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 decisions.

_BancInsure, Inc. v. Highland Bank, 2013 WL 5340887 (D. Minn. 2013)_

In this case, an insurer sought a declaratory judgment that the loss of its insured – Highland Bank – was not covered by the policy the insurer had issued. The bank had loaned about $4 million to First Premier Capital, LLC to finance First Premier’s acquisition of equipment to be leased. In return, First Premier assigned to the bank its right to rental payments under the lease along with its residual interest in the leased equipment. It later turned out that bank had been defrauded: the leased equipment did not actually exist and a guaranty of the lease was likely forged. The bank obtained an uncollectible judgment against First Premier and the lease guarantor filed for bankruptcy, declaring assets of $5,400 and liabilities in excess of $100 million.

The bank sought recovery of about $2 million from the insurer pursuant to the policy’s coverage of losses resulting from forgery: in this case, the lease guaranty. In ruling for the insurer, the court made two principal rulings. First, that the bank knew that the putative guarantor had a negative net worth, and thus the loss did not result from the forgery. Second, that the bank’s security interest in the equipment lease did not give it a security interest in the guaranty of the lessee’s obligations.

The first rationale might well be correct and justify the court’s ruling. The second is not. The court looked only at the language of the documents and concluded that did not purport to grant the bank an interest in the guaranty. However, pursuant to § 9-203(f), the attachment of a security interest in collateral – in this case, chattel paper – automatically also gives the secured party an attached security interest in any supporting obligation, such as a guaranty. The court never cited to § 9-203(f).
This is one of numerous cases in which a court was asked to determine whether a lease or personal property was a true lease or a disguised sale with a retained security interest. Section § 1-203 contains some rather detailed rules to aid courts in making this decision. Subsection (a) states the general rule that resolution depends not on the labels used in the agreement but on the facts of the case. More guidance is found in subsection (b), which lays out four circumstances in which a transaction definitively creates a security interest. Each of those circumstances requires that the lease not be subject to early termination by the lessee. The court in this case ruled – in a discussion consuming a single paragraph – that because the lease was subject to termination by the lessee, and subsection (b) was therefore inapplicable, the transaction was a true lease.

This is wrong. If the circumstances in subsection (b) are not present, that does not mean that the transaction is a lease; it merely means that the analysis falls back to the general, fact-specific standard of subsection (a). See, e.g., In re Grubbs Construction Co., 319 B.R. 698 (Bankr. M.D. Fla. 2005); Coleman v. Daimlerchrysler Services of North America, LLC, 623 S.E.2d 189 (Ga. Ct. App. 2005). Moreover, a transaction subject to termination by the lessee, can qualify as a sale and security arrangement if the lessee: (i) made a significant up-front payment that would be forfeited by terminating; (ii) must pay a significant fee for terminating; or (iii) would have strong economic incentive to exercise an option to buy, say perhaps because all of the lessee’s business equipment is subject to the lease, and the lessee would have to find alternative goods or go out of business if it failed to exercise the option. See, e.g., In re Grubbs Construction Co., 319 B.R. 698; In re Triple Marine Maintenance, Inc., 258 B.R. 659 (Bankr. E.D. Tex. 2000). The court might nevertheless have reached the correct result, but because it did not mention what the terms of the lease were, it is impossible to know.

In this case, Bank of America honored post-petition several checks that the debtor had drawn prepetition. Instead of pursuing the payees under § 549, the Chapter 7 trustee brought a turnover motion action against the bank under § 542(a) to recover the funds. The bankruptcy court denied the motion and the district court affirmed. However, the Ninth Circuit reversed. Noting that § 542(a) expressly authorizes recovery of “the value” of estate property in a person’s “possession, custody, or control,” not merely the property itself, the court ruled that the bank was liable for the amount of the
checks even though the bank lacked possession, custody, or control at the time the action was brought.

The bulk of the decision dealt with the timing issue: that the bank allegedly held property of the estate when the bankruptcy petition was filed but did not hold it when the trustee sought turnover. What the court failed to appreciate, however, was that the bank never had “possession, custody, or control” of estate property. A deposit account is not a trust or a bailment. A depositary bank has neither possession nor custody of the depositor’s money. A deposit account is merely the depositor’s loan to the bank. Consequently, § 542(a) was simply not applicable.

This is not to say that the court reached the wrong result on liability. The bank might well have been liable under § 542(b), which requires someone who owes a debt that is estate property to pay it to the trustee. In re Falzerano, 454 B.R. 81 (B.A.P. 8th Cir. 2011) (§ 542(b), not turnover under § 542(a), is the appropriate provision to use to recover a debt owed to the estate). However, subsection (b) is expressly subject to subsection (c), which provides a defense to an obligor who, in good faith and without knowledge of the bankruptcy case, pays someone else. By improperly analyzing this issue under subsection (a), the court relied on a textual argument that had no relevance and denied the bank a defense to which it might have been entitled.

The first footnote in the decision indicates that the judges unanimously concluded that oral argument was unnecessary. Perhaps if they had taken the time to listen to counsel, the court would not have issued such a fundamentally flawed opinion.

Ist Source Bank v. Wilson Bank & Trust,
735 F.3d 500 (6th Cir. 2013)

And now for the best – or worst – decision. In this case, 1st Source Bank acquired a security interest in the accounts and rigs of two trucking companies. However, the bank’s financing statement failed to include accounts in its description of the collateral, although it did specifically mention “proceeds” of the described rigs. After the debtor defaulted and went into bankruptcy, a priority dispute arose with another secured party over the bank’s security interest in accounts. The district court ruled that the bank was not perfected in the debtors’ accounts because accounts were neither mentioned in the financing statement nor proceeds of the rigs. As the district court noted, “[u]se is not a disposition of the collateral within the meaning of the definition of “proceeds.” 2012 WL 4711989 at *3. The Sixth Circuit affirmed.

Had the circuit court confined its analysis and discussion to the rationale adopted by the district court, it would have been on solid ground. That is because using equipment to generate receivables does not result in proceeds of the equipment because use of equipment is not a “sale, lease, license, exchange, or other disposition” of the equipment. See, e.g., In re Premier Golf Properties, LP, 477 B.R. 767 (B.A.P. 9th Cir. 2012); In re Wright Group, Inc., 443 B.R. 795 (Bankr. N.D. Ind. 2011). The court would have been on solid ground if in fact the debtors operated the rigs (i.e., their employees drove the rigs to haul cargo for customers who promised pay for that service).
However, if the debtors leased the rigs to customers, the resulting rights to payment would have qualified as “proceeds” see U.C.C. § 9-102(a)(64)(A), and the court’s ruling would be incorrect. Unfortunately, neither the district court opinion nor the circuit court opinion makes clear how the debtor conducted its business to generate the accounts.

More unfortunate than this omission is what the circuit court also wrote. In language that is both confused and confusing the court seems to suggest that “accounts” can never be “proceeds” because both are defined terms:

A foundational rule of statutory construction is to give effect to the intent of the Legislature by giving words their “natural and ordinary” meaning. Where two statutory provisions potentially conflict, “a specific statutory provision controls over a more general statutory provision.” Here, [Article 9] provides a comprehensive definition of the term “proceeds.” . . . Although the statutory definition of the term “proceeds” appears admittedly broad, accepting [the bank’s] interpretation of the statute would render the term “accounts” – a category defined separately in [Article 9] – meaningless. Because we are required “to construe statutes, whenever possible, in a way which gives meaning to every portion of the statute,” we decline to expand the definition of the general term, “proceeds,” in such a way that it would subsume the specific term, “accounts.” 735 F.3d at 504.

This language is quite disturbing “Accounts” undeniably can be proceeds of other collateral. See U.C.C. §§ 9-102 cmt. 5.i; 9-322 cmt. 6; 9-324 cmts. 8, 9 & 10; 9-509 cmt. 4 (all expressly contemplating that accounts can be proceeds (and vice-versa)); see also Sixth Circuit Rules That “Proceeds” Don’t Include Accounts Receivable Generated by Use of Equipment, 29 CLARKS’ SECURED TRANSACTIONS MONTHLY 1, 3 (Nov. 2013) (commenting on the case). Indeed, billions of dollars in inventory and other financing rests on the belief that accounts can be and are proceeds of other collateral. To the extent that the court suggested otherwise, it was clearly wrong.

In a letter to Chief Judge Batchelder, the author of this column urged the court to modify its opinion. Noting that in the first game of the last World Series, the umpires congregated and then reversed a clearly incorrect call by the second base umpire, the author urged the court to similarly confer and correct its misstatements. The Chief Judge did not respond.

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