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.

**In re Purdy,**

*2014 WL 3953729* (6th Cir. 2014)

This is easily one of the most troubling UCC decisions of the year. In it, a divided circuit court confused and conflated basic principles of law, leading it to reverse a completely sound bankruptcy court decision dealing with the distinction between a lease and a sale with a retained security interest.

The facts of the case are fairly simple. Sunshine Heifers, LLC “leased” 435 dairy cows to Purdy for 50 months. Under the terms of the agreement, Purdy had no right to terminate the lease early, was required to replace any cows culled from the herd, and was required to return the cows or their replacements at the end of the lease term.

In Purdy’s bankruptcy, Citizens National Bank, which had a perfected security interest in Purdy’s existing and after-acquired farm products, claimed that Purdy’s transaction with Sunshine was a sale with a retained security interest, not a lease. Although Sunshine had filed a financing statement to perfect its residual rights in the cows, in case those rights were deemed to be a security interest, Sunshine had apparently not complied with the rules of § 9-324(d) for obtaining PMSI priority in livestock. Citizens therefore claimed that its security interest had priority over Sunshine’s security interest.

The bankruptcy court ruled in favor of Citizens. Under § 1-203(b), a transaction in the form of a lease is conclusively deemed to be a sale with a retained security interest if it is not subject to termination by the lessee and is for longer than the economic life of the goods. Because uncontradicted testimony indicated that 30% of a dairy herd is culled annually, the court concluded that none of the cows originally provided under the putative lease would be returned at the end of the 50-month term of the agreement, and thus the transaction was for longer than the economic life of the goods. *See In re Purdy, 490 B.R. 530,* 536 (Bankr. W.D. Ky. 2013).

The circuit court reversed. It began its analysis by correctly noting that § 1-203 provides a two-step inquiry for distinguishing a lease from a sale. Subsection (a) indicates that the distinction is generally governed by the facts of the case but that subsection (b) provides a
bright-line test applicable in some situations. In then dealt with the bright-line test of subsection (b), on which the bankruptcy court had relied, in just two scant paragraphs.

Because Sunshine’s owner had testified that it made little difference whether Sunshine received back the same cows that it originally leased – the main thing was to receive the same number of cows back – the circuit court perfunctorily concluded that “it is clear to us that the relevant ‘good’ is the herd of cattle, which has an economic life far greater than the lease term, and not the individual cows originally placed on Purdy’s farm.” Thus, the court, concluded, the bright-line test of § 1-203(b) was not satisfied. The court then concluded that under the facts-and-circumstances test of § 1-203(a), there was no reason to re-characterize the lease as a sale.

The problem with the court’s analysis is that it confuses property and contract. In a true lease, the lessor remains the owner of the goods and has a right to the goods back at the end of the lease term while the goods still have some value. In short, the lessor has property rights in the goods subject to the lease. In this case, Sunshine was never going to get any of the original cows back. Instead, Purdy was obligated to return the same number of cows, but at the time the lease was entered into, the cows to be returned were not and could not be identified. Indeed, it is likely that some or all of them had not yet been born or conceived. Thus, when the parties entered into the lease, Sunshine did not have property rights in those as-yet unidentified cows; it merely had Purdy’s contractual promise to return the specified number of cows. While Sunshine’s contractual rights did ripen into property rights as Purdy acquired new cows to replace those culled, those rights were nothing more than a security interest in after-acquired collateral, a security interest junior to the perfected security interest of Citizens National Bank. In addition, as the dissent noted, if the herd were considered the relevant good the transaction would inevitably fail the bright-line test with respect to economic life, thus rendering that factor meaningless under the facts of this case.

There are reasons why property and contract are taught in separate courses. Those reasons should not be so blithely ignored and the two concepts should not be so thoroughly confused.


This is a case in which the court may ultimately have been correct on the merits as to the breach-of-peace claim, but jumped the gun by disposing of the matter on a motion to dismiss.

The debtors in the case alleged the following facts: the secured party’s repossession agents somehow entered the debtor’s apartment building, despite a locked security door, “banged loudly on [their] apartment door at approximately 4:00 a.m., waking them,” and demanding to speak with them. The debtors claimed to have been “terrified by the agents’ behavior, in part because they had not buzzed anyone into their building and they believed the agents had broken through the front security door . . . and . . . might break through their front door as well.” The debtors also alleged that the agents awakened several of their neighbors and that “their fear was
‘heightened’ because they ‘reside in one of the highest crime areas in Chicago.’” The complaint further alleged that they did not come out of the bedroom until 8:30, due to fear, and called police when they found a club on the car, placed by the agents. The agents returned and towed the car away before the police arrived.

In affirming the lower court’s dismissal of the breach-of-peace claim, the court noted as a preliminary matter that “[t]here is a dearth of case law analyzing the term ‘breach of the peace’” as that term is used in § 9-609(b). This is simply not true. There are hundreds of cases on what constitutes a breach of the peace and a quick Westlaw search revealed almost 70 cases in Illinois state and federal courts alone.

The court did analyze two cases: *Chrysler Credit Corp. v. Koontz*, 661 N.E.2d 1171 (Ill. Ct. App. 1996), and *Pantoja-Cahue v. Ford Motor Credit Co.*, 872 N.E.2d 1039 (Ill. Ct. App. 2007), and correctly cited the standard provided in *Koontz* that a breach of the peace means “conduct which incites or is likely to incite immediate public turbulence, or which leads to or is likely to lead to an immediate loss of public accord.”

In *Koontz*, the debtor’s car was parked on his front yard. When the debtor heard the repossession in progress, he rushed outside in his underwear and yelled “Don’t take it.” The repossession agent made no verbal or physical response and simply completed the repossession. The court ruled that the repossession did not breach the peace. In *Pantoja*, the debtor claimed that unknown repossession agents broke into the debtor’s locked garage to repossess his car. The trial court dismissed the debtor’s claim but the appellate court reversed, concluding that “breaking into a locked garage to effectuate a repossession may constitute a breach of the peace.” 872 N.E.2d at 1046. In doing so, the court noted that “where a repossession is effectuated by an actual breaking into the lessee/debtor’s premises or breaching or cutting of chains, gates, barricades, doors, or other barriers designed to exclude trespassers, the likelihood that a breach of the peace occurred is high.”

In the case at issue, the court stated that it was “abundantly clear” that the facts alleged in the complaint more closely related to *Koontz* than *Pantoja*, and rather summarily concluded that there were no facts indicating that the repossession agents entered through a barricade or the like, that there was any incitement to public turbulence or a loss of public order or tranquility, or that there was any real probability of violence at the time of the repossession. Perhaps other readers will be persuaded by this analysis, but we are skeptical that the issue is so clear.


In this case, a judgment creditor of an office space tenant sought to garnish the obligation of a sublessee. The appellate court that allowed the garnishment might well have reached the correct conclusion but its invocation of U.C.C. Article 9 was erroneous and its analysis was therefore flawed.
The basic facts of the case are as follows. The debtor rented office space from a landlord. Shortly before a hospital obtained a $617,000 judgment against the debtor, the debtor subleased the office space to a related entity (the “sublessee”). The hospital sought to garnish the sublessee’s obligation to pay rent to the debtor. The trial court denied the requested relief and the hospital appealed.

The court first dealt with the argument that the sublease did not create an enforceable obligation of the sublessee to the debtor. Although the lease required the landlord’s consent to any sublease, and the landlord had not consented, the court ruled that this did not render the sublease void, merely voidable by the landlord. As the court put it, the sublessee could not enter into the sublease, occupy the premises, and then claim that the sublease was unenforceable. Moreover even though the sublessee had been paying the landlord directly, the only party to whom the sublessee was contractually obligated was the debtor.

The court then dealt with the argument that the landlord, which had a security interest in the debtor’s accounts, had a superior right to the rents payable under the sublease. In a single paragraph, the court observed that: (i) there was no evidence that the landlord filed a financing statement; (ii) under § 9-317(a), an security interest is subordinated to the rights of a person who acquires a judicial lien before the security interest is perfected; and (iii) the hospital acquired a judicial lien upon service of the writ of garnishment.

The problem with this analysis is, of course, that § 9-109(d)(11) excludes from Article 9 the creation of any interest in or lien on real estate, “including a lease or rents thereunder.” Although the parties’ letter agreement stated that the transaction was to be governed by the Uniform Commercial Code, comment 2 to § 9-109 makes clear that “the subjective intention of the parties with respect to the legal characterization of their transaction is irrelevant to whether this Article applies.” In other words, a transaction that is outside the scope of Article 9 cannot be brought within Article 9 by agreement of the parties. Thus, Article 9 had no relevance to the landlord’s interest, if any, in the debtor’s right to payment under the sublease. Accordingly, the landlord’s apparent failure to file a financing statement was immaterial and § 9-317(a) did not speak to the priority of the landlord and the hospital’s claims to the rent under the sublease.


This case involved a conversion claim by a lender with a security interest in a borrower’s equipment and accounts against the law firm that had deposited into the firm’s IOLTA account checks from the borrower’s customers and checks constituting proceeds of the borrower’s equipment. The law firm then used the IOLTA account to pay its fees. Although the court correctly held that the law firm did not take the funds free from the lender’s interest under § 9-332(b) because the deposit account was the law firm’s rather than the debtor’s, the court’s analysis and statements regarding the initial deposit of the checks was flawed.
First, the court misconstrued the concepts of negotiability and negotiation. The court stated that, because the lender’s security interest had attached at the time at which the checks were deposited into the law firm’s IOLTA account, “the checks were not negotiable without the security interest” and thus were not properly negotiated to the law firm. The test for whether an instrument is negotiable appears in § 3-104 and is purely formal. Although the attachment of the lender’s interest might affect a holder’s rights to the check, it has no bearing on whether the check itself qualifies as a negotiable instrument. In addition, whether the checks were properly negotiated to the law firm is governed by § 3-201 and rests on whether the checks were indorsed and whether possession was transferred. Attachment of the lender’s interest was not pertinent to the question of negotiation.

Second, although the court was probably correct in concluding that the law firm was not a holder in due course, because it knew of the lender’s security interest, the court’s analysis of that issue contained a distressingly wrong statement. Specifically, the court wrote that the law firm “was not entitled to the funds and thus did not take them for value.” Priority and value are distinct concepts. The law firm apparently provided legal services to the borrower, and this unquestionably constitutes “value” within the meaning of § 3-303(a).

Nevertheless, the court’s ultimate conclusion was correct. Because the law firm was not a holder in due course, its interest in the deposited funds remained subject to the lender’s claim. The firm’s subsequent withdrawal of the funds was therefore in violation of the lender’s rights.

Kristen D. Adams
Professor and Associate Dean
Stetson Law School
adams@law.stetson.edu

Stephen L. Sepinuck
Professor & Associate Dean
Gonzaga University School of Law
Director, Commercial Law Center
ssepinuck@lawschool.gonzaga.edu