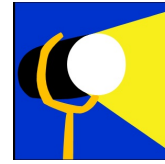


SPOTLIGHT

September 2009



The purpose of this column is to identify some of the most disconcerting judicial decisions interpreting the Uniform Commercial Code or related commercial laws. The purpose of the column is not to be mean. It is not to get judges recalled, law clerks fired, or litigators disciplined for incompetence. Instead, it is to shine a spotlight on analytical errors, and thereby provide practitioners and judges with reason to disregard the opinion.

In re Montagne, **2009 WL 2481982 (Bankr. D. Vt. 2009)**

This is a case about perfection of a security interest in proceeds of original collateral. The court adeptly waded through many arguments, wisely jettisoning the most spurious, and it may have even reached the correct result. Unfortunately, its analysis floundered in the most important issues, and attorneys should seek out more solid footing when tackling such issues.

The story begins in 2005, when Ag Venture acquired a security interest in the livestock of Montagne Heifers, Inc. (“MHI”) to secure a \$457,000 loan. MHI, which operated a dairy farm in Vermont, was owned by Michael and Diane Montagne, a married couple. Both Michael and Diane guaranteed MHI’s debt to Ag Venture. In 2006, Michael and Diane separated. In 2007, Ag Venture released Diane from liability on the debt.

Later in 2007, Michael purchased some shares in MHI from his son, John, and granted John a security interest in livestock to secure the unpaid portion of the purchase price.¹ At this point, neither Ag Venture nor John had filed a financing statement. Then, in quick succession, four critical events happened: (i) on November 24, MHI sold cows for \$500,000; (ii) on November 28, Michael transferred a \$240,000 check received in partial payment of the purchase price to Diane; (iii) on November 30, Ag Venture filed a financing statement; and (iii) on December 4, John filed a financing statement. A dispute then arose as to who among Ag Venture, John, and Diane had priority in the check.²

The court first dealt with whether Ag Venture had a security interest in the livestock and its proceeds. It properly rejected an argument that the collateral description in the security agreement was insufficient, noting that both “livestock” and “proceeds” are Article 9 categories of collateral and that is all that’s required under § 9-108.

¹ It is unclear from the court’s opinion whether the livestock of Michael or of MHI was used as collateral, but the court seems to presume it was MHI’s livestock.

² In fact, the check had been deposited into a client trust account maintained by Diane’s attorney, but the court and the parties seem to have ignored whether that fact had any effect on the analysis.

The court then analyzed whether Ag Venture waived its security interest in the livestock or its proceeds. Diane had argued that by releasing her from liability on the secured loan, Ag Venture had released its interest in the collateral. This argument is patently ridiculous and the court so ruled. The court properly distinguished between an obligor's personal liability on the loan and the *in rem* liability of the collateral. However, the court went further and in so doing, went a bit astray. The court concluded that Ag Venture "did not authorize or acquiesce in the disposition of the Collateral by the Debtor, and thus did not waive its security interest in the Proceeds." This statement is confused. While an authorization to sell collateral free and clear does operate as a waiver of the security interest in the *original collateral* sold, it does not operate as a waiver of the security interest in *proceeds*. This is evident from the text of section § 9-315(a). Paragraph (1), which deals with the continuity of the security interest in the original collateral sold, includes an exception for sales authorized free and clear. In contrast, paragraph (2), which provides that a security interest attaches to proceeds, contains no such exception. Indeed, in the normal case, a secured party authorizes a sale free and clear in order to get all or some of the proceeds. The court's dicta on this point is regrettable.

The court moved on to discuss perfection, and started that discussion quite well. The court noted that the names of the debtor and the secured party were correct and that the description of the collateral as "livestock" and "proceeds" was sufficient. The court then rejected an argument that the financing statement was ineffective because it contained an allegedly inaccurate address for the debtor. The court properly noted that under the "seriously misleading" test of § 9-506(a), an incorrect address would be immaterial. Moreover, the court rejected an argument that the two-year delay in filing somehow undermined Ag Venture's perfection. It pointed out, correctly, that the 20-day period to perfect in § 9-324(a) related only to the priority of a purchase-money security interest, not to perfection.

The court then dealt with the fact that Ag Venture's financing statement was filed after the debtor had sold the livestock. Here is where the court went significantly off course. The court ruled that it had "previously found that Ag Venture properly perfected in the original collateral – the livestock – on November 30, 2007. Therefore, Ag Venture's security interest in the Proceeds of that Collateral was likewise perfected as of that date." In fact, the court had not previously ruled that Ag Venture's security interest in the livestock was perfected, merely that it had attached and that the filing was proper. Moreover, any such ruling would likely have been wrong. Recall that the debtor had sold the livestock before Ag Venture filed. Accordingly, the buyer took free of Ag Venture's security interest in the livestock as long as it acted without knowledge of it. *See* § 9-317(b). Even if the buyer had not taken free of the Ag Venture's security interest, the sale made the buyer, not MHI, the "debtor." *See* § 9-102(a)(28) (defining "debtor" as the person having an ownership interest in the collateral). Thus, Ag Venture's later filing against MHI would probably not have been effective to perfect a security interest in the livestock now owned by MHI's buyer. In short, Ag Venture's security interest in the livestock sold was never perfected.

Even if Ag Venture's security interest in the livestock was perfected, the court still erred in its analysis of the proceeds. The court stated that "Ag Venture . . . had properly perfected its security interest in the Collateral effective as of November 30, 2007, and consequently had a perfected

security interest that extended to the Proceeds as of that date.” However, because Ag Venture’s security interest in the livestock was not perfected at the time of the sale, its attached interest in the proceeds was also not perfected. The rules in § 9-315(c) and (d) that provide for perfection in proceeds apply only if the security interest was perfected in the original collateral. Because Ag Venture’s security interest in the livestock was unperfected when the debtor sold the cows, Ag Venture’s security interest in the check was also unperfected, at least initially.

Nevertheless, the court *may* have reached the correct result, albeit for the wrong reason. Ag Venture’s security interest undeniably did attach to the check that the debtor received in payment for the cows. Because a security interest in an instrument can be perfected by filing, *see* § 9-312(a), the question should be whether Ag Venture’s subsequently filed financing statement covered the check. The filing did not mention “checks” or “instruments,” but it did refer to “proceeds” of livestock. Section 9-108(b) expressly provides that a financing statement’s description of collateral is sufficient if it describes the collateral by “category” or by “type of collateral defined in” the UCC. “Proceeds” is a defined term. Is it a “type of collateral” or a “category”? Perhaps. Even if not, it may still be a description that reasonably identifies the collateral, and that is all that is required. *See* § 9-108(a). Thus, Ag Venture’s security interest in the check *may* have been perfected, but not because its security interest in the livestock was perfected.

The court then proceeded to deal with priority, concluding that Ag Venture’s security interest in the check did indeed have priority. In doing so, the court never discussed whether Diane qualified as a holder in due course or as a protected purchaser under § 9-330. Presumably these issues were not briefed, and thus the court should not be faulted for failing to address them.

JPMorgan Chase Bank v. MAL Corporation,
2009 WL 804049 (N.D. Ill. 2009)

This case involves what is now commonly called a Nigerian e-mail scam. Perhaps due to its own sense that banks should be doing more to notify their customers of such scams, the court in this case imposed on the depository/collecting bank liability that exceeds the bounds of Article 4.

In this particular iteration of the common tale, the victim of the scam was a man named Levenfeld, who had received an unsolicited e-mail requesting his assistance in facilitating an international transfer of funds, in return for a 10% commission for his services as a “payment agent.” Levenfeld agreed to do so, acting on behalf of MAL Corporation, an entity of which he was the president, and the unnamed fraudfeasor sent him a cashier’s check in the amount of \$375,890.

The check, of course, turned out to be counterfeit. In the meantime, Levenfeld had indorsed and presented the check for deposit at MAL’s bank, JPMorgan Chase. The same day that he made the deposit, Levenfeld authorized an Article 4A payment order from MAL’s account to the fraudfeasor’s account at a Japanese bank, in the amount of about 90% of the check’s face value. The check was returned unpaid six days later, and the bank charged the amount of the check against MAL’s account, causing the account to become overdrawn by over \$330,000.

JPMorgan Chase then brought suit against MAL under a number of theories, including breach of contract, breach of transfer warranty, and its right of chargeback, among others. MAL raised a host of affirmative defenses in return. While the court properly dismissed the unjust enrichment and failure of consideration/bad faith affirmative defenses, it allowed suit to continue on the defenses of unclean hands, estoppel, inadequate notice, failure to mitigate, and waiver. In so doing, the court apparently was persuaded by MAL's contention that JPMorgan Chase may have violated reasonable commercial standards of fair dealing if it recognized the hallmarks of a Nigerian e-mail scam and failed to investigate, allowing MAL to have access to the funds via provisional credit while check processing was pending.

There are several problems with the court's holding. First, Regulation CC requires that funds associated with cashier's checks be made available on the first banking day following the banking day of deposit, contravening any intimation that the bank acted wrongfully in making the funds available prior to investigation of the check. The bank would not have had time to investigate the check – even had this been its duty in this case, which it was not – prior to making funds available according to the requirements of Regulation CC.

In addition, it was Levenfeld, rather than the bank, who possessed superior knowledge in this case regarding the doubtful collectibility of the check. Nowhere do the facts suggest that he informed any bank representative that he had received the check after responding to an unsolicited e-mail. Furthermore, and most pertinent, Article 4 simply does not impose on a depository/collecting bank the kind of investigative responsibility that the court seems to countenance. Instead, § 4-202(1) imposes a duty of "ordinary care" with respect to a limited list of tasks: "presenting an item or sending it for presentment," "sending notice of dishonor or nonpayment," "settling for an item when the bank receives final settlement," "making or providing for any necessary protest," and "notifying its transferor of any loss or delay in transit within a reasonable time after discovery thereof." MAL's affirmative defenses do not relate to any of these tasks, but instead seek to impose upon the bank a duty of care beyond § 4-202(1). In addition, as Fred Miller points out in his *Hawkland's UCC Series* treatise, applying § 4-103(5), a bank would be liable for violating its § 4-202 duty of care "only if it can be shown that had the bank exercised ordinary care the item would have been collected." 5 *Hawkland UCC Series* § 4-202:1. In this case, because the check in question was counterfeit, there was no chance that it would have been collected, and thus the bank should have no liability to MAL under this theory. As Professor Miller further states, although there are some instances in which § 1-103(b) would permit a common-law negligence claim to supplement Article 4, such cases should be limited to situations in which "a bank acted negligently outside of the collection process, as in failing to make a proper credit investigation." 1 *Hawkland UCC Series* § 4-202:1.

MAL also contended that JPMorgan Chase acted in bad faith by "misrepresenting to MAL on Chase's website or through its agents that the check had 'cleared.'" Based on the totality of MAL's argument, it appears that the only factual support for this claim is the fact that the bank gave MAL a provisional credit for the full amount which, as previously discussed, the bank was required to do under Regulation CC. In addition to the tenuous factual support for this contention, it is important to note that § 4-201(1) imposes what Official Comment 2 terms a "strong presumption" that the credit given for an item prior to final settlement is merely provisional. Given this language,

to imply that the bank should have emphasized the provisional nature of the settlement seems unreasonable.

Given the unfortunate prevalence of Nigerian e-mail scams at this time, decisions like this one are particularly disturbing, in that they would seem to allow a bank customer – even a relatively sophisticated one such as the president of a corporation – to ignore common sense, be taken in by a scheme that is on its face “too good to be true,” and then seek to pass off the results of its own bad decision onto the bank.

Ludwig v. Fifth Third Bank,
908 N.E.2d 992 (Ohio Ct. App. 2009)

This case involves an individual named Ludwig who was swindled by Thornton, a former co-worker. Ludwig continued to receive commission checks from his former employer for business he generated prior to his departure. After Ludwig’s new employer and former employer entered into litigation with one another, Ludwig felt uncomfortable continuing to accept the checks until the matter was settled. For this reason, Ludwig brought the one commission check he had already received to Thornton, and asked him to hold the check during the pendency of the litigation. Instead of doing so, Thornton deposited the check without indorsement into his own personal account with Fifth Third Bank. Thornton also intercepted and deposited without indorsement eight more commission checks.

Upon discovering Thornton’s conduct, Ludwig sued Fifth Third Bank for conversion. The trial court granted summary judgment for the bank, and the court of appeals affirmed in part, reversed in part, and remanded the case for further proceedings regarding the first of the nine converted checks.

With respect to the eight checks that Thornton intercepted, the court ruled that Ludwig could not maintain a cause of action for conversion due to the language of § 3-420(a). That provision bars an action for conversion of an instrument by a payee “who did not receive delivery of the instrument either directly or through delivery to an agent or a co-payee.” In applying this rule, the court reasoned that Thornton was not Ludwig’s agent because, according to Ludwig’s own testimony, Ludwig “had never authorized Thornton to receive checks on his behalf, . . . had never authorized Thornton to sign his name on checks, . . . [and] had never told a third party that Thornton had the right to accept payment from him.”

It appears that the court may be conflating two arguably different issues: whether a person *is* an agent of another; and whether an agent has exceeded its authority. Ludwig undeniably had authorized Thornton to hold checks for him. Therefore, Thornton was Ludwig’s agent. Thornton may have exceeded the scope of his agency, but it’s not clear that this should negate delivery to Ludwig within the meaning of § 3-420(a). Nevertheless, the court’s analysis is at least consistent with the policy behind § 3-420(a). As the comments point out, the payee who never receives delivery does not need a claim in conversion because the payee can still go after the drawer on the

obligation that the check was intended to pay. In other words, Ludwig could go after his former employer for the commissions due. The drawer, in turn, could prevent the drawee from charging the drawer's account because the item was not properly payable. The check was payable to the order of Ludwig, but the drawee paid Thornton. The drawee, in turn, could go after the depository bank for breach of a presentment warranty under § 3-417(a)(1).

As to the one check that Ludwig had received and turned over to Thornton, the court correctly noted that § 3-420 was no bar to a conversion action. Fifth Third Bank claimed that Ludwig was contributorily negligent in giving possession to Thornton, and therefore precluded from recovery under § 3-406(a), but the appellate court correctly noted that this section was not relevant. It applies only when an instrument is altered or a signature is forged, and neither of those had occurred.

Nevertheless, the court remanded the case for further proceedings. This is the most troubling aspect of the decision. The court characterized Ludwig's conduct in turning over the first commission check to Thornton as "perhaps careless," and concluded therefore that factual issues precluded summary judgment. Yet it is far from clear whether or why that should matter. Because Fifth Third accepted the check from Thornton without indorsement, the bank could not qualify as a holder within the meaning of § 1-201(b)(21)(A), much less a holder in due course within the meaning of § 3-302. As a result, the bank had no right to enforce the instrument under § 3-301 and had no property rights in the instrument. Indeed, the bank's rights in the instrument were no greater than what its transferor, Thornton, had, which is to say none at all. Remand should not have been necessary.

In re Jersey Tractor Trailer Training, Inc.,
2009 WL 2750458 (3d Cir. 2009)

We have reported on this case twice before: in a special December 2007 edition of this column we reported on the Bankruptcy Court's decision; and in the [October 2008 column](#), we reported on the District Court decision. In both we criticized the court's analysis of a priority dispute between two accounts financiers. In particular, we regarded as absurd the underlying and unsupported premise – not actually decided – that a factor could be a holder in due course of accounts or that the debtor's invoices to its customers were negotiable instruments. We also criticized the Bankruptcy Court's conclusion that the second factor had acted in bad faith because its search firm had searched under an abbreviated name of the debtor and therefore failed to discover a proper filing by the first factor. We found the affirmation of that decision even more distressing because the District Court had ruled that the second factor "had a duty to search both the debtor's correct corporate name, as well as roots of that name."

Well, perhaps this column is having some effect. Although neither of our prior discussions were cited in its opinion, the Third Circuit rejected both lower courts' analysis of good faith and remanded the case for further proceedings. In doing so, the Circuit Court quite properly noted that good faith – which requires that parties act in conformity with reasonable commercial standards of

fair dealing – “is concerned with the *fairness of conduct* rather than the *care* with which an act is performed” (quoting § 3-103 cmt. 4) (emphasis added by court). The court then concluded that the fact that search against “Jersey Tractor Trailer Training” instead of “Jersey Tractor Trailer Training, Inc.” did not reveal the first factor’s lien was “anomalous,” but not evidence of bad faith.

Unfortunately, the case is not over. The Circuit Court remanded to the Bankruptcy Court to determine whether the second factor’s investigation of the debtor’s business was sufficient to meet its duty to deal fairly in purchasing the debtor’s accounts. In doing so, the court did not address the underlying and ridiculous premises of the second factor’s arguments, including the wholly unexplained assumption that the debtor’s invoices to its customer could be negotiable instruments. Perhaps the Bankruptcy Court will finish the job the Third Circuit has started in cleaning up this mess.

In re Troutt,
2009 WL 2905923 (Bankr. S.D. Ill. 2009)

This fairly simple case deals with perfection in fixtures. The court began its analysis by citing and quoting all the relevant provisions, but then it badly misinterpreted them.

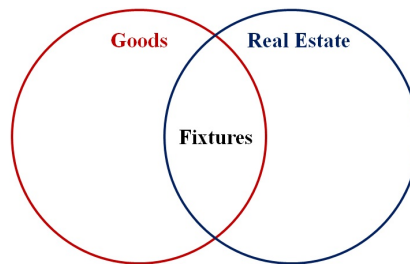
The case arose when the debtors contracted for the purchase and installation of an energy guard insulation blanket in their home. The energy guard was installed in the attic, cut to fit the contours of the house, and nailed down. The seller retained a security interest in the energy guard but did not file a financing statement or record a mortgage. The seller later assigned the contract to American General Financial Service, Inc.

The debtors filed for Chapter 13 bankruptcy protection and sought to treat American as unsecured, claiming the security interest was not perfected. The court began by quoting the definitions of “consumer goods” and “fixtures,” the automatic perfection rule of § 9-309(1), and the priority rules in § 9-334. The court then correctly noted that “[w]hile the energy guard falls within the definition of “consumer goods,” it also could fall within the definition of a “fixture.”

But from here the court seemed to misunderstand the provisions it had just quoted. The court then wrote that if the energy guard is a fixture, “then a fixture filing or a filed mortgage would be required to create a secured debt.” This is wrong on several levels. First, the statement confuses attachment with perfection. Even if a fixture filing were necessary, that filing would at most be relevant to perfection, not attachment. Second, even assuming the court meant to refer to perfection (or meant that, if the security interest was unperfected, the security interest could be avoided in bankruptcy), the court was simply wrong. The seller’s security interest was perfected under § 9-309(1) because, as the court itself had acknowledged, it was a purchase-money security interest in consumer goods. The absence of a fixture filing or recorded mortgage might be relevant to priority over a mortgagee, but not to perfection. This point is quite evident from the language of the Code and is fully acknowledged in the comments. *See* § 9-334 cmt. 8 (noting that automatically perfected PMSI in certain consumer goods that are fixtures has priority over a prior mortgage).

It is possible that the court simply stumbled over terminology. Section 9-334(a), after providing that a security interest may be created in goods that are fixtures or continue in goods that become fixtures, then states that “[a] security interest does not exist under this Article in ordinary building materials incorporated into an improvement on land.” In other words, Article 9 recognizes three classifications of realty-related goods:

- ◆ Goods may have such an incidental relationship to real estate that they remain personal property for all purposes, and a real estate mortgage would transfer no interest in them. A likely example would be a gas grill on a back yard patio.
- ◆ Goods may be so incorporated into real estate that they completely lose their character as personal property. This is what the last sentence of § 9-334(a) is speaking about. Drywall and lumber used in framing a house are examples. No Article 9 security interest can exist in such property.
- ◆ Goods may qualify as “fixtures,” and thereby straddle the line between personal property and real property. An interest in such goods can exist or be created under both Article 9 and real estate law.



See § 9-334 cmt. 3.

If the court had meant that the energy guard fell into the second category above – in other words, the energy guard was now real estate – then its ultimate conclusion that American had no security interest at all may well have been correct. Unfortunately, the court was quite clear in stating that the energy guard was a fixture – that is, that it fell into the third category above – and in reaching that conclusion the court relied upon several cases that purported to delineate what qualifies as fixtures, not what personal property becomes so incorporated into a structure that it ceases to be goods at all. If one is to accept as correct the court’s conclusion that the energy guard was a fixture, then American’s security interest really was perfected and American should not have lost.

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