "equipment" as well as "inventory."

The qualifying language (that there is continuous perfection in a cash interval situation only if the financing statement indicates the types of property constituting proceeds) has been eliminated from new section 9-315(d)(1). According to the drafters, the result intended by the qualifying language found in former section 9-306(3)(a) is achieved through the generally applicable perfection rules of new section 9-315(d)(3).

Thus, new section 9-315(d)(3) provides that a security interest in proceeds becomes unperfected on the 21st day after the security interest attaches to the proceeds "unless: . . . (3) the security interest in the proceeds is perfected other than under subsection (c) [the automatic perfection for a limited time rule] when the security interest attaches to the proceeds or within 20 days thereafter." *See* Official Comment 5 to new section 9-315.

Understanding what the drafters are saying requires some explanation. Recall that under new section 9-315(c), if the security interest in the original collateral was perfected, then a security interest in proceeds is automatically perfected and under new section 9-315(d) this automatic perfection continues for at least twenty days and will continue beyond the twenty days if action is taken to perfect the security interest in the proceeds as if it were original collateral.

To illustrate, if a financing statement covers only inventory and the inventory is sold and cash is received and the cash is used to acquire equipment, then the security interest in the equipment is perfected automatically for twenty days when the security interest in the equipment attaches (*i.e.*, when the equipment is acquired) and will continue beyond the twenty days only if the secured party files a financing statement covering *equipment* within the twenty-day period.

In this regard it should be noted that new section 9-509(b)(2) authorizes such a filing. However, a security interest in property that constitutes proceeds may be perfected otherwise than automatically. Specifically, the security interest may be perfected according to the usual perfection by filing rules. Thus, in the foregoing example, if the financing statement covered equipment as well as inventory, then the security interest in the equipment would be perfected because the financing statement covered it as original collateral, without regard to the automatic perfection rule of new section

9-315(c).

Of course, there must be a security interest in the equipment if there is to be a perfected security interest in the equipment. Under new section 9-315(a)(2), a security interest in the equipment attaches automatically to the extent that the equipment is identifiable proceeds. Stated differently, under new section 9-315 (as described in the official comment referred to above), continuous perfection in proceeds acquired with cash proceeds can result from the automatic *attachment* of a security interest to identifiable proceeds together with the rule that a security interest, however it comes to attach, is perfected if there is an effective filing covering the property that constitutes proceeds. *See* Example 2 in Official Comment 5 to new 9-315.

Under the foregoing analysis, the security interest in the property acquired with cash proceeds does not attach to the property as after-acquired original collateral but as proceeds. If it attached to the property as after-acquired original collateral then the security interest would not be enforceable under BRA § 552 as to property acquired after a debtor filed bankruptcy. Because the security interest attaches to the property as proceeds it would be continuously perfected and would be enforceable in bankruptcy.

A final point about the same place filing rule and the cash interval limitation should be made. Recall from Chapter 14 (The Nitty Gritty of Filing) that new section 9-504(2) permits the use of an "all assets" or "all personal property" description in a financing statement. A creditor who uses such a super generic description assures that a security interest in property acquired with cash proceeds will be continuously perfected provided only that the creditor is able to identify the property as proceeds. However, a debtor may be unwilling to authorize a financing statement containing a super generic description because of the effect of such a filing to limit the ability of the debtor to get credit from other parties.

Moreover, as also was explained in Chapter 8 (The Specifics of Enforceability -- A Security Agreement Authenticated by the Debtor or Its Equivalent), a super generic description is not sufficient in a security agreement and it is arguable that authentication of a security agreement describing the collateral as inventory or equipment or both does not authorize a creditor to file a financing statement using an "all assets" or "all personal property" description within the meaning of new section 9-509(b).

Recall that under new section 9-315(c) perfection as to proceeds for the twenty-day period requires that the security interest in the original collateral have been perfected. Where the perfection as to the original collateral was accomplished by filing, it would be possible for the twenty-day period to be shortened by a lapse of the filing as to the original collateral except that new section 9-315(e) provides that the security interest in the proceeds remains perfected for twenty days or until the filing as to the original collateral ceases to be effective *whichever is later*.

Under new section 9-311(b) perfection accomplished by compliance with a certificate of title law or federal law is the equivalent of filing. Therefore, proceeds of collateral a security interest in which is perfected by compliance with a certificate of title law or federal law is continuously perfected under new section 9-315(d)(1) insofar as the conditions of that provision, other than perfection by filing a financing statement, are met.

You may consider the new Article 9 scheme governing the continuation of security interests in proceeds beyond the twenty-day period during which there is automatic perfection in the next problem.

Problem 24.11 (INTERACTIVE)

Parts R Us, Inc. is an Arizona Corporation that sells new and used automobile parts. Southern Bank finances Parts R Us' inventory of parts and has taken a security interest in Parts R Us' inventory of parts, existing and after-acquired. The security interest was perfected by filing in the Secretary of State's Office in Arizona a financing statement describing the collateral as "inventory." Parts R Us sells automobile parts to a variety of buyers. The sales produce (a) an unsecured contract evidencing the debt for the price of a part; (b) a contract such as that in (a) that is secured by an interest in the part; (c) a check that is marked as a down payment on a part and has been placed in Parts R Us' cash drawer; (d) a general bank account in which another check such as that in (c) has been deposited; (e) a used alternator traded in on a new alternator that Parts R Us adds to its used parts inventory; (f) equipment purchased with a check drawn on the general bank account in (c).

Does Southern Bank have a security interest in the unsecured contract evidencing the debt for the price of the part that is perfected continuously beyond the 20-day period of automatic perfection provided for in new sections 9-315(c) and (e) without further action by Southern?

Why is Southern Bank's security interest in the unsecured contract perfected beyond the 20-day period of automatic perfection without further action by Southern?

Does Southern Bank have a security interest that is perfected continuously beyond the 20-day period of automatic perfection provided for in new sections 9-315(c) and (e) without further action by Southern in the contract evidencing the debt for the price of the part that contains a security interest to secure the price of the part?

Why is Southern Bank's security interest in the in the contract evidencing the debt for the price of the part that contains a security interest to secure the price of the part perfected beyond 20-day period of automatic perfection without further action by Southern?

Does Southern Bank have a security interest that is perfected continuously beyond the 20-day period of automatic perfection provided for in new sections 9-315(c) and (e) without further action by Southern in the check that is marked as a down payment on a part and has been placed in Parts R Us' cash drawer?

Why is Southern Bank's security interest in the check that is marked as a down payment on a part and has been placed in Parts R Us' cash drawer perfected beyond 20-day period of automatic perfection without further action by Southern?

Does Southern Bank have a security interest that is perfected continuously beyond the 20-day period of automatic perfection provided for in new sections 9-315(c) and (e) without further action by Southern in the general bank account in which another check such as that in (c) has been deposited?

On what does a conclusion that Southern Bank has a security interest in the check deposited in a general bank account that is perfected continuously beyond 20-day period of automatic perfection under new sections 9-315(c) and (e) without further action by Southern depend?

Does Southern Bank have a security interest that is perfected continuously beyond the 20-day period of automatic perfection provided for in new sections 9-315(c) and (e) without further action by Southern in the used alternator traded in on a new alternator that Parts R Us adds to its used parts inventory?

Why does Southern Bank have a security interest in the trade-in that is perfected beyond the 20-day period of automatic perfection without further action?

Does Southern Bank have a security interest that is continuously perfected beyond the 20-day period provided for in new section 9-315(d) without further action by Southern in the equipment purchased with a check drawn on the general bank account?

Why is it that Southern Bank does not have a security interest in the equipment acquired with cash proceeds that is perfected outside the 20-day period provided for in new section 9-315(d) without further action by Southern by operation of new section 9-315(d)(3)?

If Southern Bank's financing statement covered "equipment" as well as inventory, would Southern have a security interest in the equipment that is perfected continuously beyond the 20-day period provided for in new section 9-315(d) without further action by Southern?

What is it that could keep Southern Bank from having a security interest in the equipment that is perfected continuously beyond the 20-day period provided for in new section 9-315(d) without further action by Southern even if its financing statement covers "equipment" (thereby making continuing perfection under new section 9-315(d)(3) possible)?

Suppose that Southern Bank filed a financing statement indicating the collateral as "all Debtor's business assets." If Southern could prove the equipment constituted proceeds would Southern's security interest in the equipment be perfected beyond the 20-day period without further action by Southern.

Assuming the original facts of Problem 24.11 (that Southern Bank's financing statement described the collateral as "inventory") and further assuming that Southern could prove the equipment purchased with the check drawn on the bank account constituted proceeds, what would Southern have to do to assure continuing perfection of that security interest under new section 9-315(d)(3)?

If Southern Bank perfects a proceeds interest in the equipment purchased with the check drawn on the bank account after the expiration of the 20-day period provided for in new section 9-315(d) by filing a financing statement covering "equipment" then the security interest in the equipment purchased with the check drawn on the bank account is perfected from the date of the filing of the financing statement covering the equipment. True or false?

If Part R Us acquired additional auto parts with a check drawn on a bank account containing proceeds from the sale of inventory and Parts R Us added the auto parts to its inventory would there be a security interest in the additional auto parts that is perfected beyond the 20-day period?

To the extent that the security interests in any of the collateral in Problem 24.11 are continuously perfected beyond the 20-day period provided for in new section 9-315(d) by operation of one of the exceptions in new section 9-315(d), will perfection continue indefinitely?

CASE COMMENTARY

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Part VI Priority

Chapter 25 The How and Why of Priority

A. Generally

In Chapter 3 (The Nature and Scope of Secured Credit under Article 9), we explored the differences between secured and unsecured credit and the reasons why a secured creditor is likely to be much better off than an unsecured creditor both in and out of bankruptcy. We anticipated there the question that is the subject of Part VI and pointed out that the ultimate concern of a secured creditor is with priority over competing claimants to collateral, especially a trustee in bankruptcy. Having an enforceable security interest, a lien on particular property to secure a debt, is essential but it will do a creditor little good if there are conflicting claims to the property that are ahead of the creditor's security interest and the satisfaction of which will exhaust the value of the collateral.

The place to begin the discussion of priority is with the basic proposition that competing claims to the same property are possible. A legal regime in which the creation of a security interest precludes other claims to the collateral from even arising could exist. However, for the most part, Article 9 eschews such "inalienability" and debtors may voluntarily transfer interests in property to others despite the fact they already have created an Article 9 security interest in the property. Involuntary transfers resulting from legal process also are possible.

Under former section 9-311, the debtor's rights in collateral could be voluntarily or involuntarily transferred even if the debtor had agreed otherwise in the security agreement. The provision left open the possibility that law outside Article 9 could limit the effect of a transfer. It was understood that a transfer in violation of the security agreement could constitute a breach of the debtor's agreement and result in a default. It was standard practice to define default in a security agreement to include in the definition voluntary transfers made without the secured party's consent and involuntary transfers, such as sheriff's levies. New Article 9 deals with the matter of alienability somewhat differently than did former Article 9. The central provision is new section 9-401.

B. New Section 9-401(a) and the "General Rule"

We saw in Chapter 4 (Scope of Article 9) that certain transfers are entirely or largely outside the scope of Article 9 because these transfers are excluded from Article 9 coverage in new section 9-109(d). New section 9-401(a) states that, subject to certain specific identified exceptions, law outside Article 9 determines the extent to which a debtor may or may not transfer rights in collateral. According to Official Comment 4 to new section 9-401 even though a security interest in particular property is covered by new Article 9 under the general rule of new section 9-401(a) the security interest may be precluded or otherwise regulated by law outside Article 9.

Identifying laws outside Article 9 that are not somehow accounted for in Article 9 and which limit the ability of a debtor to transfer rights in collateral, especially those that deny a debtor the power to transfer an interest in property because the property is subject to a security interest, is not easy. However, under new section 9-401(a) any such laws are controlling and an attorney must be alert to their possible existence. As is explained more fully in the next subpart, the task is made more difficult by the possibility that other law may prevent something from even being property, in which case Article 9 would not apply because it governs only security interests in personal property.

C. New Section 9-401(a) and the Increased Availability of Certain Intangibles as Collateral

New section 9-401(a), by reference to new sections 9-406, 9-407, 9-408 and 9-409, increases the extent to which various intangibles may serve as collateral. It does so by generally rendering ineffective agreements that prohibit or restrict transfers for purposes of creating security interests in accounts, chattel paper, payment intangibles, general intangibles (including rights conferred by a computer software license), health-care-insurance receivables, promissory notes, letter-of-credit rights, and leases.

Under new section 9-408, most "no-assignment" clauses and even restrictions imposed by law do not render a security interest ineffective. According to the Official Comments, this provision will make it possible for creditors to take (and debtors to give) security interests in such increasingly valuable rights as those arising under a software license agreement. However, new section 9-408(d) qualifies the general rule of section 9-408 so completely that there is a serious question whether a security interest in a contract or license containing a no-assignment clause has any value, at least outside bankruptcy. Official Comment 2 to new section 9-408 uses the example of a security interest in a non-exclusive computer software license to illustrate the effect of the general rule and the limitations in new section 9-408(d).

According to the example, a no-assignment clause in such a software license would not prevent a security interest in the license from being effective. An assignment without the licensor/non-debtor's consent would be a default triggering a secured party's foreclosure rights. *See* new 9-401(b) and subpart D below. The commentary concludes, however, that

> [Under] subsection (d), the secured party (absent the licensor's agreement) is not entitled to enforce the license, or to use, assign, or otherwise enjoy the benefits of the licensed software, and the licensor need not recognize (or pay attention to) the secured party. Even if the secured party takes possession of the computers on the debtor's default, the debtor would remain free to remove the software from the computer, and load it onto another computer, and continue to use it, if the license so permits. If the debtor does not remove the software, other law may require the secured party to remove it before disposing of the computer. Disposition of the software with the computer could violate an effective prohibition on enforcement of the security interest. *See* subsection (d).

This commentary to the contrary notwithstanding, the drafters assert in Official Comment 8 to new section 9-408 that new section 9-408 makes previously unavailable property available as collateral and a security interest in that property has value "where the secured party sees the likelihood of obtaining agreement [from the non-debtor party] in the future."

Under new section 9-109(a)(1) new Article 9 applies to a transaction that creates a security interest in personal property (or fixtures). According to Official Comment 3 to new section 9-408, "other law determines whether a debtor has a property interest ('rights in collateral') and the nature of that interest." It follows that if the subject of a transaction is not even property then new Article 9 does not apply.

The court in In re Chris-Don, Inc., 367 F. Supp. 2d 696 (D. N.J. 2005), relied on this comment in holding that a New Jersey law providing that "under no circumstances, however shall a [liquor] license be deemed property . . ." was "other law" that prevented a security interest from attaching to a liquor license because it was not personal property. In so holding, the court rejected an argument that new section 9-408(c) overruled the New Jersey liquor license statute.

It may be that Chris-Don is a special case the decision in which was dictated by the express language of the non-UCC New Jersey law, but there are decisions under former Article 9 that reach similar outcomes based on the language of particular liquor license statutes. On the other hand, security interests in liquor licenses and other such intangibles, such as interests arising under franchise agreements, have been given effect in several jurisdictions despite the existence of restrictions on alienation that impact the value of such property as collateral or pose difficult issues of enforcement. *See*, *e.g.*, *Landon v. Stroud*, 709 P.2d 565 (AZ App. 1985). *See generally*, Security Interests in Liquor Licenses, 56 A.L.R. 4th 1131 (1987).

These holdings seem more in line with the intent of the drafters of new Article 9 to expand the range of what may serve as collateral. Insofar as the language of a non-UCC law by its express language appears to require a decision that no Article 9 security interest can attach, as was the case with the New Jersey statute governing liquor licenses, a court might conclude, despite Official Comment 3 to new section 9-408, that new Article 9 has overruled the non-UCC law. Where such overruling by implication is not favored it may be necessary and desirable for a state legislature to avail itself of the invitation in new section 9-408(e) to list those laws that are inconsistent with the letter and intent of new Article 9 over which new Article 9 is to prevail. For example, the Arizona version of new section 9-408(e) provides that "[section 9-408] prevails over any inconsistent provisions in title 33, chapter 7" (dealing with certain statutory liens and available at http://www.azleg.state.az.us/ArizonaRevisedStatutes.asp?Title=33).

New section 9-407 renders ineffective a term in a lease agreement that prohibits or restricts the creation of a security interest, subject to certain exceptions unique to leases, such as a transfer by a lessee of its right to possession or a transfer that involves a delegation of material performance of either party. New section 9-406, making accounts and chattel paper readily available as collateral, and new sections 9-403 and 9-404, dealing with the effect of transfers on the rights of persons owing on accounts and chattel paper (account debtors), are considered in Part VII because they impact the foreclosure of security interests in such property.

D. New Section 9-401(b) – Restrictions on Transfer Versus Default

Under new section 9-401(b) an agreement between a debtor and secured party prohibiting a transfer of a debtor's rights in collateral or making the transfer a default does not prevent a voluntary or involuntary transfer from "taking effect". Official Comment 5 to new section 9-401 characterizes new section 9-401(b) as an exception to the general rule of new section 9-401(a) that makes clear that a debtor has rights in collateral that the debtor can transfer notwithstanding any agreement to the contrary.

Official Comment 5 adds that, by contrast to new section 9-406 (and new section 9-408 discussed in subpart C above), new section 9-401(b) does not render "ineffective" an agreement prohibiting transfer or making a transfer a default and "the debtor's breach [of such an agreement] may create a default." Consequently, a security agreement should define default to include specified voluntary and involuntary transfers (such as sheriff's levies). Default and its importance to foreclosure of a security interest will be discussed in Part VII.

E. The Essential Point for Part VI (Priority)

The essential point of the foregoing discussion is that under new section 9-401(a), except in the rare circumstance where a law outside Article 9 provides to the contrary, the existence of a security interest does not prevent a voluntary or involuntary transfer from being effective. Moreover, under new section 9-401(b), even an agreement by a debtor not to give security interests to other creditors or not to suffer judgments leading to a sheriff's levy will not prevent another secured party or a lien creditor from getting an interest in collateral.

Consequently, third parties may have claims to collateral that produce priority disputes between secured parties and third parties. This important reality was pointed out directly in Problem10.3, in Chapter 10 (The Need for Value and that the Debtor Have Rights in the Collateral), and was implicit in Problems 12.1 through 12.6, in Chapter 12 (Perfection Generally).

F. New 9-201 and the Rule that Secured Parties Prevail Except

There is another basic point to be made here. Despite the possibility that third parties can get interests in collateral and that conflicts between a secured party and third parties can and do arise, the "general rule" is that secured parties prevail in such conflicts. Under former section 9-201, "except as otherwise provided by this Act, " a security agreement was effective according to its terms against purchasers of the collateral and against creditors. New section 9-201(a)similarly states:

> (a) Except as otherwise provided in [the Uniform Commercial Code], a security agreement is effective according to its terms between the parties, against purchasers of the collateral, and against creditors.
>
> * * *

But, do not be misled. The "except as otherwise provided" language in both of the foregoing sections is loaded. Understanding the Article 9 priority rules requires identifying and exploring the many exceptions to the "general rule," which is what we will do in the remainder of Part VI.

The next two problems capture the essence of basic points made in this chapter.

Problem 25.1 (INTERACTIVE)

Doris Debtor develops computer programs to assist law students to learn commercial law. Doris owns a high-powered computer that she purchased on credit from Doorway Computers, Inc. Doorway has an interest in the computer to secure its unpaid price. The security agreement that Doris signed provides that Doris may not transfer, voluntarily or involuntarily, any interest in the computer without Doorway's consent and that any transfer in violation of the provision is void. The security agreement specifically provides that any creation of a security interest in favor of a party other than Doorway is prohibited. The security agreement further provides that the breach of any promise made by Doris in the security agreement is a default. Doris also licenses graphics software from Micromedia, Inc. that Doris uses in the development of computer learning programs. The license agreement contains a "no assignment" clause that prohibits Doris from assigning any interest in the licensed software. The license agreement allows Doris to use the software on any computer so long as she does not use it on more than one at a time. Without Doorway's consent, Doris borrows from Southwest Bank and grants Southwest an interest in the computer to secure the loan. To further secure the loan, Southwest takes a security interest in the software licensed from Micromedia, Inc. Please indicate which of the following statements are true and which are false:

(a) The attempt to create a security interest in the computer in favor of Southwest Bank is ineffective and the security interest is void and of no effect.

(b) The creation of the security interest in favor of Southwest Bank would be a default on the part of Doris.

(c) If Doris were to suffer a judgment and the sheriff levied on the computer under a Writ of Execution the levy would be effective but would constitute a default on the part of Doris.

(d) The software licensed from Micromedia, Inc. by Doris constitutes goods.

(e) The "no assignment" clause in the license agreement denied Doris the power to create the security interest in the software in favor of Southwest Bank.

(f) In the event of a default by Doris of its security agreement with Southwest Bank, Southwest could enforce its security interest in the software without the cooperation of Micromedia, Inc.

(g) If, in the event of a default by Doris under its security agreement with Southwest Bank, Southwest sought to repossess and dispose of the computer to satisfy its debt, Doris could remove the software and use it on another computer.

Problem 25.2 (INTERACTIVE)

Lisa Lender lends to Donald Debtor and takes a security interest in Donald's equipment to secure the loan. Subsequently, Donald gives a security interest in the same equipment to Friendly Finance Company and the sheriff levies on the equipment pursuant to a judgment against Donald obtained by Leon Lien Creditor.

Which of the following statements best describes the new Article 9 priority scheme?

(a) Lisa Lender has a claim to the equipment that is superior to any claim made by Donald Debtor, Friendly Finance or Leon Lien Creditor except as new Article 9 may provide otherwise.

(b) Lisa Lender has a claim to the equipment that is superior to any claim made by Donald Debtor and Friendly Finance but not a claim made by Leon Lien Creditor except as new Article 9 may provide otherwise.

(c) Lisa Lender has a claim to the equipment that is superior to any claim made by Donald Debtor and Leon Lien Creditor but not a claim made by Friendly Finance except as new Article 9 may provide otherwise.

(d) Lisa Lender has a claim to the equipment that is superior to any claim made by Donald Debtor but not a claim made by Friendly Finance or Leon Lien Creditor except as new Article 9 may provide otherwise.

CASE COMMENTARY

In re *Lexington Healthcare Group, Inc.*, 335 B.R. 570 (Bkcy D. Del. 2005)

Wells Fargo Bank v. Robex, Inc., 711 N.W.2d 732 (Iowa App. 2006) (Unpublished opinion)

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2011-08-22 update

Part VI Priority

Chapter 26 Secured Party Versus Lien Creditor; Future Advances; Bankruptcy

A. Non-Purchase Money Security Interest Versus Lien Creditor

1. Generally

Among the possible competitors to collateral is a "lien creditor." We will see in subpart D below that there is a critical interaction between the Article 9 rules governing lien creditor disputes and federal bankruptcy. However, it is desirable to start with the non-bankruptcy setting.

2. The Meaning of "Lien Creditor"

As was true under former Article 9, under new section 9-102(a)(52) a "lien creditor " is a creditor who obtains a lien by litigation, especially through execution. As noted in Chapter 3 (The Nature of Secured Credit under Article 9), the most common lien making a person a lien creditor is a lien arising by a levy pursuant to a writ of execution.

In many states, including Arizona, a judicial lien arises, and hence a person becomes a lien creditor, at the time of the levy. A levy as to personal property generally requires that the sheriff seize (or otherwise take possession of) the property.

Under new section 9-102(a)(52)(C), a trustee in bankruptcy is a lien creditor from the date a bankruptcy petition is filed. The interaction between federal bankruptcy law and the new Article 9 rules governing disputes between secured parties and lien creditors is considered in subpart D below.

3. The Basic Priority Rule

As noted in Chapter 25 (The How and Why of Priority), new Article 9, new section 9-201(a), retains the "general rule" of former section 9-201, under which a secured party prevailed against a debtor and third parties "except as otherwise provided." An important "except as otherwise provided" is found in new section 9-317(a)(2)(A).

Under new section 9-317(a)(2)(A), a lien creditor who obtains a lien before a non-purchase money security interest is perfected subordinates the security interest. Conversely, if a non-purchase money security interest is perfected before a levy then the security interest has priority (is not subordinated) under the general priority rule of new section 9-201(a). New sections 9-317(a)(2)(A) and new 9-201(a) together preserve the simple first-in-time of perfection or levy priority rule that existed under former Article 9. However, new Article 9 qualifies the foregoing basic first-in-time priority rule for lien creditors and non-purchase money secured parties and increases the protection given non-purchase money secured parties against lien creditors by former Article 9.

Under new section 9-317(a)(2)(B) subject to new section 9-323(b), as discussed below, if a secured party has filed a financing statement and one of the requirements of new section 9-203(b)(3) for enforceability of a security interest (essentially that the debtor has authenticated a security agreement or the secured party has taken possession pursuant to agreement -- *see* Chapter 8 (The Specifics of Enforceability -- A Security Agreement Authenticated by the Debtor or Its Equivalent)) -- has been satisfied then the secured party has priority even if value necessary to attachment and perfection of the security interest technically has not yet been given.

Thus, a non-purchase money security interest is protected against a judicial lien obtained prior to perfection of the security interest provided that the secured party has filed a financing statement and the debtor has authenticated a security agreement (or the secured party has taken possession of the collateral) before the lien was obtained (before the levy).

The change made by new section 9-317(a)(2)(B) is not quite as dramatic as might first appear because, as noted above, new section 9-323(b) may operate to limit the protection given a non-purchase money party. Under new section 9-323(b) a discretionary advance would be at risk even if the secured party has filed and satisfied one of the conditions of new section 9-203(b)(3) unless the advance is made within 45 days of the levy or the secured party does not know of the levy. New section 9-323(b) is explained more fully in subpart C.

New section 9-317(a)(2)(B) changes the rule of former Article 9 in a less obvious way. Under former Article 9, if a non-purchase money security interest became enforceable and, hence, attached to collateral *after* a levy had been made and a lien had arisen, the security interest attached to property already subject to a lien and was subordinate to the lien under the *nemo dat* concept. *See* Official Comment 4 to new 9-317.

Because under new section 9-317(a)(2)(B) a non-purchase money party whose security interest has not attached at the time of the levy has priority if the secured party has filed at the time of the levy and one of the conditions of enforceability in new section 9-203(b)(3) has been met, a non-purchase money party is not subordinated by a lien obtained before attachment of the security interest if the secured party has filed a financing statement and the debtor has authenticated a security agreement or the secured party has taken possession of the collateral (and the secured party has given value in a timely fashion as required by new section 9-323(b)).

As will be discussed in Chapter 28 (Secured Party Versus Secured Party), the change in the priority rule also eliminates what was viewed as an anomalous outcome under former Article 9, namely, that a secured party could be ahead of another secured party under the first-to-file priority rule but be subordinate to a lien creditor under the first to levy or perfect rule.

It is important to be aware that knowledge or the absence thereof and reliance or the lack thereof were not relevant in applying the priority rule of former Article 9 and the same is true under new section 9-317(a)(2). Judgment creditors do not check the public records before directing the sheriff to levy and the absence or existence of a filing that provides constructive notice is not relevant. Actual knowledge of a security interest is similarly immaterial.

4. The meaning of "subordinate to"

Some of the priority rules that we have yet to examine speak in terms of "taking free of" a security interest. For reasons that are explored later, a person who takes free of a security interest takes title that is not subject to the security interest and can transfer the property to others free of the security interest.

The priority rule of new section 9-317(a) for lien creditors is different. New section 9-317(a) provides that under the conditions spelled out in new section 9-317(a)(2), as just discussed, a security interest is "subordinate to" the rights of a lien creditor. Former section 9-301(1)(b) likewise provided for subordination.

Subordination essentially means the lien creditor has the first crack at the property to satisfy the lien. To oversimplify somewhat, if property worth $1,000 is levied upon to satisfy a $300 judgment before a security interest in the property securing a $1,000 debt was perfected, then the lien creditor gets $300 and the secured party is able to reach only the $700 of "equity" left in the property. In practice, the resolution of conflicts between lien creditors and secured parties is anything but mathematically precise and determining how and what a secured party actually will realize on its security interest if it is subordinate to a lien creditor can be difficult at best.

The primary source of the uncertainty is that lien creditors dispose of property that has been levied upon through execution sales under circumstances that are likely to be less than optimal with respect to getting the most value out of the property. *Cf*. Official Comment 6 to new 9-401 and Part VII.

Even if a security interest is not subordinate in priority terms a levying creditor may still cause problems for a secured party. It is one thing to have priority and another to be able to effectively exercise one's rights against collateral. As noted above, when property is levied upon the sheriff seizes that property. To get at the collateral the secured party has to retake the property from the sheriff and the sheriff and the lien creditor likely will not be eager to relinquish possession without resistance. The details of this practical and legal reality are best left to Part VII, but it is useful to be aware of it early on.

You may test your understanding of the treatment of disputes between holders of non-purchase money security interests and lien creditors under new Article 9 in the next problem.

Problem 26.1 (INTERACTIVE)

Lisa Lender and Donna Debtor enter into negotiations about a $10,000 loan to be secured by an interest in Donna's equipment, existing and after-acquired. Lisa files a financing statement covering Donna's equipment. Without Lisa's knowledge the Sheriff levies on all of Donna's equipment, worth $10,000, to satisfy a $10,000 judgment awarded earlier to Leon Lien Creditor. Lisa then lends the $10,000 to Donna who signs a security agreement describing the collateral as all of Debtor's equipment, existing and after-acquired.

Who has first claim to the equipment?

Would your answer to the question posed in Problem 26.1 change if Lisa could prove that Leon knew of Lisa's negotiations with Donna?

Suppose that Lisa had closed the loan and filed before the levy. Who would have first claim to the equipment now?

Suppose that at the time of the levy Donna had signed a security agreement creating a security interest in Lisa's favor, but Lisa had not yet lent Donna the $10,000. Who would have priority now if Lisa made the loan within 45 days of the levy?

B. Lien Creditor Versus Purchase Money Security Interest

To this point we have been discussing conflicts between lien creditors and non-purchase money security interests. As was also true under former Article 9, new Article 9 gives special protection to a purchase money security interest against lien creditors.

Under new section 9-317(e) a purchase-money secured party has priority over a lien creditor whose lien was obtained prior to perfection so long as the security interest was perfected by filing before or within twenty days (previously ten days) after the debtor receives possession of the collateral. Of course, if the secured party does not file within the twenty-day period then the lien creditor will be able to subordinate the security interest under new section 9-317(a)(2).

As discussed in Chapter 18 (Perfection by Doing Nothing -- Automatic Perfection), a security interest is a purchase money security interest under new section 9-103(b) essentially when the goods are purchase-money collateral with respect to the security interest (*i.e.*, when the obligation secured was incurred to enable the debtor to acquire rights in the collateral).

You may explore the operation of the purchase money exception in new section 9-317(e) to the rule for non-purchase money cases in new section 9-317(a)(2) in the next problem.

Problem 26.2 (INTERACTIVE)

Selma Seller sells a drill press to Donald Debtor for use in Donald's business. Selma takes a security interest in the drill press to secure its unpaid price. The next day Selma delivers the drill press to Donald.

If later that same day the sheriff levies on the drill press pursuant to a writ of execution obtained by Leon Lien Creditor, who has first claim to the drill press *under new section 9-317(a)(2)*?

May Selma avoid being subordinated to the lien under new Article 9?

If so, what action must Selma take to prevent Leon from having priority?

New section 9-317(e) also deals with certain other priority disputes, namely, those between purchase money secured parties and buyers, lessees and licensees. Priority disputes involving buyers are considered in Chapter 27 (Secured Party Versus Buyers). As to lessees priority is conditioned upon delivery without knowledge of the security interest (such as is the rule under Article 2A). The inclusion of licensees is intended to make clear that the Article 9 rules cover transferees of intangibles as well as tangibles. Priorities as to intangibles and in consignment situations are dealt with in later chapters.

Recall from Chapter 17 (Perfection as to Goods Subject to Certificate of Title Legislation) that under new section 9-311(b), perfection by compliance with a certificate of title law or federal law is the equivalent of filing a financing statement. Therefore, perfection of a purchase money security interest by compliance with a certificate of title law or federal law within the twenty-day period would prevent a lien creditor who obtained the lien before perfection from subordinating the security interest.

C. Future Advances and "Non-Advances"

1. Future Advances

In Chapter 9 (The Specifics of Enforceability -- After-Acquired Property, Proceeds and Future Advances) we saw that a security interest can cover "future advances." At times "future advance" has meant an advance made pursuant to a clause in a security agreement by which collateral secures an advance made contemporaneously with the execution of the security agreement *and* any later advances as well.

This would seem to be the preferred meaning of the concept of a future advance. However, "future advance" has also referred to any advances made subsequent to the execution of the security agreement, including any initial but delayed advance and advances made pursuant to a new security agreement.

Additionally, recall that an advance made subsequent to the time a security agreement is executed may be optional, that is, at the discretion of the secured party, or it may be obligatory, meaning, in Article 9 terms, "pursuant to commitment." *See* new 9-102(a)(68). As explained below, the exact nature of the advance, including the purpose for which it is made, can impact priority.

Under former Article 9 a discretionary advance made within 45 days of a levy or such an advance made at any time without knowledge of a levy was protected against a lien obtained between the time a secured party perfected a security interest and the time the discretionary advance was made. This protection was given even though, technically speaking, the lien was obtained prior to perfection *as to the advance* (because value is not given as to a discretionary advance until the advance is made).

New Article 9 preserves the basic scheme of former Article 9 but under new section 9-323(b) it is not necessary that the security interest have been perfected prior to the time the lien is obtained. This change was made to accommodate the expansion of the protection given to holders of non-purchase money security interests in new section 9-317(a)(2) as explored in subpart A above.

Thus, a discretionary advance made within 45 days of a levy or such an advance made at any time without knowledge of a levy is protected so long as the secured party has filed a financing statement and the debtor has authenticated a security agreement or the secured party has possession of the collateral even if value was not been given prior to the advance (in which case there was no perfection prior to the advance in question).

The principal impact of the change is to protect a discretionary advance that is the first advance made by the secured party, for example, where the secured party and debtor agree that if a loan is made then the loan will be secured and the secured party files and the debtor authenticates a security agreement and before the advance is made a creditor obtains a lien on the collateral. However, a discretionary first advance is protected under new section 9-323(b) only if it is made without knowledge of a levy or within 45 days of the levy.

Note that a discretionary advance that is made more than 45 days after a levy is obtained and with knowledge of the levy is subordinated by the lien whether or not the secured party had a perfected security interest prior to the levy or was relying on the expanded protection given by new section 9-317(a)(2)(B). In this sense, as Official Comment 4 to new section 9-323 observes, "subsection (b) does not elevate the priority of a security interest that is subordinate to the rights of a lien creditor under new section 9-317(a)(2); it only subordinates."

You may consider new Article 9's treatment of future advance disputes between secured parties and lien creditors in the next problem.

Problem 26.3 (INTERACTIVE)

Lisa Lender lends $10,000 to Donald Debtor. Donald signs a security agreement giving Lisa a security interest in Donald's computer system, worth about $15,000 and used in Donald's business. Lisa immediately files properly. Subsequently, the sheriff levies on the computer system pursuant to a writ of execution obtained by Leon Lien Creditor to satisfy a judgment against Donald for $5,000. Lisa learns of the levy and threatens to foreclose. Donald advises Lisa that if she lends him another $5,000 then he will be able to get out of his current financial difficulties and Donald and Lisa can continue a business relationship that has been mutually beneficial for some time. Lisa makes the $5,000 loan. Which of the following statements are correct? Note that more than one choice may be correct.

(a) Lisa has priority over Leon only as to the original $10,000 loan and under no circumstances will Lisa have priority over Leon as to the later $5,000 loan.
(b) Lisa is subordinate to Leon as to both the original $10,000 loan and the later $5,000 loan.
(c) Lisa has priority as to both the original $10,000 loan and the later $5,000 loan if there was a future advance clause in the security agreement signed by Donald and the $5,000 loan is made within 45 days of the levy.
(d) Lisa has priority as to both the original $10,000 loan and the later $5,000 loan no matter when Lender made the $5,000 loan if the security agreement signed by Donald committed Lisa to make advances up to the value of the collateral.

Suppose the facts of Problem 26.3 were that Donald had signed an agreement providing that any loans that Lisa might make would be secured by an interest in the computer system, Lisa filed a financing statement covering the computer system, the sheriff levied, and Lisa then made a $15,000 loan. Is Lisa protected against Leon as to the $15,000 loan?

2. Non-Advances

The question arose under former Article 9 whether and to what extent former section 9-301(4) applied to interest and attorney's fees and other expenses associated with the enforcement of a security interest. The question was addressed in *Uni Imports, Inc. v. Aparacor, Inc.* , 978 F.2d 984 (7th Cir. 1991). The analysis of the question in *Uni Imports* is complicated and the opinion requires careful reading. To do so, click on the highlighted name above.

In essence, the court concluded that interest, attorney's fees and expenses associated with foreclosure were "non-advances," in the sense that they were not governed by former section 9-301(4), and that such non-advances were recoverable only to the extent that they were attributable to debts, including future advances, that were secured and had priority over a lien creditor.

In so doing, the court rejected the view that all non-advances were recoverable as having been involuntarily incurred, provided only that the security interest have been properly perfected from the outset. The court was sympathetic to the concern about the involuntary nature of most non-advances, but was bothered by the fact that non-advances have the potential to shrink the proceeds of a foreclosure that are available to lien creditors without the compensating virtue of actual future advances, which is that they put fresh value into the debtor's business.

As for the treatment of "non-advances" under new Article 9, in an earlier version of Official Comment 4 to new section 9-323, the drafters spoke to the split of authority referred to in *Uni Imports*. That draft of the comment indicated that no "negative inference" that might have been associated with former section 9-301(4) should be drawn under new Article 9 and that the difference of opinion should be resolved in favor of protection for the secured party. The current version of Official Comment 4 to new section 9-323 is silent on the matter. It would seem, therefore, that the analysis employed in *Uni Imports* might well govern under new Article 9.

You may consider where things now stand now in the next problem.

Problem 26.4 (INTERACTIVE)

Lenny Lender lends Donna Debtor $10,000. Donna signs a security agreement giving Lender a security interest in Donna's equipment, existing and after-acquired, to secure the $10,000 loan and any future advances that Lender chooses to make to Donna. Lenny immediately properly files a financing statement covering Donna's equipment. Thirty days later, the Sheriff levies on all of Donna's equipment to satisfy a $10,000 judgment awarded earlier to Leona Lien Creditor. The next day, Lenny learns of the levy. Forty days after the levy, Lenny lends Donna $2,000. Ten days following the $2,000 loan, Lenny lends Donna another $3,000. Donna defaults and Lenny repossesses and sells Donna's equipment for $16,000. By the time of the sale of the equipment, interest in the amount of $500 has accrued on the loans ($200 on the $10,000 loan, $100 on the $2,000 loan and $200 on the $3,000 loan) and Lenny has incurred another $500 in attorney's fees and expenses.

Which of the following statements is correct if the analysis employed in the *Uni Imports* decision, as discussed above, governs under new Article 9?

(a) Lenny is entitled to $10,000 of the proceeds from the sale of the equipment.

(b) Lenny is entitled to $12,000 of the proceeds from the sale of the equipment.

(c) Lenny is entitled to $12,700 of the proceeds from the sale of the equipment.

(d) Lenny is entitled to $13,000 of the proceeds from the sale of the equipment.

D. Bankruptcy

As has often been noted, the acid test of whether you have performed your responsibilities as an Article 9 attorney is whether the security interest will survive a challenge by a trustee in bankruptcy. The foregoing proposition is captured in the observation that a security interest that is not perfected on the date of bankruptcy is likely to be avoidable under Bankruptcy Reform Act (BRA) § 544(a).

We will consider BRA § 544(a) and other provisions under which trustees in bankruptcy are threats to secured parties again in Chapter 30 (Secured Party Versus Trustee in Bankruptcy). Here we take a look at BRA § 544(a) and how it interacts with the Article 9 rules governing priority disputes between lien creditors and secured parties to make perfection on the date of bankruptcy so crucial. We also examine a qualification that must be made for purchase money security interests.

As noted above, new Article 9, in section 9-102(a)(52)(C), defines lien creditor to include a trustee in bankruptcy from the date of the bankruptcy petition. Under BRA § 544(a), a trustee in bankruptcy has the rights a lien creditor would have under state law as of the date of bankruptcy. The state law to which BRA § 544(a) looks in non-purchase money cases is new section 9-317(a)(2), as discussed above.

If a lien creditor could have subordinated a security interest under state law as of the date of bankruptcy, then the security interest may be avoided by the trustee. Conversely, if a lien creditor could not subordinate a security interest on the date of bankruptcy then the trustee may not avoid the security interest under BRA § 544(a). Thus emerges the oft-stated proposition that a security interest that is perfected on the date of bankruptcy (the equivalent of the date of levy under Article 9) is not avoidable by a trustee in bankruptcy under BRA § 544(a).

You should review carefully the earlier discussion of the new Article 9 secured creditor versus lien creditor priority rules. Recall that under new section 9-317(a)(2), a non-purchase money security interest cannot be subordinated by a lien creditor who levies before the security interest is perfected so long as a financing statement has been filed and the debtor has authenticated a security agreement (or one of the other conditions stated in new section 9-203(b)(3) has been satisfied). Recall further that new section 9-317(a)(2) is subject to new section 9-323 governing the protection of future advances.

In the bankruptcy context, it would seem that a security interest that secures a discretionary advance cannot be avoided under BRA § 544(a) even if the security interest is not perfected and is not even enforceable on the date of bankruptcy so long as the discretionary advance is made within forty-five days of bankruptcy or without knowledge of the bankruptcy. Of course, a creditor is not likely to make a discretionary advance if the creditor knows of the bankruptcy, so the changes in revised Article 9 probably are important only where a creditor is unaware of a bankruptcy.

Under BRA § 544(a) there need be no actual lien creditor. It is enough that if there were such a lien creditor the security interest would have been subordinated. Hence, the lien avoidance provision is sometimes referred to as containing a "hypothetical" lien creditor test.

You may test your understanding of the inter-relationship between new section 9-317(a)(2) and BRA § 544(a) in the next problem.

Problem 26.5 (INTERACTIVE)

The facts of Problem 26.1 were as follows: Lisa Lender and Donna Debtor enter into negotiations about a $10,000 loan to be secured by an interest in Donna's equipment, existing and after-acquired. Lisa files a financing statement covering Donna's equipment. Without Lender's knowledge the Sheriff levies on all of Donna's equipment, worth $10,000, to satisfy a $10,000 judgment awarded earlier to Leon Lien Creditor. Lisa then lends the $10,000 to Donna who signs a security agreement describing the collateral as all of Donna's equipment, existing and after-acquired. Assume the foregoing facts, but assume further that rather than suffering a levy Donna filed bankruptcy.

Who has first claim to the equipment? Would your answer to the previous question change if Lisa could prove that Leon knew of Lisa's negotiations with Donna?

Suppose that Lisa had closed the loan and filed before Donna filed bankruptcy. Who would have first claim to the equipment now?

Suppose that as of the date of the bankruptcy Donna had signed a security agreement creating a security interest creating a security interest in Lisa's favor to secure a $10,000 loan, but Lisa had not yet lent Donna the $10,000 as of the time that Donna filed bankruptcy. If Lisa lent the $10,000 after bankruptcy but within 45 days of the bankruptcy would the loan be secured?

As to purchase money security interests, BRA § 546(b) comes into play. BRA § 546(b) gives a creditor the benefit of any state law under which a creditor is retroactively protected against a claim that intervenes between the time the purchase money security interest is created and the time that interest is perfected. As regards Article 9, BRA § 546(b) gives a secured party the benefit of the protection for purchase money security interests found in new section 9-317(e), discussed in subpart B above.

As will be explained further in Chapter 30 (Secured Party Versus Trustee in Bankruptcy), under BRA § 362(b)(3), a creditor may file a financing statement after bankruptcy has been filed without violating the automatic stay that would otherwise prevent such action. Consequently, the holder of a purchase money security interest may gain the protection of new section 9-317(e) and BRA § 546(b) by filing a financing statement after the debtor has filed bankruptcy. However, the secured party must file within the twenty-day period following possession of the collateral by the debtor or the trustee will be able to avoid the security interest under new section 9-317(a)(2) and BRA § 544(a)(1).

The case of *In re Custer*, 50 UCC Rep. Serv. 2d 608 (Bkcy ND Iowa 2003), presents an interesting fact situation within which to explore a number of the foregoing points. In *Custer*, a South Dakota dealer sold a vehicle to an Iowa purchaser under an installment contract that created a security interest in the vehicle. The contract contained a notice that the contract would be assigned to a creditor that actually financed the purchase. The vehicle was delivered to the debtor/buyer on April 26, 2002.

The dealer applied for a South Dakota title and the title was issued in the dealer's name on May 10, 2002. The dealer then provided the debtor with the South Dakota title so that the debtor could obtain an Iowa certificate of title on which the security interest could be noted. However, the debtor delayed applying for the Iowa certificate of title and it was not until May 31, 2002 that an Iowa title noting the security interest was issued. In the meantime, on May 9, 2002, the debtor filed bankruptcy.

The court noted that if the security interest had been perfected within twenty days after the debtor took possession then under new section 9-317(e) and BRA § 546(b), even if the perfection occurred after bankruptcy was filed, something that BRA § 362(b)(3) would allow, the trustee could not have avoided the security interest.

The court concluded, however, that because the security interest had not been perfected within the twenty-day period, new section 9-317(e) and BRA § 546(b) did not apply, the perfection on May 31, 2002 violated the automatic stay and was ineffective because BRA § 362(b)(3) did not permit such perfection, the security interest could be subordinated by a lien creditor under new section 9-317(a)(2) and, therefore, the trustee could avoid the security interest under BRA § 544(a).

Insofar as the court's analysis rests on the assumption that the security interest was not perfected until May 31, 2002, its application of the controlling new Article 9 sections and the corresponding sections of the BRA is correct. However, as was explained in Chapter 24 (Continuing Perfection – Changes as to the Use of the Collateral or in the Location of the Collateral or the Debtor; Security Interests in Proceeds), if the security interest was noted on the South Dakota title and, therefore, was perfected under South Dakota law on May 10, 2002, then under new sections 9-316(d) and 9-316(e) the security interest would continue to be perfected under Iowa law unless it became unperfected under South Dakota's certificate of title law.

If the security interest was perfected under South Dakota law and did not cease to be perfected under Iowa law then the security interest would have been perfected before the twenty-day period after the debtor received possession and the creditor should have had the benefit of new section 9-317(e) and BRA §§ 546(b) and 362(b)(3).

To test your understanding of the inter-relationship of new sections 9-317(a)(2) and 9-317(e) and BRA § 546(b), consider the next problem.

Problem 26.6 (INTERACTIVE)

The facts of Problem 26.2 were as follows: Selma Seller sells a drill press to Donald Debtor for use in Donald's business. Selma takes a security interest in the drill press to secure its unpaid price. The next day Selma delivers the drill press to Donald. The sheriff levies on the drill press later that same day. Assume further that rather than suffering a levy Donald files bankruptcy.

May Selma prevent Trustee from avoiding Selma's security interest under BRA § 544(a)?

What happens as to "non-advances" in bankruptcy is uncertain because it is not known whether *Uni Imports*, discussed in subpart C(2) above, will be applied under new Article 9. If *Uni Imports* does apply then such advances will be treated in bankruptcy as they are under state law.

CASE COMMENTARY

In re *Jeans*, 326 B.R. 722 (Bkcy W.D. Tenn. June 28, 2006)

Counseller v. Ecenbarger, Inc., 834 N.E.2d 1018 (Ind. App. 2005)

In re Millivision, Inc., 474 F.3d 4 (1st Cir. 2007)

In re Commercial Money Center, Inc., 350 B.R. 465 (B.A.P. 9th Cir. 2006)

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Part VI Priority

Chapter 27 Secured Party Versus Buyers

A. Generally

Among the transferees who may compete with secured parties are buyers. We have often seen references to purchasers. A buyer is a particular kind of purchaser, namely, one who contracts to buy goods or other property. The most important of such buyers probably is a buyer in ordinary course (BIOC), defined in revised section 1-201(b)(9) to include most buyers of goods from a seller who is in the business of selling such goods. A BIOC generally takes free of a security interest created by the person from whom the buyer buys the goods even though that security interest has been properly and timely perfected.

The rule for a buyer not in ordinary course and a BIOC of farm products resembles that applicable to lien creditors in that priority generally depends on the timing of perfection of the security interest.

A special priority rule gives consumer buyers from consumer sellers priority over security interests of secured parties who have relied on automatic perfection rather than on filing a financing statement.

Bear in mind that these special priority rules apply only if the secured party did not authorize a sale to be made free of the security interest. If you do not understand why this is so you should review Chapters 9 (The Specifics of Enforceability -- After-Acquired Property, Future Advances, Transferred Collateral and Proceeds, and the New Debtor Problem) and 16 (Perfecting Security Interests in Proceeds and Other Later Acquired Property).

B. BIOC Disputes

As was true under former section 9-307(1), under new section 9-320(a) a buyer in ordinary course (BIOC), other than a BIOC of farm products from a person engaged in a farming operation, takes free of a security interest created by the buyer's seller even though the security interest is perfected and even if the buyer knows of its existence.

It has generally been assumed that the BIOC rule stems from the historical notion of the market overt and is designed to protect the reasonable expectation of a buyer that the buyer will get good title to goods when buying from a person engaged in the business of selling such goods. *See* Law-Glossary.com, available online at http://www.law-glossary.com/definition/market-overt.html, last visited on October 12, 2010.

It has been suggested that the rule is intended to protect a creditor's security interest, *see*, *e.g.*, *Foy v. First National Bank of Elkhart*, 868 F.2d 252 (7th Cir. 1989), but it is not clear that this can be so except to the extent that the definition of a BIOC in Article 1, section 1-201(b)(9) circumscribes who may qualify as a BIOC in ways other than buying from a seller engaged in the business of selling such goods.

The person seeking BIOC status, and the priority over a secured party that goes with it, has the burden of proving that the requirements of such status in Article 1, section 1-201(b)(9) (formerly section 1-201(9)) have been met. *See*, e.g., *Agriliance, L.L.C. v. Runnells Grain Elevator, Inc.*, 272 F. Supp. 2d 800 (S.D. Iowa 2003); *Matter of Gary Aircraft Corp.*, 681 F.2d 365 (5th Cir.). The essence of BIOC status is found in the first sentence of Article 1, section 1-201(b)(9), providing as follows:

> Buyer in ordinary course of business means a person that buys goods in good faith, without knowledge that the sale violates the rights of another person in the goods, and in the ordinary course of business from a person, other than a pawnbroker, in the business of selling goods of that kind.

As for the requirement that a buyer have taken the goods without knowledge that the sale violates the rights of another, which in the Article 9 setting means violates a security interest held by another, it is important to note that it is not simply knowledge that a security interest exists but rather knowledge that the sale violates that security interest that is necessary to deny a buyer BIOC status.

A buyer is aided in establishing that the buyer is without knowledge that the sale violates another's security interest by the fact that it is *actual* knowledge, and not simply knowledge of facts that could put the buyer on notice of a violation, that is material. *See* Article 1, section 1-202 (formerly Article 1, section 1-201(25)). It is unlikely that non-consumers and many merchants will actually know the sale violates the rights of the secured party (as distinguished from knowing about a security interest). However, a buyer who is experienced in the ways of commercial financing may well wish to examine any security agreements executed by its seller. *Cf*. *Matter of Gary Aircraft Corp.*, 681 F.2d 365 (5th Cir.) (in which an experienced buyer did in fact examine a security agreement by which the seller created a security interest in the goods sold).

There is authority under former Article 9 indicating that the date of the sale controls as to whether the buyer has knowledge that could prevent the buyer from qualifying as a BIOC and knowledge acquired after that date is not relevant. Matter of Gary Aircraft Corp., *supra*. The language of section 1-201(b)(9) certainly supports such an interpretation and one would not expect decisions under new Article 9 to differ on this point.

The other major requirements for qualifying as a BIOC, namely, taking in good faith and in the ordinary course of business are relatively less straightforward and require fuller explanation. Courts under former Article 9 were in disagreement about the meaning of these requirements. *See*, *e.g.*, *Brashers Cascade Auto Auction v. Valley Auto Sales and Leasing*, 15 Cal. Rptr. 3d 70 (Cal. App. 2004) (and the cases discussed therein). The disagreement was largely traceable to the fact that "in ordinary course," as used in what was then Article 1, section 1-201(9) (now Article 1, section 1-201(b)(9)), was not defined in Article 9 or elsewhere in the UCC and good faith was defined in various sections of the UCC in different ways.

Good faith was defined in Article 1, section 1-201(19) (now Article 1, section 1-201(b)(20)) to mean honesty in fact. Under this definition a person acted in good faith so long as the person did not actually know that something was amiss or did not act with an ulterior motive. More particularly, a person could be a BIOC, insofar as the requirement of good faith was concerned, even though the facts and circumstances were such as would lead a reasonable person to inquire further and in so doing discover the seller was acting improperly.

Not surprisingly, especially for those courts that believed a buyer should not benefit from blissful ignorance at the expense of a secured party whose security interest would be lost if the buyer qualified as a BIOC, the question was how to impose upon the buyer a degree of responsibility that took greater account of the fact that the ultimate need was to properly allocate the loss resulting from a seller's misdeeds between the buyer and the secured party who were, to a greater or lesser extent, innocent. *See*, *e.g.*, *Brashers Cascade Auto Auction v. Valley Auto Sales and Leasing*, 15 Cal. Rptr. 3d 70 (Cal. App. 2004) (and the cases discussed therein); *Foy v. First National Bank of Elkhart*, 868 F.2d 252 (7th Cir. 1989).

A few courts were able to achieve the desired goal by importing into the Article 9 determination of when a buyer qualified for BIOC status the definition of good faith in Article 2, section 2-103(b)(1) (since replaced), that required a merchant buyer not only to act honestly in fact, but also "in the observance of reasonable commercial standards of fair dealing." *See* the review of such cases in *Brashers Cascade Auto Auction v. Valley Auto Sales and Leasing*, 15 Cal. Rptr. 3d 70 (Cal. App. 2004). Under this definition, good faith took on an objective dimension that could impose upon a buyer a duty to inquire whenever the facts and circumstances would lead a reasonable buyer to do so. *Id*.

Other courts were less inclined to read the Article 2 definition of good faith into Article 9, but were not disposed to allow a buyer to qualify as a BIOC provided only that the buyer acted honestly in fact and bought from a seller engaged in selling goods of the kind that were the subject of the sale. For these courts it was necessary to find in the "in ordinary course of business" language of the definition of a BIOC the objective element of reasonable behavior they deemed appropriate. *See Brashers Cascade Auto Auction* and *Foy*, *supra*.

Whatever the means by which a court was able to read the definition of a BIOC to impose an objective standard of reasonable behavior the net result, as are all determinations of reasonableness, was to require an inquiry into the particular facts and circumstances in each case. A further consequence of the demand for an inquiry into particular facts and circumstances was that the ultimate determination of BIOC status became a question of fact subject to the limited scope of review accorded to fact finders and to the variations in outcomes from case to case that necessarily result from such a process.

This lengthy dissertation on the meaning of BIOC status has focused on the state of affairs under former Article 9 and, therefore, serves only as a prelude to the discussion of BIOC status upon the adoption of new Article 9 and changes made to the definitions governing BIOC status made in conjunction with the adoption of new Article 9.

A major change, one that as will be seen in later chapters impacts matters other than BIOC status, is that made to the definition of good faith itself. Initially in new section 9-102(a)(43) and then in a proposed revision to Article 1, section 1-201(b)(20), the definition of good faith was expanded to include the observance of reasonable commercial standards of fair dealing.

The quoted language imparts to the meaning of good faith, and thence to the definition of a BIOC in Article 1, section 1-201(b)(9), the objective element and concomitant duty of reasonable inquiry that courts struggled to impose under former Article 9. *Cf*. Official Comment 20 to Article 1, section 1-201 (tracing the evolution of the definition of good faith).

Unfortunately, insofar as giving meaning to the requirement of good faith is concerned, not all states have adopted the proposed revision of the definition of good faith in Article 1. Several states have retained the more limited, honesty in fact, definition. A review of which states have adopted the expanded definition and which states have retained the narrower definition may be found at: http://www.law.unlv.edu/faculty/rowley/ra1_updates.htm.

To make matters worse, a state retaining the narrower definition in Article 1 may nonetheless have adopted and have retained new section 9-102(a)(43) containing the expanded definition of good faith. Arizona is one such state. In states that have adopted the narrower "honesty in fact" definition of good faith in Article 1 but the broader "honesty in fact" and "the observance of reasonable commercial standards of fair dealing" in Article 9 the question arises as to which definition governs determinations of when a buyer qualifies as a buyer in ordinary course.

Where buyer in ordinary of course status is material in resolving priority disputes according to the Article 9 rules, such as that contained in new section 9-320(a), it would seem that the broader Article 9 definition of good faith controls. However, since buyer in ordinary course is defined in Article 1, section 1-201(b)(9), it might be argued that the narrower definition applies.

To the extent that the proposed change to the definition of good faith is adopted or the expanded definition of good faith contained in new section 9-102(a)(43) is held to control determinations of buyer in ordinary course status, decisions under former Article 9, in which courts required as a condition of qualifying as a BIOC that a buyer behave reasonably under all the circumstances, should inform determinations of BIOC status under new Article 9 and new section 9-320(a).

Two useful examples of such decisions may be found in *Brashers Cascade Auto Auction v. Valley Auto Sales and Leasing*, 15 Cal. Rptr. 3d 70 (Cal. App. 2004) and *Foy v. First National Bank of Elkhart*, 868 F.2d 252 (7th Cir. 1989). In *Foy* the debtor's inventory of vehicles was financed by a loan from a lender who took a security interest in the vehicles. The lender retained the certificates of title to the vehicles and would turn over a certificate only when the debtor paid for the vehicle it covered.

The debtor sold several vehicles to another dealer under an arrangement whereby the debtor would repurchase the vehicles from the buyer if the vehicles did not sell within some agreed upon period of time. The debtor told the buyer that it had the certificates of title for the vehicles and would make them available when a vehicle was resold. The debtor's explanation for keeping the certificates of titles was that if a vehicle were resold the debtor would need the certificate of title. The debtor did not pay the loan debt from the sales of the vehicles and never obtained the certificates of title to the vehicles. When the debtor defaulted a dispute arose as to whether the buyer or the lender had prior claim to the vehicles.

The buyer argued that it had priority because as a BIOC it took free of the lenders security interest. The trial court held in favor of the buyer, essentially because it believed the buyer's testimony that the buyer that it did not know that the debtor was failing to pay the lender and that there was nothing unusual about the fact that the debtor kept the certificates of title, both as a matter of local practice and because of the repurchase arrangement.

On appeal the trial court's decision was upheld. In its opinion, the court of appeals, without clearly specifying the source of the requirements, concluded that to be a BIOC a buyer had to have acted honestly in fact and also reasonably under all the circumstances, but whether the buyer satisfied the requirements were questions of fact and the court of appeals was obliged to defer to the trial courts answers to the questions.

The facts and the dispute in the *Brashers* case were quite similar to those in *Foy*. Once again, a debtor who sold vehicles to another dealer for resale failed to pay its lender when the vehicles were sold. Again, the buyer from the dealer did not receive certificates of title for the vehicles it bought. The trial court concluded that the buyer qualified as a BIOC who took free of the lenders security interest. In a very lengthy opinion, the appellate court reversed and remanded. It did so because the trial court had failed to apply legal standards that required a buyer to act in a commercially reasonable manner as well as honestly in fact.

As in *Foy*, the source of the commercially reasonable standard was not clearly identified, but the court expressed the belief that a sale, at least one to a merchant buyer, could not be in ordinary course unless the buyer acted in a commercially reasonable manner. Its belief was based very much on the court's assertion that such BIOC disputes are largely between two relatively innocent parties and that a rule that allocates the loss between the parties by looking to all the facts and circumstances is needed.

The court also was concerned that if a commercially reasonable standard were not imposed, there would be an inconsistency as between the Article 9 analysis of when a buyer qualified as a BIOC and the analysis under Article 2 of when a buyer was a BIOC for purposes of Article 2, section 2-403(2) (protecting a BIOC in an entrustment of goods situation).

Decisions as to BIOC status may also be informed by those made by courts inquiring into the meaning of good faith and notice as conditions on qualifying for holder in due course status and for the special priority given to certain purchasers of chattel paper and instruments under new sections 9-330 and 9-331(a). *See*, *e.g*., *Agriliance, L.L.C. v. Runnells Grain Elevator, Inc.*, 272 F. Supp. 2d 800 (S.D. Iowa 2003). *See generally*, Chapter 29 (Secured Party Versus Secured Party (continued)). It should also be noted that decisions under former Article 9, *see*, *e.g*., *Matter of Gary Aircraft Corp.*, 681 F.2d 365 (5th Cir. 1982), indicated that the good faith requirement did not impose on a person asserting BIOC status a duty of care and decisions thus far under new Article 9 appear to agree.

A possible expanded definition of good faith, either by virtue of adoption of the proposed revision to the Article 1 definition or adoption of the definition in new section 9-102(a)(43) containing the broader notion of good faith, is not the only change made in connection with adoption of new Article 9 that can affect BIOC status.

Article 1, section 1-201(b)(9) (revising an earlier version of Article 1, section 1-201(b)(9)), purports to define buying in ordinary course. *See* Official Comment 9 to Article 1, section 1-201(b)(9) (stating that "the second sentence [of the section] explains what it means to buy in ordinary course"). Thus, section 1-201(b)(9) provides that:

> A person buys in the ordinary course if the sale to the person comports with the usual or customary practices in the kind of business in which the seller is engaged or with the sellers own usual or customary practices. (Emphasis added.)

By this language the determination of when a sale is in ordinary course is made with reference to the usual and customary practices of sellers engaged in the same business or by reference to the particular sellers selling practices.

It may be that the requirement of ordinary course does little more than excluding sales that are outside ordinary course in the sense that they are made under terms that depart from the usual terms of sale, such as a fire or liquidation sale and sales that are made to a buyer to whom the seller customarily would not sell. So understood, the ordinary course requirement will be relatively easily satisfied in most cases.

It should be kept in mind that to be a BIOC under Article 1, section 1-201(b)(9), a buyer must buy in good faith *and* without knowledge that the sale violates a security interest held by another party *and* in ordinary course. Consequently, it seems that an independent inquiry must be made as to each of the conditions and a buyer could buy in ordinary course but still not qualify as a BIOC because the buyer did not buy in good faith or bought with knowledge that the sale violated the rights of a secured party.

There can be difficulties in applying new section 9-320(a) apart from the determination of whether a particular buyer qualifies as a BIOC. As indicated above, under new section 9-320(a) a BIOC takes free only of a security interest created by the seller from whom the buyer buys. There is no ready explanation for this limitation, but it must be kept in mind when applying the section.

Note, however, that a BIOC protected by new section 9-320(a) "takes free" of a security interest created by the buyer's seller. Therefore, a transferee from the BIOC acquires the goods free of that security interest. This result is traceable to the so-called "shelter principle" found in Article 2, section Article 2, section 2-403(1). Under that principle, a transferee by purchase of goods acquires all title that the transferee's transferor had or had power to transfer. *See* Official Comment 9 to former 9-301.

The fact that a transferee from a person who took free of a security interest also takes free of that security interest illustrates an important difference between taking free of a security interest and subordinating a security interest (as provided for in new section 9-317(a) (governing lien creditor disputes)). Additionally, it is possible for a secured party to "acquiesce" as to a particular sale and in so doing "entrust" the goods under Article 2, section 2-403(2). In such a case a buyer who is a BIOC can take free of a security interest even though the security interest was created by someone other than the seller from whom the BIOC buys.

Although decided under former Article 9, the case of *Matter of Gary Aircraft Corp.*, 681 F.2d 365 (5th Cir.) offers what is perhaps the most complete explanation of the interaction between the buyer's seller limitation in new section 9-320(a) and the shelter principle in Article 2, section 2-403(1). In *Gary Aircraft*, a dealer created a security interest in an airplane in favor of a lender who properly perfected its interest in the airplane by recording the interest with the FAA (*see* Chapter 19 (Perfection Pursuant to Federal Law)). Then, without the knowledge or consent of the lender, the dealer sold the airplane to a buyer who subsequently sold the airplane to another buyer.

It was held over the lender's objection that the buyer from the dealer met the burden of proof required for it to qualify as a BIOC and that although the second buyer could not take free of the lender's security interest under former section 9-307(1) the second buyer nonetheless was not subject to the lender's security interest because the second buyer took free of that security interest under the shelter principle of Article 2, section 2-403(1).

In the course of its opinion, the court dealt with the troublesome problem of the extent to which the Article 9 priority scheme could be altered by Article 2 provisions. It explained that the second buyer could not rely on the rule in Article 2, section 2-403(1), that a bona fide purchaser for value from a person who has voidable title gets good title because to do so would negate the buyer's seller limitation in former section 9-307(1), but applying the shelter principle to protect the second buyer served only to give full effect to the taking free rule in former section 9-307(1) and the title acquired by the buyer from the dealer.

Although *Gary Aircraft* was decided under former Article 9, the court's reasoning in that case readily applies to the new Article 9 priority scheme created by new section 9-320(a) and Article 1, section 1-201(b)(9), and that priority remains subject to the shelter principle in Article 2, section 2-403(1). This is not to say that courts will always get it right.

Thus, in *Leasing One Corp. v. Caterpillar Financial Services Corp.*, 776 N.E. 2d 408 (Ind. App. 2002), the court properly acknowledged the buyer's seller limitation in new section 9-320(a), but seems not to have applied the shelter principle. That the shelter principle should have protected the subsequent buyer is not entirely clear because rather than a simple buyer from a buyer from a dealer situation, the case involved an assignee of a commercial lease through which a buyer had acquired equipment from a buyer from a dealer. The assignee of financing contracts situations poses the question of the extent to which a financer of a buyer who takes free of a security interest may stand in the shoes of the buyer as against the holder of that security interest and the answer to that question is unclear.

The facts of *Leasing One* also raised the question of whether the transaction between the transferor and the transferee of the equipment was a true lease or a lease intended as security. The court concluded that it was unnecessary to decide the question because in its view the outcome would be the same whether the transaction was a true lease or a lease intended as security. However, to the extent that an outcome turns on the application of new section 9-320(a), the answer to the question does matter because that section applies only if the transaction creates a security interest within the scope of Article 9. *See* Chapter 4 (Scope of Article 9).

In *Arcadia Financial, Ltd v. Southwest-Tex Leasing Co., Inc.*, 47 UCC Rep. Serv. 2d 1371 (Tex. App. 2002), the court appears not to have understood that under the UCC, Article 1, section 2-401(1) (*see* Chapter 4 (Scope of Article 9)), conditioning a transfer of title to goods on payment operates only to create a security interest, and consequently failed to consider the distinct possibility that the buyers of vehicles at retail in that case would qualify as BIOCs and would take free of the security interest of the creditor from whom the dealer obtained the vehicles.

Curiously, the court did discuss Article 1, section 1-201(b)(9) in considering whether an assignee from the dealer of contracts arising from the sale of the vehicles could qualify as a BIOC. It concluded that the assignee was not a BIOC because it had knowledge that the terms of the agreement between the dealer and the creditor from whom the vehicles had been obtained had been violated.

Insofar as the assignment was considered independently of the sales giving rise to the contracts that were assigned, a shorter, more accurate, explanation would seem to be that only buyers in ordinary course of *goods* qualify for BIOC status under Article 1, section 1-201(b)(9). However, there would remain the question suggested above of whether the assignee of the contracts could stand in the shoes of a buyer who takes free of a security interest and knowledge of the assignee regarding a violation of the terms of a security agreement should not be attributed to the buyer so as to deny the buyer BIOC status.

On the other hand, as alluded to in Chapter 17 (Perfection as to Goods Subject to

Certificate of Title Legislation), some certificate of title statutes provide that a transfer of a vehicle covered by a title issued under such a statute is not effective unless the certificate of title is transferred and where such a statute applies, unless the statute is expressly subject to Article 9, where a certificate is not transferred there may be no transfer of the vehicle such as would allow a buyer in ordinary course to take free of a security interest under new section 9-320(a). *Cf*., *Vibbert v. PAR, Inc.*, 224 S.W.3d 317 (Tex. App. 2006).

As noted above, under new section 9-320(a), a buyer in ordinary course of farm products from a person engaged in a farming operation does not take free of a security interest created by the buyer's seller. The reason for the farm products exclusion very simply is that agricultural lenders were able to get an exception. Application of the exclusion obviously requires knowing when goods are farm products. *See* Chapter 5 (Classification of Collateral). A BIOC of farm products gets some protection against unperfected security interests in new section 9-317(b), discussed below.

More importantly, Congress stepped in to confer protection of a BIOC of farm products in the Food Security Act (FSA) of 1985, 7 U.S.C. § 1631. Under subsection (d) of the act, except as provided in (e) of this section, and notwithstanding any other provision of Federal, State, or local law, a buyer who in ordinary course of business buys a farm product from a seller engaged in farming operations shall take free of a security interest created by the seller, even though the security interest is perfected; and even though the buyer knows of the existence of the security interest.

Thus, the FSA substitutes a federal law scheme for determining when a BIOC of farm products takes free of a security interest for the Article 9 rule. Subsection (e), to which the general rule of the FSA is subject, provides that if a state's filing system has been certified by the Secretary of Agriculture as meeting the requirements of the FSA, then a secured party who has filed an effective financing statement may give notification, the contents of which are spelled out in the act, to potential buyers of farm products that will prevent the buyers from taking free under subsection (d) of the act. *See*, *e.g*., *Agriliance, L.L.C. v. Runnells Grain Elevator, Inc.*, 272 F. Supp. 2d 800 (S.D. Iowa 2003) (discussing the operation of the FSA).

It must be stressed that the notification scheme of the FSA is applicable only to the extent that the Secretary of Agriculture has certified that a states filing system satisfies the requirements of the act. In states whose filing systems have not been certified, the rule of subsection (d) of the act applies and BIOCs take free of security interest essentially on an equal footing with BIOCs of other than farm products under new section 9-320(a). Of course, even in a state whose filing system has been certified and in which the notification scheme is applicable, if a secured party fails to give the required notification then the BIOC takes free of the security interest.

The rule of new section 9-320(a) is subject to an exception found in new section 9-320(e). That section provides:

> (e) Subsections (a) and (b) do not affect a security interest in goods in the possession of the secured party under Section 9-313.

The exception in new section 9-320(e) is intended to overrule the decision in *Tanbro Fabrics Corp. v. Deering Milliken, Inc.*, 350 N.E.2d 590 (N.Y. 1976). In *Tanbro,* a buyer from a seller had left goods in the possession of a creditor for security. The court held the buyer to be a BIOC who was entitled to take free of the security interest of the creditor who was in possession. The second to last sentence of revised section 1-201(b)(9) reinforces the effect of new section 9-320(e) to deny protection under new section 9-320(a) to a buyer where goods are in the possession of a creditor other than the seller for purposes of perfecting a security interest under new section 9-313.

However, the change to section 1-201(b)(9) and the addition of new section 9-320(e) do not appear to alter decisions under former Article 9 holding that a buyer could be a BIOC and could take free of a security interest created by the seller even where the buyer had not taken possession of the goods at the time of the seller's default so long as the buyer had a right to possession as against the seller.

The *Daniel v. Bank of Hayward*, 425 N.W.2d 416 (Wis. 1988) case offers a good illustration. The decision warrants careful reading. You may do so by clicking on the case name.

In *Daniel* a consumer buyer purchased a new van from a dealer, trading in an older RV and entering into a secured installment sales contract. Before the new van was delivered to the buyer, the dealer defaulted on a debt owed to a bank that had financed the dealer's inventory, including the van sold to the buyer. The bank took possession of the new van and insisted that the buyer had to pay the amount owed on the van without any credit for the trade in (which had been sold by the dealer) or give up the van.

The *Daniel* court held that the buyer had become a buyer in ordinary course even though the buyer had not gained possession of the van. It reasoned that the buyer had a special property interest under Article 2, section 2-501(1) at the time the new van was delivered to the dealer and this interest gave the buyer rights against the dealer sufficient to make the buyer a buyer in ordinary course. In other words, it is enough that a buyer have a right to possession rather than have taken delivery to allow the buyer to qualify as a BIOC.

The court in *Daniel* did not follow its earlier decision in *Chrysler Corp. v. Adamatic*, 208 N.W.2d 97 (1973). In that case, the court denied BIOC treatment to a buyer who had a right to possession against the debtor. However, in *Adamatic* the buyer and the seller both were merchants and the court in *Daniel* stressed that as between the bank and the *consumer* buyer the bank was in a better position to protect itself.

A word about the consequences to a buyer who does not qualify for protection under new section 9-320(a) or the Food Security Act (FSA) or the shelter rule is in order. The most obvious result is that if the buyer does not take free under the new section 9-317(b), discussed below, then the buyer is subject to the security interest. But, what it means to be subject to the security interest needs further discussion.

To begin with, it means that the security interest is enforceable against the buyer -- that the secured party may recover the collateral from the buyer. *See* Part VII below. This right to enforce the security interest would extend to any proceeds of the collateral in the possession of the buyer.

But, there may be further consequences. If, for example, the collateral or its proceeds are no longer in the possession of the buyer, then the secured party may have an action for conversion. It is uniformly agreed that a security interest involves a right to possession that can be converted. The specific elements of conversion differ from state to state, especially on the matter of the extent to which the interference with the secured party's right of possession must have been "intentional."

In *Agriliance, L.L.C. v. Runnells Grain Elevator, Inc.*, 272 F. Supp. 2d 800 (S.D. Iowa 2003), the secured party had brought an action for conversion against a buyer of farm products who had been given the notification required by the FSA. The court concluded that the actions of the buyer were sufficiently intentional to subject the buyer to damages for conversion unless the buyer was able to establish an affirmative defense.

You may explore the BIOC rules in the next several problems.

Problem 27.1 (INTERACTIVE)

Tractors & More, Inc., a distributor of farm equipment, sells equipment on credit to Danny Dealer who sells farm equipment at retail. The sale is in ordinary course and Byron takes in good faith. Tractors & More takes a security interest in the equipment and files a financing statement covering the equipment. Lucy Lender has a security interest in Tractors & More's inventory of farm equipment that was timely perfected by filing. Danny Dealer sells a tractor to Byron Buyer on credit. The sale by Danny to Byron is in ordinary course. Danny takes an interest in the tractor to secure its unpaid price and files a financing statement covering the tractor. Byron is aware of the security interest held by Tractors & More but not that of Lucy Lender. In answering the questions that follow you will find it useful to create a sketch or outline of the various transactions.

Which security interests does Byron take free of under new section 9-320(a)? If Byron does not take free of Lucy's security interest under new section 9-320(a) does Byron nonetheless take free of Lucy's security interest? If so, why?

Suppose the security agreement between Tractors & More and Lucy Lender required that Tractors & More obtain at least 30% down and Tractors & More sold to Danny Dealer for only 10% down. Would this change in the facts change the outcome under new Article 9? What further change in the facts would be necessary to prevent Danny from taking free of Lucy's security interest?

If Danny knew of the violation of the security agreement between Tractors & More and Lucy, would Byron take free of Lucy's security interest? Would your answer be different if Danny learned about the violation after he acquired the farm equipment? Who has the burden of proving when Danny learned of the violation?

If Danny knew of the violation of the security agreement between Tractors & More and Lucy at the time he acquired the farm equipment would Byron nonetheless take free of the security interest of Tractors & More?

Problem 27.2 (INTERACTIVE)

Assume the original facts of Problem 27.1. Would your analysis and answers be different if the sale to Danny Dealer was not made on terms that are usual or customary in the farm equipment sales industry or with Tractors & Mores usual or customary terms?

Suppose the sale to Danny Dealer had comported with industry practice but the sale to Danny violated the express terms of the agreement between Tractors & More and Lucy Lender. Suppose further that at the time of the sale Danny did not know of the violation, but Danny had knowledge of facts that would have lead a reasonable buyer in Danny's circumstances to inquire further and if Danny had made such an inquiry he would have learned about the violation. Would your analysis and answers be different now?

Problem 27.3 (INTERACTIVE)

Assume the basic facts of Problem 27.1. Assume further, however, that Danny Dealer defaulted on its debt to Tractors & More before Byron Buyer had taken possession of the tractor but after the farm equipment had been delivered to Danny Dealer and identified to the contract with Byron.

Would this change in the facts prevent Byron from taking free of the security interest of Tractors & More under new section 9-320(a)?

Problem 27.4 (INTERACTIVE)

Assume the facts of Problem 27.1. Assume further, however, that rather than farm equipment, Tractors & More sells supplies used in farming operations and what Byron Buyer buys from Danny Dealer is fertilizer. Would the farm products exception in new section 9-320(a) prevent Byron from taking free of the security interest of Tractors & More under new section 9-320(a)?

Problem 27.5 (INTERACTIVE)

Donald Dell grows cotton on his farm in Pinal County, Arizona. Donald's cotton crop is subject to a perfected security interest held by Southwestern Bank. Donald sells cotton from the crop subject to Southwestern's security interest to Fluffy Cotton Gin, Inc. Fluffy buys in the ordinary course of Donald's business and on terms authorized by the security agreement creating the security interest held by Southwestern.

Does Fluffy take free of Southwestern's security interest?

On what does the decision as to whether Fluffy takes free of Southwestern's security interest or not depend?

Suppose (as appears to be the case) that Arizona's filing system has not been certified by the Secretary of Agriculture pursuant to the FSA. Does Fluffy take free of Southwestern's security interest?

If Fluffy did *not* take free of Southwestern's security interest could Fluffy be liable for damages for conversion?

C. Other Than BIOC Disputes

Under former section Article 9, a buyer other than a BIOC and a BIOC of farm products could subordinate a security interest to the extent that the buyer gave value and received delivery of the property without knowledge of the security interest and before the security interest was perfected. New section 9-317(b) provides that a buyer, other than a secured party, who buys tangible chattel paper, documents, goods, instruments, or a security certificate, *takes free* of a security interest (or an agricultural lien) if the buyer gives value and receives delivery of the collateral without knowledge of the security interest or agricultural lien before it is perfected.

New section 9-317(c) extends the protection given in new section 9-317(b) to lessees that give value and take delivery without knowledge of an unperfected security interest. New section 9-321(c) protects a lessee in ordinary course against a security interest created by a lessor even if the security interest is perfected and even if the lessee knows of its existence. New section 9-317(d) protects licensees of general intangibles and buyers, other than secured parties, of accounts, electronic chattel paper, general intangibles and investment property other than a certificated security against unperfected security interests where the licensee or buyer gives value without knowledge of the security interest. Under new section 9-321(b), a licensee in ordinary course, as defined in new section 9-321(a), takes free of a security interest created by a licensor even if the security interest is perfected and even if the licensee knows of its existence.

Recall from Chapter 26 (Secured Party Versus Lien Creditor) that new section 9-317(e) protects purchase money security interests against intervening lien creditors to the extent that the secured party files a financing statement within twenty days after the debtor gets possession of the collateral. In an especially important change from former Article 9, new section 9-317(e) extends the special protection provided purchase money parties to all other than buyer in ordinary course situations.

You may explore the other than BIOC rules in the next two problems.

Problem 27.6 (INTERACTIVE)

Sid Seller sells a stereo to Donna Debtor for use in her office. Donna pays 10% down and agrees to pay the balance in twelve equal monthly installments. Sid takes an interest in the stereo to secure its price. Donna takes delivery of the stereo the same day. The next day, Sid files a financing statement covering the stereo. Two weeks later, without having made a single payment, Donna sells the stereo to Byron Buyer for use in his office and Donna then leaves town. Byron gives value for the stereo and takes delivery of it without knowing of Sid's security interest. A diagram of the transactions will be useful in answering the following questions.

Does Byron take free of Sid's security interest under new section 9-320(a)?

Would Byron take free of Sid's security interest under new section 9-317(b)?

Problem 27.7 (INTERACTIVE)

Assume the facts of Problem 27.6. Assume further, however, that Donna Debtor sold the stereo to Byron Buyer one week after delivery of the stereo to Donna and that Sid Seller did not file a financing statement covering the security interest created by Donna until after the sale of the stereo to Byron Buyer.

Does Byron take free of Sid's security interest? Be sure to refer to new section 9-317(e) before answering this question.

Suppose that Sid did not file within 20 days of delivery of the stereo to Donna. Suppose further that Byron sold the stereo to Betty Buyer who gave value and took delivery of the stereo without knowledge of Sid's security interest *after* Sid filed a financing statement. Would Betty be subject to Sid's security interest?

D. Buyers of Consumer Goods from Consumers

As was true under former Article 9, under new Article 9 a secured party who relies on automatic perfection under new section 9-309(1) (*see* Chapter 18 (Perfection by Doing Nothing -- Automatic Perfection) risks losing out to certain consumer buyers. Thus, under new section 9-320(b) a consumer buyer who buys from a consumer seller takes free of a security interest perfected automatically (and as to which no filing had been made). New section 9-320(b) makes clear that there must be both a consumer seller and a consumer buyer.

A typical case for the application of new section 9-320(b) would be that of a person who bought goods for personal use and created a purchase money security interest in the goods and then sold the goods to a neighbor or other such person who bought for personal use. To assure priority against a consumer buyer in such a case the secured party must file a financing statement before the buyer satisfies the conditions of new section 9-320(b). Recall that under new section 9-311(b), compliance with a certificate of title law is the equivalent of filing.

As was discussed in subpart B above, under new section 9-320(e), new section 9-320(a)'s protection for a BIOC does not extend to a security interest of a secured party who is in possession and whose security interest is perfected by possession. New section 9-320(e) operates to limit the effect of new section 9-320(b) as well.

You may explore the new Article 9 rules governing disputes between secured parties and consumers buying from consumer buyers in the next two problems.

Problem 27.8 (INTERACTIVE)

Sid Seller sells a stereo to Donna Debtor, an architect, for use in her home. Donna pays 10% down and agrees to pay the balance in twelve equal monthly installments. Sid takes an interest in the stereo to secure its price. Donna takes delivery of the stereo the same day. Two months later, without having made a single payment, Donna sells the stereo to Donald Dealer who deals in used electronic equipment and who plans on reselling the stereo. Donald gives value for the stereo and takes delivery of it without knowing of Sid's security interest.

Is Sid's security interest in the stereo perfected?

Is Donald subject to Sid's security interest?

Problem 27.9 (INTERACTIVE)

Donald Dealer in Arizona sells to Betty Buyer in Arizona a new cabin cruiser boat and boat trailer that are bought by Betty for personal use. Betty gives Donald security interests in the boat and boat trailer to secure the unpaid prices of the boat and trailer.

Is Donald's security interest in the *boat* perfected?

Could a consumer buyer from Betty nonetheless take free Donald's security interest in the *boat*?

What must Donald do to eliminate the risk of a consumer buyer from Betty from taking free of Donald's security interest in the boat?

What must Donald do to perfect its security interest in the *boat trailer* and prevent a buyer from Betty from taking free of Donald's security interest under new section 9-317(b? Will this action prevent a consumer buyer from Betty from taking free of Donald's security interest in the boat trailer under new section 9-320(b) even though that section provides that a consumer buyer will take free of a security interest if the buyer takes delivery "before the filing of a financing statement covering the goods" What language of new section 9-311(b) supports your answer?

E. Buyers and Future Advances

Under former Article 9, buyers other than buyers in ordinary course were protected against discretionary future advances made with knowledge of a sale or more than 45 days after a sale. New section 9-323(d) protects buyers other than buyers in ordinary course against discretionary advances to the same extent. The rule for buyers differs from that for lien creditors, considered in Chapter 26 (Secured Party Versus Lien Creditor), in that knowledge on the part of a secured party can shorten the 45-day period of protection given secured parties.

New section 9-323(e) excludes from the rule of new section 9-323(d) advances made pursuant to a commitment entered into without knowledge of a sale and before the expiration of the 45-day period.

New sections 9-323(f) and (g) give lessees other than lessees in ordinary course the same protection that is given to buyers other than buyers in ordinary course.

The rules governing disputes between buyers and secured parties regarding future advances are considered in the next two problems.

Problem 27.10 (INTERACTIVE)

Lisa Lender has a security interest in a drill press owned by Donna Debtor to secure a loan of $5,000. The security agreement provides that the interest shall secure such future advances as Lisa may choose to make to Donna. Lisa files a financing statement covering the drill press. Donna sells the drill press, which is worth $10,000, to Byron Buyer for $10,000. Thereafter, Lisa lends Donna an additional $5,000. Donna defaults. Which of the following accurately states the extent to which Lisa may satisfy the $10,000 in loans to Donna out of the drill press and why?

(a) Lisa may satisfy only $5,000 of the $10,000 in debt because the second $5,000 was not advanced pursuant to a commitment.

(b) Lisa cannot satisfy any of the $10,000 debt out of the drill press because Lisa's security interest in the drill press was not perfected.

(c) Lisa may satisfy $10,000 of the $10,000 debt out of the drill press if the second $5,000 was advanced within 45 days after the sale (even if Lisa had knowledge of the sale).

(d) Lisa may satisfy $10,000 of the $10,000 debt out of the drill press if the second $5,000 was advanced without knowledge of the sale and within 45 days after the sale.

Problem 27.11 (INTERACTIVE)

Lisa Lender has a perfected security interest in Donald Debtor's inventory, existing and after-acquired. The security agreement provides that the interest shall secure such future loans as Lisa may choose to make to Donald. Donald sells an item of inventory to Byron Buyer in the ordinary course of Donald's business and Byron otherwise qualifies as a BIOC under Article 1, section

1-201(b)(9). Thirty days after the sale to Byron, without knowledge of the sale to Byron, Lisa makes another advance to Donald.

May Lisa reach the item of inventory to satisfy the later advance?

May Lisa reach the item of inventory to satisfy the original advance?

Would your answers change if the future advance clause committed Lisa to make the later advance?

CASE COMMENTARY

Ace Equipment Sales, Inc. v. H.O. Penn Machinery Co., Inc., 871 A.2d 402 (Conn. App. 2005)

Ronald V. Odette Family Limited Partnership v. Agco Finance, LLC, 129 P.3d 95 (Kan. App. 2005)

Integrity Bank Plus v. Talking Sales, Inc., 2006 WL 212193 (D. Minn. 2006)

Genesee Regional Bank v. Palumbo, 799 N.Y.S.2d 883 (N.Y. Supreme Court 2005)

In re *Jeans*, 326 B.R. 722 (Bkcy W.D. Tenn. June 28, 2005)

First National Bank v. Lubbock Feeders, L.P., 183 S.W.3d 875 (Tex. App. 2006)

Vibbert v.PAR, Inc., 224 S.W.3d 317 (Tex. App. March 23, 2006)

Feliciana Bank & Trust v. Manuel & Sessions, L.L.C., 943 So.2d 736 (Miss.App. 2006)

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Part VI Priority

Chapter 28 Secured Party Versus Secured Party

A. Generally

New Article 9 provides a seeming maze of rules for governing disputes among secured parties claiming security interests in the same collateral. The rules largely replicate those found in former section 9-312, especially the first-to-file-or-first-to-perfect rule of former section 9-312(5)(a), but the new Article 9 rules are restructured and are more elaborate and some rules not found in former Article 9 have been added. The general rules of new Article 9 are relatively straightforward, but there are numerous qualifications that make sorting out priorities, especially as to proceeds disputes, difficult at times. The basic priority rules and those applicable to purchase-money security interests are the subject of this chapter. Special rules that apply to certain collateral and to proceeds conflicts are treated in Chapter 29 (Secured Party Versus Secured Party (continued)).

Before getting to the specific rules governing priority among secured parties, a word about subordination agreements is in order. It can happen, and not infrequently does happen, that a secured party who has priority over another secured party under one or more of the priority rules about to be discussed, will agree to subordinate its security interest to a party as to which the agreeing party has priority.

Among the reasons why a secured party with priority under the Article 9 rules might enter into a subordination agreement is that the secured party who does so does not wish to extend further credit to the debtor, but understands that additional credit may be necessary to keep the debtor viable and to better assure that the subordinated debt will be paid. It is worth emphasizing subordination is a matter of contract between the parties to the contract and who has priority under the Article 9 rules will have to be decided before any such contract is executed.

The basic scheme of new Article 9 is that most disputes among secured parties with conflicting non-purchase-money security interests in the same collateral are governed by the temporal priority rules found in new section 9-322(a). The most important temporal rule is the first-to-file-or-first-to-perfect rule in new section 9-322(a)(1). Under this rule, the party first to file a financing statement covering collateral or the first to perfect by whatever method, has priority.

The first-to-file-or-first-to-perfect rule is subject to the rules in new section 9-324, conferring priority under certain conditions to holders of purchase-money security interests without regard to the timing of filing or perfection. The first-to-file-or-first-to-perfect rule also is subject to the special priority rules contained in new sections

9-327, 9-328, 9-329, 9-330 and 9-331. These sections, awarding priority under specified conditions to holders of security interests in deposit accounts, investment property, and letter of credit rights, and to purchasers of chattel paper and instruments and to persons with rights under Articles 3, 7 and 8, again without regard to the timing of filing or perfection, are examined in Chapter 29 (Secured Party Versus Secured Party (continued)).

The first-to-file-or-first-to-perfect rule also governs most priority disputes involving proceeds. However, the application of the rule to proceeds disputes is qualified by rules contained within new section 9-324, governing purchase-money security interests, and in new sections 9-322(c), (d) and (e), which distinguish proceeds of filing collateral from those of non-filing collateral, and some of the rules applicable to specialized collateral in new sections 9-327, 9-328, 9-329, 9-330 and 9-331. Discussion of these rules also is deferred to Chapter 29 (Secured Party Versus Secured Party (continued)).

There are specific rules in new sections 9-325 and 9-326 governing disputes involving transferees of collateral and new debtors. These rules likewise will be considered in Chapter 29 (Secured Party Versus Secured Party (continued)).

B. New Section 9-322(a) and the First-to-File or First-to-Perfect Rule

1. Generally.

New section 9-322(a) actually contains three rules. Under new section 9-322(a)(2), not surprisingly, a perfected security interest or agricultural lien has priority over an unperfected security interest or agricultural lien. Under new section 9-322(a)(3), as between unperfected security interests and agricultural liens, the first to attach has priority.

The heart of new section 9-322(a) is new section 9-322(a)(1). New section 9-322(a)(1) contains the first-to-file-or-first-to-perfect priority rule found in former section 9-312(5)(a). Under this rule -- subject to the special rules for purchase-money security interests now found in new section 9-324 and examined below -- as between holders of non-purchase-money security interests, the first party to file or to perfect prevails.

The first-to-file aspect of the rule reflects the notice filing nature of the filing system under which, among other things, a party may file before concluding a secured transaction. *See* Official Comment 4 to new 9-322. Note carefully, however, that the rule is stated in the alternative. Whichever party files or perfects first prevails. If a party obtains an enforceable security interest non-purchase-money security interest and takes possession of the collateral before another party files as to the collateral, then the party who took possession has priority. Note also that the first-to-file or first-to-perfect rule operates irrespective of what the parties to a dispute know or do not know. *See* Example 1 in Official Comment 4 to new 9-322.

New section 9-322(a)(1) is subject to a special qualification pertaining to agricultural liens. Under new section 9-322(g), the first-to-file or first-to-perfect rule would give way to a priority conferred by the statute creating the agricultural lien.

Of course, the priority rules discussed here and in the other chapters in Part VI determine priority only where the Uniform Commercial Code (UCC) applies. As explained in Chapter 6 (Choice of Law), especially in international transactions, the parties may agree that a law other than the UCC applies or choice of law rules may dictate the application of a law other than the UCC. In *Usinor Industeel v. Leeco Steel Products, Inc.*, 209 F. Supp. 2d 880 (N.D. Ill. 2002), the court concluded that a U.S. lender with a perfected security interest in goods sold by a French seller to a buyer in Illinois and delivered to the buyer in Illinois had prior claim to goods as against the French seller.

In so doing, the court first held that the Convention on Contracts for the International Sale of Goods (CISG) governed only the rights and obligations of the buyer and seller and to determine the rights of a third party it was necessary to look to applicable domestic law. The court then determined that the applicable domestic law was that of Illinois, meaning the UCC, and not French law, and under UCC, Article 2, section 2-401(1), the French sellers retention of title gave rise only to a security interest and because the security interest was unperfected it was subordinate to the perfected security interest of the lender.

Although the court does not appear to expressly refer to new section 9-322(a)(2), as explained above, it is that provision that gives a perfected security interest priority over an unperfected security interest.

The *Usinor Industeel* case is a useful reminder of the desirability of including a choice of law provision in an agreement arising in an international transaction, as discussed in Chapter 6 (Choice of Law).

You may explore the essence of the first-to-file-or-first-to-perfect rule of new section 9-322(a)(1) in the next three problems.

Problem 28.1 (INTERACTIVE)

On Day 1, Southern Bank files a financing statement covering a drill press owned by Debtor. On Day 10, Ready Lender lends to Donna Debtor, Donna authenticates a security agreement describing the collateral as the drill press covered by Southern's financing statement and Ready Lender files a financing statement covering Donna's equipment. On Day 15, Southern lends to Donna and she authenticates a security agreement that describes the collateral as the drill press covered by it's filing on Day 1.

Who perfected first as between Southern Bank and Ready Lender?

Who has priority as between Southern and Ready Lender?

Would the outcome in the dispute between Southern and Ready Lender be different if Southern knew of Ready Lender's security interest when Southern lent to Donna?

Problem 28.2 (INTERACTIVE)

Assume the facts of Problem 28.1. Assume further, however, that Ready Lender takes possession of the drill press rather than filing on Day 10.

Who has priority as between Southern Bank and Ready Lender?

Suppose Southern did not file on Day 1 but rather it filed on Day 15 when it closed the loan to Donna. Who would win now?

Problem 28.3 (INTERACTIVE)

Selma Seller sells a stereo to Betty Buyer for use in her home and Selma takes a security interest in the stereo to secure the unpaid price of the stereo. Subsequently, Lenny Lender lends to Betty, takes a security interest in the stereo to secure the loan and files a financing statement covering the stereo. Betty defaults owing Selma and Lenny more than the stereo is worth.

Who has prior claim to the stereo?

2. The First-to-File Rule and After-Acquired Property.

The first-to-file or first-to-perfect rule governs disputes between non-purchase-money parties with interests in after-acquired collateral. Because there can be no perfection without attachment, competing parties may perfect security interests in after-acquired collateral simultaneously. *See* Example 4 in Official Comment 5 to new 9-322.

You may test your understanding of the application of the first-to-file-or-first-to-perfect rule to after-acquired property in the next problem.

Problem 28.4 (INTERACTIVE)

On Day 1, Southwestern Bank lends to Donald Debtor and obtains an enforceable security interest in Donald's equipment, existing and after-acquired. Also on Day 1, Southwestern files a financing statement covering Donald's equipment. On Day 10, Lisa Lender lends to Donald and obtains an enforceable security interest in Donald's equipment, existing and later-acquired. That same day, Lisa files a financing statement covering Donald's equipment. On Day 15, Donald acquires a drill press used in Donald's business.

Who perfected first as between Southwestern and Lisa?

Who has priority as between Southwestern and Lisa?

3. The First-to-File-or-First-to-Perfect Rule and Future Advances.

In Chapters 26 (Secured Party Versus Lien Creditor) and 27 (Secured Party Versus Buyers) it was seen that priority disputes involving lien creditors (new section 9-323(b)) and buyers of goods (new section 9-323(d)) as to future advances depended on the time an advance was made (or an absence of knowledge of a sale or levy) unless the advances were made pursuant to a commitment. Disputes among secured parties regarding future advances are governed by the first-to-file-or-first-to-perfect rule of new section 9-322(a)(1).

The basic proposition is that a security interest covering a later advance has the same priority as the security interest in the initial advance. This priority obtains whether the later advance is made pursuant to a future advance clause or a new security agreement covering the same collateral. The only nexus required for a filing made in connection with a security interest created by a different security agreement to perfect a security interest created by a later security agreement is that the description of the collateral in the financing statement be sufficient to cover the collateral that is the subject of the later security agreement.

There are some qualifications to the basic rule of new section 9-322(a)(1) in new section 9-323(a) for security interests securing discretionary advances that are perfected automatically or temporarily. Under new section 9-323(a), where a security interest securing an advance is perfected only automatically under new section 9-309 or temporarily under new sections 9-312(e), (f) or (g) *and* the advance is not made pursuant to a commitment entered into before or while the security interest is perfected otherwise than automatically or temporarily, then for purposes of determining priority under the first-to-file-or-first-to-perfect rule of new section 9-322(a)(1) perfection dates from the time the advance is made. *See* Official Comment 3 to new section 9-323.

Stated differently, new section 9-323(a) indicates the limited circumstances when the time an advance is made is material to priority under new section 9-322(a)(1) and in most cases applying the first-to-file-or-first-to-perfect rule of new section 9-322(a)(1) depends on the date of a filing or the date of perfection.

You may explore your understanding of the treatment of future advance priority among secured parties under new Article 9 in the next two problems.

Problem 28.5 (INTERACTIVE)

On February 1, Lisa Lender lends $5,000 to Donald Debtor and Donald signs a security agreement giving Lisa an interest in Donald's machinery to secure the loan. The security agreement provides that any advances that Lisa should choose to make in the future also will be secured by the interest in Donald's machinery. Lisa immediately files a financing statement covering the machinery. On March 1, Western Bank lends $5,000 to Donald and takes a security interest in the same machinery and on the same day files a financing statement covering the machinery. On April 1, Lisa makes another $5,000 advance. Donald defaults at a time when he owes Lisa $10,000 and Western $5,000 and the machinery is worth only $10,000.

Does Lisa get the $10,000?

If there were no future advance clause in the security agreement between Lisa and Donald and instead Donald signed a new security agreement creating a security interest in his machinery on April 1, who then would get the $10,000?

Could the secured party who loses out have avoided being subordinated? If so, how?

Assume again the original facts of Problem 28.5 but assume further that instead of filing on March 1 Western Bank took possession of the machinery pursuant to an agreement with Donald. Who has priority as to what amounts now?

If Western Bank lent to Donald on January 15 and Western took possession of Donald's machinery on that date pursuant to an agreement with Donald who would get what amounts?

Problem 28.6 (INTERACTIVE)

On September 25, Lenny Lender lends $5,000 to Donna Debtor on an unsecured basis. On September 29th, Lenny decides he needs security for the loan. At Lenny's request, Donna signs a security agreement giving Lenny a security interest in a negotiable warehouse receipt to secure the earlier unsecured loan. On October 1, Southern Bank lends $5,000 to Donna and Donna signs a security agreement giving Southern an interest in the same negotiable warehouse receipt to secure the loan. Southern does not file a financing statement covering the warehouse receipt or take possession of the warehouse receipt, but the security interest in the document is perfected temporarily under new section 9-312(e). On October 5, Lenny files a financing statement covering the warehouse receipt. On October 8, Southern makes another $5,000 advance to Donna pursuant to a discretionary future advance clause in the agreement signed by Donna on October 1. The same day, Southern files a financing statement covering the warehouse receipt. Donna defaults owing Southern $10,000 and Lenny $5,000 and the goods covered by the warehouse receipt are worth $10,000.

Which of the following statements correctly states the relative priorities of Lenny Lender and Southern Bank?

(a) Southern Bank gets the $10,000 worth of the goods covered by the negotiable warehouse receipt.

(b) Lenny Lender gets $10,000 worth of the goods covered by the negotiable warehouse receipt.

(c) Southern Bank gets $5,000 worth of the goods covered by the negotiable warehouse receipt and Lenny Lender gets $5,000 of the goods covered by the negotiable warehouse receipt.

How much of the goods would Southern Bank get if it had made a binding commitment to lend the second $5,000 at the time of the first $5,000?

4. Proceeds Disputes

Under former Article 9, certain disputes among conflicting claims to proceeds were governed by the rules applicable to special types of collateral, for example, the purchase-money priority rules of former sections 9-312(3) and (4). However, the first-to-file-or-first-to-perfect rule of former section 9-312(5)(a) governed most proceeds disputes. For purposes of applying the first-to-file-or-first-to-perfect rule, under former section 9-312(6), a date of filing or perfection as to the original collateral was the date of filing or perfection as to the collateral.

Under new Article 9, once again, if a security interest has priority over a conflicting interest in the same collateral under the first-to-file-or-first-to-perfect rule of new section 9-322(a)(1), then the security interest generally will also have priority as to the proceeds. New section 9-322(b) tracks former section 9-312(6) by providing that for the purposes of applying the first-to-file-or-first-to-perfect rule a time of filing or time of perfection as to proceeds is the time of filing or perfection as to the original collateral. Consequently, generally speaking, under new Article 9, as between parties holding non-purchase-money security interests in most collateral, the party who files or perfected first as to the original collateral has priority as to the proceeds.

You may explore the new Article 9 rules governing basic proceeds disputes in the next two problems.

Problem 28.7 (INTERACTIVE)

Central Bank and Ready Lender have non-purchase-money security interests in Delia Debtor's inventory, existing and after acquired. Both Central and Ready Lender perfected by filing, but Central filed first. Who has priority as to accounts receivables generated by the sale of Delia's inventory?

Problem 28.8 (INTERACTIVE)

Assume the facts of Problem 28.7. Assume further, however, that Central Bank's security interest is in Delia Debtor's accounts receivables, existing and later-acquired, rather than inventory and Central filed a financing statement covering the accounts before Ready Lender filed a financing statement covering the inventory.

Who has priority as to accounts generated by the sale of Delia's inventory?

Suppose that Ready Lender filed its financing statement covering Delia's inventory before Central filed a financing statement covering Delia's accounts. Who has priority as to accounts generated by the sale of Delia's inventory?

As will be discussed fully in subpart C below, purchase-money security interests may have priority over a conflicting interest as to which the purchase-money security interest would be subordinate under the first-to-file-or-first-to-perfect rule.

C. Purchase-Money Security Interests

1. Generally

Purchase-money security interests received special treatment under former Article 9 and the same is true under new Article 9. Under new Article 9, new section 9-324 governs. This section covers cases dealt with in former sections 9-312(3) and (4) and is expanded to reach a total of five categories of purchase-money security interests. The five cases are:

(1) Conflicts between non-purchase-money security interests and purchase-money security interests in collateral that is *other than* inventory or livestock;

(2) Conflicts between non-purchase-money security interests and purchase-money security interests in inventory;

(3) Conflicts between non-purchase-money and purchase-money security interests in livestock;

(4) Conflicts between non-purchase-money and purchase-money security interests in software; and

(5) Conflicts between competing purchase-money security interests in the same collateral.

The extent to which the priority awarded purchase-money security interests in collateral in each category carries over to proceeds is explained in connection with the discussion of the priority rules governing each category of purchase-money security interest. As to certain collateral, new Article 9 has added special rules governing proceeds and the discussion of these rules is deferred to Chapter 29 (Secured Party Versus Secured Party (continued)).

2. Purchase-Money Security Interests in Other Than Inventory or Livestock

a. Original Collateral

The rules governing disputes between non-purchase-money and purchase-money security interests in *other than inventory or livestock* collateral are the most straightforward and we start with these rules. Under former section 9-312(4), a purchase-money security interest in collateral other than inventory had priority over a conflicting security interest in the same collateral if the purchase-money security interest was perfected at the time the debtor received possession of the collateral or within ten days thereafter.

As is discussed below, the special priority as to original collateral carried over to proceeds of the collateral. The rules of former section 9-312(4) thereby trumped (or "primed") the usual first-to-file-or-first-to-perfect priority rules of former section 9-312(5)(a) and former section 9-312(6). The special priority was given to encourage the infusion of new assets and credit into a debtor's business.

New section 9-324(a) basically reenacts former section 9-312(4) to create an identical priority for purchase-money security interests in other than inventory. It differs in three respects. First, there is a special rule for purchase-money security interests in livestock found in new section 9-324(d) and the rule of new section 9-324(a) applies to goods other than inventory or livestock. Second, the ten-day time period is extended to twenty days. Third, the extent to which the special priority carries through to proceeds is subject to new section 9-327. The livestock and proceeds rules are considered below.

Under new section 9-324(a) a purchase-money security interest in collateral that is other than inventory or livestock has priority over a non-purchase-money security interest in such collateral IF the purchase-money security interest is perfected when the debtor receives possession of collateral or within twenty days thereafter. As with former section 9-312(4), the special priority is given to the purchase-money party to encourage the infusion of new assets and credit into the debtor's business.

It should be noted that there is no negative inference in new section 9-324(a). Consequently, a holder of a purchase-money security interest in other than inventory or in livestock who fails to satisfy the conditions for the special priority under new section 9-324(a) does not necessarily lose to a competing party because the dispute then is governed by new section 9-322(a) and the purchase-money party could prevail under the first-to-file rule.

The operation of new section 9-324(a) is the subject of the next problem.

Problem 28.9 (INTERACTIVE)

Western Bank lends to Delia Debtor and takes a security interest in Delia's equipment, existing and after-acquired. Western properly files a financing statement covering Delia's equipment. Selma Seller sells Delia a drill press and takes a security interest in the drill press sold to secure its price. Selma delivers the drill press to Delia the next day. Ten days later Selma files a financing statement covering the drill press.

Who has priority as to the drill press sold by Selma?

If Selma delayed filing a financing statement for 30 days following delivery of the drill press to Delia *and* Western did not file until 31 days after the delivery of the drill press to Delia, who would have priority as the drill press?

b. Proceeds

Under new section 9-324(a), subject to new section 9-327, the special priority for a purchase-money security interest in other than inventory or livestock carries over to the proceeds of such collateral. As is more fully explained in Chapter 29 (Secured Party Versus Secured Party (continued)), new section 9-327 gives a holder of a security interest in a deposit account who has perfected the security interest by control priority over security interests perfected otherwise than by control.

Therefore, if a holder of a purchase-money security interest in other than inventory or livestock perfects the security interest within twenty days of possession of the collateral by the debtor then the holder of the security interest has priority not only as to the original collateral but also the proceeds of the collateral, except if the proceeds are a deposit account and another creditor has perfected a security interest in the deposit account by control.

As noted above, there is no negative inference in new section 9-324(a) and if a party does not qualify for the special priority for proceeds under new section 9-324(a) then the dispute is governed by new section 9-322(a).

You may explore the application of new section 9-324(a) to a proceeds dispute in the next problem.

Problem 28.10 (INTERACTIVE)

Assume the facts of Problem 28.9. Assume further, however, that Delia Debtor sold the drill press and received a check identifiable as having been received for the drill press.

Who as between Selma Seller and Western Bank would have priority to the check?

If Selma delayed filing a financing statement for thirty days following delivery of the drill press to Delia who would have priority as to the check?

3. Purchase-Money Security Interests in Inventory

a. Original Collateral

The priority rules for purchase-money security interests in inventory are considerably more complicated than those for purchase-money security interests in other than inventory and livestock. Under former section 9-312(3), a perfected purchase-money security interest in inventory had priority over a conflicting security interest in the same inventory and also had priority in identifiable cash proceeds received on or before the delivery of the inventory to a buyer if the conditions spelled out in former section 9-312(3) were satisfied.

In particular, the special priority was conditioned on a requirement that other secured parties of record be timely notified of an impending sale. As is discussed below, the special priority in former section 9-312(3) carried over to proceeds to a much more limited extent than provided for in former section 9-312(4) for other than inventory.

As with former section 9-312(4), the purpose of the special priority of former section 9-312(3) was to encourage new financing. The rule put holders of outstanding inventory interests at risk in that any advances they made after the purchase-money interest attaches could be subordinated. The notification requirement was intended to allow non-purchase-money parties to withhold further advances. *See* Official Comment 3 to former 9-312.

The new Article 9 priority rules for purchase-money security interests in inventory are found primarily in new sections 9-324(b) and (c). The rules are more elaborate than those in former Article 9, but insofar as original collateral is concerned, the basic scheme is the same. Thus, under new section 9-324(b), a purchase-money security interest in inventory has priority over a conflicting security interest if:

(1) the security interest is perfected before the debtor gets possession of the inventory;

(2) the purchase-money secured party sends an authenticated notification to the holder of a conflicting non-purchase-money security interest entitled to notification under new section 9-324(c);

(3) the holder of the conflicting security interest entitled to notification under new section 9-324(c) receives the notification within five years before the debtor receives possession of the inventory; and

(4) the notification states that the person sending the notification has or expects to acquire a purchase-money security interest in inventory of the debtor and describes the inventory.

Under new section 9-324(b)(1) the special priority applies only if the purchase-money security interest is perfected before the debtor gets possession of the inventory. Under new section 9-324(b)(3) the required notification must be received by a party entitled to notification within five years before the debtor receives possession. The five-year period is understood to correspond to the time after which a filing lapses under new section 9-515. As to lapse, *see* Chapter 14 (The Nitty Gritty of Filing). The question could arise as to how the requirements predicated on possession should apply where the debtor never receives possession (for example, where goods are shipped directly to a third party). Official Comment 5 to new section 9-324 answers the question as follows:

> If the debtor never receives possession, the five-year period never begins, and the purchase-money security interest has priority, even if notification is not given.

This conclusion seems not to take account of the purpose of the notification requirement to protect prior non-purchase-money parties, *see* Official Comment 4 to new section 9-324, but how the requirements predicated on possession by the debtor could be interpreted differently where the debtor does not get possession is not readily apparent. As explained below, the same questions arise with respect to the special priority for purchase-money security interests in livestock that are farm products in new section 9-324(d).

New section 9-324(c) spells out which holders of conflicting security interests are entitled to notification under new section 9-324(b). Under new section 9-324(c)(1), a holder of a conflicting security interest is entitled to notification if the holder of the conflicting interest filed a financing statement covering the same type of inventory before the purchase-money party filed a financing statement.

New section 9-324(c)(2) governs where the purchase-money party perfected temporarily without filing or perfection under new section 9-312(f). In such a case the holder of the conflicting security interest is entitled to notification if it filed a financing statement before the beginning of the twenty-day period for temporary perfection under new section 9-312(f).

Whether the notification scheme achieves its intended purpose of opening up new secured credit opportunities is open to doubt. Creditors who lend against inventory generally expect to have the only security interest in inventory. The parties contemplate that additional inventory will be acquired with additional loan funds from the inventory party or on open (unsecured credit).

There may well be a provision in the security agreements between such lenders and the debtors barring the creation of other inventory security interests. Under new section 9-401, as discussed in Chapter 25 (The Why and How of Priority), the security agreement prohibition will not prevent the creation of a purchase-money security interest, but violation of the prohibition will be a default allowing the inventory lender to foreclose. Therefore, notification of an impending purchase-money security interest could produce a default and a foreclosure by an inventory lender.

The result is that debtors generally will not grant purchase-money security interests in inventory as to which there are outstanding security interests and will instead seek unsecured credit or try to work out an accommodation with the inventory lender. Ultimately, the extent to which suppliers of inventory will sell other than on a secured basis of course is dependent on how much they want the debtor's business and their risk tolerance as to the particular debtor.

To test your understanding of the new Article 9 purchase-money priority rules under new sections 9-324(b) and 9-324(c), consider the next problem.

Problem 28.11 (INTERACTIVE)

Lenny Lender has a security interest in Donna Debtor's inventory of appliance parts, existing and later-acquired. Lenny perfected its security interest by filing. Southwestern Bank is about to finance Donna's acquisition of new appliance parts. Southwestern is aware of Lenny's security interest and does not wish to lend to Donna unless it can be sure it will have priority over Lenny as to the new appliance parts.

Can you give Southwestern the assurance it desires?

If so, what must Southwestern do to be sure of the priority it seeks?

Does Southwestern risk putting Donna into default by sending the required notification?

What if the appliance parts the purchase of which was to be financed by Southwestern were to be shipped directly to buyers from the supplier and Donna would never receive possession. Would your answers change and, if so, how?

b. Proceeds

The special priority for proceeds in former section 9-312(3) was quite limited. It obtained only as to identifiable cash proceeds, as defined in former section 9-306(1) -- *see* Chapters 9 (The Specifics of Enforceability -- After-Acquired Property, Proceeds and Future Advances) and 16 (Perfecting Security Interests in Proceeds and Other Later Acquired Property) -- and did not apply to such important collateral as accounts and chattel paper.

Moreover, to be eligible for the special priority of former section 9-312(3) the cash proceeds must have been received on or before delivery of the inventory to *a buyer from the debtor*. Therefore, down payments received before delivery of inventory to a buyer would get the special priority, but installments received after delivery would not. And, of course, the priority as to certain identifiable cash proceeds was available only if the purchase-money secured party met the requirements set out in former section 9-312(3) for priority as to the original collateral.

Priority as to non-cash proceeds and otherwise eligible proceeds where the secured party had not complied with the requirements of former section 9-312(3) was governed by the first-to-file-or-first-to-perfect priority rule contained in former sections 9-312(5)(a) and 9-312(6).

New Article 9 preserves the special limited priority for proceeds of inventory for holders of purchase-money security interests in inventory. Thus, new section 9-324(b) provides a priority for identifiable cash proceeds (as defined in new section 9-102(a)(9)) received on or before delivery of inventory to a buyer from the debtor, but leaves disputes as to most non-cash proceeds to the general proceeds rules. However, there have been some changes from former Article 9.

Under new section 9-324(b), a purchase-money secured party "has priority over a conflicting security interest in chattel paper or an instrument constituting proceeds of the inventory and proceeds of the chattel paper, if so provided in section 9-330." This part of new section 9-324(b) is confusing at best.

New section 9-330 provides for a special priority for purchasers of chattel paper and the proceeds of chattel paper and purchasers of instruments under specified conditions. But, it is difficult to conceive of a situation where a conflict as to proceeds of inventory implicates both the limited proceeds priority of new section 9-324(b) and the proceeds priority given by new section 9-330. Therefore, discussion of new section 9-330 as it could apply to the proceeds of a purchase-money security interest in inventory is properly deferred to Chapter 29 (Secured Party Versus Secured Party (continued)).

Note further here, however, that the protection given to identifiable cash proceeds in new section 9-324(b) is subject to new section 9-327. As is explained in Chapter 29 (Secured Party Versus Secured Party (continued)), a security interest in a deposit account that is perfected by control has priority over a security interest in that deposit account perfected otherwise than by control. Consequently, if proceeds of inventory are cash proceeds in the form of a deposit account, the priority given to a purchase-money security interest in identifiable cash proceeds gives way to a security interest in the deposit account that was perfected by control.

You may test your understanding of the limited extent to which the priority given to a purchase-money security interest in inventory carries over to proceeds in the next two problems.

Problem 28.12 (INTERACTIVE)

Assume the facts of Problem 28.11. If Southwestern Bank satisfies the conditions in new section 9-324(b) for priority over Lenny Lender as to inventory acquired with financing provided by Western, who has priority as between Southwestern and Lenny to the various proceeds referred to below:

(a) Cash down payments made by the buyers of appliance parts from Donna Debtor and received before delivery of appliance parts to the buyers?

(b) Monthly installment payments made by the buyers of appliance parts from Donna Debtor after delivery of the appliance parts to the buyers?

(c) Appliance parts traded in by the buyers of new appliance parts from Donna Debtor before delivery of the new appliance parts to the buyers?

Explain your answers.

Problem 28.13 (INTERACTIVE)

Southern Bank has a purchase-money security interest in Donald Debtor's inventory of automobile parts. Southern perfected by filing before Donald received possession of the automobile parts and Southern has otherwise satisfied new section 9-324(b). Following the agreement with Southern, Donald borrowed from Lisa Lender and gave Lisa a security interest in accounts generated by the sale of the automobile parts. Lisa perfected by filing as to the accounts.

Who has priority as to the accounts generated by the sale of the automobile parts, Southern or Lisa?

Would your answer be different if Lisa filed as to the accounts before Southern filed and otherwise satisfied the requirements of new section 9-324(b) as to its purchase-money security interest in the automobile parts?

4. Purchase-Money Security Interests in Livestock

a. Original Collateral

New Article 9 adds a special priority for purchase-money security interests in livestock. More accurately, the priority is for purchase-money security interests in livestock *that are farm products*. Recall under new section 9-102(a)(34), livestock are farm products only where the debtor is engaged in a farming operation. The new priority rules are found in new sections 9-324(d) and (e).

New sections 9-324(d) and (e) are patterned after new sections 9-324(b) and (c) providing for priority for purchase-money security interests in inventory and proceeds under certain specified conditions, and discussed in subpart C(3) above. As with the inventory case, under new section 9-324(d)(1), the priority for the holder of a purchase-money security interest in livestock requires that the security interest be perfected when the debtor receives possession of the livestock. Also as to the priority for livestock, there must be timely notification to the earlier filed interests defined in new section 9-324(e), as required by new sections 9-324(d)(2), (d)(3) and (d)(4). *See* Official Comment 10 to new 9-324.

For reasons that are not apparent the notification required by new section 9-324(d) must be received within six months before the debtor receives possession of the livestock as contrasted with the five-year period provided for in new section 9-324(b) providing for a special priority for purchase-money security interests in inventory.

As is the case with inventory and as was discussed in subpart C(3) above, the question could arise as to how the perfection before possession and notification within six months of possession requirements are to be applied where the debtor never receives possession. As was noted in that subpart, Official Comment 5 to new section 9-324 indicates that where the debtor never receives possession, the requirements of new section 9-324(b) for inventory predicated on possession by the debtor do not apply if the debtor does not receive possession and this conclusion may well carry over to new section 9-324(d).

As discussed in the next subpart, the rules providing for a special priority for purchase-money security interests in livestock departs from that for inventory insofar as proceeds are concerned.

b. Proceeds

As noted, the special priority for purchase-money security interests in livestock that are farm products under new section 9-324(d) resembles that for inventory, but is broader with respect to the treatment of proceeds. First, as is the case with new section 9-324(a) (other than inventory and livestock), subject to the rule in new section 9-327 governing security interests in deposit accounts perfected by control, the special priority carries through to all identifiable proceeds and not just certain cash proceeds.

Second, the special priority extends to identifiable *products* of livestock in their unmanufactured states. Thus, if a security agreement covers livestock and the financing statement does also, there is a perfected security interest in the livestock and the secured party with a purchase-money security interest in livestock that constitutes farm products under new section 9-102(a)(34) will have priority as provided for in new section 9-324(d) as to identifiable products of the livestock in their unmanufactured states, including calves and colts. *See* Official Comment 10 to new 9-324.

Note, however, that if a secured party has a purchase-money security interest in specific collateral, such as a prize breeding bull, and the security agreement describes the collateral as "debtor's prize breeding bull," then there is no security interest in the products of the bull unless the security agreement so provides. In contrast to proceeds, Article 9 does not give a secured party an interest in products of collateral (unless the products somehow constitute proceeds under the definition of "proceeds" in new section 9-102(a)(64), which would not be so as to offspring of livestock). In short, there must be a security interest in collateral before there can be a conflict as to which the special priority applies.

You may test your understanding of the special priority for purchase-money security interests in livestock that are farm products as it applies to original collateral and proceeds and products in the next problem.

Problem 28.14 (INTERACTIVE)

Central Bank lends to Donald Debtor who raises and sells beef cattle. Donald gives Central a security interest in Donald's cattle, existing and later-acquired. Central properly files a financing statement covering Donald's cattle. Subsequently, Donald purchases a prize breeding bull, Super Stud, from Bulls R Us, a wholesaler of breeding bulls. Donald signs a security agreement giving Bulls R Us a security interest in Super Stud to secure its price. Bulls R Us knows about Central's security interest and wishes to be assured of the priority of its security interest in Super Stud over that of Central.

Can Bulls R Us be given such assurance? If so, how so?

If Donald sells Super Stud will any priority as to Super Stud extend to identifiable non-cash as well as cash proceeds?

Suppose Bulls R Us also desires to have a superior security interest in calves sired by the bull. Will satisfying the conditions for priority as to Super Stud assure Bulls R Us of priority as to the calves?

The question may arise as to whether purchase-money security interests in aquatic goods qualify for the special priority in new section 9-324(d) and (e). Aquatic goods are within the definition of "farm products" in new section 9-102(a)(34), but it is left to the courts to decide in a given case whether the goods are crops or livestock. *See* Official Comment 11 to new 9-324. If the aquatic goods, for example, shrimp raised on a shrimp farm, are livestock then they will be within new sections 9-324(d) and (e). If the aquatic goods are crops it is unclear how they will be treated. It seems that the special priority rule for other than inventory, discussed in subpart C(1) above, would apply, but where there is not timely perfection then the first-to-file or first-to-perfect rule of new section 9-322(a) governs.

The drafters have proposed for adoption, Model 9-324A, an optional provision for production security interests and where adopted that provision would govern a crops case. *See* Official Comment 11 to new 9-324. The model provision would replace former section 9-312(2), which was not adopted in most states and is not included in new Article 9. *See* Official Comment to Model 9-324A. *But cf.* Chapters 20 (Perfection as to Fixtures and Other Real Estate-Related Collateral) and 32 (Fixtures Priorities).

5. Purchase-Money Security Interests in Software

a. Original Collateral

New Article 9 adds a priority rule for purchase-money security interests in software. As we saw in Chapter 5 (Classification of Collateral), dealing with classification, and Chapter 18, dealing with automatic perfection, under new section 9-103(c), a purchase-money security interest in software arises only if the debtor acquires its interest in the software for the principal purpose of using the software in goods subject to a purchase-money security interest.

Under new section 9-324(f), a purchase-money security interest in software has the same priority as the purchase-money security interest in the goods in which the software was acquired for use. The priority of the interest in the goods is determined by new section 9-324(a), for other than inventory, and new section 9-324(b), for inventory. Subparts C(2) (other than inventory) and C(3) (inventory) should be consulted as to the operation of the special priority rules for purchase-money security interests in such collateral.

b. Proceeds

Because the priority given to a purchase-money security interest in software depends on whether the goods in which the software was acquired for use is other than inventory or inventory, the proceeds rules of new section 9-324(a) (other than inventory) and new section 9-324(b) (inventory) apply to conflicts involving proceeds of software subject to a purchase-money security interest. Again, subparts C(2) and C(3) should be consulted.

You may test your understanding of the priority rules for purchase-money security interests in software in the next problem.

Problem 28.15 (INTERACTIVE)

Donna Debtor purchases a computer on which Windows software is installed from Sid Seller for use in her business. The purchase is on credit and Sid takes a security interest in the computer and the software to secure the price of each. Lisa Lender holds a security interest on Donna's equipment, existing and after-acquired. Lisa filed a financing statement covering Donna's equipment before Donna purchased the computer and software. Which of the following accurately states the conditions under which Sid's security interest in the software has priority over that of Lisa?

(a) Sid will have priority over Lisa as to the software if Sid perfects its security interest in the computer before or within 20 days after Donna gets possession of the computer and Sid timely notifies Lisa of its impending interest in the computer.

(b) Sid will have priority over Lisa as to the software if Sid perfects its security interest in the computer before Donna gets possession of the computer and Sid timely notifies Lisa of its impending interest in the computer.

(c) Sid cannot get priority over Lisa as to the software under any conditions.

(d) Sid will have priority over Lisa as to the software if Sid perfects its security interest in the computer before or within 20 days after Donna gets possession of the computer.

Assume Sid satisfies the conditions for priority over Lisa as to the computer. If Donna sells the computer with the software installed in it for cash, who has priority as to the cash, Sid or Lisa?

6. Competing Purchase-Money Security Interests in the Same Collateral; Accessions and Commingled Goods

It is possible for more than one creditor to have a purchase-money security interest in the same collateral. Under former Article 9 there was a difference of opinion as to what should happen in such a case. One could reasonably argue that in a case of conflicting purchase-money security interests in the same collateral, the holders of the interests should share pro rata, *i.e.*, each creditor should get a percentage of the value of the collateral that corresponds to that part of the price of the collateral financed by that creditor. However, the prevailing view seemed to be that the priority should be resolved under the first-to-file-or-first-to-perfect rule. *See, e.g.*, *John Deere Co. v. Production Credit Ass'n*, 686 S.W.2d 904 (Tenn. App. 1984).

New Article 9 has added a provision that specifically addresses conflicts between competing purchase-money secured parties. Under new section 9-324(g)(1), if more than one security interest in the same collateral qualifies for the special priority given by new sections 9-324(a) (other than inventory or livestock), (b) (inventory), (d) (livestock) or (f) (software), then a security interest securing the unpaid price of the collateral has priority over a security interest securing a loan obligation incurred to enable the debtor to acquire rights in the collateral.

Under new section 9-324(g)(1), therefore, as between a seller and a lender, the seller is preferred. According to Official Comment 13 to new section 9-324, the rationale for this rule, which is adopted from real estate law, is that the equities favor sellers because sellers part with specific property rather than money and they would not part with property except on the understanding that the seller will have access to the property to satisfy the obligation. Under new section 9-324(g)(2), as between lenders, new section 9-322(a) governs.

To test the application of new section 9-324(g) consider the next problem.

Problem 28.16 (INTERACTIVE)

Donna Debtor purchases a computer for use in her business from Selma Seller on credit. The sales price is $4,000. Donna pays $1,600 down and promises to pay the balance of $2,400 in 12 equal monthly installments. Selma takes an interest in the computer to secure the unpaid price. Selma delivers the computer the same day. The next day Selma files a financing statement covering the computer. Donna borrowed one-half the down payment from her brother, Bob, two days before the purchase, and borrowed the other half of the down payment from his mother, Mary, the day before the purchase. Bob and Mary each took a security interest in the computer to secure their loans and each filed a financing statement covering the computer the day of the loan by each. Donna defaults as to all three debts owing Selma $2,000 and Bob and Mary $500 each. The computer is worth $2,500.

Who gets what under new section 9-324(g)? Explain your answers.

Suppose that Selma Seller delayed filing until 30 days after the delivery of the computer to Donna Debtor. How would the proceeds from the sale of the computer be distributed now?

You should be aware that conflicting purchase-money security conflicts can arise in situations involving accessions and commingled goods. There were special rules in former section 9-314 and 9-315 for dealing with such accession and commingled goods conflicts. New Article 9 has reenacted these rules in somewhat simplified form in new sections 9-335 and 9-336.

D. Priority Among Holders of Assigned Security Interests

The following case decided under former Article 9 offers an interesting opportunity to consider a number of points dealt with in Chapter 28 and prior chapters. The facts are somewhat complicated, but the court's analysis makes wading through the facts worth the effort.

Interbusiness Bank, N.A. v. First National Bank of Mifflintown

Problem 28.17 (INTERACTIVE)

Explain why the security interest of Interbusiness had priority over that of First National but First National still prevails.

Would the analysis or outcome be any different under new Article 9?

If the facts were that First National had been assigned the financing statement filed first by Allied Capital and Interbusiness had been assigned the second security interest perfected by the later filed financing statement, who would have priority?

For a more recent case addressing some of the same issues as those involved in the *Interbusiness* case but applying new Article 9 provisions, *see* *Retenbach Constructors, Inc. v. CM Partnership*, 639 S.E.2d 16 (N.C. App. 2007).

CASE COMMENTARY

Borley Storage and Transfer Co., Inc. v. Whitted, 271 Neb. 84, 710 N.W.2d 71 (Neb. 2006)

Retenbach Constructors, Inc. v. CM Partnership, 639 S.E.2d 16 (N.C. App. 2007)

Genesee Regional Bank v. Palumbo, 779 N.Y.S.2d 883 (N.Y. Supreme Court 2005)

First National Bank v. Lubbock Feeders, L.P., 183 S.W.3d 875 (Tex. App. 2006)

Sunflower Bank, N.A. v. Kindsvater, 144 p.3d 81 (Kan. App. 2006)

In re Millivision, Inc., 474 F.3d 4 (1st Cir. 2007)

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Part VI Priority

Chapter 29 Secured Party Versus Secured Party (continued)

A. Special Priority Rules for Certain Collateral

Under new section 9-322(f), the priority rules discussed in Chapter 28 (Secured Party Versus Secured Party) are subject to special priority rules in new sections 9-327, 9-328, 9-329, 9-330, 9-331 and 9-332, dealing with priority as to certain types of collateral ("the other rules of this part" as that language appears in new section 9-322(f)).

Other than for the exceptional cases dealt with in new section 9-330(c)(2), disputes as to proceeds of the collateral discussed in this subpart are governed by the rules in new section 9-322, including especially those in new sections 9-322(c), (d) and (e), discussed in subpart B below.

1. Priority of Conflicting Security Interests in a Deposit Account.

New section 9-327 sets forth four rules governing conflicts involving security interests in deposit accounts perfected by control. The meaning of control as to a deposit account is governed by new section 9-104. *See* Chapter 22 (Perfection as to Deposit Accounts, Letter of Credit Rights and Electronic Chattel Paper). New section 9-327(1) provides that a security interest in a deposit account perfected by control has priority over a security interest not perfected by control. Implicitly, under new section 9-327(1), a security interest in a deposit account perfected by control would have priority over an unperfected security interest in a deposit account.

Perfection by filing or automatically of a security interest in a deposit account is possible only to the extent the deposit account is proceeds because control is the exclusive mode of perfection as to a deposit account as original collateral. *See* new section 9-312(b)(1) and Chapters 12 (Perfection Generally) and 22 (Perfection as to Deposit Accounts, Letter of Credit Rights and Electronic Chattel Paper). Section 9-327(1) would give priority to a security interest in a deposit account perfected by control over a security interest in a deposit account perfected by filing or perfected automatically because, under the language of the provision, a secured party having control "has priority over a conflicting security interest held by a secured party that does not have control."

New section 9-327(2) governs priority in the rare case where a bank enters into a control agreement under new section 9-104(a)(2) with more than one secured party. Under new section 9-327(2), the security interests perfected by control rank according to the time control was achieved.

If the bank with which a deposit account is maintained extends credit to a customer secured by an interest in the deposit account, the bank is perfected by control under new section 9-104(a)(1). Under new section 9-327(3), a bank with which a deposit account is maintained normally has priority over all conflicting security interests in the deposit account, whether the competing secured parties claim interests in the deposit account as original collateral or as proceeds. The rule of new section 9-327(3) allows a bank to extend credit to a depositor without the need to examine the public records or its own records to determine whether there is a conflicting security interest in the deposit account.

A secured party other than the bank can protect itself against the rule in new section 9-327(3) by becoming the bank's customer as to the deposit account. Becoming a customer on an account is a way of getting control under new section 9-104(a)(3) and, under new section 9-327(4), a secured party who achieves control in this fashion gets priority over a bank with which the deposit account is maintained.

New section 9-104(a)(3) can affect the result of a priority dispute between a bank at which a deposit account is maintained and a secured party claiming a security interest in that account in a less obvious way. As explained in Chapter 4 (Scope of Article 9), rights of set-off are generally outside the scope of Article 9. As further explained in Chapter 31 (Secured Party Versus Statutory Liens Including Federal Tax Liens and Agricultural Liens), new section 9-340(a) gives priority to a bank exercising a right of set-off against a secured party holding a security interest in a deposit account.

However, the priority given by new section 9-340(a) is qualified by new section 9-340(c), which provides that "the exercise by a bank of a set-off against a deposit account is ineffective against a secured party that holds a security interest in the deposit account which is perfected by control under Section 9-104(a)(3), if the set-off is based on a claim against the debtor".

As noted above, the priority given by the rules of new section 9-327 does not extend to security interests in the proceeds *of a* deposit account. Priority as to *proceeds of a* deposit account is governed by new sections 9-322(c) through (e), as discussed in subpart B below.

Moreover, under new section 9-332(b), a transferee of funds from a deposit account takes the funds free of a security interest in the deposit account unless the transferee acts in collusion with the debtor to violate the rights of the secured party. For example, when a debtor draws a check on a deposit account subject to a security interest the payee on the check may cash the check and take the funds free of the security interest unless the payee acted in collusion with the debtor.

Under new section 9-332(b), the transferee takes free of any security interest without regard to whether the transferee has given value or relied on the transfer to its detriment. According to Official Comment 3 to new section 9-332, the policy of new section 9-332 is to help ensure that security interests in deposit accounts do not impair the free flow of funds.

In *Sonic Engineering, Inc. v. Konover Construction Co. South*, 51 UCC Rep Serv. 2d 844 (Conn Super Ct 2003), the court rejected an attempt by a judgment creditor to rely on new section 9-332(b) in a dispute with a secured party over a cashiers check issued to a marshal who had levied on a deposit account in which the secured party had a security interest perfected by control, essentially because the check had not been issued to the judgment creditor and the marshal, as an officer of the court, could not be the judgment creditor's agent.

You may test the application of new section 9-327 in the next problem.

Problem 29.1 (INTERACTIVE)

Lenny Lender lends to Delia Debtor and Delia signs a security agreement giving Lenny a security interest in a general bank account maintained at Northern Bank. Lenny immediately files a financing statement. Delia also borrowed from Northern and gave Northern a security interest in the bank account maintained at Northern. Northern did not file a financing statement.

Who has priority as to the bank account?

If Lenny were claiming the bank account as proceeds of an inventory security interest that Lenny could prove were identifiable proceeds and Lenny had filed as to the inventory before Northern took an interest in the bank account to secure its loan, as between Lenny and Northern who would have priority?

What could Lenny have done to gain priority over Northern? Explain your answer.

If Delia drew a check on the bank account maintained at Northern payable to Paul Payee and Paul cashed the check before either Lenny or Northern was able to reach the bank account to satisfy the debt owed by Delia (*i.e.*, before default and foreclosure), would either Lenny or Northern be able to recover the money paid out of the bank account to Paul?

2. Priority of Security Interests in Investment Property.

New section 9-328 contains several rules that govern priority among conflicting security interests in investment property. In Chapter 21 (Perfection as to Investment Property) it was explained that a security interest in investment property may be perfected by filing, delivery, control and, even automatically. However, control is the preferred mode of perfection. Thus, new section 9-328(1) states the most important general rule, namely, that a secured party who obtains control has priority over a secured party who does not have control.

Under this rule a secured party who perfects a security interest in investment property by getting control of the property has priority over a secured party who has not perfected a security interest in the property or has perfected a security interest in that property automatically, by delivery, or by filing. The priority given by this rule does not turn on either temporal sequence or awareness of a conflicting security interest.

The other rule of most importance to secured parties generally is that found in new section 9-328(2). Under this rule the first party to obtain control has priority over another party who also has perfected by control. This rule is analogous to the first-to-file rule of section 9-322(a)(1) and is comparable to new section 9-327(1), dealing with deposit accounts. The section appears more involved than it is because it states the rule of ranking according to timing of control in terms of the particular kinds of investment property and as to which control is achieved in different ways under Article 8. *See* new section 9-106(a) and Chapter 21 (Perfection as to Investment Property).

New section 9-328(2) is subject to new sections 9-328(3) and 9-328(4), which, respectively, give priority to a security interest held by a securities intermediary in a security entitlement or in a securities account maintained with the securities intermediary and held by a securities intermediary and a security interest held by a commodity intermediary in a commodity account maintained with the commodity intermediary.

Under new section 9-328(5), a security interest in a certificated security in registered form that is perfected by delivery has priority over a security interest in such a security perfected otherwise than by control. This rule has an important practical application that requires some explanation. It has been common practice for secured parties to perfect security interests in certificated securities by taking possession. Taking possession constitutes "delivery" under Article 8, section 8-301. Such delivery results in control of a certificate in bearer form under Article 8, section 8-106(a). Under Article 8, section 8-106(b), there is control as to a security in registered form only if there is delivery and a proper indorsement.

However, delivery of a certificated security alone is sufficient to perfect a security interest in the security under new section 9-313(a). Therefore, a secured party who takes possession of a certificated security in registered form without an indorsement does not have control but has perfected under new section 9-313(a) and would have priority over a party who perfects a security interest in the certificated security otherwise than by control, such as by filing.

New section 9-328(6) provides that conflicting security interests among brokers, securities intermediaries and commodities intermediaries that are perfected without control under new section 9-106(a), are of equal rank. Finally, under new section 9-328(7), in all cases not governed by the rules stated in new sections 9-328(1) to 9-328(6), priority among conflicting security interests in investment property is governed by new sections 9-322 and 9-323.

You may consider the basics of the priority rules for investment property in the next two problems.

Problem 29.2 (INTERACTIVE)

Donald Debtor borrows from Lisa Lender and grants Lisa Lender a security interest in all 1000 shares of Eclectic, Inc. stock held through a securities account with Bart Broker. Lisa Lender perfects her security interest by filing a financing statement covering the shares of stock. Later, Donald borrows from Friendly Finance Company and gives Friendly a security interest in the 1000 shares of Eclectic stock. Friendly knows about Lisa's security interest. Friendly perfects its security interest by control under new section 9-106(a) and Article 8, section 8-106(d)(1).

Who has priority as to the shares of Eclectic stock?

Problem 29.3 (INTERACTIVE)

Delia Debtor borrows from Lenny Lender and grants Lenny a security interest in 10 shares of General Electric Co. stock in registered form. Lenny perfects by filing a financing statement covering the shares of stock. Later, Delia borrows from Friendly Finance Company and gives Friendly a security interest in the 10 shares of General Electric Co. stock. Friendly knows about Lenny's security interest. Friendly takes possession of the 10 shares of stock but Delia does not indorse the certificates.

Who has priority as to the 10 shares of General Electric Co. stock?

3. Priority of Security Interests in Letter of Credit Rights.

New section 9-329 governs priority among conflicting security interests in letter of credit rights. Consistently with international letter of credit practices, new section 9-329(1) awards priority to a secured party who perfects a security interest directly in letter-of-credit rights, *i.e.*, gets control over the letter-of-credit rights under new section sections 9-314(a) and 9-107, over another conflicting security interest held by a security party that does not have control. Conflicting security interests that are perfected by control rank according to priority in time of obtaining control.

4. Priority of Security Interests in Chattel Paper and Instruments.

a. Generally

A person who takes a security interest in property is a purchaser under Article 1, sections 1-201(b)(29)and (b)(30). Thus, parties who lend against chattel paper and other such collateral are purchasers of the chattel paper. In commercial financing, purchasers of chattel paper and instruments may leave the property in the possession of the debtor or take possession of it.

As has been noted, a person who leaves an instrument in the possession of a debtor risks losing out to a transferee who gets possession of the instrument, especially if the instrument is negotiable. This risk is explored in subpart A(4)(c) below. A person who leaves chattel paper in the possession of a debtor also risks subordination. The reason is that there is a special priority for purchasers who take possession under conditions specified in new section 9-330 (formerly section 9-308). New Article 9 extends the special priority to purchasers who get control of electronic chattel paper.

b. Chattel Paper

i. Priority as to chattel paper claimed merely as proceeds of inventory

Under new section 9-330(a), a purchaser of chattel paper has priority over a security interest in the chattel paper that is claimed merely as proceeds of inventory if:

the purchaser gives new value;

the purchaser takes possession of the chattel paper or the purchaser obtains control of the chattel paper under new section 9-105;

the purchaser takes possession or obtains control in good faith;

the purchaser takes possession or obtains control in the ordinary course of the purchaser's business; and

the chattel paper does not indicate that it has been assigned to an identified assignee other than the purchaser.

The meaning of "merely as proceeds of inventory" is not defined. Essentially, it refers to the usual inventory financing situation where a creditor has lent against inventory as the primary collateral and has a claim to chattel paper only to the extent that the paper constitutes identifiable proceeds of the inventory.

Under former section 9-308(b) a purchaser could have priority even though the purchaser knew that the chattel paper was subject to a security interest. New section 9-330(a) eliminates any reference to knowledge. However, it adds a requirement that the chattel paper not indicate that it has been assigned to an identified assignee other than the purchaser. According to Official Comment 5 to new section 9-330, the approach comports with the expectations of the parties that what the purchaser actually knows or does not know is not relevant.

An inventory financer might require a dealer to use pre-printed form contracts that bear a legend indicating that the paper is subject to a security interest in favor of the inventory financer or require that the dealer stamp the contracts to indicate that the inventory financer has a security interest and such a legend or stamp should deny a purchaser priority under new section 9-330(a). However, a legend or stamp to the effect that the paper is subject to a security interest would not seem to be an indication that the paper has been assigned to "an identified assignee."

It is not clear why a specific legend on chattel paper should deny the priority given by new section 9-330(a) even though knowledge of the existence of a security interest does not. But, the requirement is more easily applied than one that makes knowledge relevant.

As noted above, to qualify for the special priority in new section 9-330(a), the purchaser must take the chattel paper in good faith. Under former Article 9, the requirement to act in good faith normally was easily met because good faith was defined in former Article 1, section 1-201(19) to mean honesty in fact, an essentially subjective test. However, as originally proposed and adopted, new Article 9, in new section 9-102(a)(43), expanded the definition of good faith to require not only honesty in fact but also "the observance of reasonable commercial standards of fair dealing". Later, section 9-102(a)(43) was omitted and the additional requirement was added to the definition of good faith in what is now section 1-201(b)(20) of Article 1. *See* Official Comment 20 to Article 1 (tracing the development of the current definition of good faith through Article 2, section 2-103 (Sales of Goods), Article 3, section 3-103 (Negotiable Instruments) and new 9-102 (Secured Transactions), to its present embodiment in Article 1, section 1-201(b)(20) (Applicable to all articles)).

As discussed at some length in Chapter 27 (Secured Party Versus Buyer), not all states have adopted the proposed revision of the definition of good faith in Article 1. Several states have retained the more limited, honesty in fact, definition. A review of which states have adopted the expanded definition and which states have retained the narrower definition may be found at: http://www.law.unlv.edu/faculty/rowley/ra1_updates.htm.

However, a state retaining the narrower definition in Article 1 may nonetheless have adopted and retained new section 9-102(a)(43) containing the expanded definition of good faith. Arizona is one such state. In states that have adopted the narrower "honesty in fact" definition of good faith in Article 1, but the broader "honesty in fact" and "the observance of reasonable commercial standards of fair dealing" in Article 9, the question arises as to which definition governs good faith determinations necessary to the application of a new Article 9 priority provision. Arguably, the definition specific to Article 9 should control.

To the extent that the definition in new Article 9 section 9-102(a)(43) applies, there is an objective as well as a subject test of good faith, and good faith requires that a purchaser act not only honestly in fact but also in the observance of reasonable commercial standards of fair dealing. As such, good faith could be understood to require that a purchaser inquire further when the purchaser knows facts that would lead a reasonable purchaser to do so.

It is not clear, however, what the requirement of good faith means as to a purchaser of chattel paper claimed merely as proceeds because, as explained above, the priority bestowed by new section 9-330(a) is defeated only when the chattel paper bears a legend that it has been assigned to an identified assignee other than the secured party. Thus, Official Comment 5 to new section 9-330 states that a purchaser "who gives new value in ordinary course can rely on possession of unlegended, tangible chattel paper without any concern for other facts that it may know . . . ."

The usual meaning of "value," defined in Article 1, section 1-204 (formerly Article 1, section 1-201(44)) to mean essentially a binding commitment but also to include antecedent debt, was considered in Chapter 10 (The Need for Value and Debtor's Rights in the Collateral) in connection with the requirements of enforceability under new section 9-203(b). "New value" is defined in new section 9-102(a)(57). As used in new section 9-330(b) "new value" is distinguishable from "value" in that it does not include antecedent debt (but it does include release of a security interest in other property).

New section 9-330(a) refers to purchasers who obtain control of chattel paper as well as those who take possession. The purpose of the reference is to bring within the scope of the special priority rule purchasers of electronic chattel paper, as to which possession is not possible and control under new section 9-105 is the preferred method of perfection. *See* Chapter 22 (Perfection as to Deposit Accounts, Letter of Credit Rights and Electronic Chattel Paper).

Where a purchaser of chattel paper does not qualify for the special priority given by new section 9-330(b), a dispute is governed by new section 9-322(a). Thus, for example, in a dispute between a purchaser of chattel paper who does not qualify for the special priority of new section 9-330(b) and a party with a security interest in the chattel paper other than merely as proceeds of inventory who has filed as to the chattel paper, the outcome would depend on who filed first or who perfected first under new sections 9-322(a) and (b).

The court in *Arcadia Financial, Ltd v. Southwest-Tex Leasing Co., Inc.*, 47 UCC Rep. Serv. 2d 1371 (Tex. App. 2002) was presented with the opportunity to apply new section 9-330(a) in the rather unique setting in which the creditor with an interest in inventory had such an interest by virtue of having reserved title to the goods provided to a dealer. If the court considered the application of new section 9-330(a), then it would have had to decide whether the assignee of chattel paper qualified for the special priority given by new section 9-330(a) or whether the first-to-file or first-to-perfect priority rule of new section 9-322(a) would govern.

Instead the court focused on the passage of title to the inventory items, vehicles subject to a certificate of title law, and mistakenly concluded that because the inventory party had conditioned the transfer of the certificates of title covering the ownership of the vehicles to the dealer on payment for the vehicles title to (and, implicitly as well, no other interest in) the vehicles never passed to the dealer or to the buyers from the dealer.

You may explore the application of the merely as proceeds of inventory priority for chattel paper rule in new section 9-330(a) in the next two problems.

Problem 29.4 (INTERACTIVE)

Lisa Lender perfects a security interest in Donald Dealer's inventory of automobile parts, existing and after-acquired, by filing. Donald sells automobile parts to numerous buyers on credit in the ordinary course of Donald's business. The buyers sign written contracts giving Donald an interest in the automobile parts to secure their price. Western Bank lends to Donald and takes an interest in Donald's contracts, existing and later-acquired. Western files a financing statement covering the contracts. Donald encounters cash flow problems and defaults on the debts owed to Lisa and Western.

Who has priority as to the automobile parts in the hands of the buyers?

Who has priority as to the automobile parts in Donald's possession that have not yet been sold?

Who has priority as between Lisa and Western as to the contracts for the sale of automobile parts?

Problem 29.5 (INTERACTIVE)

Assume the facts of Problem 29.4. Assume further that after borrowing from Western Bank, Donald Dealer borrows from Friendly Finance Company and assigns a large number of the contracts for the sale of automobile parts to Friendly. Friendly takes possession of the contracts in the ordinary course of its business, in good faith and for new value. Donald defaults on the debts owed to Lisa Lender, Western and Friendly.

Who has priority as between Lisa and Friendly?

Would the correct answer be different if Friendly knew about Lisa's security interest?

Would Friendly have priority over Lisa if the chattel paper bore a legend indicating that the contracts were subject to a security interest?

Would Friendly qualify for the special priority in new section 9-330(a) if the chattel paper had been assigned to Friendly to secure an outstanding unsecured debt?

If Friendly was not able to meet the conditions for the special priority in new section 9-330(a) then Lisa would have priority. Why is this so?

ii. Chattel paper claimed otherwise than merely as proceeds of inventory

New section 9-330(b) governs priority between purchasers of chattel paper and persons claiming an interest in chattel paper other than merely as proceeds of inventory. With one notable difference, the stated conditions for purchaser priority under new section 9-330(b) are the same as those in new section 9-330(a) (the merely as proceeds situation). The difference is that to qualify for the special priority in new section 9-330(b), the purchaser must not have knowledge that the purchase violates the rights of the secured party (as contrasted with the requirement in new section 9-330(a) that the chattel paper not indicate that it has been assigned to an identified assignee other than the purchaser).

Thus, a purchaser of chattel paper has priority over a security interest in the chattel paper that is claimed other than merely as proceeds of inventory if:

(a) the purchaser gives new value;

(b) the purchaser takes possession or obtains control of the chattel paper;

(c) the purchase is in the ordinary course of the purchasers business;

(d) the purchaser acts in good faith; and

(e) the purchaser acts without knowledge that the purchase violates the rights of the secured party holding an interest in the chattel paper claimed otherwise than merely as proceeds of inventory.

As used in new section 9-330(b), knowledge means "actual knowledge," as defined in Article 1, section 1-202 (formerly Article 1, section 1-201(25)). Note that it is knowledge that the purchase violates the rights of the secured party and not simply knowledge that a conflicting security interest exists. *See* Official Comment 6 to new 9-330. However, under new section 9-330(f), if chattel paper indicates that it has been assigned to an identified secured party other than the purchaser, then the purchaser of the chattel paper has knowledge that the purchase violates the rights of the secured party and the purchaser is not eligible for the special priority given by new section 9-330(b).

New section 9-330(b) requires that the purchaser take in good faith. As noted above, in connection with the discussion of new section 9-330(a), the current definition of good faith in Article 1, section 1-201(b)(20), includes a requirement that a person observe reasonable commercial standards of fair dealing. The meaning of the good faith requirement as applied to a purchaser of chattel paper claimed other than merely as proceeds of inventory is not clear.

Official Comment 6 to new section 9-330 indicates that good faith does not require a purchaser of chattel paper to search for a filing against the paper. However, that same comment appears to suggest that a purchaser who, for whatever reason, does a search and discovers a financing statement covering the chattel paper cannot ignore the discovery and may be obliged to inquire further. If further inquiry results in the purchaser acquiring knowledge that the purchase violates another's security interest, then the purchaser would not qualify for the special priority under new section 9-330(b).

Determining the meaning of good faith is complicated by the fact that priorities for purchasers of instruments, discussed below, also are conditioned on a requirement that the purchaser take in good faith, and good faith may mean something different for purchasers of instruments than it does for purchasers of chattel paper. *Cf.* Official Comment 7 to new 9-330 and Official Comment 5 to new 9-331.

As is true of new section 9-330(a), new section 9-330(b) refers to purchasers with control of chattel paper. Once again, the purpose of this reference is to bring within the scope of the special priority rule purchasers of electronic chattel paper, as to which possession is not possible and control under new section 9-105 is the preferred method of perfection. *See* Chapter 22 (Perfection as to Deposit Accounts, Letter of Credit Rights and Electronic Chattel Paper).

Where a purchaser of chattel paper does not qualify for the special priority given by new section 9-330(b), a dispute is governed by new section 9-322(a). For example, the outcome of a dispute between a purchaser of chattel paper who does not qualify for the special priority of new section 9-330(b) and a party with a security interest in the chattel paper other than merely as proceeds of inventory who has filed as to the chattel paper would depend on who filed first or who perfected first under new sections 9-322(a) and (b).

To test your understanding of the application of new section 9-330(b) to security interests in chattel paper as original collateral consider the next problem.

Problem 29.6 (INTERACTIVE)

The facts of Problem 29.4 as modified in Problem 29.5 were as follows: Lisa Lender perfects a security interest in Donald Dealer's inventory of automobile parts, existing and after-acquired, by filing. Donald sells automobile parts to several buyers on credit in the ordinary course of Donald's business. The buyers sign written contracts giving Donald an interest in the widgets to secure their price. Western Bank lends to Donald and takes an interest in Donald's contracts, existing and later-acquired. Western files a financing statement covering the contracts. After borrowing from Western, Donald borrows from Friendly Finance Company and assigns a large number of the contracts for the sale of automobile parts to Friendly. Friendly takes possession of the contracts in the ordinary course of its business, in good faith and for new value. Donald defaults on the debts owed to Lisa, Western and Friendly.

Who has priority as to the chattel paper as between Western and Friendly?

Would the answer under new section 9-330(b) be different if Friendly knew about Western's security interest in the chattel paper?

Would Friendly have priority over Western under new section 9-330(b) if the chattel paper bore a legend indicating that it had been assigned to Western?

If the chattel paper bore a legend that it was subject to a security interest held by Lisa, who would have priority as to the chattel paper as between Lisa, Western and Friendly?

Would you analysis of the disputes between Lisa and Friendly and Western and Friendly be different if the contracts generated by the sale of the inventory were in electronic form and Friendly had control of the contracts? Explain your answer.

Under new section 9-330(c)(1), subject to the special rule for deposit accounts under new section 9-327, a purchaser of chattel paper who satisfies the requirements of new section 9-330(b), also has priority as to the proceeds of the chattel paper to the extent that priority is provided for in new section 9-322. The extent to which there is priority under new section 9-322 is considered in subpart B below.

Where the proceeds consists of specific goods covered by the chattel paper or cash proceeds of the specific goods, there also is priority as to proceeds directly under new section 9-330(c)(2) for a purchaser of chattel paper who satisfies the conditions of new section 9-330(b), even if the purchaser's security interest in the proceeds is unperfected. The rule in new section 9-330(c)(2) governs certain complicated situations, such as that where a buyer in ordinary course of business returns goods to a dealer or where the goods are repossessed by the dealer. These situations are dealt with in Official Comments 8 to 11 to new section 9-330 and are beyond the scope of these materials.

c. Instruments

Under new section 9-330(d), a purchaser of an instrument has priority over a security interest in the instrument perfected by a method other than possession if the purchaser gives value and takes possession of the instrument in good faith and without knowledge that the purchase violates the rights of the secured party. The rule of new section 9-330(d) tracks that in new section 9-330(b) pertaining to chattel paper, but there is no requirement that the purchaser take delivery in the ordinary course of the purchaser's business or that it give new value. Ordinary value, as defined in Article 1, section 1-204 (formerly Article 1, section 1-201(44)) to mean essentially a binding commitment but also to include antecedent debt, *see* Chapter 10 (The Need for Value and Debtor's Rights in the Collateral), is sufficient.

As is the case with the special priority for chattel paper contained in new section 9-330(b), discussed above, it is actual knowledge that the purchase violates a conflicting security interest in the chattel paper that is material. But, as is true as to new section 9-330(b), new section 9-330(d) is subject to new section 9-330(f). Under new section 9-330(f), if an instrument indicates that it has been assigned to an identified secured party other than the purchaser then the purchaser of the instrument has knowledge that the purchase violates the rights of the secured party and the purchaser is not eligible for the special priority given by new section 9-330(d).

As is true with respect to good faith as it applies to a purchaser of chattel paper, discussed above, the meaning of good faith as a requirement for qualifying for the special priority in new section 9-330(d) is unclear. The uncertainty is again traceable to the expanded definition of good faith in Article 1, 1-201(b)(20), which imposes the objective test that a person must observe reasonable commercial standards of fair dealing.

If, for whatever reason, a purchaser conducts a search and discovers a financing statement filed by a competing party, then it may plausibly be argued that the purchaser is obliged by the good faith requirement to inquire further. If further inquiry leads the purchaser to obtain actual knowledge that the purchase violates the security interest, then the purchaser would be denied the benefit of the special priority in new section 9-330(d). *Cf.* Official Comment 7 to new 9-330. However, as a general rule, good faith does not require the purchaser of an instrument to search the public records. *See* Official Comment 7 to new 9-330. A more interesting question is whether the observance of reasonable commercial standards of fair dealing could impose on a particular purchaser a duty to search for an Article 9 filing.

In two related decisions, *Agriliance, L.L.C. v. Runnells Grain Elevator, Inc.*, 272 F. Supp. 2d 800 (S.D. Iowa 2003) and *Agriliance, L.L.C. v. Farmpro Services, Inc.*, 328 F supp 2d 958 (S.D. Iowa 2003), a federal district court concluded that the observance of reasonable commercial standards of fair dealing requires asking how a reasonable person in like circumstances would behave. Although the courts inquiry was whether the defendants were holders in due course and thereby protected by Article 3 rules despite being subordinate under the Article 9 priority rules, the test of fair dealing articulated by the court should apply as well to the good faith standard as it pertains to section 9-330(d) because, as is explained in subpart A (5) below, good faith as it applies to holders in due course is defined the same way as the good faith required of purchasers under new section 9-330(d).

It is important to keep in mind that although the effect of good faith to require a person to make such inquiry as is reasonable under the circumstances is the same for purchasers under new section 9-330(d) as for persons seeking holder in due course (HDC) status under new section 9-331(a), the ultimate question is different as to each section. The reason is that to be denied the special priority of new section 9-330(d) a purchaser must have actual knowledge that the purchase violates a security interest whereas, as is further explained in Subpart A (5) below, knowledge of the existence of a security interest is enough to prevent a person from being a HDC.

It should also be understood that new section 9-330(d) is expressly subject to new section 9-331(a). As explained in subpart A (5) below, new section 9-331(a) gives priority to a holder in due course (HDC) of a negotiable instrument. Therefore, if one party is entitled to the priority conferred by new section 9-330(d) and another person is a HDC as to that instrument, then the HDC will have priority.

On the other hand, because something less than knowledge that a purchase violates another's security interest can deny a person HDC status, a purchaser of an instrument could be denied the special priority of new section 9-331(a) and still qualify for priority under new section 9-330(d). *See* Official Comment 7 to new 9-330.

Where a purchaser of an instrument does not qualify for the special priority given by new section 9-330(d) a dispute is governed by new section 9-322(a).

You may test your understanding of the application of new section 9-330(d) in the next problem.

Problem 29.7 (INTERACTIVE)

Central Bank lends to Donna Debtor and takes a security interest in a certificate of deposit (CD) that is not negotiable but is transferred by delivery in the ordinary course of business. Central files a financing statement covering the CD. Later, Donna delivers the CD to Lenny Lender who takes possession of the CD without knowledge or notice of any claims against the CD, including that of Bank, and to satisfy an outstanding debt owed by Donna to Lenny.

Who has priority as to the CD?

Suppose that Lenny was unable to satisfy the requirements of new section 9-330(d), but Central delayed filing its financing statement until after the delivery of the CD to Lenny. Who has priority?

5. Priority of Security Interests in Negotiable Instruments, Negotiable Documents and Securities.

Under new section 9-331(a), new Article 9 does not limit the rights of a holder in due course (HDC) of a negotiable instrument conferred by Article 3, the rights of a holder to which a negotiable document has been duly negotiated provided for in Article 7, or the rights of a protected purchaser of a security given by Article 9. The interaction between new Article 9 and Article 7 is dealt with in Chapter 15 (Perfection by Possession (Including Documents of Title)). The priority conferred by Article 8, including that referred to in new section 9-331(b), is beyond the scope of these materials. However, the priority of a HDC under Article 3, including the similarities and differences that exist between that priority and the priority conferred by new section 9-330(d), is considered below.

New section 9-331(a) provides that if a person is a holder in due course and the person would take free of a security interest under Article 3 (which it normally would), then Article 9 does not prevent that outcome. Under Article 3, section 3-306, a holder in due course of a negotiable instrument generally is protected against a security interest in the instrument, even though the security interest has been properly perfected.

For the protection under new section 9-331(a) to be available, the instrument purchased must be a negotiable instrument within the meaning of Article 3, section 3-104. The details of when an instrument is negotiable under section 3-104 are beyond the scope of these materials but, generally speaking, the essential requirement is that the instrument be payable to bearer or to order, *i.e.*, that the instrument includes the words of negotiability. To qualify for the special treatment under new section 9-331(a), a purchaser must be a holder in due course (HDC) within the meaning of Article 3, section 3-302. *See*, *e.g.*, *Sonic Engineering, Inc. v. Konover Construction Co. South*, 51 UCC Rep Serv. 2d 844 (Conn Super Ct 2003) (concluding that a judgment creditor could not be a HDC within the meaning of new section 9-331(a) and its claim to a cashiers check was subordinate to that of a secured party who had a security interest in the deposit account that funded the check and which had been perfected by control.

When a purchaser is a HDC also is a matter that is largely outside the scope of these materials. However, two of the requirements, good faith and notice, are discussed here, especially because the discussion can inform the understanding of other priorities, specifically that in new section 9-330(d)).

Under Article 3, section 3-302(a)(2) to be a HDC of a negotiable instrument, the instrument must have been taken in good faith. Section 3-302(a)(2) speaks of notice rather than knowledge and requires that an instrument have been taken without notice of any claim to the instrument described in Article 3, section 3-306. As noted above, section 3-306 describes the claims a HDC takes the instrument free of and a security interest (a possessory right) is one of those claims. Consequently, a person who takes a negotiable instrument with notice that it is subject to a security interest cannot be a HDC.

Throughout much of its history, good faith under Article 3 had only a subject component; however, the definition in Article 3, section 3-103(a)(6), has been expanded to include honesty in fact and the observance of reasonable commercial standards of fair dealing. This is, of course, the very same definition found in Article 1, section 1-201(b)(20), and which applies throughout the UCC, including Article 9. Indeed, subsection of Article 3, section 3-103, defining good faith is optional because in its absence the Article 1 definition will apply. *See* Official Comment 4 to Article 3, section 1-103.

In *Agriliance, L.L.C. v. Runnells Grain Elevator, Inc.*, 272 F. Supp. 2d 800 (S.D. Iowa 2003) and *Agriliance, L.L.C. v. Farmpro Services, Inc.*, 328 F supp 2d 958 (S.D. Iowa 2003), the two court decisions discussed in subpart A(4)(c), it was held that the observance of reasonable standards of fair dealing may require that a person inquire as to the actual facts, but the scope of the duty to inquire must be determined by reference to what may reasonably be expected of a party who is similarly situated.

As for the meaning of notice, except to the extent that Article 3 specifically so provides, Article 1, section 1-202 (formerly Article 1, section 1-201(25)) governs. Section 1-202, not unexpectedly, provides that a person has notice of a fact if the person has actual knowledge of it. However, under that section a person has notice of a fact if from all the facts and circumstances known to the person at the time in question, the person has reason to know that it exists. Notice so understood is distinguishable from actual knowledge in that a person may be held to know something it does not actually know if from all the facts and circumstances the person had reason to know that something. This reason to know aspect of notice has been understood to impose on a person a duty to inquire into the actual facts when the facts that are known and the circumstances make such an inquiry reasonable.

As just noted above, the observance of reasonable standards of fair dealing aspect of good faith similarly imposes a duty to make an inquiry that is reasonable under the circumstance. To this extent the requirements of good faith and notice tend to merge. The court in the two decisions referred to above, *Agriliance, L.L.C. v. Runnells Grain Elevator, Inc.*, 272 F. Supp. 2d 800 (S.D. Iowa 2003) and *Agriliance, L.L.C. v. Farmpro Services, Inc.*, 328 F supp 2d 958 (S.D. Iowa 2003), reached precisely that conclusion. The court went on decide whether the defendant in each case had notice (in which case it would not have taken in good faith) that would deny it HDC status.

In *Runnells* the question was whether a landlord of farmland who took a cashiers check asserted to be the proceeds of crops grown on the leased land and subject to the plaintiffs security interest was under an obligation to search the filing records in which case it would have discovered the plaintiff's security interest and could not qualify as a HDC. The court held that under all the circumstances, including the fact that the check stubs disclosed how the amount of the check had been calculated, a reasonable landlord, similarly situated, would not have knowledge of and could not be held to have knowledge of the plaintiffs security interest.

By contrast, in the *Farmpro* case, the court concluded that the defendant, a lender engaged in making agricultural loans, under all the circumstances, including the fact that crops often are used as collateral for such loans, the fact that the lender had entered into an agreement expressly subordinating its security interest in the debtors crops to the plaintiff's security interest in the crops, and the fact that the lender was aware of the debtors ongoing financial difficulties, was on notice of the fact that the source of a check it received in payment of its loan was crops in which the plaintiff had a perfected security interest and the lender, therefore, should be charged with knowledge of the plaintiff's security interest and could not qualify as a HDC.

It remains to be seen whether or to what extent other courts will determine that notice and good faith are the same or are distinguishable. However, as the foregoing discussion indicates, good faith or notice requirements of holding in due course can impose a duty to inquire that could lead to knowledge of a security interest such as will deny HDC status. An important qualification to this general conclusion is in order.

In earlier chapters, it was noted that perfection of a security interest in a negotiable instrument (or a negotiable document of title) can be perfected by filing. Under new section 9-331(c), the fact that a financing statement covering a negotiable instrument (or a negotiable document of title or a security) has been filed does not constitute notice of a claim or defense such as will prevent a person from becoming a holder in due course (or deny a holder of a document of title to whom the document has been duly negotiated of rights under Article 7 or a purchaser of a security to rights conferred by Article 8). However, as just explained, actual knowledge of a financing statement or a conclusion that a holder of a negotiable instrument should have searched the public records and in so doing would have discovered a filing could prevent a holder from having HDC status under Article 3, section 3-302. *See* Official Comment 5 to new 9-331.

It will be useful to compare and contrast the special priorities conferred by new section 9-331(a), on the one hand, and new section 9-330(d), on the other. Good faith as to each of these special priorities is defined identically, in Article 1, section 1-201(b)(20), to mean honesty in fact and the observance of reasonable standards of fair dealing. Thus, decisions about good faith made as to new section 9-331(a) should apply to determinations of good faith made as to new section 9-330(d).

As interpreted by the court in the *Runnells* and *Farmpro* cases, good faith requires that a person make such inquiry as is reasonable under all the circumstances. To this extent, a person who has not acted in good faith sufficiently to qualify as a HDC for purposes of new section 9-331(a) will not be eligible for the special priority conferred by new section 9-330(d). However, although actual knowledge or knowledge the existence of a security interest in a negotiable instrument imputed as a matter of notice or good faith of will deny a person HDC status, and hence, the ability to invoke the special priority in new section 9-331(a), that person may still be eligible to rely on the special priority in new section 9-330(d) because only knowledge that a purchase violates a security interest and not simply knowledge of the existence of a security interest is required to render a person ineligible for the protection of new section 9-330(d). *See* Official Comment 7 to new 9-330.

With regard to the difference in knowledge necessary to deny a person the ability to invoke new section 9-330(d) or new section 9-331(a), it may be asked whether the court in the *Farmpro* case, *supra*, should not have stopped at having decided that the farm lender could not qualify as a HDC and have inquired further as to whether the lender was entitled to the special priority under section 9-330(d). Insofar as the new section 9-330(d) is unavailable only to the extent that a purchaser has knowledge that a purchase violates a security interest the answer would seem to be that the court should have done so.

Although all the facts and circumstances might have imposed on the lender a good faith obligation to make such inquiry as would have given the lender knowledge of the plaintiff's security interest, it would be a separate matter to decide whether the lenders inquiry would have given it knowledge that the plaintiff's security interest had been violated. Of course, the scope of the inquiry required, especially in light of the subordination agreement in that case, might have been such as to lead to such knowledge.

In Official Comment 7 to new section 9-330 the drafters state:

> Subsection (d) is subject to Section 9-331(a), which provides that Article 9 does not limit the rights of a holder in due course under Article 3. Thus, in the rare case in which the purchaser of an instrument qualifies for priority under subsection (d), but another person has the rights of a holder in due course of the instrument, the other person takes free of the purchaser's claim. Section 3-306.

That a purchaser could qualify for priority under new section 9-330(d) while another person has the rights of a holder in due course indeed would be a rare case given that new section 9-330(d) requires that a purchaser have priority of an instrument and holder as defined in Article 1, section 1-201(b)(21) is a person in possession. It seems the drafters have in mind a case in which a purchaser has relinquished physical possession of an instrument but continues to have possession such as is needed to the operation of certain provisions of new Article 9. *See, e.g.*, new sections 9-313(h) and (i) (under which possession continues in limited circumstances even though physical possession has been relinquished) and Official Comment 9 to new 9-313 (noting that the foregoing subsections of new section 9-313 are directed to the practices of mortgage warehouse lenders).

If a person fails to qualify as a HDC entitled by new section 9-331(a) to rely on Article 3 priority rules, then priority will be determined by the first to file or first to perfect rules of new section 9-322(a) and (b) (unless of course the person can invoke the special priority provided for in new section 9-330(d).

You may consider the application of new section 9-331 in the next problem.

Problem 29.8 (INTERACTIVE)

Assume the facts of Problem 29.7. Assume further that the CD is negotiable and that Lenny Lender is a holder in due course. Who has priority as to the CD as between Lenny and Central Bank? If Lenny did not qualify as a holder in due course could Lenny still have priority over Central? Under new section 9-331(c), the fact that Central filed a financing statement, in and of itself, could not prevent Lenny from being a holder in due course.

If there were circumstances sufficient to deny Lenny holder in due course status because Lenny had acted in bad faith (for example, that Lenny had done an Article 9 search and discovered

Central Bank's filing), could Lenny also be denied priority under new section 9-330(d)?

B. Special Priority Rules as to Certain Proceeds Disputes

As explained in subpart A, special priority rules sometimes apply to certain collateral under new sections 9-327, 9-328, 9-329, 9-330 and 9-331. Disputes *as to the proceeds* of collateral qualifying for the special priorities provided for in those sections may nonetheless be governed by the first-to-file-or-first-to-perfect rule of new sections 9-322(a)(1) and 9-322(b), discussed in Chapter 28 (Secured Party Versus Secured Party). However, the drafters of new Article 9 concluded that the temporal priority provided for in the first-to-file-or-first-to-perfect rule is not always appropriate as to what is referred to by the drafters as "non-filing collateral." Consequently, new section 9-322(c)(2), as qualified by new sections 9-322(d), (e) and (f), provides a special non-temporal priority rule for determining priority as to some non-filing collateral.

Non-filing collateral is collateral a security interest in which may be perfected by a method other than filing, mainly by possession or control, and possession or control is the only way to perfect or the preferable way to perfect a security interest in the collateral *and* parties who so perfect do not expect to have to do a search of the filing system. Non-filing collateral includes chattel paper, deposit accounts, negotiable documents, instruments, investment property and letter-of-credit rights. *See* Official Comment 7 to new 9-322.

Under new section 9-322(c)(2), subject to new sections 9-322(d), (e) and (f), a security interest in proceeds of non-filing collateral has priority over a conflicting security interest if:

(1) the security interest in the proceeds is perfected;

(2) the proceeds are cash proceeds or of the same type as the original collateral; and

(3) in the case of proceeds of proceeds, all intervening proceeds are cash proceeds, proceeds of the same type as the original collateral or an account relating to that collateral.

According to Official Comment 8 to new section 9-322, new section 9-322(c)(2) provides a "baseline" priority rule for proceeds of non-filing collateral in situations where the temporal (first-in-time) rules of subsection (a)(1) are not appropriate. The condition that triggers the application of the priority provided for in new section 9-322(c)(2) is that *original* collateral is non-filing collateral a security interest is entitled to priority under one of the special priority rules considered above, such as the priority for a security interest in a deposit account perfected by control given by new section 9-327(1).

It is important to note that for the subsection (c) priority rule to apply the security interest in the proceeds must be perfected. Moreover, a security interest in proceeds that would otherwise have priority under new section 9-322(c)(2) will be subordinated because perfection did not continue beyond the twenty-day period of automatic perfection provided for in new section 9-315(c). As to the continuing perfection as to proceeds matter, *see* Chapter 24 (Continuing Perfection -- Changes as to the Use of Collateral or in the Location of the Collateral or the Debtor; Security Interests in Proceeds). To guard against this possibility a secured party who perfects a security interest in non-filing collateral (for example, a deposit account) by a method other than filing (for example, by control) could file a financing statement covering filing collateral that the secured party anticipates may be acquired using funds from the deposit account at the time it takes control of the deposit account.

The application of the section 9-322(c)(2) priority also requires that the proceeds at issue be cash proceeds, defined in new section 9-102(a)(9) as "money, checks, deposit accounts, or the like" or "of the same type as the collateral." Cash proceeds would not include ordinary goods, such as inventory or equipment, or various intangibles, such as investment property or negotiable instruments (other than checks) or documents of title. According to Official Comment 8 to new section 9-322, "of the same type" means a type of property defined in the Uniform Commercial Code, such as investment property, instrument or various ordinary goods, such as inventory or equipment. As to the meaning of "type" in classifying collateral, *see* Chapter 5 (Classification of Collateral). Consequently, the priority conferred by new section 9-322(c)(2) would apply to a security interest in proceeds of a investment property that are not cash but are of the same type, such as a certificated security.

Finally, if the proceeds are proceeds of proceeds, then the new section 9-322(c)(2) priority applies only if "all intervening proceeds are cash proceeds, proceeds of the same type as the collateral, or an account relating to the collateral." According to Official comment 8 to new section 9-322, "once proceeds other than cash proceeds, proceeds of the same type as the original collateral, or an account relating to the original collateral intervene in the chain of proceeds, priority under subsection (c) is thereafter unavailable."

As explained below, where new section 9-322(c)(2) does not apply because the conditions for its application are not met, the rule provided in new section 9-322(d) may apply or, on the right facts, the priority may be governed by the first-to-file-or-perfect rule.

Not surprisingly, determining when new section 9-322(c)(2) does and does not apply can be challenging. The next problem will assist your understanding of new section 9-322(c)(2) in a relatively uncomplicated fact situation.

Problem 29.9 (INTERACTIVE)

Friendly Finance Company takes a security interest in a certificated security and perfects by filing. Lisa Lender later takes a security interest in the same certificated security and perfects by control. Delia Debtor receives cash dividends paid on the certificated security and deposits them in a general bank account in Southern Bank.

Assuming that both Friendly and Lisa can trace the cash dividends into the general bank account, who as between Friendly and Lisa would have priority as to the general bank account in Southern Bank under the usual priority rule (the first-to-file or first-to-perfect rule)?

Who has priority as to the original collateral (the certificated security)?

Does this special priority as to the original collateral carry through to the bank account (the proceeds)?

Who has priority as to the bank account under new section 9-322(c)(2)?

As noted above, new section 9-322(c)(2) is subject to new section 9-322(f). New section 9-322(f) provides that the rules of new section 9-322(c)(2) are subject to "the other provisions of this part." The other provisions of this part include the special priority rules for certain collateral examined in subpart A above.

The next problem illustrates how the language "the other provisions of this part" in new section 9-322(f) qualifies the operation of new section 9-322(c)(2).

Problem 29.10 (INTERACTIVE)

Assume the facts of Problem 29.9. Assume further, however, that Friendly Finance Company obtained control of the general bank account in Southern Bank?

On this change in facts, who has priority as to the general bank account as between Friendly and Lisa Lender?

The special rule for proceeds of non-filing collateral in new section 9-322(c)(2) also is subject to new sections 9-322(d) and (e). Under new section 9-322(d), if a security interest in non-filing collateral is perfected otherwise than by filing (*i.e.*, by possession or control), then perfected security interests in the proceeds of the collateral rank according to the time of filing. This rule is referred to by the drafters as a "new" first-to-file rule. *See* Official Comment 8 to new 9-322. However, under new section 9-322(e), the rule of new section 9-322(d) applies only if the proceeds are not cash proceeds and are filing collateral (*i.e.*, are other than non-filing collateral).

Stated more directly, where the proceeds of non-filing collateral, a security interest in which was perfected by possession or control, are filing collateral, then conflicting security interests in the proceeds rank according to the time of filing. New section 9-322(d) also is subject to new section 9-322(f), providing for priority under other provisions of this part, such as the special priority given to security interests in deposit accounts perfected by control.

The resulting brainteaser of rules may be explored in the next problem.

Problem 29.11 (INTERACTIVE)

Friendly Finance Company lends to Donald Debtor, takes a security interest in Donald's general bank account and perfects its security interest in the bank account by obtaining control. Thereafter, Lenny Lender takes a security interest in Donald's equipment, existing and after-acquired, and files a financing statement covering the equipment. Subsequently to the secured loan by Lenny Lender, Friendly also takes a security interest in Donald's equipment, existing and after-acquired, and files a financing statement covering the equipment. Donald then uses funds from the bank account to acquire equipment that Friendly can trace as proceeds of its security interest in the bank account.

Who as between Friendly Finance and Lenny Lender has priority as to the equipment under the first to file or first to perfect rule of subsections 9-322(a)(1) and (b)?

However, Lenny nonetheless has priority over Friendly as to the equipment acquired with funds from the bank account. Why is this so? Hint: The bank deposit is non-filing collateral and the equipment is filing collateral.

Why can Friendly not rely on its priority as to the bank account to get priority as to the equipment under new section 9-322(c)(2)?

Suppose the facts of Problem 29.11 were that Donald Debtor sold the equipment acquired using the funds from the bank account as to which Friendly Finance has a security interest perfected by control and Donald received a check in payment for the sale of the equipment. Assuming that Friendly and Lenny both are able to establish that the check constitutes identifiable proceeds of their security interests. Who has priority as to the check?
Hint: The check is cash proceeds but not all intervening proceeds are cash proceeds (or proceeds of the same type).

C. The "Double Debtor," "New Debtor" and "Multiple Debtor" Problems

1. Generally

Understanding the complicated priority rules considered in this subpart requires also understanding the basic rules regarding the extent to which security interests continue in or attach to transferred collateral and collateral acquired by transferees or new debtors and, also, the rules governing perfection and continuing perfection of any such security interests. These matters were considered at length in Chapters 9 (The

Specifics of Enforceability -- After-Acquired Property, Proceeds and Future Advances) and 24 (Continuing Perfection -- Changes as to the Use of the Collateral or in the Location of the Collateral or the Debtor; Security Interests in Proceeds) and it would be a good idea to review of those chapters now.

2. The "Double Debtor" Problem.

To this point we have been examining conflicts among parties whose interests were created by the same debtor. It can happen that a person (the transferee/debtor) acquires property subject to a security interest created by some other person (the transferor/former debtor/obligor) and the acquiring person (the transferee) then creates a security interest in favor of *another* creditor. In such a case, there arises what has been referred to as the "double debtor" problem. The double debtor problem was not explicitly addressed in former Article 9.

Recall from Chapter 9 (The Specifics of Enforceability -- After-Acquired Property, Proceeds and Future Advances) that under new section 9-315(a)(1), a security interest continues in transferred collateral unless the secured party authorizes the transfer free of the security interest. The transferor remains the obligor under new section 9-102(a)(59) but the transferee becomes the debtor under new section 9-102(a)(28).

Under new section 9-507(a), if the security interest in the transferred collateral was properly perfected by a filing made against the transferor, then the financing statement continues to be effective against the transferee, without further action by the secured party and irrespective of any name change (unless and until the financing statement lapses or is terminated). However, if the security interest in the transferred collateral was not timely or properly perfected, then a buyer/transferee may take free of the security interest under new sections 9-317(b) or 9-320(b). If the transferee is a buyer in ordinary course, the transferee/buyer takes free of even a perfected security interest under new section 9-320(a).

The question here is what happens if a transferee who has not taken free of a security interest in transferred collateral gives a security interest in that collateral to another secured party.

If the holder of the security interest created by the *transferor* in the transferred collateral has priority over the security interest created by the transferee under new section 9-322(a) (first to file or perfect) or under new section 9-324 (special priority for a purchase money party), then that is the end of the inquiry. However, if the holder of the security interest created by the *transferee* has priority under either new section 9-322(a) or 9-324, the holder of the security interest created by the transferor and that continued in the transferred collateral may still have priority. This can happen under new section 9-325(a).

Under new section 9-325(a), a security interest in the transferred collateral has priority over a security interest created by the transferee if:

(1) The transferee/debtor acquired the collateral subject to the security interest created by the transferor (*i.e.*, the transferee did not take free of the security interest under new sections 9-315(a)(1) or 9-317(b), 9-320(a) or (b));

(2) The security interest created by the transferor was perfected when the collateral was transferred; and

(3) There is no period after the transfer when the security interest that continued in the transferred collateral became unperfected (*e.g.*, by lapse).

The rationale for the priority given new section 9-325(a) is that the later secured party could have investigated the source of the collateral and the transferee's title to the collateral whereas the secured party holding the security interest that continued in the transferred collateral has no reason to know of or protect against the security interest created by the transferee. *See* Official Comment 3 to new 9-325.

Under new section 9-325(b), the special priority rule of new section 9-325(a) governs only where the security interest created by the transferee otherwise would have priority solely under new sections 9-322(a) or 9-324 (or the conflicting security interest was created under Articles 2 or 2A).

You may explore the operation of new section 9-325(a) in the next problem.

Problem 29.12 (INTERACTIVE)

Western Bank has a security interest in Donna Debtor's equipment, existing and after-acquired. Western filed a financing statement covering the equipment. Subsequently, without authorization, Donna sells the drill press to Byron Buyer who purchases a drill press with the proceeds of a loan from Lisa. Lisa takes a security interest in the drill press and files ten days after the delivery of the drill press to Byron Buyer.

Who as between Western Bank and Lisa Lender has priority as to the drill press under the usual priority rules, *i.e.*, those found in new section 9-322(a) and 9-324?

However, the facts present a so-called "double debtor" problem governed by new section 9-325(a). Explain how this is so.

Who has priority as between Western Bank and Lisa Lender under new section 9-325(a)?

3. The "New Debtor" Problem

As discussed in Chapters 9 (The Specifics of Enforceability -- After-Acquired Property, Proceeds and Future Advances) and 23 (Continuing Perfection -- The Need to Reperfect (Or Refile), under new section 9-102(a)(56), a "new debtor" is a person who becomes bound as a debtor under new section 9-203(d) by a security agreement created by another person. As noted in those chapters, former Article 9 did not explicitly deal with new debtor priority problems. New Article 9 addresses a number of new debtor problems, including those pertaining to continuing perfection.

Under new sections 9-507(a) and 9-508(c), a financing statement naming the original debtor continues to be effective as to collateral transferred to a new debtor without regard to name change concerns. Under new section 9-508(a), the filing against the original debtor also is effective as to collateral owned by the new debtor or collateral acquired by the new debtor up to four months after the new debtor becomes bound under new section 9-203(a). Lastly, under new section 9-508(b), the filing made against the original debtor can be effective against the new debtor as to collateral purchased more than four months after the person becomes a new debtor if the secured party files a financing statement against the new debtor before the expiration of the four-month period.

The question here is what happens if a new debtor creates a security interest in favor of a secured party other than the one to whom the original debtor gave the security interest to which the new debtor has become bound. Under new section 9-326(a), subject to new section 9-326(b), the holder of a security interest created by a new debtor that is perfected by a filing that is effective *otherwise* than by the operation of new section 9-508 has priority over (subordinates) the holder of a security interest to which the new debtor has become bound under new section 9-203(d) if that security interest is perfected by a filing that is effective *solely* under new section 9-508. *See* Official Comment 2 to new 9-326.

The usual priorities obtain where the holder of the security interest created by the original debtor timely files an initial financing statement against the new debtor because its security interest is no longer perfected *solely* under new section 9-508. According to Official Comment 2 to new section 9-326, for purposes of new section 9-326(a), effective solely under new section 9-508 does not "encompass a new initial financing statement providing the name of the new debtor, even if the initial financing statement is filed to maintain the effectiveness of a financing statement under the circumstances described in Section 9-508(b)." *Cf.* Example 4 in Official Comment 3 to new section 9-326.

The rule of new section9-326(a) is less complicated than might first appear. You may consider its application in the next problem.

Problem 29.13 (INTERACTIVE)

Central Bank holds a security interest in Ollie Debtor's existing and after-acquired inventory. The security interest was perfected by filing. Lenny Lender holds a security interest in Newton Debtor's inventory, existing and after-acquired, that also was perfected by filing. Newton becomes bound by the security agreement entered into between Ollie and Central under new 9-203(d).

The priority between Central Bank and Lenny Lender is determined by new section 9-326(a). Why is this so?

Who has priority as between Central Bank and Lenny Lender under new section 9-326(a) as to inventory owned by Newton at the time that Newton becomes bound to the security agreement entered into between Central and Ollie?

Suppose that in Problem 29.13 Central Bank and Lenny Lender were fighting over an item of inventory acquired by Newton more than four months after Newton became bound to the security agreement entered into between Ollie and Central and that Central had filed an initial financing statement naming Newton as the debtor before the four month period after Newton had become bound had expired. Who has priority as between Central and Lenny as to this later-acquired item of inventory?

In the foregoing problem, the conflict was between the holder of a security interest created by an original debtor and the holder of a security interest created by a new debtor. It could happen that a new debtor becomes bound to more than one security interest created by the original debtor and a conflict as to property owned or acquired by the new debtor could arise between the secured parties to the separate security agreements entered into by the original debtor. If both competing parties rely on new section 9-508 to make their filings against the original debtor effective against collateral owned or acquired by the new debtor, then under new section 9-326(b) (the first sentence), priority is governed by the usual priority rules ("other provisions of this part"). *See* Official Comment 3 to new section 9-326.

The next problem will allow you to apply new section 9-326(b).

Problem 29.14 (INTERACTIVE)

Southwestern Bank has a security interest in Oprah Debtor's accounts, existing and after-acquired. Southwestern Bank perfected by filing a financing statement covering the accounts. Lenny Lender also has a security interest in Oprah's accounts, existing and after-acquired. Lenny filed as to the accounts after Southwestern filed. Newton Debtor becomes bound by the security agreement entered into between Oprah and Lenny. Subsequently, Newton becomes bound by the security agreement entered into between Oprah and Southwestern.

This is a new debtor case governed by the first sentence of new section 9-326(b). Why so?

Who has priority as between Southwestern and Lenny under the first sentence in new section 9-326(b) as to accounts generated from Newton Debtor's business activity after Newton became bound to the security agreements between Oprah and Southwestern and Oprah and Lenny?

Suppose Lenny had filed a financing statement naming Newton as the debtor. Who has priority now?

4. The "Multiple Debtor" Problem.

It could happen that a person becomes bound to security interests created by more than one original debtor, *i.e.*, a person becomes a new debtor as to security interests created by *different* original debtors, and the secured parties as to the different security agreements could come into conflict as to collateral owned or acquired by the new debtor. If both secured parties involved in such a conflict rely on new section 9-508 to make their filings against their original debtors effective, then the second sentence of new section 9-326(b) governs.

The second sentence of new section 9-326(b) provides that the conflicting security interests rank according to priority in time of the new debtor becoming bound to the security agreements entered into by different original debtors. If one of the secured parties has filed against the new debtor and, therefore, is not relying on new section 9-508 to perfect its security interest, then new section 9-326(a), discussed above, governs. According to Official Comment 3 to new section 9-326, subsection (b) of new section 9-326 "reflects the generally accepted view that priority based on the first-to-file rule is inappropriate when filings were made against different debtors," but, as is true of the rules in new section 9-326(a) and the first sentence of 9-326(b), the special priority rule in the second sentence of new section 9-326(b applies only to conflicts "among security interests perfected by filed financing statements that are 'effective only under Section 9-508.'"

You may consider the application of the second sentence of new section 9-326(b) in the next problem.

Problem 29.15 (INTERACTIVE)

Central Bank has a security interest in Debbie Debtor's inventory, existing and after-acquired. Central perfected its security interest by filing. Lisa Lender has a security interest in Donald Debtor's inventory, existing and after-acquired. Lisa perfected its security interest by filing against Donald before Central filed against Debbie. Subsequently, Newton Debtor becomes bound by the security agreement entered into between Central and Debbie and later still becomes bound by the security agreement entered into between Lisa and Donald.

This is a multiple debtor situation governed by the second sentence of new section 9-326(b). Why so?

Who has priority as between Central Bank and Lisa Lender under the second sentence in new section 9-326(b) as to inventory owned or acquired by Newton Debtor?

Would the answer to the previous question be different if Lisa Lender filed against Newton Debtor?

CASE COMMENTARY

Integrity Bank Plus v. Talking Sales, Inc., 2006 WL 212193 (D. Minn. 2006)

Madisonville State Bank v. Citizens Bank, 184 S.W.3d 835 (Tex. App. 2006)

Madisonville State Bank v. Canterbury, Stuber, Elder, Gooch & Surratt, P.C., 209 S.W.3d 254 (Tex. App. 2006)

< Chapter 28 | Chapter 30 >

Part VI Priority

Chapter 30 Secured Party Versus Trustee in Bankruptcy

A. Generally

Bankruptcy is often viewed as the "acid test" of whether an Article 9 practitioner has done his or her job properly in setting up a secured credit arrangement for a client. In general terms, bankruptcy aims at an equitable, ideally a pro rata, distribution of assets among creditors. However, valid and enforceable secured claims generally must be satisfied dollar-for-dollar and to this extent secured claims undermine the equitable distribution goal. Consequently, trustees are armed with several weapons that may be used to avoid security interests leaving the claims unsecured.

The ability of a trustee to avoid a security interest that is not properly perfected under either Bankruptcy Reform Act (BRA) § 544(a) or BRA § 547 poses a special threat to secured parties. This chapter explores the nature and scope of the threat. There also is a brief examination of the problem for non-possessory, non-purchase money security interests presented by BRA § 522(f)(1)(B).

In bankruptcy, perfection of interests in personal property and fixtures is defined in terms of the extent to which an interest is vulnerable as against a lien creditor under state law. For reasons that will appear in this and other chapters, the fact that bankruptcy employs a "lien creditor" test of perfection as to personal property and fixtures (rather than the bona fide purchaser test applicable to real estate interests) is especially important to Article 9 parties.

B. Avoidance of Security Interests under BRA § 544

Please review subpart D of Chapter 26 (Secured Party Versus Lien Creditor) now. You may test your recollection of BRA § 544 in the next three problems.

Problem 30.1 (INTERACTIVE)

Lenny Lender and Donna Debtor enter into negotiations about a $10,000 loan to be secured by an interest in Donna's equipment, existing and after-acquired. Lenny then lends the $10,000 to Donna who signs a security agreement describing the collateral as all of Donna's equipment, existing and after-acquired. If Donna filed bankruptcy before Lenny filed a financing statement covering the equipment, could the trustee in bankruptcy avoid the security interest?

Suppose that Lenny and Donna had closed the loan and Lenny had filed a financing statement before Donna filed bankruptcy. Who would have first claim to the equipment now?

Suppose that as of the date of the bankruptcy Donna Debtor had signed a security agreement providing for a $10,000 secured loan and Lenny had filed a financing statement, but Lenny had not yet lent Donna the $10,000 as of the time that Donna filed bankruptcy. If Lenny lent the $10,000 after bankruptcy but without knowledge of the bankruptcy would the loan be secured?

Problem 30.2 (INTERACTIVE)

Sid Seller sells a drill press to Donald Debtor for use in Donald's business. Sid takes a security interest in the drill press to secure its unpaid price. The next day Sid delivers the drill press to Debtor. Later that same day Donald files bankruptcy.

May Sid prevent Trustee in Bankruptcy from avoiding Sid's security interest under BRA § 544(a)?

Problem 30.3 (INTERACTIVE)

Lisa Lender lends Delia Debtor $10,000. Delia signs a security agreement giving Lisa a security interest in Delia's equipment, existing and after-acquired, to secure the $10,000 loan and any future advances that Lisa chooses to make to Debtor. Lisa immediately properly files a financing statement covering Delia's equipment. Thirty days later, Delia files bankruptcy. The next day, Lisa learns of the bankruptcy. Forty days after the bankruptcy was filed, Lisa lends Delia $2,000. Ten days following the $2,000 loan, Lisa lends Delia another $3,000. Delia's equipment is worth $16,000. Interest in the amount of $500 has accrued on the loans ($200 on the $10,000 loan, $100 on the $2,000 loan and $200 on the $3,000 loan) and Lisa has incurred another $500 in attorney's fees and expenses.

To what extent may Trustee in Bankruptcy avoid Lisa's security interest?

C. Avoidable Preferences

1. The Concept of a Transfer on Account of an Antecedent Debt

BRA § 544 interacts with Article 9 to give a trustee in bankruptcy the right to avoid security interests when they are not timely perfected, usually meaning not perfected on the date of bankruptcy or within twenty days of possession of the collateral by the debtor. There is another bankruptcy law provision that can pose problems for a secured party even where the security interest has been timely perfected. BRA § 547 allows a trustee to avoid certain transfers, including security interests, as avoidable preferences.

BRA § 547(b) defines what constitutes an avoidable preference. It provides as follows:

> (b) Except as provided in subsection (c) of this section, the trustee may avoid any transfer of an interest of the debtor in property -
>
> (1) to or for the benefit of a creditor;
>
> (2) for or on account of an antecedent debt owed by the debtor before such transfer was made;
>
> (3) made while the debtor was insolvent;
>
> (4) made -
>
> (A) on or within 90 days before the date of the filing of the petition;
>
> or
>
> (B) between ninety days and one year before the date of the filing of the petition, if such creditor at the time of such transfer was an insider; and
>
> (5) that enables such creditor to receive more than such creditor would receive

if -

(A) the case were a case under chapter 7 of this title;

(B) the transfer had not been made; and

(C) such creditor received payment of such debt to the extent provided by the provisions of this title.

BRA § 547(b) can give you fits. The key to getting a handle on it is to understand that it is aimed at transfers on account of antecedent debts and that the dates of the *actual* transfer and *the transfer for purposes of BRA § 547* may be different. Examine BRA § 547(b) carefully. Notice the salient elements:

A transfer;

On account of an antecedent debt;

Made within ninety days of bankruptcy (or one year if the transferee is an insider);

Made while the debtor is insolvent (something that is presumed under BRA § 547(f));

That has the effect of preferring the transferee (true except where all creditors would be paid in full).

Transfer is broadly defined in the BRA and includes the creation of a security interest. In BRA § 547 terms, the *actual* transfer is made when a security interest is created. However, as noted earlier, *the transfer for purposes of BRA § 547* may be at a time that is different than the actual transfer. More particularly, the transfer for purposes of BRA § 547 may be at a time that causes the transfer to be on account of an antecedent debt even though the actual transfer was not.

The operation of the preference section is best understood through its application to fact situations presented in various problems. In working with the problems in this chapter you will find it useful to create a chronological sketch of the events. The next two problems involve situations that are at the opposite ends of the spectrum with regard to the vulnerability of a security interest under BRA § 547.

Problem 30.4 (INTERACTIVE)

On May 1, Carl Creditor lends to Debbie Debtor on an unsecured basis. On June 1, Carl, feeling insecure about the debt, demands and receives a security interest in Debbie's equipment. Carl files immediately. On August 1 Debbie files bankruptcy.

Is Carl's security interest in the equipment avoidable under BRA § 544? Is the security interest avoidable under BRA § 547?

Problem 30.5 (INTERACTIVE)

Assume the facts of Problem 30.4. Assume further, however, that Carl Creditor lent originally on a secured basis, the security interest in the equipment, which was not purchase money, was created at the time of the loan and Carl filed immediately. (The loan, the creation of the security interest and the filing to perfect the security interest were all on May 1.)

Is Carl's security interest avoidable under BRA § 544? Is the security interest avoidable under BRA § 547?

2. Delayed Perfection

Things can get messy when a secured party delays perfection. The reason is that delays in perfection can cause the transfer *for the purposes of* *BRA § 547* to be different than the *actual* transfer. Under BRA § 547(e), the timing of perfection is critical to the determination of when a transfer *for purposes of BRA § 547* takes place.

Under BRA § 547(e)(1)(b), for purposes of personal property and fixtures, perfection of a security interest occurs when the security interest cannot be subordinated by a lien creditor under Article 9. Under BRA § 547(e)(2)(A), if a security interest is perfected within thirty days (until 2005 ten days) of the creation of the security interest (the actual transfer), then the transfer for purposes of BRA § 547 takes place at the time the security interest is *created*. However, if perfection of a security interest is delayed beyond the thirty-day period then under BRA § 547(e)(2)(B), the transfer for purposes of BRA § 547 is when the security interest is *perfected*.

You may explore the scheme just described in the next problem.

Problem 30.6 (INTERACTIVE)

On May 1, Carrie Creditor lends to Donald Debtor and takes a non-purchase money security interest in Donald's equipment. Carrie files a financing statement on June 15 (six weeks after the security interest in the equipment was created). On August 10 Donald files bankruptcy.

Is Carrie's security interest in the equipment avoidable under BRA § 544?

Is the security interest avoidable under BRA § 547? Once again, creating a timeline of the events in this and the following questions will assist you in your analysis.

Would the result under BRA § 547 be different if Carrie had filed a financing statement on May 29?

If bankruptcy had been filed on May 28, would a May 29 filing by Carrie protect Carrie's security interest from avoidance under BRA § 547?

Suppose on the original facts (Carrie filed her financing statement on June 15) that Donald filed bankruptcy on November 1 (six months after the creation of the security interest). Would Carrie's security interest be avoidable under BRA § 547?

Suppose Donald had not filed bankruptcy until November 1, but Carrie had not filed a financing statement until September 1 (four months after the creation of the security interest). Is Carrie's security interest avoidable under BRA § 547?

3. Purchase Money Security Interests.

As has often been noted, purchase money security interests get special treatment in and out of bankruptcy. Transfers that are avoidable under BRA § 547(b) may not be avoidable because of certain exceptions in BRA § 547(c) for purchase money security interests. The exception applicable to purchase money security interests is in BRA § 547(c)(3).

After you have cut through the verbiage of BRA § 547(c)(3), you will discover that the section gives purchase money parties a thirty-day grace period (on or before 30 days after the debtor receives possession) within which to perfect and prevent the security interest from being avoided under BRA § 547(b). To this extent the scheme is not unlike that provided for in new Article 9, section 9-317(e), examined in Chapter 26 (Secured Party Versus Lien Creditor). However, the grace period in new section 9-317(e) is twenty days and not thirty days (actually, the period provided for in BRA § 547(c)(3) was twenty days until October of 2005), unless and until the period in new section 9-317(e) is changed to correspond to that in BRA § 547(c)(3) there could be some curious outcomes. You may explore the application of BRA § 547(c)(3) in the next problem.

Problem 30.7 (INTERACTIVE)

On May 30 Sid Seller sells a drill press to Donna Debtor on credit for use in Donna's business. Sid takes a security interest in the drill press to secure its price. The drill press is delivered to Donna on June 5. Sid files a financing statement covering the drill press on July 1. Donna files bankruptcy on July 2. Is Sid's security interest avoidable under BRA § 544?

If the security interest were not purchase money, would it be avoidable under BRA § 547(b)?

Is the security interest nonetheless safe from being avoided under BRA § 547(b)?

Suppose that Donna filed bankruptcy on June 30. Would new section 9-317(e) and BRA § 546(b) prevent the trustee from avoiding the security interest under BRA § 544?

If Donna filed bankruptcy on June 30 would Sid's security interest as to which Sid filed a financing statement on July 1 be avoidable under BRA § 547? Be sure to read carefully not only BRA § 547(c)(3), but also BRA § 362(b)(3).

4. After-Acquired Property Cases.

So far we have looked only at situations where the collateral in which a security interest was taken was in existence at the time the security interest was created. After-acquired property cases present special problems in bankruptcy. Recall that under BRA § 552 a security interest is not enforceable in property acquired after a bankruptcy has been filed unless the property is proceeds. However, a security interest can be avoided under BRA § 547 even where the property was acquired *before* bankruptcy was filed.

The crux of the difficulty is BRA § 547(e)(3). BRA § 547(e)(3) mandates that no matter what else may be true under BRA § 547, there can be no transfer *for purposes of BRA § 547* until the debtor has rights in the collateral, *i.e.*, until the debtor has acquired the collateral.

You may consider the operation of BRA § 547(e)(3) in the next problem.

Problem 30.8 (INTERACTIVE)

On May 1 Central Bank lends to Donald Debtor and takes a security interest in Donald's equipment, existing and after-acquired. Central files immediately. On May 1, Donald's equipment includes an Apex drill press. On June 1 Donald acquires a Superior drill press. On July 1 Donald files bankruptcy. Is Central Bank's security interest in the Apex drill press avoidable under BRA § 544? Is Central's security interest in the Superior drill press avoidable under BRA § 547?

5. BRA § 547(e)(3) and Inventory and Accounts.

BRA § 547(e)(3) presents special problems for inventory and accounts collateral as such collateral is likely to consist extensively of after-acquired inventory and accounts. Congress created a special exception that offers some protection against the effect of BRA § 547(e)(3). That exception is found in BRA § 547(c)(5). You should read the provision but you likely will not understand it without some explanation. Oversimplifying somewhat, the exception protects security interests in after-acquired inventory and accounts (and the proceeds thereof) to the extent that inventory and accounts acquired during the preference period (the ninety-day period) do not improve the position of the secured party at the expense of the estate (other creditors). Here we can do no more than lay out the basic operation of the scheme in a case that is free of the many complexities that actually may arise.

The next problem allows you to explore the basics of BRA § 547(c)(5) as applied to a simple inventory situation free of many of the complexities that actually may arise.

Problem 30.9 (INTERACTIVE)

On May 1 Southern Bank lends to Donna Debtor and takes a security interest in Donna's inventory of widgets, existing and after-acquired. Southern files immediately. On June 1 Donna owes

Southern $50,000 and the inventory of widgets is worth $40,000. During the next ninety days Donna acquires $10,000 worth of widgets. On September 1 Donna files bankruptcy. On that date the debt owed Southern is still $50,000 but the inventory of widgets is worth $50,000.

To what extent is Southern Bank's security interest avoidable under BRA § 547? Hint: Compare Southern Bank's position on June 1 with its position on September 1.

D. Avoidance of Security Interests under BRA § 522(f)

Most states have exemption laws that protect certain property against legal process. There also are some exemptions in federal law and in the bankruptcy statute. The exemption laws prevent a creditor from levying on the exempt property to enforce a judgment. They do not affect the enforcement of a security interest. Thus, a security interest is enforceable under both state law and bankruptcy law against an item of property despite the fact that the property is exempt from legal process.

However, BRA § 522(f)(1)(B) allows a debtor to avoid a non-possessory, non-purchase money security interest to the extent that the security interest impairs an exemption in property that is listed in BRA § 522(f)(1)(B).

There are certain prerequisites to the avoidance of a security interest under BRA § 522(f)(1)(B). The first is that the security interest must be non-possessory and non-purchase money.

The second, there must be an exemption to be impaired by the security interest. Most states, including Arizona, have "opted out" of the federal bankruptcy provisions. Therefore, the exemptions available to a debtor who files bankruptcy in Arizona (and most other states) are those that are provided in state law and in non-bankruptcy federal law. The latter includes some special protection for such things as social security benefits and do not have a role with regard to BRA § 522(f)(1)(B). The relevant Arizona exemptions, those for personal property, are found in A.R.S. § 1121 *et seq*. These exemptions are considered at length in B & S (cited in Chapter 3), Ch. 22. There are limited exemptions for household goods and certain personal property and also for tools of trade.

The third prerequisite for BRA § 522(f)(1)(B) to apply is that the property involved must be listed in BRA § 522(f)(1)(B). The list includes:

> "(i) household furnishings, household goods, wearing apparel, appliances, books, animals, crops, musical instruments, or jewelry that are held primarily for the personal, family, or household use of the debtor or a dependent of the debtor;
>
> (ii) implements, professional books, or tools, of the trade of the debtor or the trade of a dependent of the debtor; or
>
> (iii) professionally prescribed health aids for the debtor or a dependent of the debtor."

Lastly, the non-possessory, non-purchase money security interest must "impair" an exemption. BRA § 522(f)(2)(A) specifies what constitutes impairment. The gist of the provision is that an exemption is impaired when its dollar value is reduced by the enforcement of the security interest. Thus, if a television is exempt in the amount of $500 and there is a security interest in the television to secure a debt of $300 and the television is worth $500, then the security interest impairs the exemption in the amount of $300 and may be avoided to that extent. If the television is worth enough to satisfy both the exemption and the security interest then the security interest does not impair the exemption.

You may consider the operation of BRA § 522(f)(1)(B) in the next problem.

Problem 30.10 (INTERACTIVE)

Friendly Finance Company lends $1,000 to Donald Debtor to enable Donald to purchase a used Honda automobile for personal and family purposes. Friendly takes a security interest in the Honda and Donald uses the $1,000 to purchase the Honda. Debtor files bankruptcy in Arizona owing $1,000 to Finance Company. The Honda is worth $1,500. Arizona law, A.R.S. § 33-1125(8) provides a $1,500 exemption for a vehicle used primarily for personal purposes.

Is Friendly's security interest avoidable under BRA § 544?

Assume that Friendly timely perfected the security interest in the Honda? Is the security interest avoidable under BRA § 522(f)(1)(B)?

Suppose that Donald did not use the $1,000 to purchase the Honda. May Donald avoid Friendly's security interest under BRA § 522(f)(1)(B)?

Arizona law, A.R.S. § 33-1130(1), contains a $2,500 exemption for a vehicle used primarily in business. Suppose the facts of Problem 30.10 are that Friendly Finance Company's security interest is not purchase money and Donald Debtor uses the Honda primarily in Donald's business. Does BRA § 522(f)(1)(B) apply now? If so, to what extent is Friendly's security interest avoidable?

Recall from Chapter 11 (Enforceability and Attachment of Security Interests in Consumer Transactions) that taking a non-possessory, non-purchase money security interests in household goods (other than certain electronic goods) is an unfair trade practice under the FTC Fair Credit Practices Rule. To this extent, the importance of BRA § 522(f)(1)(B) is diminished.

CASE COMMENTARY

In re *Yates*, 332 B.R. 1 (10th Cir. BAP 2005)

In re *James Baker*, __ F.Supp.2d __, 2006 WL 1778203 (D. Colo. 2006)

In re *Watson*, 286 B.R. 594 (Bkcy D. N.J. 2002)

In re *Jeans*, 326 B.R. 722 (Bkcy W.D. Tenn. June 28, 2006)

In re Millivision, Inc., 474 F.3d 4 (1st Cir. 2007)

In re Commercial Money Center, Inc., 350 B.R. 465 (B.A.P. 9th Cir. 2006)

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2011-08-22 update

Show

Part VI Priority

Chapter 31 Secured Party Versus Statutory Liens Including Agricultural Liens and Federal Tax Liens; Bank's Right of Set-Off

A. Generally

You should recall from Chapter 3 (The Nature of Secured Credit under Article 9) that a lien is an interest in property to secure a debt and that there are essentially three kinds of liens: consensual liens, including Article 9 security interests, judicial liens obtained by litigation; and liens that arise by operation of law. The last category of lien includes both a lien created by judicial decision, a "common law lien," and a lien created by statute. Most liens of consequence that arise by operation of law today are statutory liens. This chapter examines only conflicts between secured parties and holders of liens created by statute.

Most states, including Arizona, have created a range of statutory liens aimed at protecting particular types of creditors who have been deemed deserving of such protection. Among the statutory liens are landlord liens, artisan liens and garage (repair shop) liens. Former Article 9 excluded from its coverage the creation, perfection and enforcement of statutory liens and most priority disputes involving such liens also were outside the scope of former Article 9. However, under former section 9-310 a creditor who had a lien arising by operation of law on goods in the possession of the creditor to secure debts resulting from the fact the creditors had furnished materials or services with respect to the goods was given priority over a holder of a security interest unless the lien was statutory *and* the statute *expressly* conferred priority on the holder of the security interest.

As discussed in Chapter 4 (Scope of Article 9), the creation, perfection and enforcement of most statutory liens and most priority disputes involving such liens are outside the scope of new Article 9. *See* new section 9-109(d). However, as explained in Chapter 4 and later chapters, new Article 9 does apply to agricultural liens. Thus, new Article 9 governs the perfection of agricultural liens and most priority disputes between holders of agricultural liens and Article 9 security interests (although the creation and scope of an agricultural lien are matters determined by the statute creating the lien). New Article 9, section 9-333, also continues the special priority given by former section 9-310 to holders of certain possessory liens on goods as to which materials and services have been furnished.

In many states, including Arizona, liens on property to secure the payment of delinquent taxes are given to the state and subdivisions of the state. Because the state tax lien schemes may differ from one state to another, these materials make no attempt to deal with state tax liens or priority disputes between Article 9 secured parties and tax lien holders.

Liens resulting from the failure to pay federal taxes also are possible. Federal tax liens can pose serious problems for Article 9 secured parties. The rules governing priority disputes between holders of federal tax liens and holders of Article 9 security interests, which derive heavily from court decisions as ameliorated by the Federal Tax Lien Act of 1966, are considered in subpart D below. However, an in depth treatment of federal tax liens also is beyond the scope of these materials. Chapter 5 of the B & S text (cited in Chapter 3) offers a detailed discussion of federal and state tax liens. Other chapters of the B & S text discuss various types of liens arising under state law at some length.

B. Secured Party versus Agricultural Lien

As defined in new section 9-102(a)(5) a lien is an "agricultural lien" essentially if it is an interest (other than a security interest) in farm products that is created by statute, that secures payment of an obligation for goods or services furnished in the ordinary course of business to a debtor who is engaged in a farming operation and that is not dependent on possession.

As was seen in Chapter 12 (Perfection Generally) and Chapter 13 (Overview of Perfection by Filing), agricultural liens are perfected by filing a financing statement in the Office of the Secretary of State in the state where the farm products are located. *See* new 9-302, 9-310(a) and 9-501(a). As explained in Chapter 28 (Secured Party Versus Secured Party), priority disputes generally are resolved according to the first in time to file or to perfect or to attach rules of new section 9-322(a).

These rules apply to disputes involving agricultural liens except that under new section 9-322(g) a perfected agricultural lien has priority over a conflicting security interest in (or agricultural lien on) the same collateral if the statute creating the agricultural lien so provides. As stressed in Official Comment 12 to new section 9-322, a priority provided for in a statute creating a competing agricultural lien trumps the rules of new section 9-322(a) only if the agricultural lien is perfected.

In Chapter 9 (The Specifics of Enforceability -- After-Acquired Property, Proceeds and Future Advances) and Chapter 16 (Perfecting Security Interests in Proceeds and Other Later Acquired Property) it was noted that an agricultural lien on proceeds cannot arise or be perfected under Article 9. The extent to which an agricultural lien reaches proceeds is determined by the statute creating the agricultural lien. Official Comment 12 to new section 9-322 emphasizes that the rules in new section 9-322 applying to proceeds disputes, discussed in Chapter 28 (Secured Party Versus Secured Party) and Chapter 29 (Secured Party Versus Secured Party (continued)), do not apply to proceeds disputes involving agricultural lien holders.

That same comment insists that if an agricultural lien has priority under new section 9-322(g) (because the agricultural lien is perfected and the statute creating it confers priority) *and* the statute creating the agricultural lien gives the holder of the lien a lien on proceeds, then a court should apply the principle of new section 9-322(g) and award priority to the holder of the perfected agricultural lien.

It would seem that by enacting new Article 9 a state has made a decision to displace whatever decisional law might favor an agricultural lien over a security interest with the Article 9 scheme as set forth in new section 9-322. It would further seem, however, that a holder of a statutory lien, whether or not it qualifies as an agricultural lien, is free to create an Article 9 security interest in the property subject to the lien.

If the lienholder does create a security interest then any dispute with another Article 9 party would be resolved according to the priority rules governing disputes between and among secured parties, as discussed in Chapter 28 (Secured Party Versus Secured Party) and Chapter 29 (Secured Party Versus Secured Party (continued)). *Cf. United States v. Globe Corp.*, 546 P.2d 11 (AZ 1976) (Indicating that a holder of a landlord lien could create and perfect an Article 9 security interest in property covered by the landlord lien).

The next two problems illustrate several aspects of the new Article 9 scheme for resolving disputes between agricultural liens and security interests.

Problem 31.1 (INTERACTIVE)

Selma Seller sells cottonseed on credit to Dell Debtor to be used by Dell for planting and growing cotton on farmland in Marana, Arizona, leased by Dell from Strobe Corporation, the owner of the land. Dell gives Selma an interest in the cotton grown from the seed to secure the unpaid price of the seed. Dell signs a security agreement covering the cotton crop but Selma does not file a financing statement. Dell borrows from Western Bank to finance his farming operations. Dell gives Western a security interest in "the crop of cotton to be grown this coming year" and authenticates a security agreement so describing the collateral. Western immediately files a financing statement covering the cotton crop in the Arizona Secretary of State's Office. Dell encounters serious financial difficulties and defaults on the debts to Selma and Western and also his rental obligations to Strobe Corporation. Arizona has enacted two statutes that could support a claim of an agricultural lien. They are:

A.R.S. § 33-901 Lien for furnishing labor or machinery upon agricultural land (Farm Services Lien)

A person who labors or furnishes labor or machinery or equipment in improving and preparing agricultural lands for planting crops, and to whom wages or monies are due and owing therefor, shall have a lien upon the crops produced on such lands for all unpaid amounts.

A.R.S. § 33-362 Landlord's lien for rent (Remedies of Landlord)

A. The landlord shall have a lien on all property of his tenant not exempt by law, placed upon or used on the leased premises, until the rent is paid. The lien shall not secure the payment of rent accruing after the death or bankruptcy of the lessee, or after an assignment for the benefit of the lessee's creditors.

B. The landlord may seize for rent any personal property of his tenant found on the premises, but the property of any other person, although found on the premises, shall not be liable therefor. If the tenant fails to allow the landlord to take possession of such property, the landlord may reduce the property to possession by an action to recover possession, and may hold or sell the property for the payment of the rent.

C. The landlord shall have a lien for rent upon crops grown or growing upon the leased premises, whether the rent is payable in money, articles of property or products of the premises, and also for the faithful performance of the terms of the lease, and the lien shall continue for a period of six months after expiration of the term of the lease.

D. When premises are sublet, or when the lease is assigned, the landlord shall have the same lien against the sublessee or assignee as he has against the tenant and may enforce the lien in like manner.

Which of the creditors, Selma Seller, Western Bank and Strobe Corporation, has an agricultural lien? Which of these creditors has a security interest?

Problem 31.2 (INTERACTIVE)

Assume the facts of Problem 31.1.

Does Strobe Corporation have priority over Selma Seller as to the cotton crop?

Would your answer to the previous question be different if A.R.S. § 33-362 conferred priority on the holder of a landlord's lien?

Who does have priority as to the cotton crop as between Selma and Strobe Corporation?

The statutes in some states make the determination of the priority between a security interest and a lien that could qualify as an agricultural lien more straightforward. For example, the Iowa landlord's lien statute creates a lien on crops not unlike that conferred by A.R.S. § 33-362(C) above, but the statute specifically provides that such a lien may be perfected only by filing a financing statement pursuant to new sections 9-308(a) and 9-310(a) of new Article 9 and if the lien is so perfected then the lien has priority over a prior Article 9 security interest. Moreover, according to the Iowa courts the lien applies to proceeds of crops. *See* *Agriliance, L.L.C. v. Runnells Grain Elevator, Inc.*, 272 F. Supp. 2d 800 (S.D. Iowa 2003).

In other states it may be unclear what a lienor has to do to perfect and, specifically, whether filing under Article 9 is required, and whether any priority conferred by the statute extends to proceeds. *See, e.g.*, *Stockman Bank of Montana v. AGSCO, Inc.*, 727 N.W.2d 742 (N.D. 2007) (concluding that substantial compliance with a statute was enough to give a supplier an agricultural lien created by the statute).

It is important to keep in mind in all cases that under new section 9-322(g), a priority over a security interest will be effective only if the priority is provided for in the statute creating the lien. *See* Official Comment 12 to new 9-322.

C. Priority of Possessory Liens Arising by Operation of Law

Under new section 9-333(b), a possessory lien on goods has priority over a security interest in the goods unless the lien is created by a statute that expressly provides otherwise. For purposes of the special priority given by new section 9-333(b), under new section 9-333(a), a "possessory lien" is an interest, other than a security interest or agricultural lien, that

(1) secures payment of a debt incurred for services or materials furnished with respect to the goods by a person in the ordinary course of that person's business;

(2) is created by statute or rule of law in favor of the person; and

(3) depends for its effectiveness on the person's possession or the goods.

According to new section 9-333(b), a holder of a possessory lien on goods has priority over a holder of a security interest in the goods unless the lien is created by statute *and* the statute creating the lien expressly gives priority to the security interest. Implicitly, a security interest could never have priority over a possessory lien arising under common law. Moreover, if the lien is created by statute, the lien has priority over the security interest unless the statute *expressly* confers priority on the security interest.

The reality is that many statutes creating liens that would qualify as possessory liens under new section 9-333(a) were not drafted with Article 9 in mind and may use language that leaves its intent as to priority unclear. The requirement that the statute expressly give priority to the security interest would seem to mean that doubts regarding the intent of the statute are to be resolved in favor of the lien holder. Official Comment 2 to new section 9-333 reinforces this interpretation.

Note that to qualify as a possessory lien under new section 9-333(a) the person claiming the lien must have furnished services or materials with respect to the goods involved and must have done so in the ordinary course of the person's business. A landlord's lien would not fall within new section 9-333. An agricultural lien as defined in new section 9-102(a)(5) would qualify except that new section 9-333(a) excludes agricultural liens. Actually, the exclusion seems unnecessary because under new section 9-102(a)(5) a lien can be an agricultural lien only if it is *not* dependent for its effectiveness on possession.

The clearest examples of liens that are eligible for the special priority in new section 9-333(b) are liens given to artisans and repair shops. However, if the lien is not dependent on possession then the lien does not qualify as a possessory lien under new section 9-333(a). Moreover, any statute creating such a lien must be consulted to discover whether the statute expressly gives priority to a competing security interest.

Of course, a statute may create a lien that does not qualify for priority under new section 9-333(b) and the statute may specify the priority of the lien holder over other creditors, including secured parties. In re *S.M. Acquisitions Co.*, 296 B.R. 452 (D. Ill. 2003).

You may consider the operation of new section 9-333 in the next three problems.

Problem 31.3 (INTERACTIVE)

Delia Debtor buys a television for personal use from Sid Seller on credit. Delia gives Sid an interest in the television to secure its unpaid price and Delia authenticates a security agreement that satisfies new section 9-203(b)(3)(A). Before Delia has paid the full price of the television Delia takes the television to QuicFix TV Shop for repairs. Delia fails to pay QuicFix for the cost of the repairs and Delia also defaults on the debt owed to Sid. Sid seeks to repossess the television from QuicFix. QuicFix refuses to give up the television. All of the foregoing events take place in Arizona. Arizona has enacted the following statute:

> A.R.S. § 33-1021. Lien for labor or materials furnished on personal property; right to possess property (Personal Property Lien)
>
> When an article, implement, utensil or vehicle, except motor vehicles, is repaired or cleaned, glazed or washed, with labor, with or without material, by a carpenter, mechanic, artisan or other workman, such person shall have a lien thereon for the labor or material and may retain possession thereof until the amount due is fully paid.

Does QuicFix have a personal property lien under A.R.S. § 33-1021?

Does QuicFix have a "possessory lien" under new section 9-333?

Who as between Sid Seller and QuicFix has prior claim to the television?

Note that motor vehicle situations are outside the scope of A.R.S. § 33-1021. Consider the following problem.

Problem 31.4 (INTERACTIVE)

Donald Debtor, an Arizona resident, purchases a WhirlWind fifth-wheel trailer from Sam Seller, an Arizona WhirlWind dealer. Fifth-wheel trailers are house or recreational type trailers that are designed to connect to the bed of a pick up truck (which pulls the trailer). The WhirlWind trailer was purchased on credit and Donald signed an installment contract giving Sam an interest in the trailer to secure its unpaid price. Before the price of the trailer has been paid, Donald takes the trailer to Trailer Outfitter, Inc., an Arizona business specializing in customizing and otherwise modifying trailers, for some expensive modifications. Donald fails to pay for the modifications and has defaulted on the debt owed to Sam. Arizona has enacted the following statute:

> § 33-1022. Garages; aircraft
>
> A. Proprietors of garages and repair and service stations shall have a lien upon motor vehicles of every kind and aircraft, and the parts and accessories placed thereon, for labor, materials, supplies and storage for the amount of the charges, when the amount of the charges is agreed to by the proprietor and the owner.

B. The lien shall not impair any other lien or conditional sale of record at the time the labor, materials, supplies and storage were commenced to be furnished, unless furnished with the knowledge and consent of the record lienor or vendor.

C. If a proprietor has a lien on an aircraft pursuant to subsection A of this section, the proprietor who provides labor, materials, supplies and storage for aircraft may relinquish possession of the aircraft and retain the lien by recording the lien with the county recorder of the county in which the labor, materials, supplies or storage were provided. The lien shall be filed with the county recorder within thirty days after possession is relinquished. In addition, the proprietor may record the lien with the federal aviation administration aircraft registry. A lien filed with the federal aviation administration aircraft registry shall comply with all requirements of federal law and shall accurately describe the aircraft, list the amount of the claim, list the date on which the labor, materials, supplies or storage were last furnished, be signed by the claimant showing the title of the signer, if appropriate, and be accompanied by the recording fee

D. A lien which is filed with a county recorder pursuant to subsection C of this section does not bind a purchaser of the aircraft without actual notice of the lien unless the lien has also been recorded with the federal aviation administration aircraft registry. A lien authorized under subsection C of this section may be foreclosed only by an action in court.

E. When an aircraft lien which has been recorded under this section has been satisfied, the lienholder within thirty days after satisfaction shall issue a release of the lien to the person against whom the lien was claimed and shall record the release of that lien in the county in which the lien was recorded and with the federal aviation administration aircraft registry, if the lien was recorded there. Failure to record a release upon satisfaction of the lien shall subject the lienholder to the penalties prescribed in § 33-712.

Who has prior claim to the WhirlWind trailer as between Sam Seller and Trailer Outfitter?

Does A.R.S. § 33-1022 govern? What question must be answered before you can answer the previous question? *See Western Coach Corp. v. Malibu Corp.*, 528 P.2d 868 (Ariz.App. 1974).

If A.R.S. § 33-1022 does not apply does Trailer Outfitter have a lien under A.R.S. § 33-1021 and priority under new section 9-333(b)? Be sure to read A.R.S. § 33-1021 carefully before answering.

If A.R.S. § 33-1022 does not give Sam Seller priority and Trailer Outfitter does not have priority under A.R.S. § 33-1021 and new section 9-333(b) then which of these creditors has priority?

Problem 31.5 (INTERACTIVE)

If the dispute in Problem 31.4 were over the pickup used to pull the trailer rather than the trailer itself, who would have priority as between Sam Seller and Trailer Outfitter? Be sure to read A.R.S. § 33-1022(B) carefully before answering. Explain your answer.

Notice that A.R.S. §§ 33-1021 and 33-1022 cover liens for work done on airplanes. The application of the lien statute to aircraft was considered in *U.S. v. 1980 Lear Jet, Model 35A, Serial Number 277*, 25 F.3d 793 (9^{th} Cir. 1994).

D. Secured Party versus Federal Tax Lien

Debtors who default on secured debts may well have income tax problems. The Internal Revenue Service (IRS) is a formidable adversary for taxpayers and for their creditors. The IRS can obtain a tax lien on most of a taxpayer debtor's property simply as the result of a taxpayer's failure to pay an assessed deficiency when demanded by the IRS to do so. 26 U.S.C § 6321. Unless specifically provided otherwise in an applicable statute, the tax lien arises at the time of the assessment and continues until the tax liability is satisfied. 26 U.S. C. § 6322.

A federal tax lien is basically a secret lien. No recording is necessary for the lien to be effective against a taxpayer and many of the taxpayer's creditors. Subject to important qualifications made by the Federal Tax Lien Act of 1966, 26 U.S.C. § 6321 *et seq*., the *Doctrine of Inchoateness* governs. Under this doctrine a tax lien has priority over other interests in property subject to the tax lien unless the identity of the claimant, the property in which the interest is claimed and the amount owed are fixed at the time the tax lien arises. *See, e.g., United States v. Globe Corp.* , 546 P.2d 11 (AZ 1976). Obviously, the inchoateness doctrine creates special difficulties for commercial financing involving after-acquired collateral.

The Federal Tax Lien Act in 26 U.S.C. § 6323(a) offers some protection to persons who are holders of security interests prior to the time a tax lien is recorded. However, under 26 U.S.C § 6323(h)(1), a person is a holder of a security interest within the meaning of the act only to the extent that the security interest is perfected in the sense that it cannot be subordinated by a lien creditor.

Moreover, there are special rules governing interests in after-acquired property and future advances. Under 26 U.S.C. § 6323(c), after-acquired property interests are protected only if the collateral is "commercial financing security," meaning essentially chattel paper, accounts and inventory, and only to the extent that the collateral is acquired within 45 days after the tax lien is recorded.

Likewise, discretionary future advances are protected only to the extent they are secured by security interests in chattel paper, accounts and inventory and only advances made without knowledge of the tax lien and within 45 days after the tax lien is recorded are protected. Obligatory advances, advances made pursuant to a commitment, are not subject to the 45-day or knowledge limitation.

Under the foregoing scheme, interests in after-acquired property other than chattel paper, accounts and inventory arising after a tax lien has arisen (after an assessment) are inchoate at the time the tax lien arises and will be subordinate to the tax lien, irrespective of whether or not the tax lien has been recorded. Similarly, future advances secured otherwise than by interests in chattel paper, accounts and inventory will be subordinated to the extent they are made after a tax lien arises, whether or not the tax lien has been recorded.

Security interests in chattel paper, accounts and inventory acquired within 45 days after a tax lien is recorded are protected. Future advances secured by interests in chattel paper, accounts and inventory owned by the taxpayer or acquired with 45 days after a tax lien is recorded are protected to the extent the advances are obligatory and discretionary advances are protected to a similar extent if they are made within 45 days after a tax lien is recorded and without actual knowledge that a lien has been recorded.

The message to secured parties is two-fold. First, secured parties are always at risk as to interests in and advances secured by property *other than* chattel paper, accounts and inventory, *i.e.*, "commercial financing security," and secured parties must be alert to the possibility of tax problems and resulting tax liens. Second, as to collateral consisting of chattel paper, accounts and inventory and discretionary advances secured by interests in such collateral, secured parties should examine the public records every 45 days and should take appropriate action upon discovery of a tax lien.

Appropriate action means not making any discretionary advances more than 45 days after the tax lien is recorded and may well mean treating the recording of a tax lien as a default leading to foreclosure on all collateral acquired by a debtor before the end of the 45-period after the recording of a tax lien.

Whether or not it is practicable for a secured party in a given case to act as the federal tax lien laws dictate is a nice question. In any event, acting appropriately requires knowing where to look for a tax lien. Under 26 U.S.C. § 6323(f), states may designate the place in which a tax lien is to be recorded. Arizona law, A.R.S. § 33-1032(B), designates the County Recorder's Office in the county where real property subject to a tax lien is located as the place in which the tax lien is to be recorded.

As to personal property, the place for recording a tax lien depends on whether the debtor/taxpayer is an organization (a corporation or partnership) or an individual. As to an organization, under A.R.S. § 33-1032(C)(1), the place for recording is the Office of the Secretary of State. As to individual debtor/taxpayers, under A.R.S. § 33-1032(C)(4), the County Recorder's Office in the county in which the individual resides has been designated as the place for recording a tax lien.

Federal law governs as to the form and content of a notice of a federal tax lien and state law requirements, including those of Article 9, do not determine whether a particular notice is sufficient. *See* 26 U.S.C. § 6323(f)(3) and *United States v. Union Central Life Insurance Co., 368 U.S. 291 (1961)*. Thus, for example, new Article 9 section 9-503 does not govern the sufficiency of a name used in a notice of a federal tax lien.

Interestingly, however, the courts have employed a test of the sufficiency of the debtor's name used that resembles that found in new sections 9-503 and 9-506. That test is one of reasonableness, understood to mean, would notice of a tax lien have been disclosed in a search done in the office designated by the state for filing tax liens using the debtor's legal name and the search procedures of the office so designated.

In the case of *In re Spearing Tool and Mfg. Co., Inc.*, 302 BR 351 (E.D. Mich. 2003), the court concluded that a federal tax lien filed under the name "Spearing Tool & MFG Company, Inc." as to a debtor whose registered name was "Spearing Tool and Manufacturing Co." was not effective given that the Michigan Secretary of State's Office, where the tax lien was filed, did not engage in searches using variations on the name and creditors had no independent access to the search index and the tax lien had not shown up during routine searches conducted by the creditor.

In reaching its decision, the court determined that it was not reasonable to expect a creditor to submit search requests under various spellings of the debtor's name, but it was reasonable to impose on the IRS the burden of using the correct legal name. The court added that even though the creditor in the case had access to the debtor's tax returns and could have learned of tax deficiencies from the IRS, creditors generally engage in such investigations only when deciding to extend credit initially and not when making future advances.

In the course of its opinion the court noted that "while the new version of the UCC, i.e., state law, does not control the content of federal tax liens, it does shed light on what is reasonable behavior for searchers in today's environment."

You may explore the basics of the Doctrine of Inchoateness, the Federal Tax Lien Act of 1966 and the rules governing priority disputes between Article 9 secured parties and the IRS in the next two problems.

Problem 31.6 (INTERACTIVE)

On January 1, Lisa Lender lends Delta Corporation $10,000 and takes an interest in all Delta's equipment, existing and hereafter acquired, to secure the loan. The loan agreement contains a clause providing that the interest in Delta's equipment shall secure all Delta's indebtedness to Lisa, and defines indebtedness to mean any amounts presently owed to Lisa and any advances that Lisa should choose to make in the future. Lisa properly files a financing statement. On March 1, the IRS assesses a tax deficiency against Delta. On April 1, the IRS properly records a notice of the tax lien. On May 1, Delta acquires several items of new equipment. On May 5, Lisa, without knowledge of the tax lien, lends Delta another $5,000. Delta defaults without paying anything to Lisa.

Which of the following accurately describes the outcome of a priority dispute between Lisa and the IRS? It will be helpful to you to sketch the events so as to capture the timing of the various events.

(A) Lisa's security interest is prior to the tax lien as to the equipment in existence on April 1 and as to that acquired on May 1, in the amount of $15,000.

(B) Lisa's security interest is prior to the tax lien in the amount of $15,000, but only as to the equipment in existence on March 1.

(C) Lisa's security interest is prior to the tax lien as to the equipment in existence on April 1 and as to that acquired on May 1, but only in the amount of $10,000.

(D) Lisa's security interest is prior to the tax lien only in the amount of $10,000 and only as to the equipment in existence on March 1.

Problem 31.7 **(INTERACTIVE)**

Assume the facts of Problem 31.6 but that the collateral in which Lisa Lender has a security interest is existing and later acquired inventory rather than equipment. Which of the following now accurately states the outcome of a priority dispute between Lisa and the IRS?

(A) Lisa's security interest is prior to the tax lien as to the inventory in existence on April 1 and as to that acquired on May 1, in the amount of $15,000.

(B) Lisa's security interest is prior to the tax lien in the amount of $15,000, but only as to the inventory in existence on April 1.

(C) Lisa's security interest is prior to the tax lien as to the inventory in existence on April 1 and as to that acquired on May 1, but only in the amount of $10,000.

(D) Lisa's security interest is prior to the tax lien only in the amount of $10,000 and only as to the inventory in existence on April 1.

E. Bank's Right of Set-Off

As was true under former Article 9, new Article 9, section 9-109(d)(1) excludes rights of set-off from its coverage and although a right of set-off held by a bank has sometimes been referred to as a "banker's lien" the right of a bank to set off a debt against its debtor's bank account is not really a lien at all because, as explained in Chapter 9 (The Specifics of Enforceability – After-acquired Collateral, Future Advances, Transferred Collateral and Proceeds, and the New Debtor Problem), once monies are deposited in a bank account the monies no longer belong to the debtor and a debtor-creditor relationship between the bank as the debtor and the depositor as the creditor is created. *See, e.g.*, *In re Quisenberry*, 295 B.R. 855 (Bkcy N.D. Tex. 2003).

New Article 9 adds a provision, section 9-340, subsection (a) of which generally gives priority to a bank's right of set-off (and recoupment) as against a secured party with a conflicting claim to the bank account. In so doing, new Article 9 has resolved a question that had split courts under former Article 9 in favor of the set-off party. *See* B & S (cited in Chapter 3), 26.04(C) and Official Comment 2 to new 9-340.

The priority conferred upon a bank is qualified in new section 9-340(c). Under that subsection, the exercise by a bank of a right of set-off as to a debt owed by a debtor is ineffective against a secured party who has perfected a security interest in a deposit account by getting control of the deposit account under new section 9-104(a)(3) (by becoming a customer on the account).

The qualification to the priority given the bank comports with new section 9-327(4) which, as explained in Chapter 29 (Secured Party Versus Secured Party (continued)), gives priority to a secured party who has obtained control of a deposit account by becoming a customer on the account over a bank that also has control of the account because the deposit account is maintained at the bank. *See* Official Comment 2 to new 9-340. However, the right of a bank to exercise recoupment rights is not affected by new section 9-340(c).

As noted in subpart B above, a person who has a lien arising by statute (or even as a matter of common law) is not precluded from creating an Article 9 security interest in the property subject to the lien and as also noted there whether a creditor is relying on a lien or on a consensual security interest may affect the outcome of priority disputes regarding the property involved. New section 9-340(b) makes clear that a bank may hold both a right of set-off against and an Article 9 security interest in the same deposit account and by holding a security interest a bank does not impair any right of set-off it would otherwise enjoy. *See* Official Comment 3 to new 9-340.

A bank might wish to create a security interest because it then would have a claim to proceeds of the bank account and the security interest might fare better in bankruptcy than the right of set-off. However, as explained in Chapter 8 (The Specifics of Enforceability – A Security Agreement Authenticated by the Debtor or Its Equivalent), there must be a security agreement giving the holder of the right of set-off an enforceable security interest in the deposit account and an agreement between a bank and its customer creating (or acknowledging) a right of set-off will not serve to render a security interest enforceable unless it satisfies the requirements of new section 9-203(b)(3). *See In re Quisenberry*, *supra*.

It also should be noted that new section 9-340 does not apply to bank accounts evidenced by an instrument, such as a certificate of deposit, because instruments are excluded from the definition of a deposit account in new section 9-102(a)(29). *See* Official Comment 3 to new 9-340.

You may test your understanding of the set-off rules and their interaction with the other priority rules of new Article 9 in the next two problems.

Problem 31.8 (INTERACTIVE)

Sid Seller holds a security interest created by Donna Debtor in Donna's property described in the security agreement as "all of Donna Debtor's inventory and accounts receivables, existing and after-acquired." Donna has opened a bank account at Central Bank and in the security agreement with Sid, Donna has promised to deposit in the account only proceeds from the sale of inventory and the collection of accounts. Sid timely files a financing statement covering the inventory and accounts. Donna's depositor's agreement with Central Bank provides Central Bank with a right to set off against the bank account any debts owed by Donna to Central Bank and that have matured (are past due). Donna has an unsecured line of credit with Central Bank and she has made several draws. Monthly payments owed on the line of credit and totaling $2000 are past due. Donna has defaulted on the secured debt owed to Sid. At the time of the default, Donna owes Sid $1500 on this debt. Sid is prepared to prove that the $1500 balance in the bank account maintained with Central Bank consists entirely of proceeds from the sale of inventory and the collection of accounts subject to Sid's security interest. Central Bank has asserted a right of set-off against the bank account.

Who as between Sid Seller and Central Bank has prior claim to the bank account? Would your answer change if Donna, Sid and Central had agreed in an authenticated record that Central would follow Sid's instructions as to the bank account without further assent by Donna?

Problem 31.9 (INTERACTIVE)

Assume the facts of Problem 31.8. Assume further, however, (a) Donna's line of credit with Central Bank is secured by an interest in the bank account maintained with Central Bank; (b) Sid

Seller perfected its security interest in the bank account under new section 9-104(a)(2); (c) Donna acquired an item of inventory that she paid for with a check drawn on the bank account; and (d) Both Central Bank and Sid can establish that the item of inventory constitutes proceeds of the bank account.

Who as between Sid Seller and Central Bank has priority as to the item of inventory? Explain your answer.

CASE COMMENTARY

Planned Furniture Promotions, Inc. v. Benjamin S. Youngblood, Inc., 374 F. Supp. 2d 1227 (M.D. Ga. 2005)

Stockman Bank of Montana v. AGSCO, Inc., 727 N.W.2d 742 (N.D. 2007)

In re Borden, 361 B.R. 489 (B.A.P. 8th Cir. 2007)

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2011-08-22 update

Show

Part VI Priority

Chapter 32 Fixtures Priorities

A. Generally

In Chapter 4 we saw that real estate transactions are largely outside the scope of Article 9. However, under new sections 9-109(a)(1) and 9-334(a), as was true under former Article 9, new Article 9 governs the creation and perfection of security interests in goods that are fixtures (except for ordinary building materials incorporated into an improvement on land).

In Chapter 20 (Perfection as to Fixtures and Other Real Estate-Related Collateral) it was explained that a security interest in a fixture can be perfected by the usual methods, including filing and also automatically (but not by possession). *See* new sections 9-309(1) and 9-312(a). The earlier discussion of fixtures anticipated the fact that a priority dispute can arise between an Article 9 party and a real estate party. The reason that disputes between Article 9 parties and real estate parties are possible is that, under new section 9-102(a)(41), fixtures are goods that are so affixed to real estate that an interest in the goods can arise under local real estate law.

It was noted in Chapter 20 that new section 9-102(a)(41) does not actually define "fixture," but rather refers the determination of whether or not goods are fixtures to real estate law outside Article 9. It further was noted that the pertinent law outside Article 9 ordinarily consists of tests devised by courts that make it difficult at times to know with certainty whether particular goods are fixtures or not. What is clear is that rules are needed to resolve disputes involving fixtures. These rules are the subject of this chapter.

It will be seen that outcomes in disputes involving real estate parties often turn on whether the Article 9 party has filed a "fixture filing." A fixture filing is made by filing in the real estate records a financing statement that contains special information, including an indication that it is a fixture filing, an adequate description of the real property to which the collateral is affixed and the name of a record owner of the real estate involved if the debtor is not an owner of record. *See* new sections 9-102(a)(40) and 9-502(b) and Chapter 20 (Perfection as to Fixtures and Other Real Estate-Related Collateral).

It was noted in Chapter 20 (Perfection as to Fixtures and Other Real Estate-Related Collateral) that security interests in growing crops and timber to be cut also may come into conflict with real estate interests. As will be seen below, new section 9-334 sets forth an elaborate priority scheme for dealing with such conflicts. As for growing crops, new section 9-334(i) provides quite simply that perfected security interests in growing crops have priority over a conflicting interest of an owner or encumbrancer of the real estate so long as the debtor has an interest of record or is in possession of the real estate.

Unlike disputes as to fixtures and growing crops there are no new Article 9 rules dealing with conflicts involving timber to be cut as such. That courts will struggle with fashioning outcomes for such conflicts is illustrated by the case of *Feliciana Bank & Trust v. Manuel & Sessions, L.L.C.*, 943 So.2d 736 (Miss.App. 2006), in which the court never really recognizes that new Article 9 priority rules should be consulted.

B. Secured Parties Versus Other Parties Claiming Goods as Goods

It is important to keep in mind that fixtures are goods and disputes may arise among parties who claim the goods as goods (or "personalty"). Conflicts between a secured party and other parties with interests in collateral *as goods* are governed by the priority rules examined in Chapters 26, 27, 28 and 29.

You may consider the application of those rules to disputes among parties claiming interests in the collateral *as goods* in the next four problems.

Problem 32.1 (INTERACTIVE)

Donna Debtor borrows from Western Bank and gives Western a security interest in a large drill press which is used by Donna in Donna's business and which is bolted to the floor of Donna's plant. Western files a "fixture filing" in the proper place. Thereafter, Lenny Lender lends to Donna and takes a security interest in the same drill press. Lenny files a financing statement covering the drill press with the Secretary of State's Office. Donna then defaults on both loans. Under state law a purchaser of Donna's plant would *not* acquire any interest in the drill press.

Who has priority as between Western Bank and Lenny Lender?

Problem 32.2 (INTERACTIVE)

Assume the facts of Problem 32.1. Assume further, however, that after Western Bank and Lenny Lender file, Donna Debtor sells the drill press to Byron Buyer who gives value and receives delivery without knowledge of either Western's or Lenny's security interest.

Does Byron Buyer take free of Western Bank's security interest? Does Byron Buyer take free of Lenny Lender's security interest?

Problem 32.3 (INTERACTIVE)

Assume the facts of Problem 32.1. Suppose instead of a sale Donna Debtor suffered a judgment pursuant to which the sheriff levied on the drill press after Western and Lenny filed.

Does the resulting judicial lien subordinate Western Bank's security interest? Does the resulting judicial lien subordinate Lenny Lender's security interest?

Problem 32.4 (INTERACTIVE)

Assume the facts of Problem 32.1. Assume further, however, that the drill press was affixed to Donna Debtor's plant in such a way as to give a purchaser of Donna's plant an interest in the drill press under local real estate law.

Would Lenny Lender still have priority over Western Bank?

On the change in facts, would a buyer who satisfied the conditions stated in new section 9-317(b) after Western filed take free of Western Bank's security interest?

On the change in facts, would a lien obtained by levy after Western filed subordinate Western

Bank's security interest?

C. Article 9 Security Interests Versus Real Estate Parties

1. Generally.

We now look at conflicts between secured parties and parties with an interest in the collateral arising under real estate law. Such conflicts arise only if the goods are fixtures as defined in new section 9-102(a)(41), *i.e.*, goods that are so attached to real estate that under local real estate law a party who takes an interest in the real estate acquires an interest in the goods.

Real estate parties have no interest (as real estate parties) in goods that are *not* fixtures. A possible exception, discussed below, is that in some states a real estate mortgage can reach crops. Where the goods *are* fixtures special priority rules govern disputes between Article 9 parties and real estate parties.

The general rule under former Article 9 was that a security interest was subordinate to the conflicting interest of an encumbrancer or owner of the related real estate who was not the debtor. However, the general rule was subject to a number of exceptions, most of which turned on whether or not the secured party had made a fixture filing. New Article 9 retains the basic scheme of former Article 9.

Recall from Chapter 20 (Perfection as to Fixtures and Other Real Estate Related Collateral) that a fixture filing is made by filing a financing statement meeting the special requirements of new section 9-502(b) in the real estate records, as provided for in new section 9-501(a)(1)(B). Such a filing reduces the element of surprise to an owner or encumbrancer whose interest predates the affixation of the goods to the real property insofar as the fixture filing is in the chain of title and made against the debtor, where the debtor has an interest of record in the real estate, or the financing statement names a party of record other than the debtor where the debtor is in possession but has no interest of record (such as a lessee). *See* new section 9-502(b)(3).

2. The General Rule

New section 9-334(c) preserves the general rule of former section 9-313(7) that real estate parties prevail by providing that subject to subsections (d) through (h), a security interest in fixtures is subordinate to a conflicting interest of an encumbrancer or owner of the related real property which is not the debtor. Under new section 9-102(a)(32), an "encumbrance" is a right in real property, other than an ownership interest, and includes a mortgage or other lien on real property. An "owner" obviously is a person who has or acquires an ownership interest in real property.

Consequently, Article 9 security interests are at risk as to mortgages and deed of trust holders and other encumbrancers of real estate to which goods that are fixtures are affixed, unless the Article 9 security interest is given priority under an exception to the general rule of new section 9-334(c).

3. Exceptions Requiring Fixture Filings

a. Protection for purchase money security interests

One of the more important exceptions to the general rule in new section 9-334(c) is that in new section 9-334(d). According to new section 9-334(d), subject to new section 9-334(h) for construction mortgages, a perfected security interest in fixtures has priority over a conflicting interest of an encumbrancer or owner of the real property if:

(1) the debtor has an interest of record or is in possession of the real property;

(2) the security interest is a purchase-money security interest;

(3) the interest of the encumbrancer or owner arises before the goods become fixtures; and

(4) the security interest is perfected by a fixture filing before the goods become fixtures or within 20 days thereafter.

This exception to the general rule protects purchase money security interests that are timely perfected by a fixture filing against ownership interests in and encumbrances against real property that arose before the goods become fixtures. It is intended to prevent the real estate party from reaping a windfall from affixation of the goods to the real property.

The exception operates only where the debtor is a party of record as to the real estate or is in possession. Thus, for example, if the debt secured by the goods that have become affixed to real estate was incurred by a contractor who has no interest in the real property then new section 9-334(d) does not protect the party with the security interest in the goods.

b. Construction mortgage qualification to purchase money security interest protection

Under new section 9-334(h), a purchase money security interest in fixtures that qualifies for the special protection in new section 9-334(d) is subordinate to a construction mortgage that is recorded before the goods become fixtures and before completion of construction.

New section 9-334(h) provides that a mortgage is a "construction mortgage" to the extent that it secures an obligation incurred for the cost of the land and improvements to the land if the mortgage indicates it is a construction mortgage. A mortgage given to refinance a construction mortgage has the priority given by new section 9-334(h).

c. Protection against later recorded real estate interests

New section 9-334(e) contains several additional exceptions to the general rule that real estate parties prevail. Under new section 9-334(e)(1), a perfected security interest in fixtures has priority over a conflicting real estate interest if:

(1) the debtor has an interest of record in the real property or is in possession of the property;

(2) the security interest is perfected by a fixture filing before the interest of the encumbrancer or owner is of record; and

(3) the security interest has priority over any conflicting interest of a predecessor in title of the encumbrancer or owner.

New section 9-334(e)(1) provides a first in time of filing or recording priority rule, but requires that the filing be a fixture filing so that the filing will show up in the real estate records and provide notice to real estate parties who record subsequent to the filing. *See* Official Comment 6 to new 9-334. Note that the security interest in the fixture need not be purchase money.

Under new section 9-334(e)(1)(B), the first in time exception applies only if the security interest has priority over any conflicting interest of a predecessor in title of the competing ownership or encumbrancer interest. This requirement acknowledges the usual rule that a person must be entitled to transfer what is being transferred.

Thus, a fixture security interest that is subordinate to a mortgage is subordinate to an assignee of the mortgage even where the assignment is subsequent in time to the creation and filing of the security interest. Likewise, if the fixture security interest is subordinate to the rights of an owner then it is subordinate to a subsequent grantee of the owner and a subsequent mortgagee of the owner. *See* Official Comment 6 to new 9-334.

You may test the operation of the general rule in new section 9-334(c) that real estate parties prevail over parties with security interests in fixtures and the exceptions to it in new sections 9-334(d) and 9-334(e)(1) in the next two problems.

Problem 32.5 (INTERACTIVE)

Delia Debtor owns her home. The real estate and improvements to it are subject to a deed of trust held and duly recorded by Central Bank. Delia has never owned a barbeque. Delia purchases a home gas barbecue unit from Sid Seller on credit. Delia signs an agreement giving Sid an interest in the barbeque unit to secure its price. The barbeque unit is delivered to Delia and built into a patio wall in such a way as to give a purchaser of the home an interest in the barbeque unit.

On these facts, is Sid's security interest in the barbeque unit perfected?

Is Sid's security interest prior to Central Bank's deed of trust interest? Would Sid's security interest in the barbeque be prior to the claim of Betty Buyer who purchases the home from Delia after the barbecue unit is installed and duly records the conveyance in the local real estate records?

How could Sid have assured itself of priority over Central Bank?

How could Sid Seller have assured itself of priority over Betty Buyer?

Problem 32.6 (INTERACTIVE)

Ollie Owner purchases land and contracts with Bob Builder to construct a home on the land. Ollie borrows from Southern Bank to finance construction of the home. Southern secures the loan to Ollie by taking an interest in the land and the improvements and Southern duly records its interest. Bob purchases a central air conditioning system from Selma Seller on credit and gives Selma an interest in the air conditioning system to secure the unpaid price of the system. Selma immediately makes a fixture filing. Two days later, while the home is still under construction, Selma installs the air conditioning system in such a way that the system becomes a fixture under the law outside Article 9. Bob defaults on its debt to Selma. Which of the following correctly states the priority between Selma Seller and Southern Bank?

(a) Selma Seller has priority over Southern Bank under new section 9-334(d).

(b) Southern Bank has priority over Selma Seller under new section 9-334(c).

(c) Selma Seller has priority over Southern Bank under new section 9-322(a)(1).

If Ollie Owner had bought the air conditioning unit from Selma Seller, would Selma now have priority over Southern Bank?

4. Other Exceptions to the General Rule

a. Exception for readily removable fixtures

Under new section 9-334(e)(2), a security interest perfected *by any method* before the goods become fixtures has priority over a conflicting real estate claim to a *readily removable* fixture that is (1) a factory or office machine or (2) equipment not primarily used or leased for use in the operation of the real property or (3) a *replacement* of a domestic appliance that constitutes consumer goods.

The exception to the rule of new section 9-334(c) in new section 9-334(e)(2) applies only in the limited circumstances spelled out in the provision. To the extent that the exception does apply it protects a secured party who because of the uncertainty in the law regarding what is or is not a fixture mistakenly concludes that it is taking a security interest in goods that are not or will not become fixtures and perfects otherwise then by making a fixture filing.

You may consider the operation of new section 9-334(e)(2) in the next problem.

Problem 32.7 (INTERACTIVE)

Betty Buyer owns a home subject to a deed of trust interest held by Southwestern Bank who financed the purchase of the home and duly recorded the deed of trust. Betty, who has never owned a microwave oven, buys a microwave oven from Sid Seller on credit and gives Sid an interest in the microwave oven to secure its unpaid price. Sid installs the microwave oven in Betty's kitchen. The microwave is built into a kitchen wall but would be readily removable.

Which of the following correctly states the priority between Sid Seller and Southwestern Bank? Note that more than one choice may be correct.

(a) If under law outside Article 9 the microwave oven *is* a fixture, Sid Seller has priority over Southwestern Bank under new section 9-334(e)(2).

(b) If under the law outside Article 9 the microwave oven is *not* a fixture, Sid Seller has priority over Southwestern Bank under new section 9-201(a).

(c) If under the law outside Article 9 the microwave oven *is* a fixture, Southwestern Bank has priority over Sid Seller under new section 9-334(c).

(d) If under the law outside Article 9 the microwave oven is *not* a fixture, Southwestern Bank has priority over Sid Seller under new section 9-201(a).

If the microwave were a replacement and also a fixture would Sid Seller have priority over Southwestern Bank even though Sid has made no filing - fixture or otherwise?

b. Exception for Judicial Liens on Real Property

New section 9-334(e)(3) contains an exception to the general rule of new section 9-334(c) that is more important than might first appear. Under new section 9-334(e)(3), a security interest in a fixture has priority over a lien on the real property obtained by legal process after the security interest in the fixture is perfected *by any method*.

As explained in Chapters 26 and 30, a trustee in bankruptcy cannot avoid a security interest under BRA § 544 if the security interest cannot be subordinated by a lien creditor under state law on the date of bankruptcy. In other words, federal bankruptcy law employs a lien creditor test of perfection. If a security interest is protected against a lien creditor under state law on the date of bankruptcy, then a trustee cannot avoid the security interest under BRA § 544.

New section 9-334(e)(3) provides that a security interest in a fixture perfected by any method before a lien is obtained on the real property has priority over the lien. It follows that a security interest in a fixture perfected by any method on the date of bankruptcy cannot be avoided under BRA § 544.

You may consider the application of new section 9-334(e)(3) in the next problem.

Problem 32.8 (INTERACTIVE)

The facts of Problem 32.5 were as follows: Delia owns her home. The real estate and improvements to it are subject to a deed of trust held and duly recorded by Central Bank. Debtor has never owned a barbeque. Delia purchases a home gas barbecue unit from Sid Seller on credit. Delia signs an agreement giving Sid an interest in the barbeque unit to secure its price. The barbecue unit is delivered to Delia and built into a patio wall in such a way as to give a purchaser of the home an interest in the barbeque unit. Assume further that after the barbeque is delivered the sheriff levies on the real estate pursuant to a writ obtained by Leon Lien Creditor.

Who has priority as between Sid Seller and Leon Lien Creditor?

If the sheriff levied on the barbeque who would have priority as between Sid Seller and Leon Lien Creditor?

If instead of a levy, Delia filed bankruptcy the day after the barbeque was delivered would Sid Seller's security interest in the barbeque be avoidable by the trustee under BRA § 544?

c. Disclaimed real state priority

As was also true under former Article 9, quite logically, under new section 9-334(f), if a real estate party has formally consented to a security interest or disclaimed an interest in the goods as fixtures or the debtor has the right to remove the fixtures as against an encumbrancer or owner, then the security interest has priority.

d. Exception for manufactured homes and goods covered by certificates of title

New section 9-334(e)(4) gives priority to a security interest in a manufactured home where the security interest in the manufactured home has been perfected by compliance with a certificate of title law. The exception in new section 9-334(e)(4) applies only where a state certificate of title law provides that perfection requires compliance with the certificate of title law.

e. Special rule for crops

New Article 9 also adds a special rule pertaining to crops. Under new section 9-334(i), a perfected security interest in crops growing on real property has a priority over a conflicting interest of an encumbrancer or owner of the real property if the debtor has an interest of record in or is in possession of the real property.

Official Comment 12 to new section 9-334 notes that in some jurisdictions a mortgage on real property may cover crops and that in the event crops are encumbered by both a mortgage and an Article 9 security interest new section 9-334(i) gives priority to a perfected Article 9 security interest. The comment adds that states whose real property law includes statutes that give priority to mortgagees should adopt new section 9-334(j) and expressly subordinate those statutes to new section 9-334(i).

5. Foreclosure of a Security Interest in Fixtures

As is explored more fully in Part VII, it is one thing to have priority over conflicting claimants and another to effectively foreclose an interest in collateral. Former Article 9, section 9-313(8) provided that if a secured party had priority over all owners and encumbrancers of the real estate, then on default, subject to various limitations in the Part 5 of former Article 9 governing foreclosure, the secured party could remove collateral from the real estate, but the secured party would have to reimburse any encumbrancer or owner of the real estate who was not the debtor and who had not agreed for the cost of repair of any physical injury.

Under former section 9-313(8), a secured party was not obligated to reimburse for any diminution in value of the real estate caused by the absence of the goods removed or by any necessity of replacing them, but a person entitled to reimbursement could refuse permission to remove the collateral until the secured party gave adequate security for the performance of the reimbursement obligation. The new Article 9 foreclosure rules are moved to Part 6 of new Article 9 and are placed in new sections 9-604(b), 9-604(c) and 9-604(d).

According to Official Comment 3 to new section 9-604, the rules of new sections 9-604(c) and (d) preserve the substance of former section 9-313(8). However, new section 9-604(b) is added to make clear that an interest in fixtures may be enforced either under real property law or under any of the applicable provisions of Part 6 of new Article 9 and that the section is intended to overrule decisions such as that in *Maplewood Bank & Trust v. Sears, Roebuck & Co.*, 625 A.2d 537 (N.J. Super. Ct. App. Div. 1993) indicating that a secured party's only remedy was to remove the fixtures from the real property.

CASE COMMENTARY

Feliciana Bank & Trust v. Manuel & Sessions, L.L.C., 943 So.2d 736 (Miss.App. 2006)

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Show

Part VII Enforcing an Article 9 Security Interest

Chapter 33 A Secured Party's Options On Default

A. Generally

As will be seen below, new Article 9 gives a secured party considerable flexibility with regard to satisfying a debt out of the collateral. However, as was stressed in Chapter 3 (The Nature of Secured Credit under Article 9), until a secured party has effectively foreclosed its security interest the debtor continues to be the owner of the collateral. This reminder that a secured party has only a lien on property that is collateral for a debt is important to understanding the framework created by Article 9 for satisfying a debt out of the collateral.

Moreover, although the secured party's options for foreclosing its security interest become available only after a default, the secured party must exercise its options to foreclose before the debtor ceases to be the owner of the collateral. *See*, *e.g.*, *In re Cadiz Properties, Inc.*, 278 B.R. 744 (Bkcy N.D. Tex. 2002) (wherein the court rejected an argument by the creditor that an agreement according to which the debtor placed securities in escrow to secure a loan resulted in a transfer of ownership of the securities when the debtor defaulted on the loan).

What a secured party may or must do to satisfy a secured debt out of the collateral was governed primarily by Part 5 of former Article 9 and is governed by Part 6 of new Article 9. The first choice to be made by an Article 9 secured party on default is whether to sue the debtor and go the route of a judgment and execution on non-exempt property or pursue Article 9 options for satisfying a debt out of the collateral.

New section 9-601(a) tracks former section 9-501(1) by providing that, after default, a secured party has the rights provided in Part 6, namely, to reduce a claim to judgment and enforce the claim by any available judicial procedure or, except as limited by new section 9-602, to proceed as provided for in the security agreement and exercise self help. Ordinarily, a secured party will proceed under Article 9. However, a secured party may choose to go the execution route where the collateral's value is such that a large deficiency is expected and there will have to be a lawsuit to collect what is owed anyway. The execution route is governed by law outside Article 9. Under new section 9-601(f), a secured party may purchase at an execution sale and thereafter holds the property free of any Article 9 requirements. The downside of execution sales is that they bring notoriously low returns. *See* B & S (cited in Chapter 3), Chs. 8 and 9.

By contrast, the Article 9 options for enforcing the security interest are intended to maximize the potential for recovery of the debt from the collateral and, correspondingly, to reduce the risk of large deficiencies. In general terms, as is explained below and in the remainder of Part VII, the Article 9 options are to dispose of the collateral or to retain it in satisfaction of the debt. What distinguishes these options from the execution route is that they may be pursued without judicial involvement, *i.e.*, by exercising self help.

Article 9 encourages freedom of contract. Therefore, subject to certain limits discussed below, exactly what a secured party is permitted to do or must do may be spelled out in the security agreement. *See* new 9-601(a), as discussed above. Former Article 9 made the freedom of contract point through the repeated use of the phrase "unless otherwise agreed." New Article 9 eschews this redundancy, but the ability to define rights and obligations, within certain limits, must be kept in mind.

Secured parties may not avoid by agreement the duties of good faith, diligence, reasonableness and care imposed at various points in Article 9 or other articles of the UCC. This limitation on agreement is actually found in Article 1, 1-302(b) (formerly Article 1-102(3)). New section 9-602 also limits the ability of a secured party to obtain a waiver or variance with respect to certain specified Article 9 duties and responsibilities.

Where rights and obligations may not be dispensed with by agreement, the parties are permitted to set the standards for determining whether rights have been honored or duties performed, so long as the standards agreed upon are not "manifestly unreasonable." Although former Article 9 did not expressly so provide, parties could not change the obligation of a secured party to refrain from breaching the peace in the exercise of self help nor could they set standards as to what constituted a breach of the peace. New section 9-603 makes these limitations explicit.

Under new Article 9, the restrictions on the ability of parties to alter Article 9 rights and obligations protect obligors as well as debtors. *See* new 9-602. New Article 9 thereby resolves a question existing under former Article 9 whether parties such as guarantors are permitted to waive rights and protections that debtors may not. It is important to distinguish "waivers" of rights or duties in a security agreement, which are subject to numerous limitations noted above, from agreements to waive certain Article 9 protections entered into *after default*, which by and large are enforceable. *See* new 9-602 and 9-624.

Where the collateral consists of both personal property and real estate, a secured party may choose to enforce a security interest under real estate law as to both the real estate and personal property. If a secured party chooses to proceed under real estate law the Article 9 provisions on foreclosure do not apply. *See* new 9-604. Under new Article 9 the option to proceed under real estate law extends to goods that are fixtures and decisions under former Article 9 holding that a secured party's only remedy as to fixtures was to remove them and pursue an Article 9 option are thereby rejected. *See* Official Comment 3 to new 9-604.

Former Article 9 did not address the impact of "anti-deficiency" restrictions in real estate statutes, *see* B & S (cited in Chapter 3), Ch. 9, or rules against splitting causes of action against real estate and personal property. New Article 9 also leaves these matters to the courts. *Cf*. Official Comment 3 to new 9-604.

Former section 9-501(1) provided that "the rights and remedies referred to in this subpart are cumulative." New section 9-601(c) provides that the rights with regard to enforceability are not only cumulative but may be exercised simultaneously. New section 9-601(c) makes clear that a secured party is free to "mix and match" actions to enforce a security interest and no "election of remedies " results when a secured party proceeds initially through an exercise of self help, or vice versa.

Whether a secured party must sell all the collateral it has in its possession and whether a secured party who notices a sale of collateral securing more than one debt may proceed by judicial action as to the debts other than that specified in the notice are questions that remain to be conclusively answered. On the other hand, a secured party who engages in conduct that constitutes abusive behavior or harassment risks liability under new Article 9, *see* Chapter 38 (Remedies for a Secured Party's Failure to Comply with Article 9) or liability under non-UCC law, including tort liability. *See* Official Comment 5 to new 9-601.

As noted in earlier chapters, under new section 9-102(a)(28) only a person having an interest in the collateral is a "debtor." "Obligor" is separately defined in new section 9-102(a)(59) as the person who owes the debt. New section 9-601(d) indicates that both debtors and obligors have the rights provided for in Part 6 of new Article 9. However, some care must be exercised in determining exactly what rights are enjoyed by which parties and what duties are owed to debtors or obligors, respectively. The last is especially important insofar as the determination may impact the availability of a remedy for a failure of a secured party to comply with the requirements of Article 9. *See* Official Comment 3 to new 9-625.

New Article 9 separately defines "secondary obligor" in new section 9-102(a)(71) as a person whose obligation is secondary or who has recourse against another, and many protections expressly run in favor of secondary obligors. However, according to Official Comment 2(a) to new section 9-102, the law of suretyship must be consulted to determine whether an obligation is secondary. The distinction could affect the ability of a party to assert suretyship defenses, such as impairment of the security, in an action for a deficiency. *See* Chapter 38 Remedies for a Secured Party's Failure to Comply with Article 9).

New Article 9 explicitly provides in new section 9-605(1) that the duties owed by a secured party do not run to debtors or secondary obligors who are unknown to the secured party. Thus, for example, a secured party has no duties as to a transferee of collateral from the debtor in a transaction as to which the security interest continues in the collateral *unless* the secured party is aware of the transfer. Furthermore, under new section 9-605(2), a secured party has no duties to persons who become creditors of the transferee and take security interests in the collateral.

In Chapter 28 (Secured Party Versus Secured Party), it was pointed out that a secured party who has priority over another secured party under one or more of the Article 9 priority rules may agree to subordinate its security interest to a party as to which the agreeing party has priority. A subordination agreement effectively alters the priority of the parties to the agreement that is dictated by the Article 9 priority rules. However, an agreement to subordinate one's priority does not affect the subordinated party's ability to enforce its security interest under the rules explored in the remaining chapters of Part VII.

A party who is junior to another party under the priority rules of Article 9 has the right to foreclose its security interest without regard to whether the senior party has done so. The right of a junior party to do so exists even though its actions can complicate and even negatively affect the ability of a senior party to realize its debt out of the collateral. *See* new section 9-615(g), as discussed in Chapter 35 (Disposing of Collateral to Satisfy a Secured Debt). The same would be true of a party who is in a junior position because of a subordination agreement.

In *Chesapeake Investment Services v. Olive Group Corp.*, 2003 WL 369682 (Mass. Super. 2003), the court appeared to conclude to the contrary. Of course, a subordination agreement may include a provision under which the subordinated party agrees not to enforce its security interest until the senior party has done so. However, the failure of the subordinated party to honor its promise would result only in a breach of contract and the aggrieved secured party would be left to whatever remedies are available as to such a breach.

It is important to be aware that the essential precondition of any attempt to enforce a security interest against collateral is that there be a *default*. The enforcement provisions beginning with new section 9-601 contain the explicit prefacing language "after default" (or words to that effect). As will be explained further in subpart G, action taken to collect a debt in the absence of default can have disastrous consequences for a secured party. As will also be seen in subpart G, what constitutes a default as to a security interest is a matter of contract and a determination of whether there has been a default can be as difficult to make as decisions as to whether a contract has been breached or who is the breaching party.

It should go without saying that a creditor may not seek to satisfy a secured debt out of property that is not subject to a security interest (or lien). This point was made as early as Chapter 3 (The Nature of Secured Credit under Article 9) and driven home in subpart E of Chapter 9 (The Specifics of Enforceability – After-acquired Collateral, Future Advances, Transferred Collateral and Proceeds, and the New Debtor Problem). However, the secured party in *Automotive Finance Corp. v. Smart Auto Center, Inc.*, 334 F.3d 685 (7th Cir. 2003) attempted exactly what is not permitted by Article 9, namely, to satisfy the secured debt from vehicles not subject to the security interest, and opened itself up to liability for damages for conversion.

There are situations where some interference with property not subject to a security interest is unavoidable as a practical matter. For example, a vehicle repossessed from a consumer debtor may well contain items that are not subject to the security interest. Courts will allow secured parties some leeway here, but care should be taken not to exercise any more dominion over the non-collateral items than is necessary. *See* *Nevada National Bank v. Huff*, 582 P.2d 364 (Nev. 1978). It is good practice in such situations for the secured party to prepare an inventory of items that are not subject to the security interest and make them available to the debtor as soon as is practicable.

As was seen in Chapter 4 (Scope of Article 9), new Article 9 now covers agricultural liens as well as security interests. Under new section 9-606, a default as to such a lien occurs when the secured party is entitled to enforce the lien under the statute creating the lien.

B. Getting Possession of the Collateral

For the most part, secured parties choosing to dispose of or retain collateral to enforce a security interest must first get possession of the collateral. Under new section 9-609(b)(2), a secured party may get possession of collateral by the exercise of self help or "repossession." However, the right to exercise self help recognized in new section 9-609 is limited in that there must be no breach of the peace and this limitation cannot be dispensed with in the security agreement. *See* new 9-602(6). If there is an actual or threatened breach of the peace the secured party must seek judicial assistance. Most states, including Arizona, have provisional remedy statutes to facilitate seizure of collateral by judicial process.

In some cases physical possession of collateral by a secured party will not be practical. New sections 9-609(a)(2) and 9-609(b) permit a creditor to use judicial process or to use self-help (subject to the breach of the peace limitation in new section 9-609(b)(2)), to render equipment unusable and dispose of collateral on the debtor's premises. Under new section 9-609(c), to the extent provided for in the security agreement, and at any time after default, a debtor may be required to assemble collateral and make it available to the secured party at a place reasonably convenient to both the debtor and the secured party.

As we saw in Chapter 15 (Perfection by Possession (Including Documents of Title)), a secured party in possession, including repossession after default, has the rights and responsibilities provided for in new section 9-207. In particular, the secured party must exercise due care with regard to holding and preserving the property which belongs to the debtor until after the debtor's ownership interest has been foreclosed. As noted earlier, under Article 1, section 1-302(b) (formerly Article 1, section 1-102(3)) the duty of care cannot be waived by the debtor in the security agreement. In the case of *Nevada National Bank v. Huff*, 582 P.2d 364 (Nev. 1978), the secured party was liable for damages for breaching the duty of care as to repossessed property that was stored in an place that was not reasonably secure.

As we have seen, disputes can arise between competing claimants as to who has the superior right to possession of the collateral. Thus, a secured party may find the sheriff has seized the collateral under a writ of execution or another secured party may already have repossessed the collateral. The ultimate resolution of such disputes is largely a matter of sorting out priorities as discussed in Part VI. The details of the ways that a secured party can get possession of the collateral are the subject of Chapter 34 (Getting Possession of the Collateral).

C. Disposing of or Retaining (Accepting) the Collateral in Complete or Partial Satisfaction of the Debt

After gaining possession a secured party may dispose of the collateral and apply the proceeds to the debt owed and to the expenses of foreclosure. *See* new 9-615(a) and 9-610. The rules governing dispositions are intended to maximize the return and minimize deficiencies, at least by contrast to execution sales. Dispositions may be done without the assistance of a court and the rigid formalities associated with foreclosure sales of real estate or execution sales of both real estate and personal property do not apply to an Article 9 disposition. Rather, under new sections 9-610(b) and 9-611(b), it is required only that reasonable notification be sent to persons entitled to such notification (or that the requirement of notification has been excused) and that a disposition be commercially reasonable.

Article 9 spells out how the proceeds of a disposition are to be applied. *See* new 9-615(a). It should be emphasized that under new section 9-615(a)(1), attorney's fees are chargeable against the proceeds only to the extent they are reasonable and are provided for in the security agreement.

Where a disposition does not bring enough to satisfy the debt and expenses, a secured party has the right to a deficiency but must account to the debtor for any surplus. *See* new 9-615(d). New Article 9 spells out the rules for calculating deficiencies and surpluses, requires that the calculation of a deficiency or surplus be explained to a consumer debtor, and sets forth procedures for resolving disputes regarding deficiencies and surpluses. *See* new 9-615, 9-616 and 9-626.

Comparable rules govern the application of the proceeds to a foreclosure as to intangible collateral (such as accounts) and the right to a deficiency and the need to account for a surplus. See new section 9-608(a), Official Comment 2 to new 9-608 and Chapter 37 (Foreclosure as to Intangibles).

Under former section 9-505, in certain circumstances, a secured party could retain the collateral "in satisfaction of the debt." Where a secured party retained under former section 9-505, the secured party could not seek a deficiency, but neither was the secured party obligated to account for any surplus. The absence of any need to account for a surplus meant a debtor might have to "forfeit" accumulated equity and, hence, the procedure was referred to as "strict foreclosure." Because consumers were thought to be peculiarly at risk in strict foreclosures situations, where the collateral was consumer goods and the debtor had paid sixty percent or more of the debt the secured party could not retain and had to dispose of the collateral.

New Article 9 continues to offer secured parties what amounts to an option to retain the collateral in satisfaction of the debt. However, the option is now referred to as "acceptance of collateral in satisfaction of the debt." New 9-620. More importantly, except in consumer transactions (*see* new section 9-620(g)), collateral may be accepted in *partial* as well as complete satisfaction of the debt. New 9-622. The procedure for effecting an acceptance has been changed to shift the focus to consent to such action by the debtor, but parties who may be adversely affected still have the opportunity to prevent acceptance by a timely objection. *See* new 9-620 and 9-621.

The bar to acceptance in consumer goods cases where the debtor has built up significant equity is continued. Under new sections 9-620(e) and (f), in such cases the secured party must dispose of the collateral within 90 days or such longer period as the debtor and secondary obligors may agree to *after* default.

Responding to a split in court decisions under former Article 9, new section 9-620(b) provides that acceptance is at the option of the secured party and may not be forced upon the creditor by virtue of a delay in disposing of collateral. The details of Article 9 dispositions and retentions or acceptances in partial or complete satisfaction of the debt are considered in Chapter 35 (Disposing of Collateral to Satisfy a Secured Debt).

D. Redemption of Collateral

Under new section 9-623, debtors, secondary obligors and other secured parties or lien holders may redeem the collateral from a secured party at any time before a contract for disposition of the collateral has been entered into or the process of effecting a full or partial acceptance of the collateral in satisfaction of the debt has been completed. Although new section 9-623 generally tracks former section 9-506, it confers the right of redemption on holders of non-consensual liens.

As was true under former section 9-506, a party seeking to redeem must pay the debt owing to the secured party, including any amount owing as the result of an acceleration of the entire balance owing (as discussed in Part G below), plus the secured party's expenses. *See* new 9-623 and Official Comment 2 to new 9-623. Moreover, the debtor must tender full payment and the debtor’s promise to pay is not enough. *See* *Automotive Finance Corp. v. Smart Auto Center, Inc.*, 334 F.3d 685 (7th Cir. 2003).

However, as is explored at some length in subpart G below, determining whether a debtor is in default and for how much is often less than straightforward. Therefore, it could happen that a secured party and a debtor are able to negotiate the amount necessary to allow the debtor to recover repossessed collateral (and rectify an overdue balance) thereby producing what amounts to a redemption of the collateral. *Cf*. *Automotive Finance Corp. v. Smart Auto Center, Inc.*, 334 F.3d 685 (7th Cir. 2003). Such a negotiated settlement that results in a de facto redemption might include a release by the debtor of any claims it might have for a wrongful repossession. But, if the debtor tenders full payment, the secured party should not be allowed to condition a return of the collateral on the debtor’s willingness to forego any such claims. *See*

Automotive Finance Corp., *supra*.

As explained in Chapter 39 (Enforcing Security Interests in Bankruptcy), the right of redemption may bring repossessed collateral into the debtor's estate in bankruptcy, in which case the secured party's ability to satisfy the secured debt out of the collateral will be limited by the automatic stay. Moreover, it has been held that a debtor in a Chapter 13 bankruptcy proceeding can effectively redeem collateral by making installment payments pursuant to a confirmed Chapter 13 plan. *See*, *e.g., In re Moffett*, 288 B.R. 721 (Bkcy E.D. Va. 2002), affirmed 356 F.3d 518 (4th Cir. 2004); *In re Rozier*, 283 B.R. 810 (Bkcy M.D. Ga. 2002). Further explanation of the latter point is beyond the scope of these materials.

It would seem to be important to know, both in and out of bankruptcy, when a debtor's right of redemption has expired. Because Article 9 throughout carefully distinguishes between an ownership interest and a lien interest, one might reasonably assume that the right to redeem under new section 9-623 should continue until the debtor has been effectively divested of ownership. Under this assumption, the right to redeem would end when title to the collateral passed to a purchaser at an Article 9 disposition or when the secured party had completed the requirements for accepting the collateral in complete or partial satisfaction of the debt. However, under the UCC, the passage of title has been given greatly diminished significance. *See* Article 2, section 2-401 and Official Comment 1 to section 2-401.

More importantly, new section 9-623(c) literally provides that the right to redeem terminates not only when the secured party has disposed of the collateral but also when the secured party has entered into a contract for the disposition of the collateral. Although the parties to a contract can agree that title passes when the contract is made, in the absence of such an agreement, "title passes at the time and place at which the seller completes performance with respect to the goods." Article 2, section 2-401(2). Consequently, it would appear that the right to redeem can end before title to the collateral has passed to a purchaser at a disposition.

Complicating matters even further, many Article 9 dispositions are by auction and auctions are governed by special rules found in Article 2, section 2-328. Under section 2-328(2) a sale by auction is "complete" when the auctioneer so announces by the fall of the hammer. However, the terms of the contract resulting from the acceptance of a bid may condition the sale on full payment. *See In re Atlantic Orient Corp.*, 290 B.R. 456 (Bkcy D. NH 2003). It may reasonably be asked whether the debtor's right to redeem where collateral is disposed of at an auction is terminated by an auction "contract" that the party making the highest bid fails to satisfy or whether the right continues until the contract is performed.

On the other hand, to conclude that a disposition at an auction or otherwise continues to be subject to the right of redemption until a contract for a disposition is completed could undermine the need for finality that has been deemed so important to commercial dealings generally. In this regard, it is noteworthy that a disposition or an acceptance in satisfaction of the debt can be sufficiently final to force a party who is aggrieved by a failure of the secured party to comply with Article 9 to seek damages under new section 9-626 and deny such a party an ability to upset a disposition or acceptance. *See* Chapter 35 (Disposing of Collateral to Satisfy a Secured Debt) and Chapter 38 (Remedies for a Secured Party's Failure to Comply with Article 9).

In any event, in most cases a disposition or acceptance will proceed to completion and be effective and there will be no dispute about whether the right to redeem has terminated and there appears to be no reported case in which a conclusion that the right to redeem has ended has been challenged. Of course, as the foregoing discussion should suggest a challenge is certainly possible.

E. Enforcing Collateral Against Accounts and Other Collateral Involving Third Parties

Former Article 9 contained special rules for realizing a debt from collateral such as accounts and instruments as to which the interests of third parties (account debtors) who were obligors on the accounts and instruments were necessarily implicated. New section 9-607 expands upon the treatment of such situations in former Article 9 and adds cases not addressed in former Article 9, such as enforcement of security interests in notes secured by deeds of trust and mortgages. The situations and the rules governing them are discussed in Chapter 36 (Acceptance of Collateral in Full or Partial Satisfaction of the Debt).

F. Remedies for Failure of a Secured Party to Comply with the Enforcement Rules of Article 9

As was true under former Article 9, new Article 9 provides its own remedies for failures of a secured party to comply with Article 9, including provisions governing foreclosure. *See* new 9-625. New section 9-627 expands upon an attempt in former section 9-507(2) to give greater guidance with regard to the meaning of the commercially reasonable standard as it applies to dispositions and collections.

The basic remedy for an aggrieved party, as defined in new section 9-625(c)(1), is an action for actual damages under new section 9-625(b). In a proper case, an aggrieved party entitled to relief may be able to get injunctive relief under new section 9-625(a) or statutory damages under new sections 9-625(c)(2), (e) and (f), and may be able to assert an estoppel under new section 9-625(g).

As will be explained in Chapter 38 (Remedies for a Secured Party's Failure to Comply with Article 9), under former Article 9, a secured party that failed to comply with Article 9 could be denied a deficiency. New section 9-626 deals with the denial of a deficiency in other than consumer cases, leaving to the courts the question of when a deficiency should be denied in consumer cases.

In a proper case an aggrieved party also may seek damages under tort law, for example, for "wrongful repossession," and in such cases punitive damages are possible. *See* Official Comment 3 to new 9-625.

The details of the remedies of a debtor or other aggrieved party for a failure of a secured party to comply with Article 9 are dealt with in Chapter 38 (Remedies for a Secured Party's Failure to Comply with Article 9).

You may test your understanding of the basic framework of rules governing enforcement of a security interest under new Article 9 in the next problem.

Problem 33.1 (INTERACTIVE)

Sid Seller sells Donna Debtor a computer for $5,000 to be paid for in twelve equal monthly installments. Donna buys the computer for use in her office. Sid has a perfected security interest in the computer to secure the unpaid price. Donna defaults at a time when the debt owing is $2,000 and the computer is worth $3,000. There are no other parties with an interest in the computer. Which of the following statements are true and which are false?

(a) So long as Donna does not resist, Sid may recover possession of the computer from Donna without judicial process.

(b) If Donna physically resisted Sid's attempt to repossess the computer then Sid would have to go to court to get possession of the computer.

(c) The limitation on self-help recovery of the computer cannot be dispensed with in the security agreement.

(d) Sid must exercise reasonable care as to the computer once Sid has taken possession of it unless Donna waived the duty of care in the security agreement.

And again, which of the following statements are true and which are false?

(a) After getting possession of the computer, Sid may resell it to another customer or, if Donna agrees, choose to keep the computer and treat the transaction as being at an end.

(b) If Donna had purchased the computer for use in her home then Sid could not keep the computer but would have to dispose of it within ninety days.

(c) If Sid resold the computer for $3,000 Sid would have to account to Donna for the difference between that amount and the $2,000 debt plus expenses.

(d) If the computer were worth only $500 at the time of the default and Sid resold the computer for that amount then Sid could sue Donna for $1,500 plus expenses or Sid could choose not to repossess the computer and sue Donna for the $2,000 owing on the contract.

(e) At any time prior to a disposition or a contract for disposition or acceptance of the computer in satisfaction of the debt, Donna may get the computer back from Sid by paying Sid $2,000 plus expenses incurred by Sid in enforcing its security interest.

G. The Need for a Default

As noted above, the essential pre-condition of attempts by a secured party to collect a debt from the collateral is that there be a default. Under new section 9-606, a default as to an agricultural lien occurs at the time the secured party becomes entitled to enforce the lien in accordance with the statute under which it was created. Former Article 9 did not define the very important event of default as to a security interest and neither does new Article 9. Rather, default is a matter left to the security agreement.

The parallels to breach of contract should be apparent. You should recall from contracts class how difficult it can be at times to decide whether there has been a breach of contract or who is the breaching party. These same difficulties may arise in an Article 9 transaction.

Certain defaults are relatively clear. For example, a security agreement will almost certainly make a failure to pay as agreed a default. However, in many situations it is unclear whether there is a default that will support the actions taken by the secured party. Even failure to pay situations can get complicated because of the possibility of a modification or even a waiver of the payment terms. In a secured sales transaction, Article 2, section 2-209, could apply. Under section 2-209(1), an agreement to modify a contract within Article 2 needs no consideration to be binding.

To protect against a modification where none was intended, a secured party is permitted by section 2-209(2) to include in the security agreement a provision that a modification is not effective unless it is in a signed record. However, according to the same subsection, to be enforceable against a non-merchant, such a requirement must be separately signed by the non-merchant party. Under Article 2, section 2-209(3), the requirements of Article 2, section 2-201, containing a statute of frauds, must be satisfied if the contract as modified is within its terms.

Under Article 2, sections 2-209(4) and 2-209(5), actions that do not produce an effective modification may nevertheless result in a waiver. In particular, if a secured party regularly accepts late payments, it could happen that the secured party will be held to have waived the payment date, thereby precluding it from relying on a payment made after the date provided for in the security agreement to support foreclosure.

There appears to be some difference of opinion as to whether a so-called "anti-waiver" provision in a security agreement will be effective. According to Official Comment 3 to new section 9-601, Article 9 takes no position on the issue and leaves the question to the law outside Article 9. However, under Article 2, section 2-209(5), a secured party may retract a waiver by notifying the debtor that the waived term is being reinstated, unless the retraction would be unjust because of a material change of position in reliance on the waiver.

As Official Comment 2 to Article 2, section 2-209, emphasizes, modifications are subject to the obligation of good faith imposed in Article 1, section 1-304, formerly Article 1, section 1-2 03. The meaning of good faith is considered further below.

Although the foregoing discussion of modification and waiver focuses on Article 2 and secured sales, modification and waiver issues can arise in lending transactions as well. More generally, under Article 1, section 1-103(b), "unless displaced by the particular provisions of [the Uniform Commercial Code], the principles of law and equity, including the law merchant and the law relative to capacity to contract, principal and agent, estoppel, fraud, misrepresentation, duress, coercion, mistake, bankruptcy, and other validating or invalidating cause supplement its provisions." The doctrines of modification and waiver clearly are applicable through this provision.

Insofar as default is concerned, a secured party should use care to avoid acting so as to give rise to a claim that it has waived a default, or modified the agreement so as to preclude the occurrence of a default or should be estopped to assert a default. As to each, the case law in the jurisdiction whose law governs a transaction must be consulted. *See, e.g., Automotive Finance Corp. v. Smart Auto Center, Inc., 334 F.3d 685 (7th Cir. 2003) (concluding that the debtor had failed to satisfy the elements of an equitable estoppel under Indiana law). See also, Agriliance, L.L.C. v. Runnells Grain Elevator, Inc., 272 F. Supp. 2d 800 (S.D. Iowa 2003).*

Under general contract law a party often will have what amounts to a right to "cure" a breach. The ability to cure arguably would apply to a security agreement as well except for the fact that security agreements routinely contain an "acceleration clause." Such clauses permit a creditor to accelerate the debt in the event of any default. The result, for example, that if a debtor misses a single monthly installment the creditor may demand the entire outstanding balance.

The power of a creditor to accelerate a debt is in fact greater than the foregoing suggests. Thus, under Article 1, section 1-309 (formerly Article 1, section 1-208), a creditor may accelerate a debt "at will" or "when he deems himself insecure." The only limitation on such acceleration is that the secured party must act in "good faith." However, the burden of establishing a lack of good faith is on the debtor. Under former Article 9, the debtor's burden was compounded by the fact that "good faith" was defined in former Article 1, section 1-201(19) to mean "honesty in fact" and there is no element of commercial reasonableness associated with good faith as so defined.

New Article 9 leaves the acceleration scheme of former Article 9 intact with one significant change. Following the lead of numerous court decisions, a definition of "good faith" was added to Article 9, in new section 9-102(a)(43), that required not only honesty in fact but that the creditor observe "commercially reasonable standards of fair dealing." In its most recent form, the definition of "good faith" has been moved back to Article 1 and Article 1, section 1-201(b)(20) now incorporates the "reasonable standards of fair dealing" requirement.

One result of the change from an entirely subjective test of good faith to one that has an important objective dimension of commercially reasonable behavior is that a debtor may more readily meet its burden of proving that a creditor lacked the good faith required by Article 1, section 1-309 in accelerating a debt.

Unfortunately, insofar as giving meaning to the requirement of good faith is concerned, not all states have adopted the proposed revision of the definition of good faith in Article 1. Several states have retained the more limited, honesty in fact, definition. A review of which states have adopted the expanded definition and which states have retained the narrower definition may be found at: http://www.law.unlv.edu/faculty/rowley/ra1_updates.htm.

To make matters worse, a state retaining the narrower definition in Article 1 may nonetheless have adopted and have retained new section 9-102(a)(43) containing the expanded definition of good faith. Arizona is one such state. In states that have adopted the narrower "honesty in fact" definition of good faith in Article 1 but the broader "honesty in fact" and "the observance of reasonable commercial standards of fair dealing" in Article 9, the question arises as to which definition governs determinations of good faith in the context of applying an Article 1 provision to an Article 9 dispute.

Thus, it was noted in Chapter 27 (Secured Party Versus Buyer) that where buyer in ordinary of course status is material in resolving priority disputes according to the Article 9 rules such as that contained in new section 9-320(a) it would seem that the broader Article 9 definition of good faith should control, but that because buyer in ordinary course is defined in Article 1, section 1-201(b)(9), it might be argued that the narrower definition applies.

To the extent that the proposed change to the definition of good faith in Article 1 is adopted or the expanded definition of good faith contained in new section 9-102(a)(43) is held to control determinations of good faith in applying Article 1, section 1-309 (formerly Article 1, section 1-208) to an Article 9 transaction a debtor may more readily meet its burden of proving that a creditor lacked the good faith required by Article 1, section 1-309 in accelerating a debt.

It is worth noting that the right to accelerate is not conferred as a matter of law and the security agreement should contain an acceleration clause and some articulation of when acceleration is permitted. Moreover, acceleration clauses, even those that provide that acceleration is at the option of the secured party, are not likely to be interpreted as being "self executing" or automatically accelerating the balance owing on any default without some notification to a debtor that the debt is being accelerated.

The change in the definition of good faith impacts another provision governing enforcement of a security interest. Under new Article 1, section 1-304 (formerly section 1-203), "every contract or duty within the Uniform Commercial Code imposes an obligation of good faith in its performance or enforcement." Official Comment 19 to new section 9-102 indicates that the revised definition of good faith should be employed when applying section 1-203 in the Article 9 context. There is an ongoing debate as to whether section 1-203 supports an independent action for breach of the duty of good faith that is not resolved by the change in the definition of good faith.

It is customary and desirable to define default in a security agreement to include any and all events that a creditor wishes to trigger the creditor's ability to attempt to satisfy the debt from the collateral. Among the more common events included in a standard definition of default are suffering a judgment or levy, transferring the collateral without consent, failure to keep the collateral properly insured, and failure to maintain the collateral in reasonably sound condition.

You may explore the complexities of the need for a default as an indispensable prerequisite to collecting a debt from collateral in the next problem.

Problem 33.2 (INTERACTIVE)

Donald Debtor is a computer graphics designer. Donald has borrowed from Western Bank and given Western a security interest in Donald's equipment. The security agreement contains the following provision:

> In the event of a failure to pay as required by the agreement or other grounds of insecurity Western Bank, at its option, may treat the entire balance owing as due and payable.

For over a year Donald made all required payments in a timely fashion. Donald then missed a payment. Donald discovered the failure and before hearing from Western about the missed payment, Donald sent Western a check covering the missed payment together with a letter apologizing for the "oversight." Western promptly returned Donald's check to him in a letter demanding payment of the entire balance owing on the outstanding loan and informing Donald that if he did not pay the entire balance immediately Western would repossess his equipment and pursue its other remedies under Article 9 of the Uniform Commercial Code.

What argument should Donald make that Western has no right to repossess the equipment or otherwise enforce its security interest in the equipment?

What should be Western Bank's argument that Donald had no right to cure?

What should be Donald's reply to Western Bank's argument that it had accelerated the debt and that Donald could not cure? Hint: Note carefully the language of the security agreement regarding acceleration.

Suppose that Western Bank asserts that it was not accelerating because of the missed payment but because it deemed itself to be insecure and was exercising its right to accelerate provided for in Article 1, section 1-309. What should Donald respond?

Would evidence that interest rates had increased significantly since Western and Donald concluded their loan transaction affect a determination of whether Western had the right to repossess the equipment?

What advice should Western have been given regarding the missed payment?

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2011-08-22 update

Part VII Enforcing an Article 9 Security Interest

Chapter 34 Getting Possession of the Collateral

A. Generally

As noted in Chapter 33 (A Secured Party's Options on Default), the first step in enforcing a security interest normally is to get possession of the collateral. A secured party is aided here by the right to seize collateral without judicial process. However, the right of self help is limited in that there can be no breach of the peace. New 9-609(b)(2).

As also noted in Chapter 33, there is collateral that it may not be practicable to physically repossess. In such cases, a secured party is entitled to disable the collateral, subject to the breach of the peace limitation, and dispose of the collateral on the debtor's premises. New 9-609(a)(2). Under new section 9-609(c), after default, or at any time pursuant to agreement, a secured party may require a debtor to assemble collateral and make it available to the secured party at a reasonably convenient place designated by the secured party.

There is valuable collateral as to which repossession simply is not possible. Think about things that cannot be repossessed and why they cannot. Examples include accounts receivables and general intangibles. Other valuable collateral, such as rents and other income from the original collateral and cash proceeds cannot be repossessed, at least not directly. Foreclosure as to such collateral typically implicates the rights of third parties and the subject gets separate treatment in Chapter 37 (Foreclosure as to Intangibles).

Getting possession of collateral is often a first step towards disposing of the collateral, but it is more. It is a means of preserving the collateral to help assure it is available for disposition. Less obviously, but no less important, possession of collateral gives a secured party "leverage" in dealing with a debtor because losing possession of much collateral (such as needed equipment) obviously may have a serious detrimental impact on a debtor.

Due process requires notice and an opportunity to be heard. Self help repossession denies a debtor notice and an opportunity to be heard. However, the due process protection applies only where there is state action. It has been argued that self help repossession provided for in former section 9-503 involves state action. The same argument may be made as to new section 9-609.

The Supreme Court has never ruled directly on whether self help seizure under Article 9 violates due process. *But cf. Flagg Bros., Inc. v. Brooks*, 436 U.S. 149 (1978) (Holding 5-4 that self help foreclosure of a warehouse lien under Article 7 did not violate due process). However, a number of lower federal courts have concluded that Article 9 merely recognizes a right that arises out of the debtor-creditor security arrangement and that self help repossession is private action.

Note that a security agreement that gives secured parties the remedies provided for in Article 9 runs a greater risk of being subjected to a successful due process challenge than does a security agreement that gives a secured party a right of self help as a matter of contract.

The precise scope of the breach of the peace limitation is both factually and jurisdictionally dependent. The clearest case of a breach of the peace (or threatened breach of the peace, which has been read into the limitation) is that where a debtor physically resists a repossession. Other cases present tougher calls.

There is a good faith requirement, *see* Article 1, section 1-304 (formerly Article 1, section 1-203), that might apply to cases where the breach of the peace limitation does not. You may wish to review the discussion in Chapter 33 (A Secured Party's Options on Default) of this provision and the definition of good faith in new Article 1, section 1-201(b)(20) as to this possibility.

The limitations on self help are the subject of subpart B below.

Where self help is not available, a creditor must get judicial assistance. Such assistance involves state action so due process clearly does attach. In a series of decisions beginning with *Sniadach v. Family Finance Corp.*, 395 U.S. 337 (1969), the United States Supreme Court held that the notice and hearing requirements of due process were satisfied as to a seizure of a debtor's property to satisfy a debt only where the creditor obtained a judgment on the merits before the property was seized (typically pursuant to a writ of replevin).

However, in *Mitchell v. W.T. Grant Co.*, 416 U.S. 600 (1974), the Supreme Court indicated that a state could provide for seizure of a debtor's property prior to a judgment on the merits if certain conditions were met. Many states, including Arizona, took advantage of the opening offered by the Supreme Court and enacted "provisional remedy" statutes. The Arizona law, the Provisional Remedies Act, is at A.R.S. § 12-2401 et seq., and is discussed in subpart C below.

Finally, it must be kept in mind that secured parties in possession have certain rights and responsibilities to care for the collateral and these responsibilities exist in the case of possession by repossession. *See* new 9-207 and Chapter 15 (Perfection by Possession (Including Documents of Title).

B. Some Specifics Regarding Judicially Supported and Self Help Seizures of Collateral

New section 9-609(a) and (b) track former section 9-503 by permitting a secured party *on default* to take possession of collateral through judicial process (such a writ of replevin) or by self help, if self help can be exercised without a breach of the peace. Under new section 9-609(a)(2), a secured party may forego taking possession and instead disable equipment and dispose of it on the debtor's premises and, under new section 9-609(c), a secured party may require a debtor to assemble collateral at a reasonably convenient place.

Self help repossession is the procedure of choice because it is faster, reduces the risk that a debtor will make seizure of the collateral difficult and, if successful, avoids the court costs and attorney's fees associated with a seizure effected with court assistance.

Recall from Chapter 3 (The Nature of Secured Credit under Article 9) that the law generally looks unfavorably upon self help because of the risk of a breach of the peace and unsecured creditors do not have a right of self help seizure.

An exercise of self help repossession that breaches the peace (or threatens such a breach), violates Article 9 and exposes the secured party to remedies under Part 6 of Article 9 for violations of Article 9 and also tort liability, including damages for wrongful repossession.

"Breach of the peace" is not defined in Article 9 and in general the courts must give the limitation meaning. The limitation is very much fact dependent and generalizations about its meaning are difficult. Decisions under former Article 9, which should be good law under new Article 9 because new section 9-609 parallels former section 9-503 as to the limits on self help, offer some guidance as to the meaning of breach of the peace.

Generally speaking, physical resistance by the debtor will be treated as presenting a sufficient threat of a breach of the peace as to make the exercise of self help impermissible. But, such cases are not always clear-cut. For example, there may be a question of whether the particular debtor could realistically resist.

The case of *Automotive Finance Corp. v. Smart Auto Center, Inc., 334 F.3d 685 (7th Cir. 2003), presented the interesting question of whether a repossession of collateral consisting of several items is divisible in the sense that there could be a problem as to the self-help seizure of certain items but not others. Where collateral is located at different places it makes sense that the seizure at each place should be treated separately. Less clear is the case where the all the collateral is located at one place, but the debtor does not appear and resist until some of the items have been seized.*

In *Automotive Finance* the secured party had a security interest in sixteen vehicles held for sale by the debtor and a repossession agency had seized sixteen of twenty vehicles when the debtor showed up and sought to prevent the taking of the other vehicles. An altercation ensued and the repossession agency eventually seized the remaining four vehicles subject to the security interest. The Seventh Circuit Court of Appeals affirmed a trial court decision that the debtor was entitled to damages for wrongful repossession as to the last four vehicles but not the first sixteen. In so holding, the court concluded that the repossession was complete as to the first sixteen vehicles when the debtor intervened.

The court's holding raises the question of at what point a particular exercise of self help is complete in the sense that an objection by the debtor will be of no effect. There was no discussion in the *Automotive Finance* opinion of why the repossession was complete as to the sixteen vehicles. Apparently, the repossession agency had taken the vehicles off the debtor's lot, but there is no indication that the vehicles had been towed away. If the vehicles had only been loaded on a vehicle carrier it may be argued that the debtor can still prevent self help by physically intervening because it is a breach of the peace or the threat thereof that is controlling.

The question of when an exercise of self help is complete can arise as to single items as well as multiple items. For example, suppose the debtor arrives on the scene after a vehicle is attached to a tow truck but has not as yet been towed away. Arguably the repossession is not complete even if the vehicle was parked on a public street. On the other hand, if a debtor goes to a secured party's premises (or some storage location) and causes an altercation that constitutes a breach of the peace the exercise of self help was complete and permissible for purposes of the application of new section 9-609.

There was a consensus that "stealth" did not by itself produce a breach of the peace and a debtor did not have to be notified of an impending repossession. Indeed, if a debtor had to be given notice then much of the value of self help could be lost and the risk of confrontations resulting in a breach of the peace would be increased. A self help repossession of a vehicle from a public street in front of a debtor's home was permissible.

However, if the repossession was undertaken at 2 A.M. then a court might conclude there was a threatened or actual breach of the peace. Likewise, a seizure of a vehicle from an open carport attached to a debtor's home likely would not violate the breach of the peace limitation, but such a repossession done in the early morning hours likely would.

Courts have been consistent in holding that intrusions into a debtor's home or attached structures such as a closed garage, breach the peace. Any type of forcible entry could well constitute a breach of the peace. However, entry into a place of business, by contrast to a debtor's home, might well be permitted, especially if the debtor agreed to such entry in the security agreement. An entry onto premises or into structures that was not consented to in an enforceable agreement is a trespass. However, a trespass alone does not necessarily result in a breach of the peace.

In *Salisbury Livestock Co. v. Colorado Central Credit Union*, 793 P.2d 470 (Wyo. 1990), the court was faced with the question of whether a trespass onto the property of a third party to effect a self help repossession was a privileged trespass or resulted in a breach of the peace that rendered the self help repossession impermissible. The court ultimately remanded the case for a jury determination of whether there was a breach of the peace under all the circumstances, but in its opinion the court makes a number of important points and the opinion warrants a close reading. You may do so by clicking on the case name above.

Among the points made by the court were that:

> Self help repossession has economic advantages that benefit both creditors and debtors, but self help is subject to abuse and the risks of confrontation and physical injury are real;
>
> Where a secured party enters property without consent there is a trespass that may be privileged depending on whether or not the peace is breached or threatened;
>
> Whether or not a breach of the peace has resulted or was threatened can be a jury question, especially where residential property is involved.

As noted in Chapter 33 (A Secured Party's Options on Default), an agreement by a debtor to waive the breach of the peace limitation is not be enforceable under new section 9-602(6) and an agreement to allow an entry into the debtor's home likewise would be ineffective.

It is important to keep in mind that a secured party has a right to possession of the collateral only after default. A seizure, especially a self help repossession, done without a default can have disastrous consequences for a secured party by way of damages under Part 6 of Article 9 or for wrongful repossession, which could include punitive damages. A review of the discussion of default in Chapter 33 (A Secured Party's Options on Default) is in order here.

The question arose under former Article 9 as to whether a secured party could be liable for improper self help action by a person hired by the secured party to recover property. Early on, there was a tendency to allow the secured party to escape liability on the theory that the person engaging in the wrongful action, typically referred to as a "repo agent," was an independent contractor and not a true agent.

Eventually, however, courts began to hold secured parties liable, for example, because self help repossession was inherently dangerous and a secured party could not delegate responsibility for avoiding a breach of the peace or because the secured party was negligent in selecting the particular repo agent. Of course, the latter ground would require proof of negligent action by the secured party.

As noted in subpart A and in Chapter 33 (A Secured Party's Options on Default), the duty of good faith imposed by Article 1, section 1-304 (formerly Article 1, section 203) attaches to actions under Article 9 and under Article 1, section 1-302(b) (formerly Article 1, section 1-102(3)) cannot be contracted away by the debtor. Therefore, a secured party who fails to act in good faith, as measured by the honesty in fact and reasonable standards of fair dealing test in Article 1, section 1-201(b)(20), could be held accountable even in circumstances where there is no breach of the peace.

As pointed out in Chapters 27 (Secured Party Versus Buyer) and 33 (A Secured Party's Options on Default), under Article 1, section 1-201(b)(20), as proposed for adoption by the states, good faith requires honesty in fact and the observance of reasonable standards of fair dealing but some states have chosen to retain the narrower honesty in fact definition of good faith in Article 1. As also pointed out, however, new section 9-102(a)(43), contains the expanded definition of good faith and, arguably, that definition should control in Article 9 disputes.

You may explore the right under new Article 9 of a secured party to get possession of collateral through the exercise of self help in the next problem.

Problem 34.1 (INTERACTIVE)

Jane (in Chapter 3 (The Nature of Secured Credit under Article 9)) purchases a used Toyota from Dream Machine, Inc. (DM) (also from Chapter 3). Jane has signed an agreement giving DM an interest in the Toyota to secure Jane's debt to DM. Jane defaults. DM hires Big Mac, a "repo agent," to seize the Toyota. Big Mac locates the Toyota parked on the street in front of Jane's home.

May Big Mac seize the Toyota without judicial process and without notifying Jane in advance?

Would your answer change if Jane appeared and physically resisted the seizure?

Would it matter at what point in the exercise of self help Jane appeared?

Would self help repossession of the Toyota from the driveway of the home of a friend of Jane's be permissible?

Would self help repossession by Big Mac from a carport attached to Jane's house be permissible?

If the self help repossession from Jane's attached carport took place at 2 a.m., would the repossession be permissible?

Would a self help repossession by Big Mac from a locked garage attached to Jane's house be permissible?

Would consent by Jane in the security agreement to a forcible entry into her home change the answer to the question whether self repossession from the locked garage is permissible?

Could DM be held liable for actions by Big Mac that violated the breach of the peace limitation on self help repossession?

Suppose that DM's credit manager asked Jane to come to his office so that they could work out their differences and while Jane was in the credit manager's office the Toyota was repossessed. Would the repossession be permissible?

An oft-litigated issue under former Article 9 was whether a self help repossession done with the assistance of an off duty peace officer or one who was not acting pursuant to legal process was permissible. The argument in favor of permitting a peace officer to assist is that it would reduce the likelihood of a breach of the peace. However, a number of courts concluded that the presence of a peace officer denied a debtor the right to resist self help and thereby forced a secured party to get legal process. The decisions sometimes turned on the degree to which the peace officer was actively or passively involved.

In *Walker v. Walthal*, 588 P.2d 863 (Ariz. App. 1978), the court addressed the question of whether a repossession assisted by a peace officer impermissibly interfered with a debtor's right to resist self help and considered further whether such assistance of the peace officer meant the repossession was "under color of law" and involved state action. You should read the court's opinion by clicking on the case name above.

You may test your understanding of the peace officer limitation on self help in the next problem.

Problem 34.2 (INTERACTIVE)

Assume the basic facts of Problem 34.1. On default, DM goes to Jane's home and demands possession of the Toyota. Jane refuses. The next day DM returns with a personal friend who is an off duty deputy sheriff. Jane turns the Toyota over to DM. Is the repossession "legal"? Why or why not?

Recall from Chapter 11 (Enforceability and Attachment of Security Interests in Consumer Transactions) that there are laws outside Article 9 that can limit the enforceability of security interests in consumer goods. Section 44-5501 of the Arizona Revised Statutes was examined in Chapter 11. A.R.S. § 44-5501(B) and (C) qualify the right of a secured party to seize the collateral in consumer credit cases as follows:

> B. *Notwithstanding any agreement to the contrary, if the seller or his assignee retakes goods which were the subject of the sale, the buyer shall not be personally liable for the unpaid balance of the price if the sales price were one thousand dollars or less.* * * * [Emphasis added.]
>
> C. * * * *If the seller or assignee elects not to retake the goods, but brings an action for the unpaid balance, the goods may not thereafter be retaken and are not subject to judicial process to enforce any judgment obtained therein.* [Emphasis added.]

You may consider the application of A.R.S. 44-5501(B) and (C) in the next problem.

Problem 34.3 (INTERACTIVE)

Donald Debtor, who resides in Tucson, Arizona, buys a stereo from Selma Seller, an Arizona retailer. Donald agrees to pay the $500 purchase price in twelve equal monthly installments. Donald signs an agreement giving Selma an interest in the stereo to secure the unpaid price. Donald defaults without having made a single payment.

May Selma repossess the stereo?

If Selma repossesses the stereo, may it recover any resulting deficiency from Donald?

If Selma chose to get a judgment and a writ of execution, putting aside the question of whether the stereo is exempt, could the sheriff levy on the stereo?

Suppose Donald paid cash for the stereo using the proceeds of a loan from Lisa Lender that is secured by an interest in the stereo. If Lisa repossessed the stereo, could Lisa recover any resulting deficiency from Donald?

C. Getting Possession of the Collateral When Self Help Is Not

Possible

If self help repossession is not permissible, a secured party must seek judicial assistance. Doing so requires filing a lawsuit and obtaining legal process, typically replevin, that provides for seizure of the collateral. Due process clearly attaches when judicial assistance is invoked.

As noted in subpart A, under the *Sniadach* line of decisions, *see* B & S (cited in Chapter 3), Ch. 15, due process initially required that a creditor get a judgment on the merits against a debtor before the debtor's property could be seized. However, as also noted there, in its decision in *Mitchell v. W.T. Grant Co.*, 416 U.S. 600 (1974), the Supreme Court permitted states to enact provisional remedy statutes under which collateral can be seized prior to judgment if certain conditions are met.

Simply stated, pre-judgment seizure of collateral is permissible if a creditor has to apply for a special writ and in the application the creditor has to plead with particularity the facts giving rise to the claim, the writ can be issued only by a judicial officer, the creditor has to post a bond indemnifying the debtor against a wrongful seizure and, perhaps most importantly, the debtor has to be accorded the right to demand a prompt hearing on whether a seizure was rightful.

Taking its cue from *Mitchell*, Arizona enacted the Provisional Remedies Act (PRA), A.R.S. § 12-2401 *et seq*. To examine its provisions click on its title.

It is not obvious from the PRA, but to get a provisional remedy a creditor must file a law suit seeking to recover an unpaid debt. Moreover, provisional remedies work in conjunction with conventional collection remedies that are the subject of separate statutes and the requirements of these statutes must be satisfied along with the PRA.

Replevin is the remedy most often used where a creditor has an interest in property that is the target of a provisional remedy request. In the case of secured credit, a creditor will ask for a provisional remedy *in the nature of replevin*. *See* B & S (cited in Chapter 3), Ch. 15.

A.R.S. §12-2402(A) provides for a provisional remedy *without notice*. There still must be notice of the right to demand a prompt hearing, but as provided for in A.R.S. § 12-2402(D), the notice need not be given until after the debtor's property has been seized. A "without notice" provisional remedy gives a creditor many of the advantages of self help repossession. In particular, a creditor who can seize property prior to notice enjoys the "leverage" that goes with divesting the debtor of possession and placing on the debtor the burden of forcing a hearing to recover the property.

The key section for secured parties is A.R.S. § 12-2402(A)(2) is the key section for secured parties because a secured party is a party "otherwise lawfully entitled to the possession of the property claimed" and is entitled to a provisional remedy in the nature of replevin without prior notice. To avail itself of the right conferred by A.R.S. § 12-2402(A)(2), a secured party must file a lawsuit and apply for a provisional remedy in the nature of replevin without notice by satisfying the specific requirements set forth in A.R.S. § 12-2402(A)(2).

Under A.R.S. § 12-2402(B), a secured party must by affidavit establish with particularity to the court's satisfaction facts sufficient to support the secured party's claim that the secured party has a right to a without notice provisional remedy under A.R.S. § 12-2402(A)(2) and that the requirements of other statutes have or will be met. The last includes the need to post a bond as demanded by the replevin statute.

A "without notice" provisional remedy is not available under A.R.S. § 12-2402(A)(2) to get possession of consumer goods unless the security interest in the goods is purchase money. *See* *Searles v. First National Bank*, 619 P.2d 749 (Ariz. App. 1980) (Upholding the constitutionality of the PRA and the limitation as to consumer goods). The content of the notice given to a debtor is prescribed by A.R.S. § 12-2402(E).

The most important right of a debtor whose property has been taken pursuant to the PRA is to move to quash the provisional remedy and force a prompt hearing as provided for in A.R.S. § 12-2402(C). Under A.R.S. § 12-2402(C), the issues at the hearing are limited to the probable validity of the secured party's claim and any defenses available to the debtor (such as that the debt has been paid or there was no default) and whether the requirements of A.R.S. § 12-2402(A)(2) and (B) have been satisfied. If a debtor is successful at a hearing on the motion to quash the secured party must return the property and could be liable for damages for wrongful seizure of the collateral as well.

You may explore the application of the PRA scheme for allowing a secured party to get possession of collateral where self help is unavailable in the next problem.

Problem 34.4 **(INTERACTIVE)**

Assume the facts of Problem 34.1. Assume further that when Big Mac attempts self help repossession and Jane physically resists.

Must DM get a judgment on the merits before it is permitted to seize the Toyota?

May DM get a provisional remedy (PR)?

What must DM do to obtain a PR in the nature of replevin?

Is DM entitled to a PR without notice (even though the collateral constitutes consumer goods)?

Does getting a PR in the nature of replevin mean that no notice need be given to Jane?

What is the benefit to DM of a without notice PR?

What rights does Jane have in response to a seizure of the Toyota pursuant to a PR in the nature of replevin without notice?

D. The Secured Party's Duty of Care as to Property in the Secured Party's Possession (Including Property Other Than Collateral)

As noted several times, under new section 9-207(a) a secured party in possession of the debtor's property must act reasonably with regard to the care and custody of that property and this duty of care is imposed upon a secured party who is in possession of property seized in an exercise of self help or with judicial assistance.

Under Article 1, section 1-302(b) (formerly Article 1, section 1-102(3)) this duty of care cannot be contracted away by the debtor. However, Article 1, section 1-302(b) standards of care that are "not manifestly unreasonable" may be defined in the security agreement. The meaning of the quoted language is unclear at best, but should be understood to preclude the fixing of standards that effectively do away with the duty of care.

What it means to act reasonably is necessarily fact dependent, but at a minimum should require that recovered property be stored in a manner that preserves the property and protects it against unreasonable risk of loss or damage.

It can happen in the course of a seizure of collateral that property that is not subject to a security interest is incidentally seized. For example, some of the contents of a repossessed vehicle may well not be collateral. Courts have recognized that this is to some extent unavoidable (but the baby in the car case), but because a secured party technically has no right of possession as to non-collateral it is especially important for the secured party to use special care to account for non-collateral and return it to the debtor as expeditiously as possible. *See*, *e.g.*, *National Bank v. Huff*, 582 P.2d 364 (Nev. 1978).

The application of new section 9-207 and Article 1, section 1-302(b) (formerly Article 1, section 1-102(3)) are considered in the next problem.

Problem 34.5 (INTERACTIVE)

Donald Debtor defaulted on a loan secured by an interest in his Dodge Pickup on which was a factory-installed camper shell. Big Mac, on behalf of the lender, Southwestern Bank, repossessed the vehicle without incident. Big Mac then towed the vehicle to a storage lot where other repossessed vehicles were kept until disposed of. The lot was fenced and lighted. Access to the lot was through a gate that was kept locked at night but not during the daylight hours. When Big Mac employees were out repossessing vehicles there was no one at the lot.

Three days after the vehicle was seized, Donald went to Southwestern and informed the bank that there were several expensive hunting guns and fishing rods stored in the camper. Southwestern immediately called Big Mac and inquired about the guns and fishing rods.

When Big Mac employees looked inside the camper they did not find any guns or fishing rods. There was no sign of any breaking and entering, but it was apparent that someone had gone into the camper because several items, including a propane stove and refrigerator that came with the vehicle had been taken. In the course of removal of the stove and refrigerator the camper interior had been badly damaged. Donald is prepared to describe the guns and rods in detail and prove that he kept them in the camper at all times.

Is Southwestern Bank liable for converting the missing hunting guns and fishing rods? If not, does Donald Debtor have any other recourse regarding these items of property?

Does Donald Debtor have any recourse regarding the theft of the stove and refrigerator and the damage to the interior of the camper?

Would your answers be different if the security agreement contained a provision under which Southwestern was relieved of any responsibility for any losses that in its judgment are not its responsibility?

CASE COMMENTARY

Ace Equipment Sales, Inc. v. H.O. Penn Machinery Co., Inc., 871 A.2d 402 (Conn. App. 2005)

Thompson v. First State Bank, 709 N.W.2d 307 (Minn. App. 2006)

Davenport v. Bates, 2006 WL 3627875 (Tenn. App. 2006)

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2011-08-22 update

Part VII Enforcing an Article 9 Security Interest

Chapter 35 Disposing of Collateral

A. Generally

As was seen in Chapter 33 (A Secured Party's Options on Default), until the secured party has effectively foreclosed its security interest, the debtor continues to be the owner of the collateral. Under new Article 9, as was true under former Article 9, there are essentially two ways a secured party may foreclose its security interest in the collateral and divest the debtor of the debtor's ownership interest: Dispose of the collateral or attempt to retain (accept) it in complete or partial satisfaction of the debt. Retention of the collateral in complete or partial satisfaction of the debt is the subject of Chapter 36 (Acceptance of Collateral in Full or Partial Satisfaction of the Debt).

As was true under former Article 9, under new Article 9, section 9-610, a secured party may dispose of collateral only in a "commercially reasonable" manner. Moreover, as also was true under former Article 9, under new sections 9-611 and 9-612, most parties who are impacted by the disposition must be sent "reasonable notification." The commercially reasonable and reasonable notification requirements generally necessitate an examination of the circumstances of a particular disposition in the context of the purposes the standards are intended to serve.

As will be seen in subpart B, new Article 9 attempts to provide more guidance than given by former Article 9. However, in the last analysis, the question is whether the disposition was reasonably likely, as judged by commercial standards, to bring the highest return and the smallest deficiency and whether the notification was reasonably calculated to permit persons entitled to such notification to act to protect their interests. The matters of greatest importance are what is available for distribution to whom and whether anyone will be stuck with a deficiency or benefit from a surplus. The rules for applying the proceeds of a disposition and for calculating deficiencies and surpluses are given separate attention in subpart B(3).

Under former section 9-112 the duties discussed in this chapter also were owed to persons who owned the collateral but were not obligors on the secured debt. Under new Article 9, debtor is defined to mean only a person who has an interest in the collateral, new 9-102(a)(28), but certain of the duties owed by secured parties run to obligors as well as debtors. On the other hand, new section 9-605(1) explicitly provides that the duties owed by a secured party do not run to debtors or secondary obligors who are unknown to the secured party. Thus, a secured party has no duties as to a transferee of collateral from the debtor in a transaction as to which the security interest continues in the collateral *unless* the secured party is aware of the transfer. Moreover, under new section 9-605(2), a secured party has no duties as to persons who become creditors of the new debtor and take security interests in the collateral.

B. Disposition of Collateral

1. Commercially Reasonable

The disposition scheme of new Article 9 echoes that found in former Article 9, section 9-507(3). A range of different sorts of dispositions after a default is available. Both public and private sales are authorized. Generally speaking, a public sale is one that is open to the public and characterized by competitive bidding among those who have the opportunity to buy. *See* Official Comment 7 to new 9-610. A private sale, by contrast, is one that is limited to buyers selected by the secured party, including other customers, and in which the price is negotiated rather than being driven by competitive bidding. However, as is discussed more fully in subpart B (2) below, distinguishing a public from a private sale is not always easy.

Under new section 9-610(b) *every* aspect of a disposition must be commercially reasonable. As was true with former Article 9, new Article 9 does not actually define commercially reasonable, but some guidance as to its meaning is offered by new section 9-627(b).

Under new section 9-627(b)(3) dispositions made in conformity with reasonable commercial practices among dealers in the type of collateral involved are deemed to be commercially reasonable. Courts at times have suggested that a disposition in conformity with practices among dealers renders the disposition commercially reasonable. *See*, *e.g.*, *Automotive Finance Corp. v. Smart Auto Center*, Inc., 334 F.3d 685 (7th Cir. 2003). However, new section 9-627(b)(3) actually requires that the practices themselves be reasonable. For example, there is a place for wholesaling under new section 9-627(b)(3) because such dispositions may be more economical than retail dispositions, but "dumping collateral" under circumstances where there is no real competition among buyers should not be permitted (even if dealers commonly engage in such dispositions).

Under new sections 9-627(b)(1) and (b)(2), dispositions made in a recognized market or at a price current in a recognized market also are deemed to be commercially reasonable. "Recognized market" is not defined but would seem to be limited to situations where the price that collateral will bring is determined by internal market operations and not by negotiations between buyers and sellers. Thus, securities sold on a securities exchange are sold on a recognized market.

On the other hand, goods that bring an individually negotiated price within some range of prices specified by a "blue book" are not sold on a recognized market. *See* Official Comment 4 to new 9-627 (providing that the concept of a recognized market in subsections (b)(1) and (b)(2) is quite limited; it applies only to markets in which there are standardized price quotations for property that is essentially fungible, such as stock exchanges). Likewise, sale at a dealer auction does not constitute a sale in a recognized market. *Id*.

New section 9-610(a) allows a secured party to sell collateral in its then condition. Section 9-615(a)(1), on the other hand, allows a secured party to recover from the proceeds of a disposition the reasonable expenses of collection and enforcement, and these would include the costs of preparing collateral for disposition. The question may arise whether a secured party must expend money to prepare collateral for disposition where doing so will bring a higher price.

Since every aspect of a disposition must be commercially reasonable it may be that there is an affirmative duty to prepare collateral for disposition where the prospects for a higher price that will cover the costs of preparation are such that it is reasonable for a secured party to incur the costs. However, in *Automotive Finance Corp. v. Smart Auto Center, Inc.*, 334 F.3d 685 (7th Cir. 2003), it was held that a sale to a party who has experience with the disposition of vehicles as to which there are odometer or title problems is commercially reasonable without discussing any responsibility on the part of the secured party to remedy the problems with the vehicles.

Consistently with the commercially reasonable standard, new Article 9 does not dictate a time within which a disposition must be made. Moreover, as will be seen below, holding collateral for an unreasonable length of time will not result in a forced acceptance in satisfaction of the debt. On the other hand, delaying for an unreasonable amount of time might result in damages under new section 9-625 or even a loss of a deficiency. As noted in Chapter 33 (A Secured Party's Options on Default), a secured party who complies with the requirements of new Article 9 is entitled to a deficiency but must account for any surplus.

Under new section 9-610(c), a secured party may purchase at any public disposition but may purchase at private disposition only if the collateral is sold on a recognized market or is the subject of widely distributed standard price quotations. The question of what is and what is not a recognized market was discussed above (and the embellishment in new section 9-610(c) would not change the conclusion that sales within a range of blue book prices does not permit a secured party to purchase at a private sale).

A sale to a person related to the secured party, as defined in new section 9-102(a)(63) would not be a sale to the secured party within the meaning of this restriction but as discussed in subpart B (1) below, sales to persons related to the secured party can impact the calculation of a deficiency or surplus. Likewise, a sale to a party with whom the secured party regularly does business would not be within the restriction in new section 9-610(c) or constitute a sale to the secured party unless the party to whom the collateral is sold is controlled by the secured party or the sale is otherwise not viewed as an arms length transaction. *See Automotive Finance Corp. v. Smart Auto Center, Inc.*, 334 F.3d 685 (7th Cir. 2003) (holding a sale to a party who has experience with the disposition of vehicles as to which there are odometer or title problems to be commercially reasonable).

A recurring question under former Article 9 was whether a low price relative to fair market value or what parties might reasonably have expected a sale to bring renders a sale *not* commercially reasonable. New section 9-627(a) reformulates former section 9-507(2) on this point by providing that the fact that a greater amount could have been obtained by a disposition conducted at a different time or in a different way does not of itself preclude a showing that the disposition was commercially reasonable. The key phrase is "not of itself" and a low price will certainly lead a court to scrutinize all aspects of a disposition to discover if there were defects in the disposition that contributed to the low price. Many of the decisions rendered with regard to former Article 9 dispositions are likely to be informative as to dispositions under new Article 9.

The opinion in *Chavers v. Frazier*, 93 B.R. 366 (Bkcy M.D. Tenn. 1989),decided under former Article 9, is thoughtful and informative and should be read carefully. You can do so by clicking on the case name above.

As you will have noticed, the court in *Chavers* gives special attention to defects in the advertising of the resale of the Lear Jet. Advertising of a disposition must be commercially reasonable. But, advertising should be distinguished from the separate requirement that reasonable notification must be sent to parties who are entitled to be sent such notification. The notification requirement is explored in the next subsection. The court in *Chavers* also concluded that the failure of the secured party to dispose of the collateral in a commercially reasonable manner should result in the loss of a deficiency claim for the secured party. Deficiencies and surpluses are considered more fully in subpart B(1) below and in Chapter 38 (Remedies for a Secured Party's Failure to Comply with Article 9).

Where the dollar amounts justify the time and expense, a secured party may ask for a court's blessing as to a proposed disposition under new section 9-627(c).

You may explore the requirement that a disposition be commercially reasonable in every respect in the next two problems.

Problem 35.1 (INTERACTIVE)

The court in *Chavers* concluded that the disposition of a private Lear Jet was not commercially reasonable under former section 9-504(3).

Would the fact that the jet had sold initially for $850,000 and was sold for $415,000 a year later be enough by itself to render the disposition not commercially reasonable under new Article 9?

What language of new section 9-627 supports your answer?

Problem 35.2 (INTERACTIVE)

Under new section 9-610(b), every aspect of a disposition must be commercially reasonable and, as noted in the CANINE text, a low resale price is likely to lead to greater scrutiny of a disposition to determine whether it was commercially reasonable in every respect.

Which of the following aspects of the disposition in *Chavers* would be viewed as supporting a conclusion that the disposition was not commercially reasonable had the case been decided under new Article 9?

(a) The proceeds of the resale.

(b) The hastiness of the resale.

(c) The failure to investigate the specialized market for private jets.

(d) The resale was advertised for a total of 60 days.

(e) Most of the advertising of the resale was in the Wall Street Journal.

(f) The resale was public rather than private.

Rather than explain why each of the factors contributed to the conclusion that the sale in *Chavers* was not commercially reasonable, how would you advise a secured party such as *Chavers* to proceed?

What other actions might the secured party be advised to take to better assure that the disposition would be deemed commercially reasonable?

If the Chavers had sold the jet for a price that was within the range of prices for a Lear Jet as listed in a trade publication covering private aircraft, would the sale have been commercially reasonable without regard to other factors?

A possibly useful contrast to the disposition in *Chavers* in another case involving specialized collateral (units of a limited partnership) is offered by *Vornado PS, L.L.C. v. Primestone Investment Partners, L.P.*, 821 A.2d 296 (Chancery Del. 2002). The secured party took the following steps in the course of disposing of the units at a public sale.

(a) Hired a prominent investment banking firm, to assist it in developing a marketing process and identifying potential purchasers of the Units. At 306

(b) Gave notice to debtor and guarantors that it intended to sell the units at a public auction scheduled for 4 p.m. on November 20, 2001 (the default having occurred in late October?). At 306

(c) Retained a licensed auctioneer. At 306

(d) Advertised foreclosure sale in the New York Times on November 6 and 13, and in the Chicago Tribune on November 7. at 306

(e) Compiled a list of, and contacted, 51 potential purchasers, including public companies, opportunity funds, private investors, pension funds and advisors. At 307

(f) Requested debtor to provide a list of potential purchasers (but no response was ever received). At 307

(g) Opened the bidding at $ 8.35 per unit, which was the closing price of shares on the day of the foreclosure sale of publicly traded stock agreed to be the functional equivalent of a partnership unit. At 310.

(h) Purchased the partnership units for this price.

The secured party was the only bidder at the public auction. There was evidence indicating that potential bidders declined to participate because they had only public information about the limited partnership and were not provided confidential inside information. The debtor argued that there should have been a private rather than a public sale. The court granted the secured party's motion for summary judgment because there was no genuine issue of material fact as to the commercially reasonableness of the sale. As to the evidence that potential bidders were put off by the lack of inside information, the court noted that the secured party also lacked such information. The court rejected the argument that the sale should have been private rather than public because new section 9-610(c), subject to narrow exceptions not applicable to the disposition under review, permits a secured party to purchase only at a public sale and a private sale would have eliminated the one viable buyer of the partnership units.

As was noted earlier and stressed in *Chavers*, the secured party has the burden of proving that a disposition was commercially reasonable when the matter is put in issue. The outcome of a dispute may depend very much on who is given what burden of proof as to which issues. However, allocating burdens of proof is often a tricky business and the burden of going forward by presenting evidence as to an issue and the ultimate burden of persuasion are not always distinguished.

In *Automotive Finance Corp. v. Smart Auto Center, Inc.*, 334 F.3d 685 (7th Cir. 2003), the debtor unsuccessfully argued that the secured party had prevented the debtor from bidding at the auction at which the collateral was sold. Although the court did not refer specifically to the fact that the burden of commercial reasonableness is on the secured party, the court apparently was satisfied that the secured party had the better of the issue because it has presented evidence that at least one auction house barred the debtor from bidding because of past failures to pay as promised.

Under new section 9-602(7), the right to a commercially reasonable disposition, as is true of most requirements governing the disposition of collateral, cannot be waived. *See also*, new section 9-624 (expressly identifying those rights that can be waived by agreement after default). In *Sovereign Bank v. Alverado*, 2003 WL 21771751 (Conn. Super. Ct. July 15, 2003), the court rejected an argument that the requirement to dispose of collateral in a commercially reasonable manner was dispensed with where the debtor was credited with the fair market value of the collateral. This decision makes good sense not only for the reason offered by the court, namely, that a disposition might bring more than the fair market value, but because fair market value is an elusive concept.

2. Reasonable Notification

As was true under former section 9-504(3), new section 9-611(b) requires that, unless excused, a secured party must send a reasonable authenticated notification of a disposition. There are several aspects to the reasonable notification requirement.

First, the requirement may be excused. Under new section 9-611(d), reasonable notification is excused if the collateral is perishable or threatens to decline speedily in value or is of a type customarily sold on a recognized market. The perishable goods and speedily declining value excuses are easy enough to understand (but not always easy to apply). The "recognized market" idea was discussed above and that discussion should be consulted here.

Second, the notification must be reasonable as to time. Under new section 9-612, whether a notification is sent within a reasonable time is a question of fact, but except in a consumer transaction, a notification of a disposition sent after default and ten or more days before the earliest time set for a disposition in the notification is sent within a reasonable time. Under new section 9-612 a notification sent earlier than ten days before a disposition could be reasonable, but the burden of showing it to be so would be on the secured party.

Third, the notification must be *sent* as opposed to being received. New section 9-102(a)(74)(A) provides that a notification is sent when it is deposited in the mail or delivered for transmission or transmitted by any other usual means of communication with the costs of mailing or transmitting paid and it is addressed to any address reasonable under the circumstances.

Under former Article 9 there was an issue as to whether notification could be oral. New section 9-102(a)(74)(B), under which causing notification to be received in the time it would have been received if properly sent under new section 9-102(a)(74)(A), may leave the question unanswered. However, a secured party always should put the notification in such a form as to have a copy of it and also should obtain evidence of when it was sent. Moreover, although "send" is the operative word, a secured party who knows a notification was not received would be wise to make reasonable further efforts to see that the notification gets to the person to whom it is sent. *See* Official Comment 6 to new 9-611 (discussing the need for a "second try").

Fourth, there is the question of form and content of a notification. Under former section 9-504(3) notification as to a public sale had to indicate the time and place for the sale and notification as to a private sale had to indicate the time after which a sale would be made. New section 9-613(1) more expansively provides that the contents of a notification in an *other than a consumer-goods transaction* are *sufficient* if the notification describes the debtor and secured party, describes the collateral, states the method of disposition (public or private), states that the debtor is entitled to an accounting as to any unpaid debt (and the charge for providing such an accounting), and states the time and place of a public disposition or the time after which any other disposition is to be made. According to Official Comment 2 to new section 9-613, "the reference to 'time' of disposition means, as it did under former Section 9-504(3), not only the hour of the day but also the date."

Under new sections 9-613(2), (3) and (4), whether a notification lacking any of the information required by subsection (1) is reasonable is a question of fact and substantial compliance with subsection (1) is enough, meaning that no particular phrasing is required.

A number of questions are raised by these requirements. One is what is intended by the use of the word "sufficient." A reading of new section 9-613 in its entirety, together with the official comments to new section 9-613, suggests that the drafters were attempting to capture the notion that there is some flexibility with respect to the contents of a notification. The final test is whether the notification meets the reasonableness requirement of new section 9-611(b). But, reasonableness must be judged by reference to the purpose of the notification requirement.

It is generally understood that the purpose of the notification requirement is to allow the debtor and obligor and other parties with a stake in the outcome of a disposition to protect their interests by redeeming the collateral under new section 9-623 or seeking to negotiate a purchase through a private sale or appear at a public sale and bid on the collateral or otherwise act to try to assure that the collateral brings a fair price. *See, e.g., In re Downing*, 286 BR 900 (Bkcy W.D. Mo. 2002).

Reasonableness so understood typically will be a question of fact. But, it can also happen that a judge determines that a particular notification is sufficient with respect to its purposes as a matter of law. Thus, according to Official Comment 2 to new section 9-613, a notification that includes the information set forth in paragraph (1) is sufficient as a matter of law, even if the phrasing is different or there are minor errors that are not seriously misleading. As for whether a notification that does not include the information contained in paragraph (1) of new section 9-613(b) is sufficient, new section 9-613(2) and Official Comment 2 indicate that whether such a notification is sufficient is a question of fact for the trier of fact.

Another question posed by the notification scheme of new Article 9 is when an error is minor and not seriously misleading within the meaning of new section 9-613(3)(B). Such language is used elsewhere in new Article 9, most notably in new section 9-506. As explained in Chapter 14 (The Nitty Gritty of Filing), whether financing statement is seriously misleading must be determined by reference to the notice filing scheme of Article 9 and the purpose to alert searchers whose interests may be adversely impacted by an outstanding security interest that they should make further inquiry. As also explained in Chapter 14, because financing statements are indexed using the debtor's name, errors in the debtors name are deemed to be seriously misleading unless a financing statement containing an error as to the debtor's name would turn up in a search in the particular filing office using the correct name.

New section 9-613 provides no such guidance as to errors in a notification required by new section 9-611(b). It makes sense that any error in a notification should be judged by reference to the purposes of notification discussed above, namely, to allow parties affected by a disposition to protect their interests. Thus, the seriously misleading error language of new section 9-613(3)(B) should be understood to mean that a notification containing an error that prevents affected parties from protecting their interests is not sufficient.

As the foregoing suggests, whatever there may be said for providing secured parties with some degree of forgiveness with respect to the sufficiency of the required notification, the scheme inevitably will necessitate involved inquiries in certain cases. The drafters of new Article 9 were aware that this is so and have set forth in new section 9-613(5) a safe harbor form. Although new section 9-613(5) does not say so in so many words, the clear intent of the section is that a secured party who completes the form will be deemed to have provided sufficient information sufficient to satisfy the reasonable notification requirement of new section 9-611(b). Given the uncertainties discussed above, although new Article 9 does not mandate the use of the form, it is difficult to conceive of any persuasive reasons for not using the form.

Unfortunately, the form in new section 9-613(5) does not remove all the uncertainties. The form provides, consistently with paragraph (1) of new section 9-613, that "[For a public disposition]" the notification should use the following language: "We will sell [or lease or license], as applicable] the [describe collateral] [to the highest qualified bidder] in public" on a specified day and date, at a specified time and at a specified place. The form further provides that "[For a private disposition]" the notification should use the following language: "We will sell [or lease or license, as applicable] the [describe collateral] privately sometime after [day and date]." Apart from the somewhat confusing use of square brackets and italics and the legitimate issue of why "to the highest qualified bidder" is bracketed, suggesting the language is optional, two rather basic questions are posed.

The first is whether the notification literally must indicate that the disposition will be public or private. There was a split of authority on this question under former Article 9. One might reasonably read the form, implicitly if not explicitly, to require that the disposition be designated public or private. *See* *In re Downing*, 286 BR 900 (Bkcy W.D. Mo. 2002). Whether or not that designation technically is required, a secured party would be well advised to include such a designation so as to avoid the need to litigate the issue. However, designating the disposition public or private is more easily said then done.

The reason for the difficulty is that Article 9 nowhere defines what is a public and what is a private sale. Courts and commentators under former Article 9 generally were of the belief that a private disposition was one made to a private party, including a customer, at a price negotiated by the secured party and that party (or simply set by the secured party). It likewise was generally agreed that what distinguished a public from a private sale was a provision for competitive bidding such as characterizes an auction. However, there was some disagreement about the extent to which a disposition had to be open to the public to qualify as a public disposition. Thus, for some courts and commentators, an auction open only to dealers was a private disposition and the court in at least one case decided under new Article 9 agreed. *See* *In re Downing*, 286 BR 900 (Bkcy W.D. Mo. 2002) (citing with approval B. Clark, Law of Secured Transactions Under the Uniform Commercial Code, § 4,08(2) at 4-98 (1988) and cases decided under former Article 9).

Official Comment 7 to new section 9-610 provides that:

> [A] public disposition is one at which the price is determined after the public has had a meaningful opportunity for competitive bidding. Meaningful opportunity is meant to imply that some form of advertisement or public notice must precede the sale (or other disposition) and that the public must have access to the sale (disposition).

This comment seems quite clearly to make an auction open only to dealers a private disposition. It may, more generally, be understood to mean that any disposition that is not open to the public and as to which the public has not had a meaningful opportunity to engage in competitive bidding is a private sale. However, the matter is not completely free from doubt and a secured party may have little choice but to look for decided cases offering guidance on the question of when a disposition is public and when it is private in the jurisdiction in which the disposition is made.

In *Sovereign Bank v Alverado*, 2003 WL 21771751 (Conn. Super. Ct. July 15, 2003) the secured party appeared to have sought to finesse the question of what is public and what is private by sending a notification that "the vehicle will be resold at Southern Auto Auction by private or public sale at anytime after 4:00 p.m. on June 24, 1998." The court held that this compound notification satisfied the requirement of reasonable notification in new Article 9. That holding seems clearly at odds with the mandate that the notification as to a public disposition must state the time and place at which the collateral will be disposed of.

New section 9-614 dictates the contents of the notification required *in consumer goods transactions*. In contrast to new section 9-613(1) for other than consumer goods cases, which uses the phrasing that a notification is sufficient if, new section 9-614(1) states that "in a consumer-goods transaction, . . . a notification of disposition must provide [specified information]." New section 9-614(1)(A) mandates that the notification provide the information required by new section 9-613(1) for other than consumer goods cases. New sections 9-614(1)(B), (1)(C) and (1)(D) require additional information thought to be proper for consumers, for example, a description of any liability for a deficiency, as required by new section 9-614(1)(B).

Also, there seems to be nothing in new section 9-614 that parallels new section 9-613(2), under which a notification may be sufficient even if it lacks information required by new section 9-613(1). Consequently, the failure to include information required by new section 9-614 and, by incorporation, new section 9-613, would seem to be fatal to the notification. Thus, in *In re Downing*, 286 BR 900 (Bkcy W.D. Mo. 2002), it was held that a notification that did not inform the debtor whether the disposition would be public or private or the description of any liability for a deficiency required by new section 9-614(1)(B) or the right to an accounting as to the unpaid indebtedness provided for in new section 9-613(1)(D), failed to satisfy new section 9-611(b)'s requirement of reasonable notification.

New section 9-614(5) reinforces the conclusion that the omission of information renders a notification insufficient insofar as it speaks only to the addition of information not required by new section 9-614(1). On the other hand, as is the case with non-consumer goods transactions, no particular phrasing of a notification is required.

New section 9-614(3) contains a safe harbor form that when completed is deemed to provide sufficient information for consumer goods transactions. The consumer goods form is designed for persons as to whom the legalities are not familiar and hence it uses language that is more likely to be understood by a layperson. Because new section 9-614 is less forgiving as to omission and errors, not using the form in new section 9-614(3) is inviting problems. New sections 9-614(4), (5) and (6), all assume the use of the form and address only information added to that specified in the form.

As is true of new section 9-613 for non-consumer goods transactions, there is at least a question whether the notification must in so many words indicate whether a disposition will be public or private. The court in *Downing*, *supra*, concluded that there is such a requirement and other courts may reasonably be expected to follow suit. In any event, the wiser course of action for a secured party is to do so.

As discussed above, indicating whether a disposition is public or private requires a secured party to decide whether the disposition it intends is public or private. As is further discussed above, that decision is more difficult than one would expect or hope. The court in *Downing*, *supra*, appeared to agree with those courts and commentators concluding that a dealer only auction is a private sale and intimated that the secured party should disclose the terms of a contemplated private sale because to do so would aid the debtor in efforts to redeem the collateral, which is one of the purposes of the requirement of reasonable notification.

It remains to be seen the extent to which other courts will agree with the conclusions of the court in *Downing* on the questions of whether the notification must expressly indicate that the disposition will be public or private, whether a dealer only auction is a private disposition and whether the secured party must disclose the terms of a contemplated private sale.

There remains the important question of the persons who are entitled to be sent reasonable notification. Former section 9-504(3) was unsatisfactory on this point and some states, including Arizona, adopted special provisions seeking to clarify the answer to the question of to whom notification had to be sent. New section 9-611(c) addresses the question in rather more elaborate, but complicated, fashion.

Under new section 9-611(c)(1) and (c)(2), in both consumer and other than consumer goods cases, notification must be sent to the debtor and any secondary obligor (unless the right to such notification is properly waived after default as provided for in new section 9-624(a)). Recall that a "debtor" under new section 9-102(a)(28)(A) is a person having an interest in the collateral, whether or not the person is an obligor. A "secondary obligor" is defined in new section 9-102(a)(71) to mean an obligor whose obligation is secondary or the obligor has a right of recourse against the debtor, another obligor or the property of either. Thus, a secondary obligor is someone who guarantees that a secured debt will be paid and if the debt is not paid the secondary obligor is liable.

It makes sense that a secondary obligor be sent notification of a disposition because the disposition determines how much of a secured debt will be satisfied out of the collateral and how much continues to be owed (as a deficiency). The requirement that notification be sent to a secondary obligor resolves a question left open under former Article 9 as to whether a guarantor was entitled to be sent notification.

In consumer goods cases notification need be sent *only* to debtors and secondary obligors. In other than consumer goods cases notification may have to be sent to persons other than the debtor and any secondary obligors. Determining who these other persons are requires knowing the "notification date." The "notification date" is a cut off date provided for in new section 9-611(a), under which the notification date is the earlier of the date on which the secured party sends notification to the debtor and any secondary obligor or the date the debtor and any secondary obligor waive the right to notification.

New section 9-611(c)(3)(A) requires that the secured party send notification to any person from whom the secured has received an authenticated notification of a claim before the *notification date*. Under new section 9-611(c)(3)(B), again in other than consumer goods cases, reasonable notification must be sent to any secured party or lienholder who, ten days before the notification date, held a security interest or lien on the collateral that was perfected by filing a properly filed financing statement. Under new section 9-611(c)(3)(C), reasonable notification must be sent to any secured party not dealt with in (A) or (B), who ten days before the notification date held a security interest perfected by compliance with a state or federal law as required by new section 9-311(a).

All the subsections of new section 9-611(c) together, oversimplifying somewhat, mean that *in consumer goods cases* a secured party must send reasonable notification only to the debtor and any secondary obligor who has not waived the right to notification after default and, *in other than consumer goods cases*, a secured party must send notification to the debtor and secondary obligors and also must send reasonable notification to any other person from whom the secured party receives an authenticated notice of a claim ten days before the notification date and to any secured party or lienholder who has filed a financing statement or noted a security interest on a certificate of title or recorded in a federal office where such recording is required ten days before the notification date.

Under new section 9-611(e), a secured party complies with new section 9-611(c)(3)(B) (requiring notification to be sent to a person who ten days before the notification date held a security interest perfected by a proper filing), (1) if between twenty and thirty days before the notification date, the secured party requests information about a filed financing statement in a commercially reasonable manner and the secured party receives no response to its request before the notification date; or (2) if the secured party receives a response to the request and sends an authenticated notification to each secured party or lienholder named in the response.

You may explore the requirement that reasonable notification be sent in the next problem.

Problem 35.3 (INTERACTIVE)

(a) Assume a dispute involving the facts of *Chavers v. Frazier*, discussed in subpart B(1) above, but arising under new Article 9.

To which persons in that case must reasonable notification of the disposition of the jet be sent if notification has not been waived or excused?

If in *Chavers v. Frazier*, a party "Lender" had lent to the debtors and recorded a security interest in the jet with the FAA two days before Chavers (the secured party) sent notification to the debtors and secondary obligors, would Chavers be required to send notification to Lender? In answering the question, be sure to examine all of new section 9-611(c).

Would your answer to the previous question be different if Lender had recorded its security interest twenty days before notification was sent to the debtors and secondary obligor?

Would your answers to the foregoing questions be the same if the jet were used primarily for personal, family or household purposes?

If Chavers sent the required notification to the persons entitled to it after default and 10 days before the time set for the disposition in the notification, would the notification have been sent within a reasonable time before the disposition?

Is the next statement true or false? To be sufficient Chavers' notification should state the time and place for the disposition.

Are the next statements true or false? If the jet in *Chavers v. Frazier* were bought for use primarily for personal purposes, the notification would *not* have to state the time and place for the disposition but would have to describe the liability for a deficiency. A debtor cannot waive the right to reasonable notification until after default and must do so in an authenticated agreement, but a secondary obligor may waive the right to reasonable notification in the security agreement.

3. Application of the Proceeds of a Disposition

The bottom line concerns as to dispositions are who gets what from the proceeds of a disposition and whether and to what extent anyone will be stuck with a deficiency or benefit from a surplus. Deficiencies and surpluses are treated separately in subpart B(4) below but they depend heavily on the application of the rules determining how the proceeds of a disposition are to be distributed.

New sections 9-615(a) provides:

> (a) A secured party shall apply or pay over for application the cash proceeds of disposition under Section 9-610 in the following order to:
>
> (1) the reasonable expenses of retaking, holding, preparing for disposition, processing, and disposing, and, to the extent provided for by agreement and not prohibited by law, reasonable attorney's fees and legal expenses incurred by the secured party;
>
> (2) the satisfaction of obligations secured by the security interest or agricultural lien under which the disposition is made;
>
> (3) the satisfaction of obligations secured by any subordinate security interest in or other lien on the collateral if:
>
> (A) the secured party receives from the holder of the subordinate security interest an authenticated demand for proceeds before distribution of the proceeds is completed; and

(B) if a consignor has an interest in the collateral, the subordinate security interest or lien is senior to the interest of the consignor; and

(4) a secured party that is a consignor of the collateral if the secured party receives from the consignor an authenticated demand for proceeds before distribution of the proceeds is completed.

New section 9-615(b) adds:

(b) If requested by a secured party, a holder of a subordinate security interest or other lien shall furnish reasonable proof of the interest or lien within a reasonable time. Unless the holder does so, the secured party need not comply with the holder's demand under subsection (a)(3).

The obligations secured by the security interest or agricultural lien, as provided for in new section 9-615(a)(2), include interest that has accrued to the time of the default. Arguably, interest accruing from the time of default until the collateral is disposed of also is recoverable.

You may explore the rules governing distribution of the proceeds of a disposition under new Article 9 in the next problem.

Problem 35.4 (INTERACTIVE)

Southern Bank recently repossessed and sold Donna Debtor's inventory and equipment to enforce a timely perfected security interest in the inventory and equipment. The balance owing on the loan at the time Donna defaulted by missing two monthly payments was $60,000. Interest on the loan was 10% a year. The Article 9 disposition took place two months after Donna defaulted. You represented Southern in the provisional remedy action that was necessary to get possession of the collateral from Donna and your reasonable fees in connection with this action amounted to $3,000. You charged Southern another $850 for arranging the public sale of the collateral including the required notifications and advertising of the sale. The expenses of the sale itself were reasonable and totaled $1,000. The sale brought $75,000.

(a) Is the following statement true or false? The $1,000 for the expenses of the sale must be satisfied first out of the proceeds of the sale ahead of Southern Banks secured obligations.

(b) Are your attorney's fees for recovering the collateral and for arranging the sale recoverable and must they be satisfied out the proceeds along with the expenses of the sale?

(c) What is the amount of Southern Bank's secured obligations?

(d) Suppose that at the time of the sale Southern Bank had received an authenticated claim in the amount of $20,000 interest in the collateral from Lender who filed after Southern. Is the following statement true or false? Lender's claim must be satisfied out of the proceeds after the reasonable expenses of the sale are paid but before Southern's obligation is paid.

(e) If Lender's claim must be satisfied out of the proceeds of the disposition, how much does Lender get? (For purposes of answering this question, assume all of your attorney's fees are recoverable from the proceeds.)

(f) Suppose Southern Bank also received a demand for $1,500 from Supplies R Us, one of several unsecured creditors of Donna Debtor. Must the $1,500 be satisfied out of the proceeds of the sale?

(g) What happens to Southern Bank's security interest when its disposition is completed? *See* new section 9-617(a) as explained below.

New section 9-615(a) interacts with new section 9-617. New section 9-617(a) provides that a disposition discharges the security interest under which a disposition is made and also discharges any subordinate security interests or liens. Under new section 9-617(b), a good faith transferee at a disposition gets title free of security interests and other liens that are subordinate to the security interest under which a disposition is made even if the disposition is defective in some respect. The effect of new section 9-617 is to increase the proceeds received at a disposition and the amount a claimant under new section 9-615(a) is likely to receive.

Note that new section 9-617(a) speaks only to the security interest under which a disposition is conducted and any subordinate security interests. The question arises as to what happens to a senior security interest if a junior secured party conducts a disposition. In the ideal, the holder of a senior security interest will intervene and take control of the disposition. In this regard, recall the desirability of defining a default to include all events that threaten to undermine a security interest. But, it could happen that a senior party fails to intervene and that a disposition is conducted by the junior secured party.

Former Article 9 did not address the question of what happens to the senior security interest if a disposition by a junior party goes forward. New section 9-615(g) provides that a junior secured party who acts in good faith and without knowledge that the disposition violates the rights of a senior interest gets the cash proceeds of the disposition free of the senior security interest and has no obligation to apply the proceeds to the senior interest or to account to the senior interest for any surplus. The effect of new section 9-615(g) is to require the senior party to pursue the collateral in the hands of the transferee at the disposition.

New sections 9-615(a) and (g) refer to cash proceeds of a disposition. Former Article 9 did not address the question of non-cash proceeds. Under new section 9-615(c) a secured party need not apply or pay over noncash proceeds unless the failure to do so would be commercially unreasonable (and if a secured party is required by new section 9-615(c) to apply or pay over noncash proceeds of a disposition then it must do so in a commercially reasonable manner). *See* Official Comment 3 to new 9-615 .

The treatment of noncash proceeds impacts determinations of deficiencies and surpluses, matters dealt with in subpart (B)(4), and a secured party would be well advised to deal with the noncash proceeds situations in the original security agreement. *See* new 9-603 (permitting the parties to agree upon standards for measuring the fulfillment of rights of debtors and obligors and duties of secured parties so long as the standards are not manifestly unreasonable).

There is more to new section 9-615(c) and the treatment of noncash proceeds, but the essence of the matter can be gleaned from the following problem.

Problem 35.5 (INTERACTIVE)

Donald Debtor defaults and Delia Dealer disposes of collateral in a private sale conducted according to Delia's usual business practices, including a credit check of the purchaser of the collateral. Delia receives cash proceeds and a secured obligation from the purchaser to pay the balance over time (*i.e.,* chattel paper).

Must Delia account to Donald immediately for the amount to be realized on the secured obligation?

Would your answer be the same if the noncash proceeds are generated by a disposition not conducted according to Delia's regular business practices?

Could uncertainties about the Delia's obligations have been reduced at the time the security agreement was drafted?

4. Deficiencies and Surpluses

A disposition may bring more than enough to pay expenses and satisfy the indebtedness and timely and properly asserted subordinate claims to which the proceeds of a disposition must be applied under new section 9-615(a). If so, there is a "surplus. Often, certainly in consumer goods cases, the proceeds will not be sufficient to pay expenses and satisfy the indebtedness and subordinate claims to the collateral. When this happens there is a "deficiency."

New section 9-615(d), the successor to former section 9-504(2), confirms the essential point that if a disposition does not produce enough to cover the secured party's reimbursable expenses, the secured obligation and designated subordinate claims then there will be a deficiency and if the disposition brings more than enough to cover these amounts then there is a surplus. However, new Article 9 restates the right to a surplus and the obligation to pay a deficiency. Thus, new section 9-615(d)(1) requires the secured party to account for and "pay" to the *debtor* for any surplus and new section 9-615(d)(2) imposes the liability for any deficiency on the *obligor*.

As was noted in earlier chapters new Article 9 distinguishes an "obligor" from a "debtor." "Obligor" is defined in new section 9-102(a)(59) essentially as the person who is obligated to pay the secured debt. Under new section 9-102(a)(28), a "debtor" is a person who has an interest in the collateral but who may or may not be an obligor on the secured debt. Under new section 9-615(d) any surplus is owed to the "debtor," but it is the "obligor" who is liable for any deficiency.

The new Article 9 clarification has a non-obvious application to situations where collateral has been transferred. Recall that the general rule under new section 9-315(a)(1) is that a security interest continues in collateral unless the secured party authorizes the transfer free of the security interest. *See* Chapters 16 (Perfecting Security Interests in Proceeds and Other Later Acquired Property) and 27 (Secured Party Versus Buyers). Thus, for example, in the event of a sale where the security interest continues in the property sold, the buyer is the debtor to whom any surplus must be paid and the seller is the obligor who is liable for any deficiency.

Because many transfers that result in a continuation of the security interest will be wrongful and made without the knowledge of the secured party, it could happen that the secured party improperly pays a surplus to the seller/obligor who no longer is the debtor. However, new sections 9-605 (no duty is owed to a person that the secured party does not know to be a debtor or obligor) and 9-628(a) (a secured party is not liable for failure to comply with Article 9 to a person not known to be a debtor or obligor), *see* Chapter 38 (Remedies for a Secured Party's Failure to Comply with Article 9), may exonerate a secured party from liability in such a case.

If a buyer takes free of a security interest as the result of a priority rule such as new section 9-320(a), *see* Chapter 27 (Secured Party Versus Buyers), the property no longer is collateral and the buyer is not a debtor to whom any surplus is owed (but the seller is still an obligor on the now unsecured debt). *See* Official Comment 5 to new 9-615. It seems that a secured party would not know of a transfer only where the transferred collateral remained in the possession of the transferor/obligor and this probably would happen only infrequently.

New Article 9 contains numerous rules governing the calculation of a deficiency or surplus. New section 9-615(f) applies where the purchaser at a disposition is the secured party or a person related to the secured party or a secondary obligor. Under new section 9-615(f), if a disposition is made to the secured party or a person related to the secured party or a secondary obligor *and* the amount of the proceeds is significantly less than what would be expected in a complying disposition to a person other than the secured party, a person not related to the secured party or a secondary obligor, then the surplus or deficiency is calculated on the basis of an amount that would have been realized had there been a complying disposition to a person other than the secured party or a person not related to the secured party.

Under new section 9-102(a)(62) a person is related to a secured party who is an *individual* if the person is the secured party's spouse, sibling or sibling-in-law, an ancestor or lineal descendant of the secured party or the secured party's spouse, or any other relative by blood or marriage of the secured party or the secured party's spouse. New section 9-102(a)(63) in turn defines "person related to " a secured party that is an *organization* as a person controlling or controlled by the organization, an officer or director of the organization, the spouse of any of the foregoing persons, and any individual who is related by blood or marriage to any of the foregoing individuals who shares the home of such an individual.

The basic intent of new section 9-615(f) is to control for dispositions that are (or may not be) "arms length" (referred to elsewhere, for example in federal bankruptcy law, as transfers to "insiders"). However, the application of the section requires special judicial involvement and scrutiny and it will be interesting to see how the provision works in practice.

As noted in subpart (B)(1) above, burdens of proof can affect the outcome of disputes about whether the secured party has complied with the obligations imposed as to Article 9 dispositions. Where the debtor or obligor is the moving party, generally speaking, the burden of proving that the secured party has failed to meet its obligations would be on the debtor or obligor. This would be the case, for example, where the debtor or obligor is seeking to recover damages under new section 9-625 for failure of the secured party to comply with Article 9. Remedies for failure of a secured party to comply with Article 9 are discussed more fully in Chapter 38 (Remedies for a Secured Partys Failure to Comply with Article 9).

However, deficiency and surplus disputes involve special rules. Under new section 9-626(a)(1) and (a)(2), when a surplus or deficiency is challenged in an other than consumer transaction, the secured party has the burden of establishing that a disposition was done in accordance with the requirements of Part 6, especially that the disposition was made in a commercially reasonable manner. If the secured party fails to prove that it met the requirements of Part 6, then under new section 9-626(a)(3) a deficiency is limited to the greater of the proceeds of the disposition or the amount that would have been realized had the secured party satisfied the requirements of Part 6. New section 9-626(a)(4) provides that the amount that would have been realized is equal to the sum of the secured obligation, expenses and attorney's fees, unless the secured party proves a lesser amount.

As explained above, under new section 9-615(f), deficiencies and surpluses in connection with dispositions to the secured party, or a person related to the secured party, or a secondary obligor, are subject to recalculation. New section 9-626(a)(5) provides that in such situations, other than in a consumer transaction, the debtor or obligor has the burden of proving that the amount of proceeds is significantly less than a complying disposition to a person other than the secured party, a person related to the secured party or a secondary obligor.

The existence of these special rules as to burdens of proof makes the decision as to whether a transaction is governed by Article 9 all the more important. For example, in *Allco Enterprises, Inc. v. Goldstein Family Living Trust*, 48 UCC Rep. Serv. 2d 752 (Or. App. 2002), the court finessed the often difficult question of whether a lease is intended as security, in which case it would be within the scope of Article 9 or a true lease, outside the scope of Article 9, *see* Chapter 4 (Scope of Article 9), by concluding that because the purported leases at issue in the case by their terms required that dispositions of leased property be commercially reasonable it did not matter how the leases were characterized. However, although the court examined the question of whether the disposition in the case had been conducted in a commercially reasonable manner as if the transaction were covered by new Article 9, it erroneously failed to apply the special burden of proof rules just discussed.

As considered more fully in Chapter 38 (Remedies for a Secured Party's Failure to Comply with Article 9), under new section 9-626(b), courts are left to fashion rules, including those governing burdens of proof, in consumer transactions.

Related to the question of who has the burden of proof in a particular action is the question of the extent to which there is an issue of fact or law involved. Thus, commercially reasonableness, and issues of reasonableness more generally, is understood to be a question of fact. That this is so can impact the standard of review where a trial court decision is appealed. Generally speaking, fact determinations are reviewed under a clearly erroneous standard. Important questions of law may, however, also be involved. For example, the meaning of a "recognized market" as used in various sections governing dispositions, including new section 9-627(b)(1) and (b)(2), discussed above, would seem to be a question of law.

It should be pointed out that where a secured party and a debtor work out an acceptance of the collateral in partial satisfaction of the debt, a deficiency remains. Deficiencies in partial acceptance situations are discussed in Chapter 36 (Acceptance of Collateral in Full or Partial Satisfaction of the Debt). On the other hand, as will be discussed further in Chapter 38 (Remedies for a Secured Party's Failure to Comply with Article 9), under new section 9-625, the failure of a secured party to comply with the obligations imposed by new section 9-616 can produce liability for any loss caused plus $500. And, as is discussed separately in Chapter 37 (Foreclosure as to Intangibles), in certain transactions involving intangibles, there may be no right to a deficiency or obligation to account for a surplus.

The rules for determining the amount of a surplus or deficiency and when the secured party has a right to a deficiency are considered more fully in Chapter 38 (Remedies for a Secured Party's Failure to Comply with Article 9).

Recall from Chapter 34 (Getting Possession of the Collateral) that under A.R.S. §44-5501, in certain consumer goods cases, a secured party who elects to repossess the goods cannot claim a deficiency.

New Article 9, section 9-616, requires that debtors in consumer goods cases involving surpluses and consumer obligors in deficiency cases receive an explanation that states the amount of the deficiency or surplus and explains how a surplus or deficiency was calculated. New section 9-616(a)(1) defines "explanation" and new section 9-616(c) specifies information that must be included in the explanation and the order in which it must be stated.

Under new section 9-616(b), the explanation must be sent after the disposition and before or when the secured party makes an accounting for any surplus or first makes a written demand for payment of a deficiency. A secured party who does not seek a deficiency or pay a surplus need not provide the explanation unless requested by the debtor or obligor to do so. On the other hand, a debtor need not wait for the secured party to send an explanation and may request an explanation and a requested explanation must be sent within fourteen days of the request.

You may explore the rules governing surpluses and deficiencies in the next problem.

Problem 35.6 (INTERACTIVE)

Assume the facts of Problem 35.4, but that the sale brought only enough to pay the reasonable expenses and $40,000 of Southern Bank's obligation. If the sale was not to Southern or a person related to Southern or any secondary obligor and the sale was commercially reasonable and reasonable notification was sent to anyone entitled to be sent such notification, Bank has a claim for a deficiency under new section 9-615(d)(2) against Donna Debtor (who is the obligor as well as the debtor).

(a) What is the amount of the deficiency as to Southern Bank?

(b) What must Southern Bank do to collect the deficiency?

(c) Does Lender (the secured party who filed after Southern Bank and made a timely claim to Southern Bank regarding the proceeds of the disposition) also have a deficiency claim?

(d) If the proceeds from the disposition are sufficient to satisfy reasonable expenses and Southern Bank's and Lender's obligations, and there is $10,000 left over, who gets the $10,000?

(e) If Southern Bank failed to comply with the commercially reasonable or reasonable notification requirements, and the disposition brought only enough to pay $40,000 of Southern's obligation and the expenses recoverable from the proceeds of the disposition, and Donna Debtor defended the suit for a deficiency by challenging the disposition on grounds of non-compliance with Part 6 of Article 9, what would be the amount of Southern's deficiency claim?

(f) If the transaction in Problem 35.6 were a consumer transaction, would the deficiency owed to Southern Bank where Southern failed to comply with Part 6 of Article 9 be calculated in the same way?

CASE COMMENTARY

Knutson v. Walker and Associates, Inc., 2005 WL 1950202 (D. Colo. 2005) (Not reported in F. Supp. 2d)

Orix Financial Services, Inc. v. Thunder Ridge Energy, Inc., 2006 WL 587483 (S.D.N.Y. 2006) (Slip Opinion)

Citicorp Leasing, Inc. v. United American Funding, Inc., 2005 WL 1847300 (S.D.N.Y. 2005) (Not reported in F. Supp. 2d)

AKA Management, Inc. v. Branch Banking and Trust Co., 621 S.E.2d 576 (Ga. App. 2005)

Panora State Bank v. Dickinson, __ N.W. 3d __, 2006 WL 228882 (Iowa App. Feb. 1, 2006)

Missouri State Credit Union v. Wilson, 176 S.W.3d (Mo. App. 2005)

Merchant's Bank of New York v. Gold Lane Corporation, 814 N.Y.S.2d 99, 2006 WL 945091 (N.Y. 1st App. Div. 2006)

Federal Express Credit Union v. Lanier, 2005 WL 2806638 (Tenn. App. 2005) (slip copy)

Lister v. Lee-Swofford Investments, L.L.P., __ S.W.3d __, 2006 WL 798005 (Tex. App. 2006)

D.A.N. Joint Venture, III v. Clark, 218 S.W.3d 455 (Mo. App. 2006)

Keybank National Association v. DPR Construction, Inc., 149 P.3d 233 (Or. App. 2006)

Davenport v. Bates, 2006 WL 3627875 (Tenn. App. 2006)

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Part VII Enforcing an Article 9 Security Interest

Chapter 36 Acceptance of Collateral in Full or Partial Satisfaction of the Debt

A. Generally

As we saw in Chapter 33 (A Secured Party's Options on Default), on default a secured party has two Article 9 options for enforcing a security interest. The disposition option was examined in detail in Chapter 35 (Disposing of Collateral to Satisfy a Secured Debt). The other option is retention or, as it is denominated in new Article 9, acceptance in satisfaction of the debt. Acceptance of collateral in complete or partial satisfaction of the debt requires strict compliance with the Article 9 rules as to *when* a complete or partial acceptance is allowed and *how* an acceptance is to be effected. *See* 9-620, 9-621 and 9-622.

Once again it is important to bear in mind that the debtor is the owner of the collateral and until its security interest has been foreclosed by either of the foregoing options the secured party has only a lien on the collateral.

As will be explained more fully below, although the debtor (and other parties with an interest in the collateral) can be divested of ownership of or some other interest in the collateral, even if the secured party fails to comply with all the requirements for acceptance, there can be no acceptance in complete or partial satisfaction of the debt unless a proposal of an acceptance has been made. *See In re Cadiz Properties, Inc.*, 278 B.R. 744 (ND Tex. 2002).

Acceptance in satisfaction of the debt can eliminate or reduce a secured party's right to a deficiency, but it can also work a "strict foreclosure" in the sense that it has the potential to deny the benefit of a surplus to those who would be entitled to it in a disposition situation. Because of the "strict foreclosure" nature of acceptance, affected parties must be given a reasonable opportunity to force a disposition. *See* new 9-620(a) and 9-621. Moreover, acceptance in partial satisfaction of the debt, as allowed by new Article 9, and which is designed to facilitate settlements and reduce the frequency of costly deficiency litigation, is not permitted in a consumer transaction.

Under former Article 9, section 9-505(1), where the collateral was consumer goods, secured parties were required to dispose of the collateral in cases where debtors have built up significant equity. Mandatory disposition as to consumer goods is continued under new sections 9-620(e), (f) and (g). Consequently, acceptance in satisfaction of the debt is not always an option and when it is an option there are rigid procedures that must be followed.

B. Other than consumer goods cases.

Under former section 9-505(2), a secured party who gave proper notification of an intent to retain the collateral to the debtor and certain other parties could effect a strict foreclosure (meaning keep the collateral in satisfaction of the debt and forego any need to account for a surplus or right to a deficiency), but the debtor or other persons entitled to notification could by timely and proper objection prevent retention and force a disposition. Obviously, a secured party would be most likely to seek to retain in satisfaction of the debt when there was a surplus and least likely to do so where there would be a deficiency.

New Article 9 makes a number of changes to the retention scheme provided for in former section 9-505(2). To begin with, new Article 9 refers to retention as "acceptance." In addition, new Article 9 permits partial as well as full acceptance in other than consumer cases. By preserving a surplus or leaving a deficiency owing, the partial acceptance option may encourage the parties to negotiate a settlement of a secured debt.

New section 9-620(a) eliminates a possession requirement imposed by former section 9-505(2) and thereby makes clear that acceptance is available as to intangibles. Beyond these formal and substantive changes, new Article 9 seeks to clarify the procedures that must be followed to effect an acceptance.

Acceptance of the collateral in complete or partial satisfaction of the debt is governed by new sections 9-620, 9-621 and 9-622. Consistently with the use of the description "acceptance" and the intent of the scheme to encourage the secured party and debtor to work out the terms of a settlement, new section 9-620(a) refers to the debtor's "consent" and new section 9-620(c)(1) requires that the debtor agree to the terms of an acceptance in partial satisfaction of the debt in a record authenticated by the debtor after default.

However, under new section 9-620(c)(2), a debtor "consents" to an acceptance in complete satisfaction of the debt if the debtor receives an essentially unconditional proposal that the debtor fails to object to within twenty days after the proposal is sent. Under new section 9-620(a)(2), parties other than the debtor consent only in the sense that they do not timely object.

Under new section 9-620(b), acceptance is entirely at the option of the secured party and acceptance cannot be forced upon a secured party (as some courts concluded under former Article 9). However, a secured party who holds collateral for an extended period without good reason may be held to have acted in a commercially unreasonable manner thereby subjecting the secured party to the risks that go with failures to comply with Article 9. *See* Chapter 38 (Remedies for a Secured Party's Failure to Comply with Article 9).

As was true under former Article 9, under new sections 9-620(c)(2) and 9-620(d), it is enough that the secured party "send" a proposal for acceptance to parties entitled to such notification and an objection can prevent acceptance only if it is actually received by the secured party within twenty days after a notification is sent. However, given that under new section 9-620(a)(1) a debtor must consent to an acceptance as defined in new section 9-620(c), notification of a desire to accept collateral in satisfaction of a debt need not be sent to the debtor.

To govern situations where notification is required, new section 9-621 provides a somewhat more streamlined version of the notification scheme devised for dispositions in new section 9-611 and discussed in Chapter 35 (Disposing of Collateral to Satisfy a Secured Debt). The scheme does not use the "notification date" device for fixing a cut off for who must be sent notification employed by new section 9-611 applicable to dispositions.

Under new section 9-621(a)(1), a secured party must send notification to any person from whom the secured party receives an authenticated notification of a claim of interest in the collateral before the debtor consents to an acceptance. Under new sections 9-621(a)(2) and (a)(3), the secured party also must send notification to any other secured party or lien holder who, ten or more days before the debtor consented to the acceptance, perfected a security interest or other lien by properly filing a financing statement or by compliance with a law other than Article 9.

There is no protection for secured parties in acceptance cases against delays in obtaining information from filing offices such as is given to secured parties in disposition situations under new section 9-611(e). On the other hand, under new section 9-621(b), only in the case of a partial disposition must the secured party send notification to a guarantor (secondary obligor).

Under new sections 9-622(a)(1) and (a)(2), an effective acceptance (one that is consented to by the debtor and not timely objected to by a party who is entitled to object) discharges the obligation to the extent consented to by the debtor and transfers all the debtor's rights in the collateral to the secured party. Under new sections 9-622(a)(3) and (a)(4), an effective acceptance also discharges the security interest or agricultural lien that is the subject of the acceptance and any *subordinate* security interest or lien and terminates any other subordinate interest.

Under new section 9-622(b), subordinate interests are discharged or terminated even if the secured party fails to send notification to a party entitled to notification under new section 9-621. In such a case an aggrieved party's only recourse is for damages under new section 9-625, as discussed in Chapter 38 (Remedies for a Secured Party's Failure to Comply with Article 9). *See* Official Comment 2 to new 9-620.

On the other hand, where an acceptance is not effective because the debtor has not consented or a party entitled to notification has timely objected, subordinate interests are not discharged or terminated. *See* Official Comment 2 to 9-622. In the case of In re Cadiz Properties, Inc., 278 B.R. 744 (ND Tex. 2002), it was held that where no proposal for acceptance had ever been made, there could be no transfer of ownership of stock to the secured party and as the owner of stock that gave the debtor a controlling interest in the corporation, a board of directors elected by the debtor had the authority to put the corporation into bankruptcy.

The attempt to encourage settlement through the device of acceptance in partial satisfaction of the debt means that the secured party and the debtor may negotiate an acceptance that is not directly subject to the commercially reasonable requirement imposed on dispositions. Moreover, under new section 9-622(a)(1), a debt is discharged by a acceptance in partial satisfaction of the debt only as provided for in the agreement and the remaining debt continues as a possible basis for a deficiency action by the secured party.

Because liability for a deficiency continues in the case of an acceptance in partial satisfaction of the debt, new section 9-621(b) requires that guarantors (who are liable for deficiencies) be afforded an opportunity to object. As noted above, under new section 9-622(b), subordinate interests are discharged or terminated *even if* the secured party fails to comply with procedures required for acceptance. Any such failure by the secured party does expose the secured party to the risk of liability under new section 9-625.

You may explore the basics of acceptance in complete or partial satisfaction of a debt in other than consumer cases in the next three problems.

Problem 36.1 (INTERACTIVE)

Assume the facts of *Chavers v. Frazier*, considered in Chapter 35 (Disposing of Collateral to Satisfy a Secured Debt). Be sure you understand the interests of the various parties involved in the case (perhaps by sketching them out).

(a) Could Chavers have simply kept the jet in satisfaction of the debt? Would the debtors be likely to have consented to an acceptance in complete satisfaction of the debt given the facts of that case? Would Chavers have been likely to propose an acceptance in complete satisfaction of the debt? What circumstances might lead Chavers nevertheless to propose an acceptance in complete satisfaction of the debt?

(b) Would Chavers have been inclined to propose a partial acceptance? Would the debtors be likely to agree to a partial acceptance? Explain your answers.

Problem 36.2 (INTERACTIVE)

If the debtors and Chavers were able to reach an agreement on an acceptance in partial satisfaction of the debt, what would be the effect on the secondary obligor (Mrs. Frazier)?

Must Mrs. Frazier be given an opportunity to object?

If Mrs. Frazier were not sent notification of a proposed acceptance in partial satisfaction of the debt as required by new section 9-621(b) would the acceptance still be effective?

If the acceptance were still effective even though the required notification was not sent, would Mrs. Frazier have any recourse against Chavers?

Problem 36.3 (INTERACTIVE)

Assume again the facts of *Chavers v. Frazier*. Suppose, however, the jet also was subject to a perfected security interest held by a party "Lender" to secure a $50,000 loan.

Would an acceptance in complete or partial satisfaction of the debt discharge Lender's security interest? Must Lender be given an opportunity to object to any proposed acceptance in complete or partial satisfaction of the debt?

If Lender were entitled to receive notification of a proposed acceptance but Chavers failed to send it would an acceptance consented to by the debtors and not timely objected to by Mrs. Frazier discharge Lender's security interest?

Would Lender have any recourse based on the failure of the secured party to send the required notification?

C. Consumer goods and consumer transactions

The requirements for acceptance in other than consumer transactions generally apply to consumer goods and consumer transactions cases. However, consumers are thought to be at greater risk regarding the strict foreclosure effect of retention or acceptance and some special limitations are imposed to protect consumers.

Under new sections 9-620(e) and (f), if a debtor has paid 60% of the cash price of a purchase money security interest in consumer goods or 60% of the principal amount of the obligation in non-purchase money in consumer goods, then the secured party must dispose of the goods within 90 days after taking possession or within such longer period of time agreed to by the debtor and all secondary obligors in an authenticated agreement entered into after default.

A secured party who does not dispose of the goods within the 90-day period (or a specially agreed to period) may be liable for damages under new section 9-625. The secured party also could be liable for conversion as a remedy available under supplemental principles of law, as provided for in new Article 1, section 1-103(b) (formerly section 1-103). *See* Official Comment 12 to new 9-620.

Under new section 9-624(b), a debtor may waive the right to mandatory disposition but only by an agreement to that effect entered into and authenticated *after* default.

Under new section 9-620(g), acceptance in partial satisfaction of a debt is not available in a consumer transaction. According to Official Comment 12 to new 9-620, an attempted acceptance in partial satisfaction of a debt in a consumer transaction is void.

Bear in mind that a "consumer transaction" is defined separately in new section 9-102(a)(26) as one in which an individual incurs an obligation for personal, family or household purposes secured by an interest collateral held or acquired for personal, family, or household purposes. Thus, mandatory disposition under new section 9-620(e) may be required as to "consumer goods," defined in new section 9-102(a)(23) as goods used or bought for use primarily for personal, family or household purposes, whereas the bar in new section 9-620(g) on acceptance in partial satisfaction of the debt applies only in consumer transactions.

You may explore the acceptance rules of new Article 9 applicable to consumer situations in the next two problems.

Problem 36.4 (INTERACTIVE)

Assume again the facts of *Chavers v. Frazier* from Chapter 35 (Disposing of Collateral to Satisfy a Secured Debt) but that on default the debtors had paid $600,000 of the $850,000 price of the jet.

Would acceptance of the jet in satisfaction of the debt be an option available to Chavers?

If the jet had been purchased for personal, family, or household purposes, would acceptance be an option for Chavers?

Problem 36.5 (INTERACTIVE)

Suppose the facts of *Chavers v. Frazier* from Chapter 35 were that the debtors bought the jet for personal use and at the time of the default they had paid only $400,000 of the price owed. The Chavers are not likely to be inclined to an acceptance in full satisfaction of the debt because they would lose their right to assert a deficiency. However, they might well favor an acceptance in partial satisfaction of the debt. Is acceptance in partial satisfaction of the debt an option? This question is deceptively complicated. In answering this question you should refer to new section 9-620(g) but you also must examine carefully new section 9-102(a)(26).

CASE COMMENTARY

Knutson v. Walker and Associates, Inc., 2005 WL 1950202 (D. Colo. 2005) (Not reported in F. Supp. 2d)

Ronald V. Odette Family Limited Partnership v. Agco Finance, LLC, 129 P.3d 95 (Kan. App. 2005)

Merchant's Bank of New York v. Gold Lane Corporation, 814 N.Y.S.2d 99, 2006 WL 945091 (N.Y. 1st App. Div. 2006)

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2011-08-22 update

Part VII Enforcing an Article 9 Security Interest

Chapter 37 Foreclosure as to Intangibles

A. Generally

Intangible collateral includes accounts, chattel paper and general intangibles. It also includes instruments. Such collateral consists essentially of promises by third parties to pay or perform certain other obligations. It is the promise of the third parties (account debtors as to accounts, chattel paper and general intangibles and obligors as to instruments) that is the primary security.

Accounts, chattel paper, general intangibles and instruments may secure debts, in which case there is a security transaction that is largely indistinguishable from a security interest in goods. *See* new section 9-109(a)(1). However, accounts, chattel paper, payment intangibles and promissory notes also may be sold and under new section 9-109(a)(3) such sales are within the scope of Article 9.

The primary difference between an interest in intangibles to secure an indebtedness and a sale of intangibles is that in sales transactions, under new section 9-608(b), the debtor is not entitled to any surplus and the obligor is not liable for a deficiency whereas in a security transaction, under new section 9-608(a)(4), the debtor is entitled to any surplus and the obligor is liable for any deficiency. However, these general rules may be altered by agreement and it is possible that there will be no right of charge back or right of recourse (no deficiency liability) in a security transaction and that there will be deficiency liability in a sales case.

Where the secured party is not required to account for any surplus or the debtor is not liable for any deficiency, the secured party assumes the risk that the account debtor or obligor will be unable or unwilling to pay and the debtor is off the hook. Where the secured party must account for a surplus or a debtor is liable for any deficiency, under new section 9-607(c), actions taken by the secured party must be commercially reasonable.

B. Foreclosure as to Assignments of Interests in Accounts and Chattel Paper to Secure Debts; Foreclosure as to Deposit Accounts

1. Satisfying Debts Out of Deposit Accounts

As has been noted in the past, sales of intangibles and security interests in intangibles may take many forms and generalizations are difficult. These materials will focus on assignments of interests in intangibles to secure debts and, more specifically, on security interests in accounts and chattel paper. But, first a word about satisfying debts that are secured by interests in deposit accounts, which are general bank accounts and are not accounts within the meaning of Article 9, is in order.

If a secured party has a security interest in a deposit account and the secured party is the bank in which the account is maintained, then the security interest is perfected by control under new section 9-104(a)(1). Under new section 9-607(a)(4) the bank/secured party is free to apply the balance in the deposit account to the obligation secured by the deposit account.

If a security interest in a deposit account is perfected by control under new section 9-104(a)(2) (the bank in which the account is maintained has agreed to follow the secured parties instructions without further assent by the debtor) or under new section 9-104(a)(3) (the secured party has become a customer on the deposit account) then, under new section 9-607(a)(5), the secured party may instruct the bank to pay the balance of the deposit account to or for the benefit of the secured party.

For completeness, it should be noted that a bank is not an account debtor, as defined in new section 9-102(a)(3), with respect to a deposit account or, more clearly, with respect to a negotiable instrument. That a bank is not an account debtor means that the rules governing assignments found in new sections 9-403, 9-404, 9-405 and 9-406, which are discussed below, do not apply. *See* Official Comments 5d and 5h to New 9-102.

2. Foreclosing on Accounts and Chattel Paper Assigned for Security

Assignments for security of accounts and chattel paper are three-party transactions. In such transactions the *secured party/assignee*, is taking an interest in the obligations owed by the *account debtor* on an account or chattel paper, typically a right to payment, to secure the debt owed by the *debtor/assignor*. Rules governing the extent to which an account debtor may continue to pay the debtor after an assignment and when defenses and claims against a debtor may be asserted by the account debtor against the secured party are necessary.

Under new section 9-406(a) an account debtor may discharge its obligation by paying the debtor (assignor) until the account debtor receives a notification, authenticated by the assignor or the assignee, that the amount due or to become due has been assigned and that payment is to be made to the secured party (assignee). However, also under new section 9-406(a), if an account debtor continues to pay the assignor after having received an authenticated notification then the debt is not discharged and the account debtor may incur double liability.

An account debtor may request reasonable proof of an assignment and if the secured party does not seasonably provide such proof the account debtor may continue to pay the debtor.

Under new section 9-209, once the obligation owed by the assignor/debtor has been paid, if there is no commitment by the assignee (secured party) to make further advances, the debtor may make an authenticated demand on the secured party to provide an authenticated record that releases the account debtor from any further obligation and the secured party must send such a release to the account debtor within ten days of receiving the demand.

The general rule of new section 9-404(a) is that an account debtor may assert against the secured party all claims and defenses the account debtor has against the debtor. However, under new section 9-403(b), in a commercial setting, the debtor (assignor) and the account debtor may agree that the account debtor will not assert claims and defenses against the secured party (assignee).

In *Systran Financial Services Corp. v. Giant Cement Holding, Inc.*, 252 F. Supp. 2d 500 (N.D. Ohio 2003), the court held that an arbitration clause was enforceable by an account debtor against an assignee. In so holding, the court concluded that new section 9-404 governed a factoring arrangement (under which accounts were sold to the assignee at a discount) and that the Article 2 provisions that appeared to distinguish assignments of contracts and assignments for financing did not.

The court noted that the assignee (as with such assignees generally) could have required its assignor/debtor to agree not to include an arbitration clause in its contracts with its customers, but that the account debtor had not by its actions in resisting the claim waived the right to arbitration.

Of course, an agreement by an assignor not to include an arbitration clause in a contract would not be enforceable against the account debtor if the assignor entered into contracts providing for arbitration in violation of the agreement. The assignee could require that the assignor include in its contracts a provision under which the account debtor waived as against the assignee any claims or defenses it might have against the assignor.

Such "waiver of defense" clauses are expressly enforceable under the conditions spelled out in new section 9-403(b), namely, that the assignee have given value and taken the assignment without notice of a claim or defense. However, the assignee would have to establish a way to oversee the assignor's contracts so as to assure that the waiver of defense clause was included in its contracts.

Under new section 9-403(d) "waiver of defenses" agreements are not effective against account debtors in consumer transactions (the debtor is an individual, the obligation is secured by an interest in consumer goods and the obligation was incurred for personal, family, or household purposes). New section 9-403(d) reinforces the protection given to consumers by the FTC Preservation of Consumer Defenses and Claims Rule, 16 CFR Part 433 (in the Selected Statutes).

It is important to point out that an account debtor, to which the foregoing rules apply, under new section 9-102(a)(3) means a person obligated on an account, chattel paper or general intangible. As explained in Chapter 5 (Classification of Collateral), general intangible, as defined in new section 9-102(a)(42), includes a payment intangible, as separately defined in new section 9-102(a)(61).

However, commercial tort claims, deposit accounts and letter of credit rights are excluded from the definition of general intangibles. The effect of the exclusion is that persons obligated as to such collateral, in particular, banks and tortfeasors, are not account debtors and the rules regarding assignments discussed here do not apply.

Moreover, the definition of account debtor in new section 9-102(a)(3) expressly excludes persons obligated on a negotiable instrument and a person so obligated, even where the negotiable instrument is chattel paper as defined in the last sentence of new section 9-102(a)(11), is not an account debtor to which the rules governing assignments apply. For the most part, Article 3 and not Article 9 governs negotiable instruments. *See* Official Comments 5d and 5h to new 9-102.

For convenience the discussion of the rules regarding assignments and foreclosure, more generally, has been narrowed to focus on transactions involving accounts and chattel paper (other than negotiable instruments).

There are essentially two kinds of assignments of accounts and chattel paper to secured debts. One is referred to as "notification" financing. In a notification situation the account debtor is notified at the time of the assignment to pay the secured party and not the debtor and under new section 9-406, as discussed above, the account debtor must cease paying the debtor and pay the secured party or risk incurring double liability.

In a sense the collateral in a notification financing situation is being foreclosed upon from the outset (from the time of the assignment for security) and the debt is satisfied by payments made by the account debtor directly to the secured party. However, even though the secured party has taken over collection from the account debtor or debtors, apart from an agreement to the contrary, the debtor continues to be responsible if the account debtor or debtors' payments do not satisfy the secured debt. *See* new section 9-608(a)(4).

Stated differently, the secured party has a right against the debtor for a deficiency. If the payments from the account debtor or debtors exceed the amount of the secured debt there is a surplus and new section 9-608(a)(4) further provides, subject to an agreement to the contrary, that the debtor is entitled to the surplus.

The other type of assignment is known as "non-notification " financing. In a non-notification situation the account debtor is not notified at the time of the assignment that it should pay the secured party at the time of the assignment and, under new section 9-406, the account debtor may continue to pay the debtor until notified otherwise. New section 9-607(a) provides the foreclosure options of a secured party in non-notification situations.

Under new section 9-607(a)(1), the secured party, on default by the debtor, may notify the account debtors to pay the secured party and the secured party more generally takes control of and may enforce the obligation owed to the debtor by the account debtor against the account debtor. Under new section 9-607(a)(2), the secured party could leave the debtor in charge of collecting the account debtors' promises to pay and take the proceeds of such payments, but doing so is not routine because the contractual relationship between the secured party and the debtor has broken down.

If an assignment of an account or chattel paper is not for security and rather is an outright sale then there is no deficiency liability and no obligation to account for any surplus, unless the parties agree otherwise. However, we are focusing here on assignments for security and the rule as to such assignments is that the debtor is liable for any deficiency and is entitled to any surplus, except as the parties may agree otherwise. The rules regarding liability for a deficiency and the need to account for any surplus apply to both notification and non-notification financing.

The fact that a debtor is liable for any deficiency and is entitled to any surplus means that a secured party cannot with impunity act so as to reduce the amount collected on the accounts or chattel paper and thereby cause a deficiency (or increase a deficiency that would otherwise have resulted) or eliminate a surplus (or reduce the surplus that otherwise would have resulted).

It may happen that an account debtor is unable or unwilling to pay any or all of the face amount of an assigned account or chattel paper. The latter could happen if the account debtor asserts a claim or defense, such as for breach of warranty, that is good against the debtor and, hence, is also good against the secured party under new section 9-404(a), as discussed above. In either situation, the secured party may wish to settle the account debt for less than the face amount of the account.

A settlement for less than the face amount of the account could produce or increase a deficiency or eliminate or reduce a surplus. For this reason, new section 9-607(c) requires that a secured party proceed in a commercially reasonable manner. Just what is commercially reasonable with respect to particular actions, including especially settling disputed accounts, may be difficult to determine.

New sections 9-602 and 9-624 prohibit the parties from eliminating by agreement the secured party's obligation to proceed in a commercially reasonable manner and thereby avoid the problem, but new section 9-603(a) does allow the parties to set standards that are not manifestly unreasonable for testing the commercial reasonableness of a secured party's actions. A secured party would be well advised to spell out in the security agreement those actions that the debtor agrees will be commercially reasonable.

You may consider the new Article 9 rules governing foreclosure of an interest in an account or chattel paper to secure an indebtedness in the next problem.

Problem 37.1 (INTERACTIVE)

Donald Debtor sells farming equipment to retailers of such equipment. Donald borrows from Northern Bank and assigns Donald's interest in contracts made with retailers as security for the loan. Under the security agreement between Northern and Donald assigning the contracts, Donald continues to collect on the contracts and the retailers are not advised of the assignment (*i.e.*, this is "non-notification" financing). There is no provision in the agreement eliminating Bank's obligation to account for any surplus or Donald's liability for a deficiency. Donald defaults on the loan debt.

(a) May Northern enforce its security interest in the contracts by notifying the retailers (account debtors) to pay Northern and not pay Donald and otherwise taking control of collection (or by leaving the collection of the retailers' payments to Donald and taking the proceeds)?

(b) If a retailer continues to pay Donald after Donald's default and notification by Northern to pay it and not Donald is the retailer still obligated to pay Northern?

(c) Suppose that one or more of the retailers complain that Donald has not delivered the equipment as promised in the contracts between the retailers and Donald. May such claims by the retailers be asserted against Northern?

(d) If the retailers may assert the claims of breach of contract by Donald against Northern, to what extent may Northern "forgive" the indebtedness or otherwise settle the dispute? Why is there such a limitation on Northern's actions?

(e) Could Northern assign all the contracts to Friendly Finance Company "for collection"?

(f) Could Northern simply sell all the contracts to Friendly Finance Company at a discount and take itself out of the collection process?

(g) Could the terms of the security agreement assist Nothern (and you) in answering questions the answer to which turn on commercial reasonableness?

CASE COMMENTARY

Novartis Animal Health Us, Inc. v. Earle Palmer Brown, L.L.C., 424 F.Supp.2d 1358 (N.D. Ga.2006)

Orix Financial Services, Inc. v. Thunder Ridge Energy, Inc., 2006 WL 587483 (S.D.N.Y. 2006) (Slip Opinion)

Genesee Regional Bank v. Palumbo, 799 N.Y.S.2d 883 (N.Y. Supreme Court 2005)

Wells Fargo Bank Minnesota, National Association v. B.C.B.U, 143 Cal. App. 4th 493 (Cal. App. 2006)

IIG Capital, LLC v. Archipelago, L.L.C., 829 N.Y.S. 2d 10 (N.Y. App. Div. 2007)

Coffey v. Singer Asset Finance Co., L.L.C., 2007 WL 258962 (Tex. App. 2007)

Keybank National Association v. DPR Construction, Inc., 149 P.3d 233 (Or. App. 2006)

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Part VII Enforcing an Article 9 Security Interest

Chapter 38 Remedies for a Secured Party's Failure to Comply with Article 9

A. Generally

It has been noted that a disposition or acceptance may be effective even if a secured party fails to comply with mandated procedures but that the secured party who fails to comply with Article 9 can be subjected to liability or could lose, in part or in whole, a claim to a deficiency. In this chapter we look more closely at the risks of liability or of losing a deficiency and, more generally, at the remedies that exist for parties aggrieved by a secured party's failure to comply with Article 9.

B. Basic Remedies

Former Article 9 provided for injunctive relief and for damages liability in former section 9-507(1). New Article 9, section 9-625, continues to give a party who is aggrieved by a failure of a secured party to comply with Article 9 the right to seek injunctive relief or actual, and in certain cases, statutory damages. However, new section 9-625 expands upon former section 9-507(1) by making the basic remedies for non-compliance available both as to failures to follow the rules governing "collection, enforcement, disposition or acceptance " in Part 6 of Article 9 and for violations of other obligations imposed by Article 9.

The rules outside Part 6 of new Article 9 for which remedies are provided include those that impose on secured parties the obligations not to file an unauthorized financing statement, to file a timely termination statement when required, to provide information about the collateral and the debt when requested under new section 9-210 and to exercise care as to collateral in the secured party's possession under new section 9-207, as well as to act in good faith as required by Article 1, section 1- 304 (formerly Article 1, section 1-203).

The treatment of unauthorized filings warrants special comment. As discussed in subpart D below, and as was also discussed in Chapter 13 (Overview of Perfection by Filing), New Article 9 provides for civil liability for unauthorized filings, including statutory damages. In so doing new Article 9 tracks laws in many states, including Arizona, strictly regulating recordings affecting real estate. *See* B & S (cited in Chapter 3), Ch. 13. New Article 9 also adds a provision, new section 9-518, that allows a person who believes a filing is inaccurate or was wrongfully filed to file a correction statement.

However, under new section 9-518(c) a correction statement does not affect the effectiveness of the filing with respect to which the correction statement was filed. *See* Official Comment 2 to new section 9-518. And, the drafters have taken the position that Article 9 cannot provide a satisfactory or complete solution to problems caused by misuse of the Article 9 filing system. *See* Official Comment 3 to new section 9-518. Nonetheless, at least one state has enacted a non-uniform version of new section 9-518 that adds specific remedies for fraudulent and unauthorized filings. *See* Vernon's Texas Code Annotated, § 9.5185.

Under new section 9-625(a), a party who is aggrieved by a failure of the secured party to comply with Article 9 may seek injunctive relief. Bear in mind that injunctive relief is equitable in nature and a party seeking such relief must show that there is a risk of irreparable injury and no remedy at law. As for damages, under new section 9-625(b) a person may be liable for damages in the amount of any loss caused including loss resulting from the debtor's inability to obtain, or increased costs of, alternative financing.

Recovering actual damages involves causation and measurement issues, both of which can be complicated. The aggrieved party has the burden of proof on both issues. Because causation and damages measurement are largely questions of fact and the scope of review is limited. Recovering consequential damages in the form of lost business opportunities can be especially challenging.

In *Automotive Finance Corp. v. Smart Auto Cente, Inc.*, 334 F.3d 685 (7th Cir. 2003), the appellate court affirmed a trial court bench holding that appeared to give little weight to the debtor's argument that an improper repossession of vehicles constituting the debtor's inventory had prevented a sale of the business to a third party. Although there was no express finding to this effect, it may be that the courts were satisfied that the sale did not go through for reasons other than the actions of the secured party. As to the measure of damages itself, the trial court basically rejected the testimony of the debtor's expert witness.

In affirming the decision the appellate court noted that under F.R.C.P. 52(a) the trial court is required to make specific findings of fact, but concluded that the decision should be upheld because it could be ascertained from the record that the secured party was clearly entitled to the judgment awarded.

Under new section 9-625(c)(1), except as otherwise provided in new section 9-628, a person who was a debtor, an obligor, or held a security interest in or other lien on the collateral, at the time of the failure to comply, may recover actual damages under new section 9-625(b).

C. Consumer Cases

A special type of recovery is available under new section 9-625(c)(2) to debtors and secondary obligors when the collateral is consumer goods. Under new section 9-625(c)(2), again subject to new section 9-628, if the collateral is consumer goods, a person that was a debtor or a secondary obligor at the time a secured party failed to comply with Part 6 may recover "in any event" damages (meaning whether or not the debtor or secondary obligor can prove actual damages -- or perhaps, even if actual damages are proved) an amount equal to the credit service charge plus ten percent of the principal amount of the obligation or the time-price differential plus ten percent of the cash price.

Neither "credit service charge" nor "time price differential" is defined in Article 9. In the law outside of Article 9, time price differential or TPD is the difference between the cash price and the time (credit) price for that item. TPD was more important before laws of most states were changed to render the distinction between interest and TPD as a matter of usury limitations relatively insignificant. For all practical purposes, both credit service charge and TPD refer to the finance charge imposed on a credit sale or a loan.

The provision for "in any event" damages in new section 9-625(c)(2) appears to be intended to allow a debtor to recover the amount provided for whether or not the debtor can prove actual damages. However, was been uncertainty under former Article 9 whether the "in any event" damages were in lieu of actual damages and made available because of the difficulty, especially in consumer cases, of proving actual damages resulting from a failure to comply with foreclosure rules or whether "in any event" damages could be recovered as a sort of penalty even where actual damages are established. New Article 9 leaves the question unanswered.

D. Special Remedies for both Consumer and Non-Consumer Debtors and Obligors

New Article 9 provides that certain parties may recover statutory damages in addition to actual damages for failures to comply in specified cases where actual damages may be difficult to prove. Under new section 9-625(e), a debtor, consumer obligor or other person named as a debtor in a filed record is entitled to statutory damages in the amount of $500 where:

a secured party fails to comply with section 9-208;

a secured party fails to comply with section 9-209;

a person files a record that the person is not entitled to file under Section 9-509(a);

a secured party fails to cause the secured party of record to file or send a termination statement as required by section 9-513(a) or (c);

a secured party fails to comply with section 9-616(b)(1) and the failure is part of a pattern, or is consistent with a practice, of noncompliance; or

a secured party fails to comply with section 9-616(b)(2).

Under new section 9-625(f), a debtor or consumer obligor also may recover statutory damages of $500 as well as actual damages where a secured party has, without reasonable cause, failed to provide required information under new section 9-210. According to new section 9-625(f), a recipient of a request who never claimed an interest in the collateral has reasonable cause for a failure to comply with a request.

A more serious sanction for failure to satisfy new section 9-210 is possible. New section 9-625(g) provides for a kind of estoppel in that if a secured party fails to comply with a proper request regarding a list of collateral or a statement of account under new section 9-210, the secured party may claim a security interest only as shown in the list or statement included in the request as against a person who is reasonably misled by the failure.

Again, in a proper case, tort damages, including punitive damages are possible under new Article 1, section 1-103(b) (formerly section 1-103) (supplementary principles of general law). *Cf*. Official Comment 12 to new 9-620. As we saw in Chapter 33 (A Secured Party's Options on Default), such liability is especially likely where a secured party acts to enforce a security interest in the absence of a default or breaches the peace in exercising self help.

Relief outside Article 9 is especially important as to unauthorized or fraudulent filings. As was seen above, new section 9-625(e) provides for statutory damages against a person who files a record that person is not entitled to file. However, as discussed in Chapter 13 (Overview of Perfection by Filing), new Article 9 provides for the filing of a correction statement but such a statement does not prevent a “bogus” filing from being effective and judicial action to expunge the filing may be needed.

You may explore the remedies available when a secured party fails to comply with Article 9 in the next four problems.

Problem 38.1 (INTERACTIVE)

Selma Seller supplies David Dealer's inventory of widgets on credit and has a perfected security interest in the widgets. David and Selma have been involved in an ongoing dispute about the quality of the widgets. David withheld the payment due last month but offered to place the payment in escrow pending a resolution of the quality dispute. Selma advised Donald that she deems herself insecure and has demanded that David pay the entire balance due on the contract for the sale of the widgets. In her demand letter, Selma relied explicitly on UCC Article 1, section 1-309 (formerly Article 1, section 1-208). David refused to pay as Selma demanded. Selma sent her employees to David's place of business to recover possession of the widgets. David physically resisted giving up possession of the widgets to Selma's employees. Selma's employees persisted and over David's complaints took possession of the widgets. David has closed his business and come to you for advice.

(a) Which of the following are accurate statements of the remedies? (More than one may be correct.)

(i) There is a possibility of injunctive or other equitable relief to stop any disposition or acceptance action by Selma.

(ii) There is a possibility of tort damages, including punitive damages.

(iii) David is entitled to actual damages for failure to comply with Part 6, including consequential damages resulting from the close of the business (to the extent that David can prove they resulted from the Selma's failure to comply with Part 6).

(iv) David may recover statutory damages.

(b) Suppose David Dealer was indebted to Supplies R Us when Selma took the above-described actions and David has now defaulted to Supplies R Us. Is Supplies R Us a person entitled to seek actual damages against Selma under new Article 9?

Problem 38.2 (INTERACTIVE)

Central Bank has a perfected security interest in Donna Debtor's inventory and equipment, existing and later-acquired. Lenny Lender, who was contemplating a loan to Donna, discovered Central's security interest. As provided for in new section 9-210, Lenny, through Donna, requested information from Central about the debt owed to it by Donna and the security interest held by Central. Central ignored the request. Lenny decided against making the loan to Donna.

May Donna recover actual damages, including any loss resulting Donna's inability to obtain or the increased cost of alternative financing, from Central Bank?

Could Donna recover statutory damages based on Central’s failure to respond to Lenny's request under new section 9-210?

Suppose that Donna had submitted a list of collateral in the form required by new section 9-210, could Donna now recover statutory damages.

Suppose the list submitted by Donna omitted several items of collateral from the list. If Central failed to respond could Central assert a security interest in the omitted items against Lenny?

Problem 38.3 (INTERACTIVE)

Sid Seller sells Bonnie Buyer a recreational vehicle (RV) for vacationing. Bonnie signs a security agreement giving Sid an interest in the RV to secure the unpaid price. The cash price is $12,000. The finance charge is $800. Before paying any of her contract obligation of $12,800, Bonnie defaults. Sid repossesses and without notification resells the RV for $9,800. Sid sues Bonnie for $3,000 plus the expenses associated with repossession and resale. Bonnie files an answer denying liability and asserting a counterclaim of $2,000. Bonnie is unable to prove any damages resulting from the failure of notification.

What damages would Bonnie be able to recover under new section 9-625(c)(2) (putting aside any possible adjustments to be made for deficiency liability, a matter that is discussed later)?

Problem 38.4 (INTERACTIVE)

First National Bank and Delia Debtor, a sole proprietor, have been engaged in an ongoing dispute regarding a debt allegedly owed by Delia to First National. First National has filed a financing statement indicating as collateral all of Delia's equipment, inventory and accounts receivables, existing and after-acquired. Delia is prepared to prove that First National had no authority to file the financing statement.

What remedies against First National does Delia have under new Article 9?

Do any of these remedies prevent the filing from being effective?

What must Delia do to prevent the filing from being effective?

E. Loss of All or Part of a Claim for a Deficiency

New Article 9, in new sections 9-626(a)(3) and 9-615(f), also address, at least in part, the risk of losing all or part of a deficiency. As explained in Chapter 35 (Disposing of Collateral to Satisfy a Secured Debt), new section 9-626(a)(3) adopts the rebuttable presumption approach for calculating deficiencies and surpluses in other than consumer cases.

Thus, if a secured party fails to prove it acted in compliance with Part 6 of new Article 9, then the liability of a debtor or secondary obligor is limited to an amount by which the sum of the secured obligation, expenses and attorney's fees exceeds the greater of the proceeds of the disposition or the amount of proceeds that would have been realized if the secured party had complied with Part 6.

Under new section 9-626(a)(4), for purposes of the limitation in new section 9-626(a)(3), the amount that would have been realized had the secured party complied with Part 6 is equal to the sum of the secured obligation, expenses and attorney's fees (*i.e.*, the debt owed), unless the secured party can prove a lesser amount would have been realized.

If collateral is disposed of to the secured party, a person related to the secured party or a secondary obligor and the proceeds are significantly below the range of proceeds that a complying disposition to a person other than the secured party, etc. would have brought, then new section 9-625(f) limits a deficiency to the amount that would have been realized in such a disposition. However, under new section 9-626(a)(5), the debtor or obligor has the burden of proving that the proceeds actually realized are significantly less than would have been brought by a complying disposition to someone other than the secured party, person related to the secured party, or a secondary obligor.

You may explore the limitations on collecting deficiencies in new section 9-626(a)(3) in the next problem.

Problem 38.5 (INTERACTIVE)

Debbie Dealer sells a Mack Tractor and Semi-Trailer to Byron Buyer for $75,000. Byron pays $15,000 down and agrees to pay the balance in 60 equal monthly installments of $1,100. Debbie takes a security interest in the tractor and trailer and properly perfects that interest. Byron defaults after making six payments ($6,600). Debbie accelerates the balance owing ($53,400) pursuant to an acceleration clause in the security agreement. Byron fails to pay the balance. Debbie repossesses the tractor and trailer. Debbie sends Byron a letter informing him that the tractor and trailer will be sold at a public sale three weeks after the date of the letter. One week after sending the letter Debbie sells the tractor and trailer to another customer for $40,000. Debbie sues Byron for $14,000 (an amount that includes $600 in expenses incurred in repossessing the tractor and trailer). Byron answers Debbie's complaint alleging that she has failed to comply with Part 6 of Article 9 in disposing of the tractor and trailer.

Has Debbie Dealer complied with Article 9 in disposing of the tractor and trailer? Explain your answer.

Who has the burden of proving that Debbie did or did not comply with Article 9 in disposing of the tractor and trailer?

What approach to calculating a deficiency applies here?

How much should Debbie recover in her deficiency action against Byron?

Can Byron upset the sale because of the failure of Debbie to comply with Article 9 in disposing of the tractor and trailer?

The limitation on deficiency recovery in new sections 9-626(a)(3) and (a)(4) applies only in other than a consumer transaction. Recall that a consumer transaction as defined in new section 9-102(a)(26) is one in which an individual incurs an obligation for personal, family or household purposes that is secured by an interest in collateral held for a personal, family or household purpose. According to new section 9-626(b) fashioning rules for consumer transactions is left to the courts. Moreover, under new section 9-626(b), courts are not to draw any inferences from the scheme devised for other than consumer transactions.

Under former Article 9, courts took three different approaches to the question of when a secured party could lose a deficiency. *See* Official Comment 4 to new 9-626. The first was that a secured party who failed to comply with the foreclosure rules in Article 9 could not recover any deficiency -- the deficiency claim was barred by the failure to comply. The rationale was that strict compliance with the foreclosure rules was a condition to recovering a deficiency.

The second approach was that there was a rebuttable presumption that the collateral was worth the amount owed and a secured party could recover a deficiency only to the extent it could show that the failure to comply did not produce the deficiency. In other words, the secured party had the burden to prove that the deficiency would have resulted even if there had been no failure to comply. The court in *Chavers*, considered in Chapter 35 (Disposing of Collateral to Satisfy a Secured Debt), took this approach. It also is the approach taken in new sections 9-626(a)(3) and (a)(4), as considered above.

The third approach (that taken by the Arizona courts) was that a secured party could recover a deficiency except to the extent the debtor was able to prove an offsetting loss caused by the failure to comply with Article 9. The rationale of this view was that former 9-507(1) provided the only remedies for failures to comply with Article 9 and under former 9-507(1) a debtor had to prove a loss.

What the courts actually will do with new sections 9-626(b) remains to be seen. However, it is difficult to believe that courts would fashion rules that are less favorable to consumers than the rules in new section 9-626(a)(3) and (a)(4) for other than consumer transaction cases and they could opt for a complete loss of deficiency approach.

In *In re Downing*, 286 B.R. 900 (Bkcy W.D. Mo. 2002), which involved a consumer transaction, was decided under new Article 9. The court denied a deficiency entirely where the secured party had failed to provide the reasonable notification required by new section 9-611(b). In doing so, the court looked to decisions in Missouri under former Article 9 that concluded that because deficiencies were not recoverable at common law the right to a deficiency was conditioned on strict compliance with Article 9. However, the court made no reference to new section 9-626.

It is important to note that whatever rules the courts fashion may interact with new section 9-625(c)(2) and A.R.S. § 44-5501 to produce some interesting results. Thus, in a case to which A.R.S. § 44-5501 applies, a secured party could be denied a deficiency and suffer a counter claim for "in any event" damages.

You may consider this possibility in the next problem.

Problem 38.6 (INTERACTIVE)

Delia Debtor in Arizona purchases a stereo system from Sid Seller for use in her home. The price of the system as posted is $900. Delia purchases on time, "no money down." Delia signs an agreement promising to pay Sid $1200 in equal monthly installments over the next year. The agreement gives Sid an interest in the stereo system to secure the unpaid balance of the price. Delia defaults before making any monthly payments. Sid repossesses the stereo system and without notice to Delia resells the system for $500. Sid then sues Delia for $700 asserted to be owed as a deficiency. Delia counterclaims. Which of the following most accurately states the most likely outcome of this litigation?

(a) Sid Seller can recover $700.

(b) Sid Seller can recover $700 less $390 (10% of the cash price plus the finance charge).

(c) Sid Seller can recover whatever part of $700 that Sid can show would have been the amount of the deficiency if Sid had complied with Article 9.

(d) Sid Seller can recover nothing and Delia Debtor can recover $390.

CASE COMMENTARY

Knutson v. Walker and Associates, Inc., 2005 WL 1950202 (D. Colo. 2005) (Not reported in F. Supp. 2d)

Semmelman v. Mellor, 2006 WL 90094 (D. Minn. 2006)

Citicorp Leasing, Inc. v. United American Funding, Inc., 2005 WL 1847300 (S.D.N.Y. 2005) (Not reported in F. Supp. 2d)

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D.A.N. Joint Venture, III v. Clark, 218 S.W.3d 455 (Mo. App. 2006)

Davenport v. Bates, 2006 WL 3627875 (Tenn. App. 2006)

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Chapter 39 Enforcing Security Interests in Bankruptcy

A. Generally

We are concerned with bankruptcy because it is important to put secured credit into a broader context that includes debt collection outside bankruptcy and also those rules that govern collection in bankruptcy. Without the broader context, one would have a rather distorted view of debt collection law generally and Article 9 in particular. Some "messy" detail regarding the federal bankruptcy law, the Bankruptcy Reform Act (BRA) or "Code" is unavoidable. However, our concern is with the implications of bankruptcy for secured creditors.

As has often been noted, bankruptcy is the "acid test" of whether you have done your job as an attorney for a secured creditor. There are several types of bankruptcy proceedings, including Chapter 7 (liquidation), Chapter 11 (reorganization) and Chapter 13 (individual rehabilitation).

In a Chapter 7 proceeding a trustee gathers all the property of the estate and distributes it to secured claims, priority unsecured claims and unsecured claims, with the amount available for the latter two types of claims being adjusted downward for any allowable exemptions. Chapter 11 and Chapter 13 bankruptcy are "pay out" bankruptcies in which a debtor attempts to pay off some of the debts according to a plan.

To a large extent, we will limit our treatment to Chapter 7 (Liquidation) bankruptcies because they are easier to understand and best illustrate the theoretical objectives of bankruptcy, namely, to achieve an equitable distribution of a debtor's assets and enable the debtor to make a "fresh start" through the device of a discharge.

As was seen in Chapter 30 (Secured Party Versus Trustee in Bankruptcy), the equitable distribution goal is undermined by the fact that enforceable secured claims must be paid dollar-for-dollar before any other claims are to be paid (and, hence, trustees, who represent unsecured creditors, are in an adversarial relationship with secured parties).

We also noted in Chapter 30 (Secured Party Versus Trustee in Bankruptcy) that a discharge does not apply to secured claims and is of concern only as to deficiencies (which are unsecured). You would benefit from reading B & S (cited in Chapter 3), Ch. 6.

We saw in Chapter 9 (The Specifics of Enforceability -- After-Acquired Property, Proceeds and Future Advances) that, under BRA 552(b), a security interest that is fully enforceable under Article 9 may be unenforceable as to property, other than proceeds, that is acquired after bankruptcy is filed. A review of that section as discussed in Chapters 9 (The Specifics of Enforceability -- After-Acquired Property, Proceeds and Future Advances) and 30 (Secured Party Versus Trustee in Bankruptcy) is in order.

In Chapters 26 (Secured Party Versus Lien Creditor) and 30 (Secured Party Versus Trustee in Bankruptcy), we examined BRA § 544(a) and its impact on unperfected security interests, BRA § 547, under which even perfected security interests may be vulnerable as avoidable preferences, and also BRA § 522(f)(1)(B), a provision that empowers a debtor to avoid certain non-possessory, non-purchase money security interests that impair exemptions.

Here we will focus our attention on two other matters affecting Article 9 security interests. The first is the automatic stay under BRA § 362. The second is the distribution scheme (the claims settlement process) in bankruptcy and the proposition that secured claims fare better in bankruptcy than do unsecured claims.

B. The Automatic Stay

We considered the automatic stay in Chapter 26 (Secured Party Versus Lien Creditor) and Chapter 30 (Secured Party Versus Trustee in Bankruptcy) as it affects the ability of a secured party to perfect after bankruptcy has been filed. BRA § 362(a) sets forth the actions that are barred and BRA § 362(b) contains the exceptions. BRA §§ 362(a)(4) and (a)(5) prohibit any act to create, perfect, or enforce any lien against property of the estate and any such action against property of the debtor to the extent that the lien secures a claim that arose before bankruptcy was filed.

The automatic stay, in fact, bars essentially all activity by which a creditor seeks to improve its position to collect a debt from property of the bankruptcy estate or the debtor's property after bankruptcy has been filed, unless there is an exception to the stay.

BRA § 362(b)(3) contains the exception to the stay that allows perfection after bankruptcy is filed in certain cases that we examined in Chapter 26 (Secured Party Versus Lien Creditor) and Chapter 30 (Secured Party Versus Trustee in Bankruptcy).

Under BRA § 362(a) the stay automatically goes into effect immediately upon the filing of a petition in bankruptcy ("the commencement of a case"). The stay is important to Article 9 secured parties because it bars them from enforcing even a perfected security interest until the stay is terminated under BRA § 362(c) or is lifted under BRA § 362(d). It is important to debtors because it allows them to continue in possession of collateral, and under certain conditions, including especially providing adequate protection of a security interest in the collateral, to use or even sell the collateral. *See* BRA § 363.

Actions that violate the automatic stay typically are treated as being ineffective. *See, e.g., In re Custer*, 50 UCC Rep. Serv. 2d 608 (Bkcy ND Iowa 2003) (in which the court held that an attempt to perfect a security interest after bankruptcy had been filed and that was not within the exception to the stay in BRA § 362(b)(3) was void). Moreover, a creditor who violates the stay can be held in contempt or have to pay attorney's fees and could be liable for damages under BRA § 362(k) (formerly in BRA § 362(h)). *See, e.g., In re Moffett*, 288 B.R. 721 (Bkcy E.D. Va. 2002), affirmed, 356 F.3d 518 (4th Cir. 2004); *In re* Rozier, 283 BR 810 (Bkcy M.D. Ga. 2002).

Recall that creditors learn about a bankruptcy through notice from the court or independently, but there may be some time lag between the filing, which is when the stay goes into effect, and the time a creditor learns about the bankruptcy. However, the stay operates whether or not a creditor knows about the bankruptcy. A creditor who acts out of ignorance of the bankruptcy is less likely to suffer sanctions than one who intentionally chooses not to obey the stay.

The stay prohibits any action to foreclose a security interest in property of the estate that has not been completed as of the time a bankruptcy is filed. When a debtor files bankruptcy most of the debtor's property becomes property of the estate. BRA § 541(a)(1) broadly defines property of the estate to include all property in which the debtor has a legal or equitable interest on the date of bankruptcy, subject to certain exclusions set out in the remainder of BRA § 541.

In *United States v. Whiting Pools, Inc., 462 U.S. 198 (1983), the Supreme Court held that the IRS could be forced to turn over to the estate property of the debtor that had been seized to satisfy a federal tax lien before the debtor filed a Chapter 11 bankruptcy but which had not been disposed of at the time the bankruptcy petition was filed.*

In so holding, the Court compared the federal tax lien scheme to that provided for in the enforcement provisions of Article 9 and concluded that until the property had been disposed of the IRS had only a lien and the debtor had a sufficient interest in the property to make it property of the bankruptcy estate subject to the turnover provisions of the bankruptcy statute.

Although the Supreme Court in *Whiting Pools* did not refer to a right of redemption as such, it has been held that until the debtor's right to redeem under new Article 9 section 9-623 has been foreclosed by a disposition (or acceptance in satisfaction of the debt) collateral seized by an Article 9 secured party is property of the bankruptcy estate subject to the automatic stay. *In re* Moffett, 288 B.R. 721 (Bkcy E.D. Va. 2002), *affirmed*, 356 F.3d 518 (4th Cir. 2004), is an apt example.

In Moffett the court distinguished the right to possession from an ownership interest and concluded that only the former was lost when collateral is repossessed and the right to redeem under new section 9-623 continues until the collateral has been disposed of. In so holding, the court rejected an argument that new section 9-619 transfers ownership of a vehicle to a secured party upon repossession.

According to the court, new section 9-619 is intended only to facilitate a disposition of a vehicle subject to a certificate of title law imposing as a condition of an effective transfer of the vehicle that a change of ownership be reflected in the motor vehicle records and that new section 9-619(c) makes clear that a transfer of record pursuant to new section 9-619 is not of itself a disposition and does not relieve the secured party of its obligations under Article 9.

The court further refused to read the Virginia certificate of title statute to transfer title by operation of law at the time a vehicle is repossessed because to so interpret the certificate of title law would be to nullify new section 9-623 and the right to redemption that it creates. *Id*. *See also, In re Sanders*, 291 B.R. 97 (Bkcy E.D. MI 2003).

Consequently, the prevailing view is that a secured party who has repossessed but has not yet disposed of collateral at the time a petition in bankruptcy is filed is barred by the automatic stay from proceeding to dispose of the collateral and may be forced to turn the collateral over to the bankruptcy estate.

Decisions to the contrary tend to have turned on a conclusion that ownership of collateral is transferred when the collateral is repossessed as a matter of non-UCC law, in particular, certificate of title statutes. *See In re Menashe*, 301 B.R. 757 (Bkcy S.D. Fla. 2003) (concluding that the UCC is silent as to the effect of a repossession on ownership and interpreting the Florida certificate of title statute to mean that the debtor is divested of ownership when a vehicle is repossessed); *In re* Rozier, 283 B.R. 810 (Bkcy M.D. Ga. 2002) (in which the court refused to follow cases interpreting Florida and Alabama law to effect a transfer of ownership at the time of a repossession because the applicable Georgia law did not do so).

The message to practitioners is that they must examine applicable non-UCC law, especially certificate of title statutes, to determine whether such law could counter the general view that the right of redemption under new section 9-623 is sufficient to bring repossessed property into the bankruptcy estate and subject it to the automatic stay. However, even where non-UCC law is susceptible to such an interpretation, the argument that such an interpretation would nullify new section 9-623 and that new section 9-619 cuts against such an interpretation may well be persuasive. *See Moffett, supra; In re Estis*, 311 B.R. 592 (Bkcy D. Kan. 2004).

For completeness, it should be noted that *Whiting Pools, supra*, involved a Chapter 11 reorganization proceeding and the Supreme Court declined to indicate whether its reasoning would also apply to a Chapter 7 liquidation or Chapter 13 rehabilitation proceeding. However, the cases just discussed, holding that the right of redemption is sufficient to bring repossessed property into the bankruptcy estate and to trigger the automatic stay and turn over, involved Chapter 13 proceedings. It also should be noted that the duration of the stay and turn over orders are conditioned on adequate protection as discussed below.

Secured parties may seek relief from the stay by filing a "lift stay" motion. Relief must be granted under BRA § 362(d)(2) when the debtor has no equity in the collateral *and* the collateral is not needed for an effective organization. Where reorganization of a business is not possible or has little chance for success, a court may well conclude that collateral that is the target of a lift stay motion is not necessary to an effective reorganization.

Relief from the stay also may be granted under BRA § 362(d)(1) "for cause." Most for cause motions assert a lack of adequate protection of the secured party's security interest.

Adequate protection is not defined in the Code. BRA § 361 indicates that periodic payments, substitute liens and providing a secured party the "indubitable equivalent" of the secured party's interest in the collateral all may provide adequate protection. Debtors who file bankruptcy generally do not have a sufficient cash flow situation to make periodic payments and substitute liens have the effect of denying to other creditors payment out of property that otherwise would be available. "Indubitable equivalent" has no meaning in the abstract and basically is whatever a court says it is in a particular case.

In practice, the most important decision in a "for cause" lift stay proceeding is whether there is a lack of adequate protection. The U.S. Supreme Court, in *United Savings Ass'n v. Timbers of Inwood Forest Associates*, 484 U.S. 365 (1988), made it clear that it is only the value of the collateral that must be adequately protected. Therefore, a secured party may lack adequate protection because the collateral is being used or sold or the value of the collateral is otherwise deteriorating, but the fact that a secured party is not able to foreclose and is losing the opportunity to reinvest the value of collateral, as it would outside bankruptcy, does not result in a lack of adequate protection.

It is important to be aware that interest accruing after bankruptcy is filed is not an allowable claim, *i.e.*, post-filing interest generally is not recoverable in bankruptcy. However, under BRA § 506(b) interest and attorney's fees may be recoverable by an oversecured creditor. Whether excess security must be adequately protected is a question the answer to which is not entirely clear.

Courts often look at whether there is an “equity cushion,” meaning whether the collateral is worth more than the debt and whether the value of the collateral is deteriorating in such a way that the debt will become undersecured or even unsecured.

It is useful to contrast two situations. First, if a debtor is using equipment in the debtor's business there will be some amount of depreciation. If there is no equity cushion sufficient to protect against the deteriorating value of the equipment then the debtor may be required to provide adequate protection, for example, by making periodic payments. Second, if a creditor has a mortgage on real estate then because real estate generally appreciates rather than depreciating in value, there is less chance that a court would find a lack of adequate protection.

Many adequate protection battles are fought as to cash collateral. Cash collateral is defined in BRA § 363(a) to mean collateral that is in the form of cash or cash equivalents, including deposit accounts. Cash collateral includes cash proceeds from collateral.

Recall from Chapter 9 (The Specifics of Enforceability -- After-Acquired Property, Proceeds and Future Advances) that new Article 9 defines proceeds in new section 9-102(a)(64) to include income from collateral that is not disposed of. It was noted in Chapter 9 that there is a question whether bankruptcy courts will give to proceeds, as used in the bankruptcy act, the expansive meaning given to the concept in new Article 9.

However, there may be an issue only as to BRA § 552(b) limiting the enforceability of security interests in collateral acquired after a bankruptcy is filed to proceeds. The reason is that BRA § 363(a) expressly includes within the meaning of cash collateral not only cash and cash equivalents, but also "proceeds, products, offspring, rents or profits and certain charges arising in connection with hotel and motel lodgings. Consequently, cash proceeds are cash collateral but so also are products, offspring, rents or profits of collateral generally.

The meaning of cash collateral is important because, under BRA § 363(c)(2), a debtor may use cash collateral only if the debtor gets the secured party's consent or a court order based on a finding that the secured party's interest in the cash collateral is adequately protected.

You may explore the basics of the automatic stay and relief from the stay in the next four problems.

Problem 39.1 (INTERACTIVE)

We have considered the example of Jane purchasing a Toyota from Dream Machine, Inc. (DM) on credit secured by an enforceable interest in the Toyota and what DM may do outside of bankruptcy if Jane defaults. Suppose that just after Jane defaulted and after DM has begun efforts to recover the Toyota from Jane, Jane filed a Chapter 7 bankruptcy.

(a) If DM continues with efforts to repossess the Toyota, has it violated the automatic stay? Are sanctions likely to be imposed?

(b) Suppose DM had already repossessed the Toyota at the time Jane filed bankruptcy but DM had not yet disposed of the Toyota (or completed an acceptance of it) as the date of bankruptcy.

Could DM go ahead with a disposition (or acceptance) after bankruptcy?

(c) Is it possible that DM will be forced to turn the Toyota over to Jane (actually the trustee)?

Problem 39.2 (INTERACTIVE)

Donna Debtor operates a plumbing parts shop. Western Bank has a security interest n Donna's inventory of pluming parts and equipment, existing and later-acquired. Donna has filed a Chapter 11 bankruptcy. The collateral in which Western has an enforceable security interest is worth no more than $200,000 and the debt owing is $205,000. Donna closed the plumbing parts shop two weeks before bankruptcy and has no plans to reopen the shop. Western has moved for relief from the stay.

Should the motion be granted?

Problem 39.3 (INTERACTIVE)

Assume the facts of Problem 39.2. Assume further, however, that Donna Debtor's business has been in continuous operation and Donna filed bankruptcy because of a legal dispute with a supplier that interrupted Donna's cash flow. Donna expects the legal dispute to be resolved soon and that the business will begin to show a profit within a few months and the facts tend to support the Debtor's expectations. Western Bank has a security interest in a delivery truck worth about $20,000. Western is owed $15,000 on the loan. Western has moved for relief from the stay as to the truck.

(a) Should relief be granted under BRA § 362(d)(2)?

(b) Should relief be granted under BRA § 362(d)(1)?

(c) If Western Bank was owed $20,000 and the truck was worth only $20,000, would Western have a better chance for getting relief from the stay?

Problem 39.4 (INTERACTIVE)

Donald Debtor manufactures and sells automobile parts. Lisa Lender lends to Donald and perfects a security interest in Donald's existing and after-acquired inventory of widgets. Donald defaults on the loan and files bankruptcy seeking to reorganize its business. Donald has a bank account at Central Bank in which Donald has deposited only proceeds from the sale of widgets.

Is Lisa's security interest enforceable in bankruptcy?

May Donald draw checks on the bank account without Lisa's consent?

C. The Claims Distribution Process

We earlier examined the basic scheme for distribution of assets in a Chapter 7 liquidation proceeding. We noted that an enforceable secured claim must be paid dollar for dollar and that a claim is secured under BRA § 506(a) to the extent of the value of the collateral up to the amount of the secured debt.

Unsecured creditors, by contrast, get a pro rata share of what assets are left after secured claims and priority unsecured claims (such as administrative claims, including attorney's fees incurred for the benefit of the estate), are satisfied.

The percentage of an unsecured claim that will be paid is captured in the following formula:

(Total assets - secured claims [-exemptions for individuals] - priority unsecured claims)

divided by

Total of unsecured claims.

In Article 9 terms, that portion of a debt that exceeds the value of collateral is a deficiency and a deficiency is an unsecured claim. If a creditor is undersecured, *i.e.*, there is a deficiency, the creditor is both a secured claimholder and an unsecured claimholder.

The unsecured portion affects the numerator of the equation in that the reduced amount of the secured debt leaves more in the numerator. However, the unsecured claim must be added to the denominator. An undersecured creditor takes dollar for dollar on the secured portion of its debt and gets the same percentage of the unsecured claim as do other unsecured creditors.

You may explore the bankruptcy distribution scheme in the next problem.

Problem 39.5 **(INTERACTIVE)**

On the date of bankruptcy Delia Debtor has assets worth $100,000. Included in these assets is a widget worth $10,000 that is subject to a timely perfected security interest held by Southwestern Bank to secure a debt of $10,000. There are no applicable exemptions. The priority unsecured claims total $10,000. The total of general unsecured claims is $100,000.

(a) How much will Southwestern Bank take out of the bankruptcy?

(b) How much would an unsecured creditor with a $10,000 unsecured claim take out of bankruptcy?

(c) How much would Southwestern Bank take out of the bankruptcy if the widget in which it has a security interest is worth only $5,000. In answering this question, assume that despite the change in facts the total value of the assets continues to be $100,000.

CASE COMMENTARY

In re Yates, 332 B.R. 1 (10th Cir. BAP 2005)

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