Barring adverse reaction, this column will be a new, regular feature in the Newsletter. Its purpose is to identify some of the most flawed judicial decisions interpreting the Uniform Commercial Code to be published after the previous edition of the Newsletter. 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 shine a spotlight on major errors of analysis, and thereby provide practitioners and judges with reason to disregard the opinion as precedent.

To merit attention in this column, a decision must not merely err on a matter of law. The error must be patent and fundamental to the analysis. One the other hand, the decision need not reach the wrong result. In fact, a good candidate may contain multiple errors that cancel each other out, so that in the end the right result is reached, albeit for wrong reasons. The two decisions discussed below are among the most misguided UCC opinions of the year. You be the judge: which is worse?


This case concerned whether a secured party violated the debtor’s rights while enforcing a security interest. In 1987, the debtor borrowed $250,000 from the secured party and in return gave the secured party an option, upon default, to buy the debtor’s interest in a redemption agreement for $350,000 minus the amount of the debt then outstanding. In 1998, after a series of defaults, the secured party notified the debtor that it was exercising its option to purchase debtor’s redemption rights and that this satisfied the debtor’s secured obligation. Four years later, the debtor sued claiming this violated his rights under Part 6 of Article 9.

The court committed the first of its numerous errors by ruling that former Article 9 applied to the dispute because the transaction and the default both took place prior to the effective date of revised Article 9. In fact, revised Article 9 applies as long as the litigation was commenced after the July 1, 2001 effective date, which it did. See § 9-701(a), (c). Indeed, both parties thought revised Article 9 controlled, but the court ruled otherwise without even citing to the transition rules. 718 N.W.2d at 831-32.

The court’s next error was more substantial. Although both parties regarded the debtor’s rights under the redemption agreement as the relevant collateral, the court instead treated the secured party’s option to purchase those rights as the collateral. Indeed, the court was quite specific on this point, italicizing its disagreement with the parties’ position and then reiterating twice more that the option, not the redemption rights, were the pertinent collateral. Id. at 832-33. This is just plainly wrong. The option may well have been a security device – a point alluded to by the court – but it was not the collateral. Collateral is, after all, property in which the debtor has an interest. See § 9-102(a)(28) (defining “debtor”). The debtor had no rights in the option; the debtor issued the option.

From here, the court went on to discuss whether the option structure constituted an impermissible pre-default waiver of the debtor’s right to: (i) notification of a disposition, (ii) a commercially reasonable disposition; (iii) redeem the collateral prior to the disposition; and (iv) payment of a surplus. See § 9-602. The court concluded that the secured party’s exercise of
the option could indeed be a disposition of the collateral (a conclusion arguably inconsistent with its treatment of the option as the pertinent collateral), and thus violate the duties to give reasonable advance notification of the disposition, to permit redemption prior to disposition, and to conduct a commercially reasonable sale. However, it concluded that the debtor was not entitled to any surplus. This conclusion was not explained. Instead, the court supported it merely by quoting former § 9-504(2), which provided that the debtor is not entitled to a surplus if the underlying transaction is a sale of accounts or chattel paper. Yet the underlying transaction was a $¼ million loan, not a sale of accounts or chattel paper, so this portion of the court’s analysis was again wrong.

Despite all this, the court concluded that the secured party did not in fact dispose of the collateral, but instead had conducted a strict foreclosure by exercising the purchase option. 718 N.W.2d at 839-40. Because the debtor did not object within 21 days, the strict foreclosure was effective. Given that the secured party’s notification that it was exercising the option was phrased not as a proposal to which the debtor could object, but as a fait accompli, this conclusion is questionable. Still, no express wording is required for a proposed strict foreclosure and there is no specific requirement that the proposal inform the debtor of the right to object. Thus, the court may have reached the correct result, at least if it had applied revised Article 9. However, former Article 9 – which the court had erroneously concluded was the applicable law – limited strict foreclosure to collateral in possession of the secured party, see former § 9-505(2). Here, both the option and the redemption rights to which it related were intangible, and thus incapable of possession. Thus, strict foreclosure was – at least arguably – not available at all.


This case pitted a putative secured party against a transferee of fund from the debtor’s deposit account. Madisonville State Bank (“MSB”) had a security interest in the debtor’s accounts, inventory, chattel paper, documents, and equipment. Sometime later, the debtor paid approximately $59,400 to its law firm for services rendered. The payment was made from a deposit account at First State Bank. MSB sued the law firm for conversion and, not surprisingly, the law firm moved for summary judgment on the basis of § 9-332(b). The trial court granted the motion and MSB appealed.

MSB argued that § 9-332 did not apply because MSB did not have a security interest in the deposit account, instead it had a security interest in certain proceeds, which were deposited into the deposit account. Although the decision of the court of appeals is a bit unclear, the court apparently accepted this argument and reversed the lower court. In other words, it seems to have concluded that § 9-332 applies only if the security interest in the deposit account is claimed as original collateral. This is, of course, nonsense. Article 9 expressly treats proceeds as collateral. See § 9-102(a)(12)(A) & comment 3(a). Indeed, the vernacular of Article 9 throughout clearly treats a security interest in proceeds as a security interest in whatever those proceeds happen to be. Indeed, it does this in particular with respect to deposit accounts, thus unambiguously indicating that a security interest in a deposit account can arise if proceeds of other collateral are deposited into a deposit account. See, e.g., § 9-312(b).

The court then compounded this error by apparently also concluding that § 9-332(b) could not protect the law firm because it protects a transferee from a perfected security interest in a deposit account, and MSB had no control agreement with First State Bank, and thus was unperfected. If this
is really what the court ruled, then the court erred in two ways. First, and less important, MSB may well have had a perfected interest in the deposit account. The court never bothered to mention whether MSB was perfected in the original collateral by filing, but if MSB was, then it was perfected in the identifiable proceeds deposited into the deposit account under § 9-315(d)(2). Second, and more important, § 9-332(b) makes no reference to perfection. Perfection is mentioned in the examples to comment 2, but merely as an illustration, not as a requirement for the provision to be applicable). The provision itself, though, allows a transferee to take free whether the security interest is perfected or unperfected.

Stephen L. Sepinuck
Professor, Gonzaga University School of Law
Chair, UCC Committee
ssepinuck@lawschool.gonzaga.edu
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The last column focused on judicial opinions containing one or more patent analytical errors. In contrast, the decisions noted here might not be wrong; reasonable readers might well conclude that both courts’ analysis is correct. To that extent, then the cases present valuable lessons for litigators and legislatures.

Manufacturers and Traders Trust v. Wyoming Sand and Stone,
2007 WL 397377 (3d Cir. 2007)

In the case, the debtor wished to sell several collateralized motor vehicles by auction. To facilitate the sale, the debtor’s president asked the secured party to execute lien releases on the vehicles, with the understanding that the loan proceeds would be used to pay down the secured obligation. The secured party signed a release of lien on the back of the certificates of title and delivered the certificates to the auctioneer. Several of the vehicles were sold and the proceeds transferred to the secured party. The debtor then filed for Chapter 11 bankruptcy protection.

At the secured party’s request, the state department of motor vehicles issued new certificates of title for the unsold vehicles. These certificates noted the secured party’s lien. Thereafter, the debtor again hired the auctioneer to sell the remaining vehicles and the secured party again signed and delivered a release of lien to facilitate the sale and maximize the sale proceeds. The auctioneer sold the vehicles and the proceeds were placed in an escrow account maintained by the secured party. One of the debtor’s unsecured creditor’s then challenged the secured party’s right to the auction sale proceeds.1

The bankruptcy court and district court both ruled that by executing the release of lien on the certificates of title, the secured party released its security interest and was therefore not entitled to the sale proceeds. On appeal, the Third Circuit affirmed. The secured party tried to distinguish a 1992 bankruptcy court decision involving a mistakenly executed lien released by arguing that in that case, In re Cavalieri, 142 B.R. 710 (Bankr. E.D. Pa. 1992), the creditor has also mistakenly marked the loan agreement as “paid.” The Third Circuit was unpersuaded. It ruled that the secured party had released its lien prior to the sale and thus was simply not entitled to the sale proceeds.

1 It is unclear from the opinion whether the challenge applied to both auction sales or only to the postpetition sale.
There are several aspects of this decision that are disturbing. First, in some places the court seems to confuse the concepts of attachment and perfection. For example, near the end of the brief opinion, the court stated, “[t]he crucial factor is whether the lien is noted on the certificates. . . . Because M & T Bank released the lien, no lien was noted on the certificates.” Nevertheless, the court does correctly treat the issue as an attachment question, not a perfection question, and any confusion or ambiguity in the court’s language is of minor consequence.

Second, the opinion contains no discussion of the potentially conditional nature of the secured party’s execution of the lien releases. There appears to be no dispute that the creditor executed the lien releases to facilitate the sale (i.e., to maximize the sale proceeds) and with the express understanding that it was to receive the sale proceeds. The court expressly ruled that the secured party’s motive to facilitate the sale “was not determinative,” by which it apparently meant not relevant. However, it never discussed whether the secured party’s act was conditional. Perhaps the secured party never advanced such an argument. It should have. Just as the execution and delivery of any single document at a closing is normally conditioned on the execution and delivery of all the other closing documents, perhaps the secured party’s execution of the lien release was conditional on receipt of the sale proceeds.

Perhaps related to this, there was also a disturbing inattention to agency principles. The secured party delivered the executed lien releases not to the debtor, but to the hired auctioneer. While the debtor may have been the one who initially selected and hired the auctioneer, it was apparently the auctioneer – not the debtor – who decided to seek the lien releases before conducting the sale. It seems plausible, then, the at least for this purpose, the auctioneer became the secured party’s agent, not merely the debtor’s agent. After all, the debtor and the secured party had compatible interests in facilitating the auction, and there is thus no reason to think that the auctioneer could not be the agent of both parties. See, e.g., Restatement (Third) of Agency § 3.16 (2006). If so, there arguably was no effective delivery of the lien releases prior to the sale, thus preventing the lien releases from having effect until then.

Regardless of whether the deficiencies in the court’s opinion are traceable to omissions from the creditor’s brief, the lesson for secured parties are clear. Do not execute and deliver a bare release of lien prior to a sale of the collateral. Instead sign an authorization for the debtor to sell the property free of the security interest. See § 9-315(a)(1).

In re Villa,

The interaction of state certificate of title laws with revised Article 9 of the Uniform Commercial Code is not always smooth. The newly proposed Uniform Certificate of Title Act should remove all or almost all of the problems and confusion, but unless and until states enact it, creditors, lawyers, and judges are left trying to harmonize two different pieces legislation that do not always seem to be speaking the same language. This case is illustrative.

Under Kansas law, a security interest in a mobile home may normally be perfected only by having the lien noted on the certificate of title. It is not enough to send the appropriate
documentation to the Division of Vehicles. Instead, the lien must be noted on the certificate. However, a purchase-money security interest ("PMSI") in a mobile home may be perfected merely by completing and sending a notice of security interest to the Division, along with the applicable fee. Specifically, the statute provides that:

The dealer or secured party may, within 10 days of the sale and delivery, mail or deliver the notice of security interest, together with a fee of $2.50, to the division. . . . The proper completion and timely mailing or delivery of a notice of security interest . . . shall perfect a security interest in the . . . mobile home described on the date of such mailing or delivery."

In the case at hand, the debtor purchased a mobile home from a dealer on June 17, 2003. She granted the dealer a PMSI to secure a portion of the purchase price. The dealer immediately assigned its paper to Home Pride Finance Corp. and mailed the existing certificate of title to Home Pride. However, no certificate of title listing the debtor as owners was ever issued. The mobile home was delivered to debtor before August 1, 2003.

On August 15, 2003, Home Pride filed a properly completed notice of security interest, along with the requisite fee. Two years later, the debtor filed for bankruptcy protection and the trustee eventually sought to avoid Home Pride’s lien, claiming it was unperfected because the notice of security interest was not filed within the applicable 10-day period. The court agreed. It ruled that because notice was sent 14 days after delivery, it was not “timely” mailed within the meaning of the statute.

The case is a bit troubling because the delay in mailing is invisible to any subsequent searcher. In other words, the purpose of statute’s perfection rules is to provide a method of giving public notice of a security interest to others interested in acquiring an interest in the property. Anyone searching after the notice was filed would learn precisely the same thing, regardless of whether the notice was filed within the 10-day period or after it. Thus, there is simply no reason for perfection to depend on when the notice was filed, merely on the fact that it had been filed.

Home Pride appears to have made this point to the court, arguing that the 10-day rule was simply a relation-back provision. In other words, a creditor who mails the notice within the 10-day is deemed perfected on the date of mailing, whereas one who mails it later is deemed perfected on when the Division files it. While the court found merit in Home Pride’s argument, it felt constrained by the plain wording of the statute. It also noted that its interpretation promotes prompt filing.

One might well disagree with the court’s conclusion and its almost cavalier disregard of he basic principles underlying Article 9. Nevertheless, the court had a difficult task. The state’s certificate of title statute simply does not mesh well with Article 9 and the language or policy of one was going to have to yield to the other. Perhaps the lesson here is for state legislatures and state bar UCC Committees to closely scrutinize any state law or proposed state legislation that supplants

Cf. Uniform Certificate of Title Act §§ 25, 26(a), making perfection effective upon delivery of the security-interest statement to the appropriate state agency and payment of the applicable fee, regardless of whether the interest is ever noted on the certificate. See also U.C.C. § 9-516(a) (providing a similar rule for perfection by filing a financing statement).

Article 9’s filing system, and make sure the two work together properly. The UCC Committee of the ABA stands by to assist in this endeavor. It can provide experts willing to assist in the analysis involved.

Stephen L. Sepinuck
Professor, Gonzaga University School of Law
Chair, UCC Committee
ssepinuck@lawschool.gonzaga.edu

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4 See U.C.C. § 9-311(a).
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**Featured Case**

*Provident Bank v. Community Home Mortgage Corp.*, 2007 WL 1350262 (E.D.N.Y. 2007), is a disturbing case reminiscent of the notorious OPM Leasing scandal of the early 1980s, which involved the fraudulent “double booking” of equipment leases. This case, however, involved the double booking of home mortgage loans.

Community Home Mortgage Corporation ("CHMC") originated residential mortgage loans and pledged them to its warehouse lenders. For nine mortgage loans, CHMC required the borrowers to execute duplicate original promissory notes. It then sold one set of originals to NetBank and another set to Southwest Securities Bank. CHMC did not endorse any of the notes it sold to Southwest. In contrast it endorsed seven of the nine it sold to Netbank. Netbank also took possession of eight notes (including the two not endorsed) before Southwest took possession of its corresponding notes. However, for five of the notes, Southwest recorded its assignment of mortgage before Netbank. This set up a priority battle between the two lenders:

As an initial matter, the court assumed that the mortgagors were not required to pay on both original notes. In addition, both Southwest and Netbank had given value for notes that were not overdue and that were devoid of facial irregularities. Thus, the court faced the unenviable task of assigning priority to one of two innocent parties.

The court then ruled that Article 9, not real-property law, governed the priority in the mortgage loans. In doing so, the court correctly noted that attachment and perfection in a note automatically extend to any mortgage supporting the note. U.C.C. §§ 9-203(g), 9-308(e). Thus, the court’s analysis focused exclusively on the notes, rather than the
mortgages. As a result, the court rejected Southwest’s argument that it should win as to the five loans for which Southwest had recorded an assignment of mortgage before Netbank.

With respect to Article 9 priority, the court ruled that Netbank was a holder in due course of the seven endorsed notes, and thus entitled to priority of them under § 9-331. As to the other two notes, Netbank won because it took possession before Southwest took possession of its corresponding notes.

The decision is troubling for several reasons. First, the fact that holder-in-due course status could be used to resolve the priority battle with respect to seven notes was merely fortuitous. Because CHMC never indorsed the notes that it sold to Southwest, Southwest was not a holder of the notes, and thus automatically disqualified from holder-in-due-course status. However, the facts could have easily been otherwise. Both parties might have received endorsed certificates. Then the court would have faced a priority battle between two apparent holders in due course. Nothing in Article 3 or Article 9 is designed to resolve such a dispute.

Second, the court’s conclusion that the first to possess would have priority when holder-in-due-course status did not resolve the issue was likewise troubling. The court never indicated from where it derived this rule. Although § 9-330(d) does give priority to a purchaser of a note who takes possession, its language does not refer to the first to take possession. Indeed, it does not seem to contemplate that purchasers could simultaneously be in possession. The first-to-file-or-perfect rule of § 9-322(a)(1) might apply, but the court nowhere discussed whether or when either party filed a financing statement.

In short, none of the priority rules relied upon by the court was designed to deal with this type of problem. Perhaps that was because the court implicitly treated the two original notes in each transaction as the same piece of property. While doing so has the advantage of protecting the unsophisticated home buyer duped into making the duplicate notes, it ignores an assumption underlying both Articles 3 and 9 that anything capable of being possessed is unique.

Perhaps because of this, Southwest had exhorted the court to exercise its equitable powers to divide the loan interests equally. The court gave that argument rather short shrift. We think it merited more attention.

Honorable Mentions

The following recent decisions, while not as disconcerting as the featured case, are also noteworthy for their questionable analysis.


This is yet another decision putting judicial limits on a dragnet clause. The court ruled that neither the first loan agreement, which included a clause indicating that
collateral securing other loans also secures this one, nor the second loan agreement, which included a clause purporting to make the collateral secure all other debts of the borrowers, was adequate to make the collateral granted in the second agreement secure the debt created in the first. The court relied in part on the fact that the first loan was made more than 10 days before the debtor acquired the collateral and the second loan was made to three co-debtors whereas the first loan was made to only one of them.

*In re TXNB Internal Case*, 2007 WL 914983 (5th Cir. 2007)

In this troubling opinion, the court ruled that the party deemed to have somehow had no cause of action for interference with its property rights. Specifically, the court ruled that a buyer who took gas in part payment of an antecedent debt and was therefore not a buyer in ordinary course was not liable to a secured party for conversion for selling the gas to purchasers who were buyers in ordinary course because it had no knowledge or notice of the lien. In addition, the buyer was not liable for conversion of the sale proceeds because an action for conversion of money requires a segregated fund or a transfer for safekeeping. However, the court ruled that the buyer may be liable in a collection action.

*In re Cook*, 2007 WL 680170 (Bankr. W.D. Mo. 2007)

The court ruled that a security interest in an automobile perfected by notation on an Arkansas certificate of title for the car became unperfected after the car was re-certificated in Missouri because the new certificate failed to list the lien. The court correctly noted that, pursuant to § 9-303, Missouri law begins to govern perfection and priority upon issuance of the Missouri certificate. However, it missed § 9-316(d), (e), pursuant to which the previously perfected security interest should have remain perfected.

Stephen L. Sepinuck  
Professor, Gonzaga University School of Law  
Chair, UCC Committee  
ssepinuck@lawschool.gonzaga.edu

Kristen Adams  
Professor, Stetson University College of Law  
Chair, Subcommittee on General Provisions & Relations to Other Law  
adams@law.stetson.edu
SPOTLIGHT

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_In re Rowe_,
_369 B.R. 73_ (D. Mass. 2007)

This case involves a very restrictive application of U.C.C. § 9-203(b)’s requirement of an authenticated security agreement. It is reminiscent of the well known, but widely disfavored, holding in _American Card Co. v. H.M.H. Co._, 196 A.2d 150 (R.I. 1963).

Lake Equipment Leasing, Inc. and Jeffrey M. Rowe executed an “equipment lease” by which Lake leased a plow with a digging attachment to Rowe for five years. The document identified Rowe’s Chevy truck as “collateral” – presumably for Rowe’s payment obligations – and listed the truck by its vehicle identification number. The title certificate for the truck also listed Lake as the “first lienholder.” In addition, Rowe executed a limited power of attorney that would permit a third party, Frank’s Far Rockaway Auto School, Inc., to sign certain documents to secure title to the truck. In spite of all this, the court concluded that there was no valid security agreement.

The court acknowledged, as a preliminary matter, that the parties’ failure to execute a document entitled “security agreement” was not dispositive of whether the parties had in fact created a security agreement. Nevertheless, the court ruled that the lease, title certificate, and limited power of attorney were insufficient to establish the existence of a security agreement because of the absence of “granting language” by which the debtor expressly transferred rights in the truck. The court cited _In re Modafferi_, 45 B.R. 370, 372 (S.D.N.Y. 1985), in support of this portion of its holding. The court correctly quoted Modafferi, but misapplied it. Modafferi involved a financing statement signed by the debtor together with a promissory note that was silent as to the existence of collateral. In essence, the only document in any way indicating the existence of collateral was the financing statement. Because the purpose of a financing statement is to put third parties on notice that the filer _may_ have a security interest in the identified property, it has never played well as a security agreement and the Modafferi court ruled that it was insufficient. In doing so, it noted that “some language reflecting a desire to grant a security interest must be contained within the documents offered to establish a security agreement under U.C.C. § 9-203.”

But the facts in Rowe were substantially different. The transaction document between the parties which created the payment obligation expressly indicated that Rowe’s truck was to serve as “collateral.” Indeed, the references to “collateral” and “first lienholder” are otherwise nonsensical and the limited power of attorney is otherwise unnecessary. Nevertheless, the Rowe court seemed to equate “language reflecting a desire to grant a security interest” with “language granting a security
interest.” Because the documents contained no explicit “granting language,” the court held that no security interest was created. The court’s holding is overly restrictive and fails to respect the likely intent of the parties.


This case totally misconstrues the legal effect of a secured party’s failure to provide notice of a disposition of collateral pursuant to U.C.C. § 9-611.

Gould & Eberhardt Gear Machinery Corp. borrowed approximately $3 million from UPS Capital Business Credit. The loans were guaranteed by the United States Department of Agriculture and were secured by G&E’s business assets as well as certain real estate owned by G&E’s president and owner. After G&E defaulted on its repayment obligations, UPS and the USDA decided to accelerate the indebtedness and liquidate the collateral. As part of this process, UPS asked G&E to execute a “Waiver of Notice Regarding Disposition of Collateral,” and G&E did so. The court ruled that this waiver was insufficient because it referred only to a non-U.C.C. portion of the Massachusetts General Laws and did not purport to waive the notification requirement of Article 9.

Despite the default, G&E and UPS continued to discuss alternatives to foreclosure on the business assets (the real estate was foreclosed upon separately). As part of these discussions, G&E located a potential purchaser for the company’s business assets – RP Machine Enterprises, Inc. RP offered to purchase G&E’s assets as part of a joint-venture arrangement with G&E. UPS verbally accepted the offer, and the parties entered into a secured party bill of sale whereby UPS purported to transfer its interests in the G&E assets for $700,000.

After the agreement was executed, and while G&E’s president was out of the country, RP’s personnel entered G&E’s premises and began removing property from the premises. In response, G&E sought protection through a Chapter 11 bankruptcy proceeding, claiming that the notification of the sale was insufficient. The bankruptcy court agreed, ruled that the defective notice rendered the sale ineffective to transfer title, and ordered turnover of the property. This was patently in error. While it would have been appropriate for the court to have considered the defective nature of the notification in determining G&E’s liability, if any, for a deficiency, Article 9 provides no support for using it to invalidate the sale. Indeed, just the opposite; both the Code and the comments expressly provide that a good faith transferee in a disposition gets to keep the property even if the secured party failed to comply with Article 9. See § 9-617 & comment 2.

Nevertheless, the ruling was apparently never appealed and RP ultimately purchased the assets through the bankruptcy process, albeit for a much higher price. It then sued UPS for breach of contract to recover the difference. In ruling on RP’s motion for summary judgment, the district court then compounded the bankruptcy court’s mistake. It not only accepted without question the bankruptcy court’s conclusion that the sale was invalid (although in fairness the issue was not before it), but somehow also concluded that RP had no cause of action for breach against UPS. In doing so, the court never cited § 9-610(d), which provides that a secured party makes a warranty of title
in a disposition contract unless it follows the normal to disclaim that warranty. The court’s holding may be explained at least in part by the fact that none of the cases in this portion of the court’s opinion arose under the U.C.C. One case involved the sale of electricity, one involved a pre-U.C.C. conditional sale of an automobile, and the others all involved real estate. Nevertheless, the court seems to have assumed – without any reasoned analysis – that because the bankruptcy court had invalidated the sale, no valid contract ever existed.

**Attorney’s Title Insurance Fund, Inc. v. Regions Bank,**

*491 F. Supp. 2d 1087 (S.D. Fla. 2007)*

This last case illustrates a common misconception: that any payment transaction can be reversed if the underlying transaction to which it is connected is fraudulent. The decision reflects no error of analysis by the court, but instead a rather pointless litigation tactic.

In the case, two unnamed imposters purported to sell certain real property that belonged to Mr. and Mrs. Chuven to an individual named Jacobs, who apparently had no knowledge of the fraudulent scheme. Home Equity Mortgage Company financed Jacobs’ purchase, and Attorney’s Title Insurance Fund, Inc. provided the title insurance for the transaction. At the closing, the closing agent delivered to the imposters a check for the purchase price, made payable to Mr. and Mrs. Chuven. The check was drawn upon Regions Bank. The imposters forged the Chuvens’ endorsement, and Regions Bank paid the check.

After the Chuvens learned of the fraudulent transaction, they got the deed to Jacob cancelled. Attorney’s Title paid the unpaid balance of Home Equity Mortgage’s loan to Jacob and thereby acquired any cause of action the Chuvens (or, for that matter, Home Equity Mortgage) might have based upon the fraud. Attorney’s Title then sued Regions Bank to recover based upon the bank’s payment of the check. Although, as the court noted, Attorney’s Title failed to identify any particular legal theory under which it was entitled to recovery, the suit was apparently based upon a theory of conversion; specifically, that Regions Bank had converted the Chuvens’ funds by paying the check to the fraudfeasors. (As is ordinarily the case in Article 3 litigation, the fraudfeasors were apparently judgment-proof or unavailable for suit and were therefore not part of the litigation.)

Because the check was never delivered to the Chuvens, however, the Chuvens had no rights in the check and therefore no cause of action in conversion. Instead, the only rights they had in this transaction stemmed from the underlying transaction – that is, the fraudulent scheme to sell their property. Attorney’s Title argued that the Chuvens had received constructive delivery of the check when it was given to the fraudfeasors. For this argument to succeed, the fraudfeasors must have been acting as agents for the Chuvens. Since the Chuvens were not involved in the scheme, the fraudfeasors could not have been acting as their agents, and the constructive delivery argument therefore fails.

To recap, the Chuvens– and by assignment, Attorney’s Title – had no cause of action based upon the payment transaction because the check was never delivered to them or to their agent. See § 3-420(a)(ii). Indeed, the imposters’ indorsement of the check was valid. See § 3-404(a). The
Chuvens’ only cause of action related to the unauthorized and fraudulent land sale, and that action was satisfied by cancellation of the deed. Thus, subrogation to the Chuvens’ rights provided no cause of action to Attorney’s Title. It is, however, possible that Attorney’s Title has its own cause of action against the closing agent if she knew or should have known of the fraudulent scheme. The specific contours of any such cause of action would depend upon the relationship, if any, between the closing agent and Attorney’s Title, which is not revealed in the facts of the case.

Stephen L. Sepinuck
Professor, Gonzaga University School of Law
Chair, U.C.C. Committee
ssepinuck@lawschool.gonzaga.edu

Kristen Adams
Professor, Stetson University College of Law
Chair, Subcommittee on General Provisions & Relations to Other Law
adams@law.stetson.edu
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Few cases from last year contain as many serious errors as this one. Fortunately, some of the errors countered each other, such that the court floundered into the correct result, at least in part.

The case is essentially a priority battle between two secured parties. It began in 2002, when Wawal Savings Bank granted the debtor, Jersey Tractor Trailer Training, Inc., a $315,000 line of credit secured by an interest in substantially all of the debtor’s assets. Wawal perfected its interest by filing a proper financing statement and the security agreement allowed the debtor to collect its own accounts and use the proceeds in its business.

The following year, to alleviate severe cash flow problems, the debtor sought to sell some of its accounts to Yale Factors. In its credit check of the debtor, Yale conducted a UCC search against “Jersey Tractor Trailer Training,” an incomplete version of the debtor’s name that omitted the corporate identifier. The search failed to disclose Wawal’s filing. Relying on its apparent priority, Yale then purchased some of the debtor’s accounts and filed its own financing statement.

In late 2005, as the debtor’s finances deteriorated, Wawal and Yale each learned of the debtor’s relationship with the other. Wawal asserted its priority in the debtor’s accounts and the debtor informed Yale that it would not renew its factoring contract. Nevertheless, Yale continued to collect the debtor’s accounts and even went so far as to obtain an ex parte restraining order that prohibited the debtor from collecting. The debtor filed for bankruptcy protection and Wawal bought an adversary proceeding to determine the priority of its interest in the debtor’s remaining accounts as well as in amounts that Yale had already collected.

The court began its analysis with a lengthy discussion of a seemingly irrelevant issue: whether the debtor’s factoring arrangement with Yale was a sale of accounts or a borrowing against accounts. In fact, the issue could be relevant under § 9-315(a)(1) because, if it were a sale, and if Wawal had authorized the debtor to conduct the sale free of its security interest, then Yale would have taken the accounts free of Wawal’s interest. Indeed, this was one of Yale’s arguments. The court properly concluded that the transaction was a sale but then – again properly – concluded that Wawal had not authorized the sale free and clear because it did not know of the factoring arrangement with Yale. So far, so good.
The court then addressed whether Yale took priority in the accounts as a holder in due course. This is, of course, an absolute impossibility. A person can be a holder in due course of a negotiable instrument, see § 3-302, but there is no such thing as a holder in due course of accounts. Nevertheless, Yale argued – and the court accepted for the purposes of discussion, see n.4 – that the debtor’s invoices to its customers were negotiable instruments. This is absurd. A negotiable instrument is either a promise to pay or an order to pay issued by the person making the promise or order (that is, by the drawer or maker of the instrument), not a writing issued by the person claiming a right to be paid. §§ 3-104(a), 3-105(a). A creditor’s invoice thus cannot possibly be a negotiable instrument; it is the wrong kind of document and is issued by the wrong party. Error one.

In evaluating whether Yale was a holder in due course, the court focused on the requirement of good faith. This is the most disturbing aspect of the decision. The obligation of good faith requires “honesty in fact and observance of reasonable commercial standards of fair dealing.” The latter half of this standard – reasonable commercial standards of fair dealing – is not a requirement that the holder act in a commercially reasonable manner, cf. §§ 9-607(c), 9-610(b) (requiring that collections on collateral and dispositions of collateral be conducted in a commercially reasonable manner), it is a requirement of fair dealing. As such, it is a requirement that applies only to people in contract with each other. See § 1-304 (“every contract or duty within the Uniform Commercial Code imposes an obligation of good faith in its performance and enforcement”). This point is borne out by P.E.B. Commentary No. 10 (February 10, 1994), which makes it quite clear that the obligation of good faith attaches only to contractual promises and statutory duties; a person simply cannot owe a duty of good faith to a stranger. Beyond that, § 9-331(c) provides that a filed financing statement is not notice of a claim against an instrument, and thus cannot prevent a holder from qualifying as a holder in due course. Unfortunately, there is language in comment 5 to § 9-331 that indicates otherwise, and expressly suggests that a junior secured party may have a duty to search to determine if a senior lender has contractually prohibited the debtor from granting a junior security interest in accounts.

The court picked up on this comment and took it a step further. It concluded that Yale had failed to act in good faith because Yale had conducted an improper search. Although the record failed to explain why the search firm had missed the filing, and thus it was unclear whether the error was Yale’s or its search firm’s, the court ruled that did not matter. It noted that a search revealing no significant secured debt at a time the debtor faced severe liquidity problems “should have raised red flags” and required further inquiry. It described Yale’s loan officer as “inexperience[d]” and Yale’s conduct as “reckless.” Error two.

At this point, the court appears headed to the correct result. Wawal should win this case. It has the senior security interest. It should win as to the remaining accounts under § 9-322(a)(1) as the first to file or perfect. And, indeed, that is what the court so ruled. Wawal should also win – at least presumptively – as to collections by Yale. That is because of the difference between a disposition of tangible collateral and a collection of receivables. When a junior secured party

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1 The court should have cited Article 3 for this point, but instead relied on Article 9.
disposes of collateral, any senior security interest remains unaffected and the buyer takes subject to it. See § 9-617. Because of that, the senior secured party has no claim to the proceeds of the junior’s disposition. See § 9-615(a). However, when a junior secured party collects on accounts, the account debtor’s obligation is discharged, with the result that the senior’s collateral is gone. To compensate for this, the comments to Article 9 make clear that the junior secured party must account to the senior for the amounts collected, unless the junior qualifies for priority as a holder in due course, good faith purchaser of an instrument, or noncollusive transferee of money. See §§ 9-330 comment 7, 9-331 comment 5, 9-607 comment 5.

The court did not analyze Yale’s potential priority under these rules. Nevertheless, the court rejected Wawal’s claim against Yale for conversion because it concluded that Wawal had no right to dominion and control over the debtor’s accounts. The court noted that Wawal’s agreement with the debtor allowed the debtor to collect its accounts until Wawal declared a default. Accordingly, so the court reasoned, Yale’s collection of the accounts prior to that declaration did not amount to a conversion of Wawal’s property. Perhaps the court’s confusion here emanates from the fact that the tort of conversion originated as an action relating to tangible property, and the language used in old cases seems inapplicable to intangible assets, such as accounts. Yet once Yale collected, the accounts were gone. What more should be necessary to maintain a conversion claim? Error three.

Glimcher Supermall Venture, LLC v. Coleman Co., 739 N.W.2d 813 (S.D. 2007)

This case is another example of a court reaching the right result for the wrong reason. In the process, the court provides a seriously flawed analysis of the Uniform Fraudulent Transfer Act (“UFTA”) that we can only hope others will not follow.

In 1994, Coleman Company, a South Dakota corporation, decided to open a retail outlet in a new mall in Auburn, Washington. To reduce the risk associated with this venture, a new corporation – Black Hills Gold Factory Outlet Store, Inc. – was formed. It had substantially the same shareholders, officers, and directors as Coleman. Black Hills leased space in the mall and purchased jewelry on credit from Coleman.

In 2001, Black Hills ceased operations. It vacated the store 19 months before the end of the lease term. It paid the lessor for the time it was in possession but paid nothing for those additional 19 months. Shortly after it ceased operations, Black Hills transferred all it remaining assets – $45,000 in cash and $225,000 in inventory – to Coleman in satisfaction of a $600,000 debt for unpaid inventory. The lessor sued Black Hills for the remaining rent due and obtained a judgment for $90,000. The lessor then brought a fraudulent transfer action in South Dakota against Coleman. The trial court ruled that the transfers to Coleman were not done with fraudulent intent and were made in exchange for reasonably equivalent value. The lessor appealed to the state supreme court, which reversed on both grounds.
In addressing the claim of actual fraud, the court looked at the badges of fraud listed in section 4(b) of the UFTA, which South Dakota has enacted. It concluded without much difficulty that the transfers were to an insider, were made after the lessor had already threatened legal action, involved substantially all of the debtor’s assets, and were done when the debtor was insolvent. To this the court added that the debtor had concealed the transfer, absconded, and removed assets. These additional conclusions are dubious. The court’s basis for the concealment point was that the lessor had no knowledge of the transfer and was somewhat misled by the fact that the debtor had in fact paid rent for the one month after it vacated the premises. The court seemed to treat this payment to the plaintiff as an effort to conceal the fact that it was about to make transfers that would make it unable to pay any more. It is odd indeed to suggest that payment of a lawful debt to the plaintiff makes the avoidance action stronger. As to absconding, the court concluded that the debtor’s failure to inform the lessor of its plans to abandon the premises qualified as absconding. This misconstrues the term. The debtor did not move to South Dakota by transferring its inventory to Coleman; the debtor ceased operations. This is not the case of an individual who moved to a foreign country—or even a different domestic jurisdiction—to evade capture or make collection more difficult. Ceasing operations is not absconding. The court made essentially the same error with respect to removal and concealment of assets. It treated the transfer to Coleman—which was, after all, a lawful creditor of the debtor—as “removal” of assets.

As a result of this analysis, the court reversed the trial court’s ruling on what is essentially a factual question. But it did not stop there. It did not remand for reconsideration, it ruled that the transfer was made with actual intent to hinder, delay, or defraud.

If this were the only disturbing aspect of the court’s decision, it would not merit discussion in this column. Of far greater concern is how the court dealt with the lessor’s claim of constructive fraud: whether the debtor received reasonably equivalent value for its transfers to Coleman. The UFTA expressly provides that value is given for a transfer if an antecedent debt is satisfied or secured. UFTA § 3(a). See also Bankruptcy Code § 548(d)(2)(A) (providing similarly for the purposes of the Bankruptcy Code’s fraudulent transfer provision). Because payment of a debt normally reduces the amount of debt on a dollar-for-dollar basis, payment of a lawful debt is always in exchange for reasonably equivalent value. On that facts of this case, in which the debtor transferred assets worth $270,000 in exchange for cancellation of a $600,000 debt, the debtor’s receipt of reasonably equivalent value is simply beyond question. Nevertheless, the court ignored the clear mandate of the text and ruled that value must be measured from the perspective of the frustrated creditor, not from the debtor’s perspective. Because cancellation of the debt was of no value to the lessor, reasonably equivalent value was not received.

This analysis confuses fraudulent transfers with preferences. The debtor’s transfers to Coleman were quite possibly preferential transfers to an insider that could be avoided if the debtor went into bankruptcy within the next year. But creditor equality is basically the province of preference law, not fraudulent transfer law. Although some courts have held that a payment to one
creditor can be for the purpose of delaying or defrauding another creditor,\(^2\) such cases are and should be rare. More importantly, such transfers simply cannot be transfers for less than reasonably equivalent value.

Nevertheless, despite the court’s very questionable analysis of both fraudulent transfer claims, it may have reached the correct result. The UFTA has, in addition to actions based on actual fraud and lack of reasonably equivalent value, a cause of action for a transfer to an insider. The elements are essentially those of a preference: the transfer must be on account of an antecedent debtor, it must be made while the debtor is insolvent, and the insider must either know or have reason to know that the debtor is insolvent. UFTA § 5(b). The facts of the case seem to satisfy these elements, a point the dissenting justices noted. Unfortunately, the lessor had either not brought a § 5(b) claim or had abandoned it. Consequently, the state supreme court should have affirmed the trial court’s judgment.

**In re Zych,**

*2007 WL 4409797* (Minn. Ct. App. 2007)

This case involves a dispute arising from a security interest in cattle and has some truly disconcerting language regarding whether a security interest can attach to a commercial tort claim as proceeds of other collateral.

On April 25, 2005, Zych sold 217 head of cattle through a subsidiary of GFI America for just over $220,000. GFI’s payment for the cattle was dishonored due to insufficient funds and shortly thereafter GFI filed for bankruptcy under Chapter 11. Zych brought a claim against GFI’s lender, Wachovia, claiming that Wachovia had violated the Packers and Stockyards Act in its treatment of the cattle proceeds from the April 25 transaction. The classification of this claim as a “commercial tort claim” within the meaning of § 9-102(a)(13) was not in dispute.

In Zych’s own subsequent Chapter 11 action, Zych’s attorneys filed a UCC financing statement declaring their lien on various items of collateral, including any settlement from Zych’s claim against Wachovia. Meanwhile, Zych’s secured lender, Rabo Agrifinance, claimed that its security interest in the cattle extended to the claim against Wachovia, both as proceeds of the cattle and as a “general intangible” under the parties’ security agreement.

Relying upon the language of § 9-108(e) and § 9-204(b)(2), the court ruled that Rabo had no security interest in Zych’s claim against Wachovia because: (1) the security agreement did not

\(^2\) See, e.g., *In re McGalliard, 183 B.R. 726* (Bankr. M.D.N.C. 1995) (citing other cases on the point); *In re Fieser*, 248 B.R. 648 (Bankr. M.D. Fla. 1999) (denying discharge to man who, thinking himself fatally ill, borrowed money on credit cards covered by insurance feature and used funds to pay off home mortgage); *First National Bank v. Hooper*, 48 S.W.3d 802 (Tex. Ct. App. 2001) (delivery of deed of trust to unsecured creditor was done with intent to delay, hinder or defraud other creditors; court’s review on appeal incorrectly held no reasonably equivalent value was given).
describe the claim with the requisite degree of specificity; and (2) the commercial tort claim did not exist at the time at which the security agreement was perfected. That ruling is undoubtedly correct to the extent that Rabo’s interest was asserted as an interest in after-acquired collateral. However, the court also ruled that these provisions prevented Rabo’s security interest from attaching to the claim against Wachovia as proceeds. This is patently wrong and confuses the concepts of after-acquired property and proceeds. Moreover, it effectively nullifies the portion of the definition of proceeds in § 9-102(a)(64)(D) that expressly includes claims arising out of the loss of the collateral. Perhaps most important, there is no way for lenders to draft around this problem. The court expressly ruled that Article 9 still applies to commercial tort claims and their proceeds – and implicitly, therefore, lenders cannot hope to acquire a security interest in commercial tort claims under other law – but that the specificity rule of § 9-108(e) and the prohibition on attachment in § 9-204(b) apply even to commercial tort claims as proceeds of other collateral.

Stephen L. Sepinuck  
Professor, Gonzaga University School of Law  
Chair, U.C.C. Committee  
ssepinuck@lawschool.gonzaga.edu

Kristen Adams  
Professor, Stetson University College of Law  
Chair, Subcommittee on General Provisions & Relations to Other Law  
adams@law.stetson.edu