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Turley: Turley: Missouri Carries Article 9 into the Twenty-First Century

Missouri Carries Article 9 Into the Twenty-First Century

*First National Bank v. Erb Equipment Co., Inc.*¹

I. INTRODUCTION

The Uniform Commercial Code (UCC) was originally promulgated in 1951² and was officially adopted in Missouri in 1963.³ Much like the Constitution of the United States, this body of law governs transactions that are continuously evolving. It is virtually impossible for the drafters to foresee every possible factual situation. Thus, as this evolution of commercial transactions takes place, it is essential for both the courts and legislative bodies to regularly review, interpret, and modify the provisions to conform with the underlying goal of secured transactions: to provide a simple and unified structure with which the immense variety of present day secured financing transactions can go forward with less cost and greater certainty.⁴

The Missouri Court of Appeals for the Eastern District of Missouri did just that in deciding *First National Bank v. Erb Equipment Co., Inc.* The case illustrated two crucial concepts. First, the case implicitly settled the law in Missouri concerning the nation-wide jurisdictional debate over what happens to purchase money security interests when they are refinanced or consolidated with other debts. This Note will explain the various approaches and explain why Missouri's implicit adoption of the "dual-status approach" is consistent with the Uniform Commercial Code.

Second, against the great weight of case authority, *First National Bank* decided that a junior creditor was not accountable to a senior creditor for proceeds from the junior's foreclosure. This Note will explain why this is the only correct conclusion consistent with the Uniform Commercial Code.

II. FACTS AND HOLDING

The plaintiff, First National Bank (Bank), brought an action against the defendant, Erb Equipment Company (Erb), which engages in selling, leasing, and servicing John Deere industrial machinery.⁵ AmEarth, a company in the

1. 921 S.W.2d 57 (Mo. Ct. App. 1996), *appeal after remand*, No. 73068, 1998 WL 128619 (Mo. Ct. App. Mar. 24, 1998).

2. General Comment of the National Conference of Commissioners on Uniform State Laws and the American Law Institute, *reprinted in* SELECTED COMMERCIAL STATUTES 18 (West 1997).

3. MO. REV. STAT. §§ 400.1-400.101 (1994).

4. U.C.C. § 1-101 cmt..

5. *First Nat'l Bank v. Erb Equip. Co., Inc.*, 921 S.W.2d 57 (Mo. Ct. App. 1996), *appeal after remand*, No. 73068, 1998 WL 128619 (Mo. Ct. App. Mar. 24, 1998).

business of mining and excavating, was a debtor to both parties.⁶ Both the Bank and Erb had a security interest in AmEarth's equipment, and, following default, Erb repossessed and sold certain items of equipment.⁷ The Bank initiated the instant action to recover the proceeds from Erb's foreclosure.⁸

In July 1987, the Bank received a blanket security interest in all of AmEarth's equipment "whether now or hereafter owned, existing, or acquired" pursuant to a loan of \$450,000 to AmEarth.⁹ Prior to Erb's involvement with AmEarth, the Bank had perfected its security interest in AmEarth's equipment.¹⁰

Also in July, 1987, AmEarth purchased two pieces of machinery from Erb.¹¹ AmEarth financed this transaction by exchanging two other pieces of machinery for trade-in value, and the remainder of the debt was covered by a security note and agreement giving Erb a security interest in the equipment.¹² Within this security instrument, Erb assigned the note and security agreement to Associates Commercial Corporation (Associates), with Associates retaining a right of recourse against Erb.¹³ AmEarth leased three other pieces of equipment from Erb on August 10, 1987.¹⁴

Beginning in 1988, AmEarth encountered financial difficulties and fell behind in its payments to Associates.¹⁵ As a result of this default, Associates sought payment from Erb, which paid off the note and took a reassignment.¹⁶

On December 27, 1988, AmEarth and Erb entered into a "global financing plan" to consolidate the parties' different financial transactions into one security document.¹⁷ First, the agreement refinanced the amount that AmEarth owed Erb for Erb's payment of the 1987 note to Associates.¹⁸ Second, the agreement allowed for AmEarth to purchase its leased equipment.¹⁹ Third, the agreement also covered other obligations AmEarth owed Erb.²⁰ These obligations were unrelated to the financing of any of the equipment.²¹ Last, the agreement offset the total cost of this combined debt with the trade-in value of two pieces of machinery and a rental credit on one of the leased pieces of machinery.²²

6. *Id.* at 59.

7. *Id.* at 60.

8. *Id.*

9. *Id.* at 59.

10. *First Nat'l Bank*, 921 S.W.2d at 59.

11. *Id.*

12. *Id.* at 59-60.

13. *Id.* at 60.

14. *Id.*

15. *First Nat'l Bank*, 921 S.W.2d at 60.

16. *Id.*

17. *Id.*

18. *Id.*

19. *First Nat'l Bank*, 921 S.W.2d at 60.

20. *Id.*

21. *Id.*

22. *Id.*

Before AmEarth ceased operations in 1989, it had made only one payment to Erb under this agreement.²³ As a result, Erb repossessed AmEarth's machinery on July 29, 1989.²⁴ The Bank, in response, sent a written demand that Erb return the machinery to AmEarth.²⁵ The Bank's loans to AmEarth were also in default at this time, but the Bank did not take any action to foreclose on the machinery or request that the property be turned over to the Bank.²⁶

Erb held a foreclosure sale at which it purchased all five pieces of equipment.²⁷ The combined sale price was \$429,000, leaving a deficiency of \$200,000.²⁸

The Bank, claiming it had a superior security interest due to its earlier filing date, filed a claim against Erb for the proceeds of the foreclosure sale.²⁹ Erb counterclaimed for tortious interference with Erb's right of contract and asserted a claim for equitable subrogation to the rights of Associates.³⁰ Erb argued that it had a superior interest under the "purchase money security interest" exception.³¹ The trial court granted the Bank's summary judgment motion on the issue of the proceeds, denied Erb's summary judgment motion on Erb's counterclaim, and granted Erb's summary judgment motion on the Bank's claim for prejudgment interest and punitive damages.³² The trial court reasoned that the Bank was entitled to the proceeds because Erb's purchase money security interest was extinguished by the 1988 "global financing plan."³³ Thus, Erb took the money from the foreclosure sale subject to the Bank's security interest.³⁴ Also, because Erb retained the machinery after the sale, the court found Erb liable for conversion.³⁵ Both parties appealed.³⁶

On appeal, the Missouri Court of Appeals for the Eastern District affirmed in part and reversed in part.³⁷ By looking at the purpose of the Uniform Commercial Code and analyzing two existing rules adopted by other jurisdictions,³⁸ the court suggested that the definition of a "purchase security interest" includes a single security agreement that covers both purchase money debt and nonpurchase money debt as long as the agreement clearly delineates the

23. *Id.*

24. *First Nat'l Bank*, 921 S.W.2d at 60.

25. *Id.*

26. *Id.*

27. *Id.*

28. *Id.*

29. *Id.*

30. *Id.* at 60-61.

31. *Id.* at 61.

32. *First Nat'l Bank*, 921 S.W.2d at 61.

33. *Id.*

34. *Id.*

35. *Id.*

36. *Id.*

37. *Id.* at 64.

38. *Id.* at 61-62.

different debts, their respective collateral, and the portion of each payment to be applied to each debt.³⁹ Applying this interpretation to the facts at hand, the court found the 1988 agreement did not adequately differentiate between the two types of debt.⁴⁰ Thus, the court affirmed that Erb did not have a purchase money security interest and that the Bank's interest was superior.⁴¹ However, because the Bank never exercised its security interest in the equipment, the court reversed the Bank's entitlement to the proceeds from the sale and reversed Erb's conversion liability.⁴² Although Erb did not have a purchase money security interest in the equipment, Erb still had a valid security interest.⁴³ Absent repossession by the Bank, Erb had every right to exercise its security rights.⁴⁴

III. LEGAL BACKGROUND

A. Purpose of Article 9 of the Uniform Commercial Code

Article 9 of the Uniform Commercial Code was drafted ultimately to promote commercial activity.⁴⁵ The creation of a security interest facilitated this goal by encouraging lending through elimination of some of the risks creditors faced.⁴⁶ By receiving a security interest in collateral in return for a loan, a creditor's greatest advantage is that if the debtor defaults, the creditor can proceed directly against the asset using self-help measures provided in Article 9, without first having to initiate a lawsuit.⁴⁷

B. Blanket Security Interests

Some secured parties routinely take what is commonly referred to as a "blanket" security interest. This type of interest covers not only collateral owned by the debtor at the time of the agreement, but also all collateral that is later acquired by the debtor.⁴⁸ The benefits of a blanket security interest are obvious. The blanket creditor's interest will attach to every piece of collateral owned by the debtor.⁴⁹

39. *Id.* at 63.

40. *Id.*

41. *Id.*

42. *First Nat'l Bank*, 921 S.W.2d at 64.

43. *Id.*

44. *Id.*

45. U.C.C. § 1-102(2). Unless otherwise noted, all provisions cited to Uniform Commercial Code are identical to the provisions in Missouri's Uniform Commercial Code found in the Missouri Revised Statutes, Chapter 400.

46. U.C.C. § 1-102(2).

47. *See* U.C.C. § 9-503.

48. *See* U.C.C. § 9-204.

49. Technically, security interests attach to the debtor's rights in the collateral, not

However, blanket security interests can be detrimental to the debtor. If a debtor is subject to a blanket security interest, the debtor has essentially limited his access to additional credit. A debtor with a current blanket security interest attached to his collateral has little appeal to other creditors in the marketplace due to Article 9's priority rules. Those rules, set out in Section 9-312, resolve conflicts between multiple secured parties who have an interest in the same collateral. Section 9-312(5) states:

In all cases not governed by other rules in this section, priority between conflicting security interests . . . shall be determined according to the following rules:

(a) conflicting security interests rank according to priority in time of filing or perfection. Priority dates from the time a filing is first made covering the collateral or the time the security is first perfected, whichever is earlier, provided that there is no period thereafter when there is neither filing nor perfection.

(b) so long as conflicting security interest are unperfected, the first to attach has priority.⁵⁰

This general rule is commonly referred to as "the first in time rule." For blanket security interests, the interest in after-acquired property is perfected when it attaches,⁵¹ and that perfection will, for priority purposes, relate back to the *original filing date* on the blanket lien.⁵² Thus, the problem created by blanket security interests is that a blanket security interest creditor will always defeat a second subsequent creditor in any priority conflicts. Because of this priority rule, other creditors will not be as willing to loan to a debtor with a blanket security lien since other creditors will always be subordinate to the blanket security interest creditor. The problem for the debtor with a blanket security lien is that he will find himself in the stranglehold of the blanket secured party. If such secured party does not want to make subsequent loans to the debtor, the debtor may not be able to find any other willing creditors in the marketplace due to the existence of the blanket security lien.

However, the drafters of the UCC provided a safety mechanism to free a debtor from the stranglehold of any one creditor. The UCC provides exceptions to the general "first in time" priority rule. One such exception involves purchase

to the collateral itself. See U.C.C. § 9-311 and discussions *infra* note 192.

50. U.C.C. § 9-312(5).

51. In this context, attachment will typically occur when the debtor acquires rights in the collateral. See U.C.C. §§ 9-203(1); 9-303(1).

52. In this context, perfection will ordinarily be accomplished by the filing of a financing statement.

money security interests in collateral other than inventory.⁵³ Section 9-312(4) states:

A purchase money security interest in collateral other than inventory has priority over a conflicting security interest in the same collateral or its proceeds if the purchase money security interest is perfected at the time the debtor receives possession of the collateral or within ten days thereafter.⁵⁴

The debtor with an existing blanket security interest creditor has thus regained appeal to other creditors because now purchase money security interests will take priority. Even with an after-acquired property clause in a blanket security interest agreement, a subsequent purchase money secured party will have priority as long as it files within ten days.⁵⁵ If a subsequent creditor does not have a purchase money security interest, or fails to file within ten days, then the general priority rule of "first in time" would apply.⁵⁶ Hence, in knowing which priority rules to apply to conflicts among creditors, it is essential to first label the types of security interests that are involved.

C. Impact of Consolidation and Refinancing on Purchase Money Security Interest Status

Section 9-107 states:

A security interest is a 'purchase money security interest' to the extent that it is (a) taken or retained by the seller of the collateral to secure all or part of its price; or (b) taken by a person who by making advances or incurring an obligation gives value to enable the debtor to acquire rights in or the use of collateral if such value is in fact so used.⁵⁷

Although the definition appears to be straightforward, several questions are left unanswered. Two of the most prevalent questions now being debated in the courts are (1) what happens when purchase money debt is consolidated with nonpurchase money debt, and (2) what happens to purchase money debt when it is refinanced? Among the federal circuit courts and the state courts, there

53. The UCC also provides for exceptions for security interests in crops, U.C.C. § 9-312(2), and purchase money security interests in inventory, U.C.C. § 9-312(3).

54. U.C.C. § 9-312(4).

55. U.C.C. § 9-312(4). Missouri allows a secured party 20 days to file pursuant to MO. REV. STAT. § 400.9-312(4) (1994).

56. U.C.C. § 9-312(5)(a).

57. U.C.C. § 9-107.

exists a widespread debate on how to decide these issues.⁵⁸ Thus far, courts have adopted two main approaches.⁵⁹

One approach is to hold that refinancing of a purchase money loan, or consolidation with other debt, removes the “purchase money” status. Without purchase money status, a security interest is subject to the normal rules of priority.⁶⁰ These courts usually follow one of two lines of reasoning to reach this result.

Some courts reach this result by applying a strict, literal interpretation of the definition of purchase money security interest.⁶¹ These courts conclude that unless an interest secures only the specified collateral purchase price, it is not a purchase money security interest.⁶² This approach is commonly known as the “transformation” approach.⁶³ When a debtor refinances or consolidates, these courts find that the security interest no longer represents the collateral purchase price, hence it does not fit the definition of a purchase money security interest.⁶⁴

58. Many courts deal with purchase money status issues as disputes between debtors and creditors arising under Section 522(f) of the Bankruptcy Code because it allows the debtor to avoid liens in certain nonpurchase money security interests. *See* 11 U.S.C. § 522(f)(2) (1994).

59. *See infra* notes 62 and 81.

60. U.C.C. § 9-312(5)(a).

61. *See infra* note 62.

62. *See Snap-On Tools, Inc. v. Freeman*, 956 F.2d 252, 255 (11th Cir. 1992) (affirming Bankruptcy Court’s decision that creditor’s purchase money security interest was transformed into a nonpurchase money interest upon consolidation with other debts); *Southtrust Bank v. Borg-Warner Acceptance Corp.*, 760 F.2d 1240, 1243 (11th Cir. 1985) (finding exercise of future advances and after-acquired property clauses in security agreement destroyed purchase money status); *Roberts Furniture Co. v. Pierce*, 507 F.2d 990, 992 (5th Cir. 1975) (purchase money security interest extinguished when made to secure debt other than price of the collateral); *In re Hillard*, 198 B.R. 620 (Bankr. N.D. Ala. 1996) (finding that a refinancing agreement that extended the length of the loan, reduced the monthly payments, and increased the interest rate extinguished the creditor’s purchase money status); *Lee v. Davis/McGraw, Inc.*, 169 B.R. 790, 794 (Bankr. S.D. Ga. 1994) (finding purchase money security interest lost status when it secured more than the price of the collateral purchased in the transaction in which the interest was created); *In re Keeton*, 161 B.R. 410, 412 (Bankr. S.D. Ohio 1993) (purchase money security interest was transformed into nonpurchase money when debtors refinanced the security agreement); *Parish v. Lincoln Fin. Co.*, 147 B.R. 187, 188-89 (Bankr. E.D. Mo. 1992) (holding that when debtor combined purchase money security interest with other obligations, the interest was transformed into a nonpurchase money security interest); *Hipps v. Landmark Fin. Serv.*, 89 B.R. 264, 266 (Bankr. N.D. Ga. 1988) (after evaluating both transformation and dual-status rule, court follows transformation approach); *In re Snipes*, 86 B.R. 1006, 1009 (Bankr. W.D. Mo. 1988) (finding Missouri prior case law required consolidation of purchase money debt with nonpurchase money debt extinguished purchase money status).

63. *See supra* note 62.

64. *See supra* note 62.

For example, in *Parish v. Lincoln Finance Co.*,⁶⁵ the United States Bankruptcy Court for the Eastern District of Missouri held that refinancing and consolidation of the creditor's purchase money security interests "transformed" the security interest into a nonpurchase money security interest.⁶⁶ The plaintiffs had purchased several pieces of personal property in which the debtor retained a purchase money security interest.⁶⁷ After the original purchase, the plaintiffs purchased an additional item.⁶⁸ The seller refinanced the original agreement and consolidated the balance with the new purchase.⁶⁹ This process was repeated four additional times.⁷⁰ Although each subsequent agreement listed all the personal items as subject to a purchase money security interest, the court did not agree.⁷¹ The court concluded that "the consolidated agreement transformed even the claim of purchase money security interest in the most recent property into a nonpurchase money security interest."⁷²

Other courts reach this same result by applying the theory of novation.⁷³ These courts reason that a refinancing or consolidation extinguishes the prior purchase money debt because the original debt is treated as paid off and a new debt is incurred.⁷⁴ This new debt is not used to acquire the rights of the collateral, so it does not qualify as a purchase money security interest. Proponents of the novation rule rely on official Comment 2 to Section 9-107 to support their analysis. Comment 2 states:

When a purchase money security interest is claimed by a secured party who is not a seller, he must of course have given present consideration. This section therefore provides that the purchase money party must be one who gives value by "making advances or incurring an obligation;" the quoted language excludes from the purchase money category any security interest taken as security for or in satisfaction of a *pre-existing claim or antecedent debt*.⁷⁵

65. 147 B.R. 187 (Bankr. E.D. Mo. 1992).

66. *Id.* at 188-89.

67. *Id.* at 187.

68. *Id.*

69. *Id.*

70. *Parish*, 147 B.R. at 188.

71. *Id.* at 187-88.

72. *Id.* at 188-89.

73. See *Dominion Bank v. Nuckolls*, 780 F.2d 408, 413 (4th Cir. 1985) (following the novation approach of *Matthews v. Transamerica Financial Services*); *Matthews v. Transamerica Fin. Serv.*, 724 F.2d 798, 800 (9th Cir. 1984) (finding the "purchase money character of the security interest was extinguished when the proceeds from the first renewal note were used to satisfy the original note"); *Gillie v. First State Bank*, 96 B.R. 689, 693 (Bankr. N.D. Tex. 1989) (finding novation, when a second note paid off the first and destroyed bank's purchase money security interest).

74. See cases *supra* note 73.

75. U.C.C. § 9-107, cmt. 2 (emphasis added).

In *Mathews v. Transamerica Financial Service*,⁷⁶ the Ninth Circuit expressly adopted the novation approach. Plaintiff Mathews had taken an original loan to buy a piano and stereo from Transamerica Financial Service (Transamerica), which retained a purchase money security interest in the assets.⁷⁷ Subsequently, the plaintiff refinanced the loan.⁷⁸ Upon the plaintiff's filing for bankruptcy, the court, relying on Comment 2, found that the defendant no longer retained a purchase money security interest.⁷⁹ The court reasoned that the new loan proceeds were not used to acquire rights in the piano or stereo because the plaintiff already owned them.⁸⁰

The second main approach to questions of refinancing and consolidation is commonly known as the "dual-status approach."⁸¹ In contrast to the transformation and novation approaches, the dual-status rule concludes that a refinancing or consolidation does not automatically destroy a purchase money security interest.⁸² This rule allows security interests to be divided into portions of both purchase money debt and nonpurchase money debt. These courts premise their decision on the "to the extent" language of the definition of purchase money security interest.⁸³ Courts that have adopted this approach argue that this language indicates the drafters' intent to allow one security instrument to cover both purchase money and nonpurchase money obligations.⁸⁴

76. *Mathews v. Transamerica Fin. Serv.*, 724 F.2d 798 (9th Cir. 1984).

77. *Id.* at 799.

78. *Id.*

79. *Id.*

80. *Id.* at 800.

81. See *Billings v. Avco Colo. Indus. Bank*, 838 F.2d 405 (10th Cir. 1988) (allowing purchase money status to remain despite refinancing); *In re Pristas*, 742 F.2d 797, 801 (3d Cir. 1984) (rejecting the "transformation rule" as misguided and adopting the "dual-status approach" because it was more in harmony with the U.C.C.); *In re Krueger*, 172 B.R. 572, 575 (Bankr. N.D. Ohio 1994) (finding refinancing did not extinguish purchase money security); *In re Leftwich*, 174 B.R. 54, 60 (Bankr. W.D. Va. 1994) (distinguishing the facts of the case from a Fourth Circuit novation rule to find consolidated debt maintained its purchase money status); *In re Clark*, 156 B.R. 693, 695 (Bankr. S.D. Fla. 1993) (refinancing did not destroy creditor's purchase money security interest in stereo); *In re Parsley*, 104 B.R. 72, 75 (Bankr. S.D. Ind. 1988) (adopting the dual-status approach and applying FIFO, "finding it to be equitable to the parties and consistent with both congressional intent . . . and with state concerns"); *In re Hemingson*, 84 B.R. 604, 607 (Bankr. D. Minn. 1988) (adopting the dual-status rule "because it gives credence to the Uniform Commercial Code"); *Geist v. Converse County Bank*, 79 B.R. 939, 942 (D. Wyo. 1987) (rejecting transformation rule "because it ignores the critical language of § 9-107— 'to the extent that'").

82. See *Pristas*, 742 F.2d at 797; *Billings*, 838 F.2d at 405; *Short*, 170 B.R. at 128.

83. U.C.C. § 9-107. See *supra* note 57 and accompanying text for the exact wording of Section 9-107.

84. *Pristas*, 742 F.2d at 800.

The Third Circuit, in *In re Pristas*,⁸⁵ adopted the dual-status approach in finding that a purchase money security interest was retained even though that debt was consolidated with other subsequent purchases.⁸⁶ The court rejected the transformation rule, finding that its application is “inconsistent with the Commercial Code, which gives favored treatment to those [purchase money security interest] financing arrangements on the theory that they are beneficial both to buyers and sellers.”⁸⁷ The court went even further and decided how to allocate the debt by turning to a state statute.⁸⁸

Proponents of the dual-status approach criticize the transformation rule as being “unnecessarily restrictive and ignoring the commercial reality of the credit transactions.”⁸⁹ The dual-status approach arguably benefits both the debtor and the secured party by allowing the debtor to take advantage of a new, presumably favorable, financing arrangement while still allowing the creditor to maintain his superior purchase money security interest.

It should be noted, however, that even in cases that seem to embrace the transformation approach, a court also may partially embrace the dual-status approach. In the consolidation cases, many, if not all, of the courts implicitly indicate that if the instrument would clearly delineate which collateral was securing which debt, the court would uphold the purchase money security interest. For example, in *Southtrust Bank of Alabama National Association v. Borg-Warner Acceptance Corp.*,⁹⁰ the Eleventh Circuit expressly rejected the dual-status approach. However, the court’s decision seemed to be based on the fact that the court was “without some guideline, legislative or contractual, . . . to distill from a mass of transactions the extent to which a security interest is purchase money.”⁹¹ The court stated, “[U]nless the lender contractually provides some method for determining the extent to which each item of collateral secures its purchase money, it effectively gives up its purchase money status.”⁹² This dicta implicitly indicated the court’s willingness to adopt the dual-status approach in instances in which the distinction between the purchase money debt and nonpurchase money debt is made expressly clear in the instrument.

Several courts in the Seventh Circuit have expanded this proposition to the extent of having a “case-by-case” approach to determine the existence of purchase money status.⁹³ In *In re Short*, the United States Bankruptcy Court for

85. 742 F.2d 797 (3d Cir. 1984).

86. *Id.* at 802.

87. *Id.* at 801.

88. *Id.*

89. *In re Hillard*, 198 B.R. 620, 623 (Bankr. N.D. Ala. 1996).

90. 760 F.2d 1240, 1243 (11th Cir. 1985).

91. *Id.*

92. *Id.*

93. *See In re Short*, 170 B.R. 128 (Bankr. S.D. Ill. 1994); *In re Hatfield*, 117 B.R. 387, 389-90 (Bankr. C.D. Ill. 1990); *Gayhart v. Beneficial Fin. Co.*, 33 B.R. 699, 700-01 (Bankr. N.D. Ill. 1983); *Johnson v. Richardson*, 47 B.R. 113, 117 (Bankr. W.D. Wis.

the Southern District of Illinois continued to enforce the “middle-of-the-road approach” of Illinois courts to determine the status of purchase money security interests upon consolidation and refinancing.⁹⁴ The *In re Short* court found that a case-by-case approach better serves the “diversity of fact situations” encountered and “gives effect to the parties’ intent as derived from the facts of a particular transaction.”⁹⁵

Since this jurisdictional conflict has been present for quite a while now, it comes as no surprise to find that various legislative bodies are taking action. The National Conference of Commissioners on Uniform State Laws (NCCUSL) is beginning to recognize and rectify the problem. In 1992, a report of the Article 9 Study Committee to the Permanent Editorial Board (PEB) of the Uniform Commercial Code made a recommendation with regard to Section 9-107 that would end this debate.⁹⁶ The committee recommended revisions that would clarify that a security interest retains its purchase money status even if it secures nonpurchase money debt, is renewed, or is refinanced or restructured.⁹⁷ The committee also recommended placing the burden on the secured party to prove the extent to which a purchase money security interest exists.⁹⁸

This concept continues to be discussed in the current revision processes. Following up on the report of the Study Committee, NCCUSL (in conjunction with the American Law Institute) appointed a drafting committee to revise Article 9.⁹⁹ The revision is expected to be promulgated in 1998.¹⁰⁰ The October 1997 revised draft of Article 9 includes a provision that directly resolves the issue of how to handle refinancing and consolidation of purchase money security interests.¹⁰¹ Section 9-104(e)¹⁰² in the October 1997 draft reads:

A purchase money security interest does not lose its status as such even if:
 (1) the purchase money collateral also secures an obligation that
 is not a purchase money obligation;

1985).

94. *Short*, 170 B.R. at 133.

95. *Id.* at 134-35.

96. PERMANENT EDITORIAL BOARD OF THE UCC, REPORT OF ARTICLE 9 STUDY COMMITTEE (1992).

97. PERMANENT EDITORIAL BOARD OF THE UCC, REPORT OF ARTICLE 9 STUDY COMMITTEE (1992).

98. PERMANENT EDITORIAL BOARD OF THE UCC, REPORT OF ARTICLE 9 STUDY COMMITTEE (1992).

99. *Revision of Uniform Commercial Code Article 9-Secured Transactions; Sales of Accounts and Chattel Paper*, (visited Apr. 10, 1998) <[http:// www.law.upenn.edu/bll/ulc/ucc9/m12draft.htm](http://www.law.upenn.edu/bll/ulc/ucc9/m12draft.htm)>.

100. *Id.*

101. *Id.*

102. This draft has renumbered and reordered some sections. The definition of purchase money security interest that is currently in § 9-107 was moved to § 9-104 in the draft. *Id.*

- (2) collateral that is not the purchase money collateral also secures the purchase money obligation; or
- (3) *the purchase money obligation has been renewed, refinanced, consolidated, or restructured.*¹⁰³

With these proposed revisions, it becomes clear that the drafting committee advocates a dual-status approach. In the Comments following revised Section 9-107, the drafters expressly reject the transformation approach and adopt the dual-status approach.¹⁰⁴ To correlate with the adoption of the dual-status approach, the drafters also have included a new provision, Section 9-104(c) that details how payments are to be applied to obligations that include purchase money security interests and nonpurchase money security interests.¹⁰⁵ This provision resolves the practical accounting problems that arise when an obligation involves both purchase money and nonpurchase money.

On a state level, some legislatures already have made amendments and additions to Section 9-107 to statutorily indicate the effect of consolidation and refinancing on purchase money security interests. In 1981, Tennessee added a subsection (c) to Section 9-107 that allows for purchase money security interest to continue despite consolidation with other debt or refinancing and includes a first-in, first-out method of allocating payments.¹⁰⁶ In 1989, the Louisiana legislature added the following sentence to Section 9-107, "The fact that the collateral additionally secures other future indebtedness of the debtor as a result of cross-collateralization shall not affect purchase money security interest status."¹⁰⁷ And in 1993, the North Carolina legislature amended Section 9-107 to add, "A purchase money security interest under this section will continue in the collateral when the underlying security agreement is refinanced or modified with the same creditor."¹⁰⁸ These state legislative changes indicate an express adoption of the dual-status approach.

Based on the uniformity of the Study Committee Report and the draft revisions, it seems highly likely that Article 9 soon will expressly advocate the dual-status approach. Whether states that currently interpret purchase money security status using a transformation rule will follow the new provisions is a question left unanswered.

D. Priority Disputes over Foreclosure Proceeds

When a debtor extends security interests in the same collateral to two different creditors and then defaults, a dispute may arise between the creditors

103. U.C.C. § 9-104(e) (Proposed Official Revision 1997) (emphasis added).

104. *Id.*

105. *Id.*

106. TENN. CODE ANN. § 47-9-107(c) (1996).

107. LA. REV. STAT. ANN. § 10:9-107 (West 1990).

108. N.C. GEN. STAT. § 25-9-107 (1996).

concerning the available remedies. One particular dispute may arise between a senior secured party and a junior secured party when the junior holds a foreclosure sale. The senior will, of course, want the proceeds of the junior's sale.

Part 5 of Article 9 details the procedures available to secured parties upon the default of a debtor. Specifically, Sections 9-503 and 9-504 grant secured parties the right to repossess and dispose of the collateral after default by the debtor.¹⁰⁹ Lacking any language indicating a preference for particular secured parties, these rights extend to *all* secured parties.¹¹⁰ Thus, a junior secured party may conduct a foreclosure notwithstanding the existence of the senior.

Section 9-504(1) expressly ranks how the foreclosure proceeds are to be distributed.¹¹¹ First, the proceeds are to be applied to the foreclosure expenses incurred by the secured party.¹¹² Second, the proceeds are to be used to satisfy the security interest of the secured party holding the foreclosure sale.¹¹³ And lastly, the proceeds are to be used to satisfy any junior.¹¹⁴ Section 9-504(2) requires that any remaining surplus be turned over to the debtor.¹¹⁵

Read literally, these provisions leave a senior secured party out of the distribution process. Seniors, of course, argue for a different result. Although there are few cases dealing with this precise issue, the few available cases display that the courts are inclined to make the junior accountable to the senior for the proceeds of the junior's foreclosure sale.¹¹⁶

Courts suggesting that they would follow this approach rely heavily on the wording of Section 9-306(2), which states in relevant part that "a security interest . . . continues in any identifiable proceeds including collection received by the debtor" combined with the priority provisions of the UCC.¹¹⁷ Proponents of this result conclude that since the collateral is reduced to money, the senior retains priority with respect to the money.¹¹⁸

In *Consolidated Equipment Sales, Inc. v. First Bank Trust Co. of Guthrie*, for example, the Oklahoma Supreme Court required the junior secured party that conducted the foreclosure sale to turn over the proceeds of that sale to the

109. U.C.C. §§ 9-503, 9-504.

110. U.C.C. §§ 9-503, 9-504.

111. U.C.C. § 9-504(1).

112. U.C.C. § 9-504(1)(a).

113. U.C.C. § 9-504(1)(b).

114. U.C.C. § 9-504(1)(c).

115. U.C.C. § 9-504(2).

116. See *New Hampshire Bus. Dev. Corp. v. F.R. Lepage Bakery, Inc.*, 832 F.2d 7, 10-11 (1st Cir. 1987); *Stotts v. Johnson*, 791 S.W.2d 351, 353 (Ark. 1990); *Bank of Danville v. Farmers Nat'l Bank*, 602 S.W.2d 160, 164 (Ky. 1980); *Production Credit Ass'n v. Melland*, 278 N.W.2d 780, 788 (N.D. 1979); *Consolidated Equip. Sales, Inc. v. First State Bank & Trust Co.*, 627 P.2d 432, 438 (Okla. 1981).

117. U.C.C. § 9-306(2). See *supra* note 116.

118. See *supra* note 115.

senior.¹¹⁹ The court further stated that, because the junior had failed to turn over the proceeds, it was liable to the senior for conversion.¹²⁰ In reaching this decision, the court relied on Section 9-306(2).¹²¹ However, the court also expressly stated that the junior was entitled to repossess and sell the collateral, notwithstanding the fact that there was a senior security interest holder.¹²² Thus, the junior's wrong consisted of its failure to turn over the proceeds of sale, not its repossession and conduct of the sale.

In *Stotts v. Johnson*,¹²³ the Arkansas Supreme Court relied on the only extensive commentary relating to the issue at hand to hold that the junior creditor was required to turn the proceeds of the junior creditor's disposition over to the senior creditor.¹²⁴ The court quoted a policy argument presented in *Common Law and Equity Under the Uniform Commercial Code* which stated, "The plain meaning and logical implications of Sections such as 9-306 and 9-504 may be preempted by a pervasive spirit of priority that supports giving a senior secured party a claim to the proceeds of a junior creditor's collateral."¹²⁵

While some jurisdictions may follow this approach, current and past Article 9 provisions, scholarly commentary, and a few cases indicate that the drafters intended a different result.¹²⁶ Satisfaction of a superior security interest is deliberately excluded from the distribution of proceeds in Section 9-504(1).¹²⁷ Scholars have concluded that this indicates senior secured parties are not entitled to the proceeds from the junior's foreclosure sale.¹²⁸ Professor Steve Nickles, co-author of *Common Law and Equity*, argues that this proposition is strengthened by examining the 1950 Proposed Draft of the Uniform Commercial Code, Section 9-504.¹²⁹ Under this version, proceeds were distributed in a manner similar to the current Article 9 except that Section 9-504(1)(b) of this

119. *Consolidated Equip. Sales*, 627 P.2d at 438.

120. *Id.* (citing *Davidson v. First Nat'l Bank & Trust Co.*, 609 P.2d 1259 (Okla. 1976)). The conversion theory was premised on the fact that the repossessed collateral was sold in a commercially unreasonable manner because the junior creditor made repairs to collateral after repossession to sell it for higher price. *Id.*

121. *Id.*

122. *Id.*

123. 791 S.W.2d 351 (Ark. 1990).

124. *Id.* at 353.

125. *Id.* See HILLMAN, *infra* note 128, § 25.02[4][d].

126. See the following cases for examples of courts not allowing a senior the right to proceeds from a junior's foreclosure sale: *United States v. Cohoon*, No. 88-80-CIV-2, 1990 WL 488915, at *16 (E.D.N.C. Feb. 16, 1990); *Continental Bank v. Krebs*, 540 N.E.2d 1023, 1026 (Ill. App. Ct. 1989); *Chadron Energy Corp. v. First Nat'l Bank*, 459 N.W.2d 718, 733 (Neb. 1990); *First Union Nat'l Bank v. Tectamar, Inc.*, 235 S.E.2d 894, 896 (N.C. Ct. App. 1977).

127. See *supra* notes 111-15 and accompanying text.

128. R. HILLMAN, et. al., *COMMON LAW AND EQUITY UNDER THE UNIFORM COMMERCIAL CODE* § 25.02[4][a] (1985).

129. *Id.*

version specifically required that proceeds be applied to satisfy any security interests that had priority over the security interest under which the disposition was made.¹³⁰ Because this version was not adopted in the Final 1950 Proposed Draft (or ever as a part of the official text), the drafters implicitly have rejected the requirement that a junior secured party is liable to the senior secured party for proceeds from the junior's foreclosure sale.

Another argument against applying a junior creditor's proceeds towards a senior creditor's security interest is found by analyzing the remedies available to the senior secured party. When a secured party disposes of collateral after a default, Section 9-504(4) expressly discharges that security interest and any other *subordinate* security interest.¹³¹ Hence, all superior security interests still survive foreclosure. The sale by the junior does not leave the senior without a remedy. Because the senior still has a security interest, it can enforce this interest against the buyer of the collateral.¹³² Thus, it appears that the purpose of Section 9-504(1)(c)'s requirement that surplus proceeds are to be applied against the junior secured party's interest is that this remains the junior's only option after the sale by the senior has destroyed the junior's security interest.¹³³

Critics find that the senior's reliance on Section 9-306 to assert a right in a junior's proceeds is wrong for two reasons. First, and most importantly, it is inconsistent with the literal interpretation of the distribution scheme of Section 9-504.¹³⁴ Giving a senior rights in the junior's proceeds is the functional equivalent of adding a senior creditor in the distribution scheme of Section 9-504. However, Section 9-504 does not include a senior creditor in the allocation of the proceeds. And based on the historical analysis of Section 9-504 above, such an allocation has been expressly rejected by the drafters.

Second, reliance on Section 9-306 to find a continuing senior security interest in a junior's proceeds is misplaced.¹³⁵ The Official Comment to the 1972 official text states that the purpose of Section 9-306 is to state "a secured party's rights to the proceeds *received by the debtor* on disposition of collateral. . ."¹³⁶ Hence, a senior creditor cannot use this provision to assert his rights in a junior's proceeds because the section refers to proceeds received by the debtor, not a junior secured party. For example, in *United States v. Cohoon*, the United States District Court for the Eastern District of North Carolina rejected a senior's argument that a junior's proceeds qualified as proceeds "received by the debtor"

130. *Id.*

131. U.C.C. § 9-504(4).

132. Thus, buyers at foreclosure sales should pay no more than the value of the collateral's equity.

133. U.C.C. § 9-504(4). The junior has to request participation in writing.

134. *Chadron Energy Corp. v. First Nat'l Bank*, 459 N.W.2d 718, 733 (Neb. 1990).

135. *United States v. Cohoon*, No. 88-80-CIV-2, 1990 WL 488915, at *11-*16 (E.D.N.C. Feb. 16, 1990).

136. U.C.C. § 9-306, cmt. 1 (emphasis added).

within the meaning of Section 9-306.¹³⁷ The court stated that the “omission of senior secured creditors would seem to indicate that § 9-306(2) should be given a narrow reading so that the security interest continues only in proceeds received by the debtor.”¹³⁸ The court further added that “the current version added the words ‘proceeds including collections received by the debtor’ apparently for clarity’s sake and not out of desire to expand the category of proceeds in which a security interest continues.”¹³⁹

In *First National Bank v. Erb Equipment Co., Inc.*, a Missouri court was confronted for the first time with the issue of whether a junior secured party that conducted a foreclosure sale was accountable to a senior secured party. The court was also called upon to decide whether Missouri courts should follow the dual-status approach with regard to purchase money security interests.

IV. INSTANT DECISION

In resolving the instant case, the Missouri Court of Appeals for the Eastern District labeled the interests of the Bank and Erb, decided which secured party held the superior security interest, and analyzed what remedies a senior secured party has upon disposition of the collateral by a junior.¹⁴⁰

A. Labeling Interests

This court concluded that Erb’s agreement with the debtor did not meet the qualifications for a purchase money security interest.¹⁴¹ The court stated that in order for an instrument to retain its purchase money security interest status, the instrument must “clearly delineate the respective debts involved, which items of collateral secure purchase money, and the amount of payments which are to be applied against each purchase money portion of the instrument.”¹⁴² The court derived this result from the meaning of the words “to the extent of” found in the definition of purchase money security interest.¹⁴³ After expressly refusing to adopt either a transformation approach or dual-status approach, the court relied on the general purposes of these commercial transactions statutes, stated in Section 1-102(2), to determine the effect to give to that language.¹⁴⁴ The court reasoned that the rule adopted would facilitate commercial transactions because, by clearly indicating what each item of collateral secures what amount of

137. *Cohon*, 1990 WL 488915, at *11-*16.

138. *Id.* at *13.

139. *Id.*

140. *First Nat’l Bank v. Erb Equip. Co., Inc.*, 921 S.W.2d 57 (Mo. Ct. App. 1996), *appeal after remand*, No. 73068, 1998 WL 128619 (Mo. Ct. App. Mar. 24, 1998).

141. *Id.* at 63.

142. *Id.*

143. U.C.C. § 9-107.

144. *Id.* at 62-63.

purchase money, creditors are able to know exactly where they stand. Thus, borrowers are able to have flexibility to borrow from more than one source.¹⁴⁵ However, the court noted that since a purchase money security interest is an exception, the requirements of purchase money security interest status clearly must be met.¹⁴⁶

Because the agreement between the Bank and the debtor, consolidating both purchase money debt and nonpurchase money debt, did not clearly delineate the debts involved or how payments were to be applied, the court found the agreement did not retain any of its purchase money security interest status.¹⁴⁷ Because a purchase money security interest was not involved, the court applied the general rule of “first in time” between the Bank and Erb’s competing security interest.¹⁴⁸ Since the Bank was the first to perfect its interest, the court found that the Bank held a superior security interest.¹⁴⁹

B. Damages

By applying the provisions set out in Part 5 of Article 9, the court found: (1) Erb was not guilty of conversion, and (2) the Bank’s superior security interest did not apply to the proceeds from Erb’s foreclosure sale of the debtor’s collateral.¹⁵⁰

Because Erb had a valid security interest in the debtor’s collateral, Section 9-503 permitted Erb to take possession of the collateral on default.¹⁵¹ The court noted Erb’s right to take possession was irrelevant as to whether the Bank had a superior interest because Erb held a valid security interest, and the right to repossess and to conduct a foreclosure sale applies to all secured parties.¹⁵² Since Erb’s foreclosure sale was expressly permitted by statute, the court found Erb was not liable for conversion.¹⁵³

Also, the court relied on Section 9-504 to find that the Bank’s superior security interest did not require Erb to be accountable to the Bank for Erb’s proceeds from the foreclosure sale. Because Section 9-504(1) ranks how the proceeds are to be disposed of, and because a superior security interest is not mentioned in this list, the court concluded that a superior security interest is not one of the categories of distribution for the proceeds.

145. *Id.*

146. *Id.* at 63.

147. *Id.*

148. U.C.C. § 9-312(5)(a).

149. First Nat’l Bank v. Erb Equip. Co., Inc., 921 S.W.2d 57, 63 (Mo. Ct. App. 1996), *appeal after remand*, No. 73068, 1998 WL 128619 (Mo. Ct. App. Mar. 24, 1998).

150. *Id.* at 64.

151. *Id.*

152. *Id.*

153. *Id.*

The court, however, did note that the Bank's security interest was not extinguished by the sale of the collateral by Erb, the inferior interest holder.¹⁵⁴ The court further stated that, presumably, the Bank still had its security interest in the collateral and could enforce that interest against the buyer of the collateral.¹⁵⁵

Based on the above findings, the court affirmed the declaration of the Bank's superior security interest and reversed the award of damages to the Bank for the proceeds of Erb's foreclosure sale.¹⁵⁶

V. COMMENT

A. Purchase Money Security Status

In *First National Bank v. Erb Equipment Co., Inc.*,¹⁵⁷ the Missouri Court of Appeals signaled Missouri's increasingly liberal approach towards Article 9 of the UCC in order to facilitate the Article's underlying purpose of promoting commercial activities.

Using the bankruptcy courts as indicators, Missouri courts typically have followed a transformation approach in dealing with purchase money security interests.¹⁵⁸ Although the *First National Bank* court declined the opportunity to expressly adopt either the transformation or dual-status rule, the court's decision implicitly rejected the transformation and adopted the dual-status approach.¹⁵⁹ *First National Bank* declared that unless an instrument clearly delineates the respective debts involved, which item of collateral secures its purchase money, and the amount of the payments to be applied against the purchase money portion of the instrument, the creditor loses any original purchase money security status.¹⁶⁰ The adoption of the rule embraced in *First National Bank* indicates the court's desire to abandon the rigid application of the transformation rule.

Concededly, the transformation rule provides for a clear, bright-line approach. However, a bright-line approach is not always consistent with carrying

154. *Id.* at 64.

155. *Id.* In fact, the Bank successfully asserted its security interest in a replevin action against Erb, who, in addition to being the seller at the foreclosure sale, also was the buyer. *First Nat'l Bank v. Erb Equipment Co., Inc.*, No. 73068, 1998 WL 128619 (Mo. Ct. App. Mar. 24, 1998).

156. *Id.* The court found the other issues raised by the parties concerning Erb's affirmative defenses, the commercial reasonableness of the sale, punitive damages, and prejudgment interest to be moot. *Id.*

157. *First Nat'l Bank*, 921 S.W.2d 57.

158. See *In re Snipes*, 86 B.R. 1006 (Bankr. W.D. Mo. 1988); *In re Faughn*, 69 B.R. 18 (Bankr. E.D. Mo. 1986); *In re Jackson*, No. 40666, 1971 WL 17851 (Bankr. W.D. Mo. Feb. 17, 1971).

159. *First Nat'l Bank*, 921 S.W.2d at 62.

160. *Id.* at 63.

out intended purposes. The rule adopted in *First National Bank* allows for the flexibility the UCC requires.

The dual-status analysis is better suited to the provision of the Uniform Commercial Code for three reasons. First, there is a valid argument that the transformation and novation approaches are seriously flawed. Robert Lloyd, professor of law at the University of Tennessee, explained these flaws in his article entitled "Consolidated and Refinanced Purchase Money Loans Under the Bankruptcy Code and the Uniform Commercial Code."¹⁶¹ The problem with the transformation approach is that earlier courts read too much into Official Comment 2 to Section 9-107.¹⁶² The comment specifically excluded "from the purchase money category any security interest taken as security for or in satisfaction of a pre-existing claim or antecedent debt."¹⁶³ This emphasizes the obvious point that purchase money cannot be antecedent debt.¹⁶⁴ This does not logically extend to the conclusion drawn by courts that if *any* part of the debt secured is nonpurchase money, then the purchase money portion loses its purchase money status.¹⁶⁵

The novation approach is flawed due to an uncritical reading of early novation decisions.¹⁶⁶ When the novation approach to destroying purchase money status was created, it already was established that the intent of the parties is a critical element in finding that a novation occurred.¹⁶⁷ However, early courts did not expressly make this clear in their decisions. Thus, subsequent cases interpreted earlier novation cases to mean that a novation occurred *every* time refinancing occurred, ignoring the parties intentions.¹⁶⁸ Thus, when the Fifth and Ninth Circuits endorsed the transformation and the novation approaches respectively, subsequent courts that encountered the issue turned to these flawed decisions as authority.¹⁶⁹

Second, the specific provisions of Article 9 indicate that the drafters intended purchase money security interest to receive "preferential" treatment.¹⁷⁰ A court's adoption of either a transformation or novation rule seriously hinders the ability of a creditor to take advantage of a purchase money security interest. Thus, when courts adopt such rules and demonstrate reluctance towards

161. Robert M. Lloyd, *Consolidated and Refinanced Purchase Money Loans Under the Bankruptcy Code and the Uniform Commercial Code*, 45 CONS. FIN. L.Q. 69 (1991).

162. Lloyd, *supra* note 161, at 70.

163. *See supra* note 75 and accompanying text.

164. Lloyd, *supra* note 161, at 70.

165. Lloyd, *supra* note 161, at 70.

166. Lloyd, *supra* note 161, at 71.

167. Lloyd, *supra* note 161, at 71.

168. Lloyd, *supra* note 161, at 71.

169. For Fifth Circuit endorsement of transformation, *Roberts Furniture Co. v. Pierce*, 507 F.2d 990, 996 (5th Cir. 1975). For the Ninth Circuit endorsement of novation, see *supra* note 73 and accompanying text.

170. *See In re Pristas*, 742 F.2d at 797, 801 (3d Cir. 1984).

maintaining purchase money security status, they abrogate the drafters' intent that these interests to be favored. In a transformation approach, the creditor must choose between foreclosing immediately or risking a loss in a bankruptcy proceeding by refinancing the security agreement. To the debtor's detriment, many creditors presumably would prefer to foreclose immediately.

Third, the novation and transformation approaches ignore the precise wording of Section 9-107.¹⁷¹ If the drafters had not intended that a security interest could cover both purchase money debt and nonpurchase money debt, there would be no effect of the language "to the extent."¹⁷²

One possible criticism of the dual-status approach is the increase in transactional costs. Presumably, the creditor will be the one that carries most, if not all, of the increased costs. The creditor will want to ensure the proper procedures are followed so that any original purchase money security interest that is affected by refinancing, consolidating, or securing additional debt or collateral will maintain its purchase money security interest status. This is crucial to the creditor because, for him, the biggest advantage of purchase money security status is that his interest is superior to all other creditors. That is, a different priority rule applies to creditors who have purchase money security interest status.¹⁷³ The debtor will be less concerned with the status because upon default he probably is indifferent to whether a superior or subordinate creditor forecloses on his collateral.¹⁷⁴ Notably, it does not seem unreasonable that the bulk of the increased transactional costs should fall on the creditor because the creditor who preserves the purchase money security interest status gains from the rule.

Besides being logistically consistent with the provisions of the Uniform Commercial Code as explained above, the *First National Bank* decision also has several practical advantages that facilitate the underlying purpose of the purchase money security interest—to facilitate the flow of financing.¹⁷⁵

One of the crucial advantages of the rule adopted in *First National Bank* is that it is a giant step toward resolving the status of purchase money security interests. Because the definition of purchase money security interests lends little help and jurisdictions have conflicting results, both creditors and debtors are left in a bewildered state as to the legal effect of original purchase money secured interests that are subsequently altered in some manner. It is important for courts to remove the uncertainty that exists in this area if secured transactions are to be facilitated properly. Currently, in the legal market there are many unintended

171. *Billings v. Avco Colorado Indus. Bank*, 838 F.2d 405, 408 (10th Cir. 1988).

172. *Id.*

173. See *supra* note 54 and accompanying text.

174. In a bankruptcy proceeding, the debtor may actually prefer that the security interest loses purchase money security status so that the creditor's lien may be avoided pursuant to 11 U.S.C. § 522(f) (1994).

175. *Snap-On Tools Corp. v. Freeman*, 124 B.R. 840, 843 (Bankr. N.D. Ala. 1991).

risks¹⁷⁶ to debtors and creditors because it is unclear where the law stands. Hence, in the midst of this jurisdictional conflict, the benefits of secured transactions on the commercial market are deteriorated. The *First National Bank* court's rule begins removing this uncertainty to give creditors a clearer picture of their position.

Another practical advantage to the adopted rule is that potential creditors will be able to easily ascertain the status of any security interest. Debtors implicitly will benefit from this because they will be equipped with the potential to fully leverage the value of any collateral. The clear delineation requirement will let other creditors know what value, if any, is left in the collateral over and above the purchase money security interest.

A final advantage of the *First National Bank* dual-status approach is that it encourages creditors holding purchase money security interests to help debtors work out financial problems without filing for bankruptcy.¹⁷⁷ A good illustration of this premise is found in *Billings v. Avco Colorado Industrial Bank*.¹⁷⁸ In *Billings*, the United States Court of Appeals for the Tenth Circuit found that a security agreement maintained its purchase money status even after the debtor and creditor had refinanced the agreement.¹⁷⁹ The debtor had run into some financial difficulty and was not able to make the required payment to the creditor for furniture purchased.¹⁸⁰ The creditor refinanced the agreement, reducing the monthly payment from \$105.50 to \$58.00.¹⁸¹ The new agreement canceled the old note and specifically stated that the creditor would maintain a purchase money security interest in the collateral.¹⁸² Within the refinancing process, although no new collateral was added, an additional \$9.67 was advanced to the debtor.¹⁸³ In this instance, a dual-status approach allowed the creditor to cooperate with the debtor and yet still preserve his security status even though refinancing occurred.¹⁸⁴ This result could not have occurred in a transformation jurisdiction.

As illustrated by the facts in *Billings*, many courts that adopt the dual-status approach do so because of its effect on credit transactions. The adoption of the transformation or novation approach could have a "chilling" effect on credit transactions by forcing some creditors to refrain from extending credit due to the added risk that the purchase money status easily could be destroyed, losing the

176. "Unintended risks" meaning risks not expected by the drafters of the UCC.

177. *Billings*, 838 F.2d at 409.

178. 838 F.2d. 405 (10th Cir. 1988).

179. *Id.* at 409.

180. *Id.* at 406.

181. *Id.*

182. *Id.*

183. *Id.*

184. *Id.* at 409.

creditor's priority status and leaving the creditor out of any bankruptcy proceeding.¹⁸⁵

While the *First National Bank* rule seems clear, there appear to be some issues that neither the rule nor the court addresses. For example, the rule requires the instrument to have an allocation provision that apportions the payments. But could a Missouri court rely on a state statute to determine the allocation method as in *In re Pristas*?¹⁸⁶ Presumably, as the rule is applied to varying facts, the rule will develop to maintain the secured transaction goals.

In *In re Keeton*, the United States Bankruptcy Court for the Southern District of Ohio adopted the transformation approach.¹⁸⁷ The court recognized the policy considerations advanced by dual-status courts, but found that such policy considerations were "the domain of Congress rather than this court."¹⁸⁸ This statement has much validity. While the literal language of the provisions does support a dual-status approach, the widespread inconsistency among court decisions should convince the legislature to intervene to directly address the issue. Thus, the Missouri court decision in *First National Bank* paved the way for the Missouri legislature to settle the issue.

B. Damages

The other legally significant issue of this case is the court's treatment of damages. As discussed earlier, jurisdictions who have confronted the issue of a superior creditor's rights when a subordinate creditor forecloses on a debtor's collateral seem to suggest that the superior creditor is entitled to the proceeds.¹⁸⁹ Applying the UCC provisions, the *First National Bank* court correctly concluded that the senior creditor did not have rights in the junior creditor's proceeds.

Interestingly enough, while the court's decision has major precedential value on the issue of resolving conflicts between a junior creditor and a senior creditor when a junior creditor conducts a foreclosure sale, the court's analysis was only a few paragraphs long. The following section will attempt to decipher the court's limited disclosure of its reasoning behind the holding that the Bank was not entitled to the proceeds of Erb's foreclosure sale.

The first step in the analysis is understanding the effect of a security interest in collateral. A security interest attaches to certain rights in collateral. However, even after a secured creditor attaches his interest in collateral, the debtor still maintains rights in the secured collateral. The debtor usually retains two main

185. *In re Clark*, 156 B.R. at 695. See *supra* note 58 for the effect of Section 522(f).

186. *In re Pristas*, 742 F.2d at 801-802 (finding that a state statute of the Goods and Services Installment Act could be used to supply an apportionment formula).

187. *In re Keeton*, 161 B.R. at 412.

188. *Id.*

189. See *supra* note 116 and accompanying text.

rights. First, the debtor usually retains the right to possession of the collateral.¹⁹⁰ Second, the debtor retains the right to equity in the collateral.

The concept of the debtor's equity is best illustrated by an example. Suppose X, a debtor, is able to purchase a \$12,000 widget for only \$10,000. Bank loans X the \$10,000 to buy the widget and, pursuant to the loan agreement, takes a security interest in the widget. Upon default by X, Bank can repossess the widget and sell it. Suppose at the time of the foreclosure sale the widget's fair market value is still \$12,000. Bank is entitled to only the amount of the security interest, \$10,000. X is entitled to the surplus, \$2,000. This process extracts the debtor's equity in the collateral and returns it to the debtor.

Because the debtor retains possessory and equity rights in collateral even after a security interest attaches, the debtor is able to use the remaining rights in the collateral as security interests for other creditors pursuant to Section 9-311. Section 9-311 specifically states that "[t]he debtor's rights in collateral may be voluntarily or involuntarily transferred notwithstanding a provision in the security agreement prohibiting any transfer or making the transfer constitute a default." A debtor may offer his remaining rights of equity and possession in the collateral as a security interest to another creditor.

The next step in the court's reasoning relies on the remedies provided for in Sections 9-503 and 9-504. These sections grant *a secured party* the right to possess the collateral after default by the debtor and the right to dispose of the collateral after default by the debtor.¹⁹¹ These rights are granted to *all* secured parties, regardless of whether they are a superior or subordinate creditor.

Finally, it is important to make the crucial distinction that security interests attach to the debtor's *specific rights* in the collateral; security interests do not attach to the collateral itself.¹⁹² As discussed earlier, when a debtor uses the same collateral for a second security interest, the debtor has transferred his *remaining* rights in the collateral; these rights are entirely different from the rights transferred to a prior creditor. Thus, when collateral is sold by a secured party at a foreclosure sale, the sale extinguishes *that party's security interest* in the collateral. The proceeds reflect the sale of that particular security interest. The foreclosure sale does not necessarily extinguish all other interests in the collateral. However, the UCC specifically states that when a superior security interest holder conducts a foreclosure sale, the sale does extinguish any junior security interests.¹⁹³ Proceeds from a foreclosure sale represent the value of that secured party's rights in the collateral; they do not necessarily represent the value of all the rights in the collateral. Thus, it is important for a buyer at a

190. There are some instances in which the secured party maintains possession of the collateral. See U.C.C. § 9-305.

191. U.C.C. §§ 9-503; 9-504.

192. See U.C.C. § 9-203(1)(c) requiring a debtor to have rights in the collateral for a security interest to exist. See also U.C.C. § 9-311.

193. U.C.C. § 9-504(4)

foreclosure sale to know the status of collateral in order to know which debtor's rights in the collateral the buyer is purchasing.

Applying these basic principles to the facts at hand, it becomes clear that the Bank had no right to the proceeds from Erb's foreclosure sale because they were not proceeds of the Bank's security interest; they were proceeds of Erb's security interest. When AmEarth defaulted, Erb had every right under Sections 9-503 and 9-504 to foreclose on AmEarth's equipment because Erb held a valid security interest in the equipment.¹⁹⁴ Erb's foreclosure sale extinguished Erb's security interest in the property, but not the Bank's security interest. Section 9-504(4) would not apply here, because as decided by the court, Erb was the junior secured party. Because the Bank's security interest has not been extinguished by Erb's foreclosure sale, the Bank still may assert its security interest rights.

This conclusion that a junior creditor is not liable to a senior creditor for proceeds from the junior's foreclosure sale appears to be consistent with the UCC provisions. A senior is not harmed by the junior's foreclosure sale and still has ways to vindicate his rights. The senior's security interest still exists and may be asserted against two possible parties: the buyer at the foreclosure sale or sometimes the junior.¹⁹⁵

It is clear that this is the correct result when contrasted with the protective measures available to the junior secured party when the *senior* secured party conducts the foreclosure sale. Pursuant to Section 9-504(4), the junior security interest is extinguished by the superior security interest holder's foreclosure sale.¹⁹⁶ Yet, the junior secured party has a right to proceeds from the senior's foreclosure sale pursuant to Section 9-504(1).¹⁹⁷ When the junior conducts the sale, the senior has no right to the proceeds, but his security interest has not been extinguished. Some critics of this approach argue that this result is economically inefficient and discourages people from buying at a foreclosure sale.¹⁹⁸

The efficiency argument stems from the scenario illustrated by the facts of this case. Both the senior creditor and the junior creditor presumably will end up conducting foreclosure sales to satisfy their security interests when, in effect, one sale could be conducted and both the security interests could be satisfied

194. It is important in the facts of this case that the superior creditor, the Bank, never attempted to possess or demand possession of the collateral before Erb's foreclosure sale.

195. In fact, the Bank successfully asserted its security interest in a replevin action against Erb, who, in addition to being the seller at the foreclosure sale, was the buyer. *First Nat'l Bank v. Erb Equipment Co., Inc.*, No. 73068, 1998 WL 128619 (Mo. Ct. App. Mar. 24, 1998).

Notice, however, that a senior may not assert his rights against a "good faith purchaser" pursuant to U.C.C. § 9-504(4).

196. U.C.C. § 9-504(4).

197. U.C.C. § 9-504(1).

198. *See supra* note 128, § 25.04[d].

according to ranking. This is the approach when the superior creditor conducts the sale.

However, the inefficient result from the facts of *First National Bank* do not represent inefficiency within the UCC provisions. Rather, the inefficiency was actually created by the actions of the parties. This is best illustrated by examining how different facts in this case would have produced an entirely different result. First, the Bank could have repossessed the collateral first and held the foreclosure sale itself. In that instance, Sections 9-504(1) and (4) would apply such that one foreclosure sale would have been conducted to extinguish the Bank and Erb's security interests. This did not happen here because the Bank failed to repossess the collateral first.

Second, the Bank's precise actions were determinative of the outcome in this case. The Bank requested that the collateral be returned to *AmEarth*, the debtor. The Bank never requested that the collateral be turned over to the *Bank*. If the Bank had requested possession of the collateral, and Erb failed to turn the collateral over, the Bank then would have had a conversion claim against Erb.¹⁹⁹ Thus, the reason for this inefficient result of two sales is because the Bank presumably did not understand its rights. The UCC contains provisions that allows a senior superior rights to conduct a foreclosure sale.²⁰⁰ These provisions support the argument that the drafters did not intend junior creditors conducting their own foreclosure sales to be liable to senior creditors for the junior's proceeds.

The second critique is that this approach discourages buyers at a foreclosure sale.²⁰¹ Critics argue that this result lowers the number of potential buyers at a foreclosure sale, which, in turn, lowers the overall prices paid.²⁰² This argument can be expanded. Buyers at foreclosure sales are threatened with the risk that an outstanding senior secured interest will be enforced against them. This increased risk may drive down the price that buyers are willing to pay for the collateral. This effectively would impede the subordinate creditor's rights to receive a commercially reasonable value for the collateral. The problem with this criticism is that the risks involved in foreclosure sales are not unique to security interest transactions. The discussed risks are an inherent feature of any foreclosure sale. This argument has less weight when one considers there are many mechanisms out there for a buyer to protect himself.

Policy implications dictated the result of *First National Bank*. First, junior creditors should not be hindered in any manner by inaction of a senior secured creditor. Thus, junior creditors should be allowed to conduct their own foreclosures regardless of the existence of a senior. Second, senior creditors

199. See *supra* note 128, § 25.02[2][c] explaining how Section 9-201 gives a superior secured party a superior right to possession over a subordinate secured party.

200. See *supra* note 128, § 25.02[2][c] explaining how Section 9-201 gives a superior secured party a superior right to possession over a subordinate secured party.

201. See *supra* note 128, § 25.04[d].

202. *Id.*

should not be overprotected. The UCC provides mechanisms for the senior to protect his rights. Thus, it is unnecessary for the courts to read more into the provisions that would allow a senior priority rights in a junior's proceeds.

The approach involved in the *First National Bank* decision is consistent with the provisions of Article 9. While other jurisdictions would have reached a contrary result in determining which creditor was entitled to the proceeds, a contrary finding would reward an ignorant party and set dangerous precedents that are not supported by the provisions of Article 9. The Missouri Court of Appeals' decision correctly applied the provisions so that the holding, inefficient as it may be, left the senior secured party with the fruits of its own actions and the proper interpretation of Article 9 undisturbed.

VI. CONCLUSION

The facts that arose in *First National Bank* forced the Missouri Court of Appeals to make some critical decisions. The court decided that a purchase money security interest can survive refinancing and consolidation and that a senior creditor does not have priority to a junior creditor's foreclosure proceeds. These decisions ensure that secured transactions will remain a vital part of Missouri's commercial arena for years to come.

STACEY A. TURLEY