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## Secured Party's Right to Sue Third Persons for Damage to or Defects in Collateral

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# Secured Party's Right to Sue Third Persons for Damage to or Defects in Collateral

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## I. Introduction

The proverb "there is many a slip 'twixt the cup and the lip" might have been written with the secured creditor in mind.<sup>1</sup> Many tragedies may befall him to defeat his expectations. He takes his security interest hoping for the best, but preparing for the worst—nonperformance of the obligation secured. If he does not carefully comply with the Article Nine provisions concerning the enforceability and perfection<sup>2</sup> of a security interest, he may ultimately be unsecured. If his security interest is enforceable and perfected, it may turn out that some other party has priority to the collateral.<sup>3</sup> Even if the secured party has priority, the collateral may be worth less than expected. The purpose of this article is to explore the rights of a secured party in the event that this tragedy befalls him as a result of damage to the collateral caused by a third person or because the collateral proves to be defective and, thus, worth less than anticipated. Such rights may be particularly important when the collateral is uninsured through oversight of the secured party or debtor or when adequate insurance coverage cannot be obtained.

## II. Secured Party's Claim

Article Nine of the Uniform Commercial Code does not contain a general provision dealing with the question of when a secured party can sue a third person for damage to or defects in the collateral. However, Article Two does indicate the circumstances under which a seller who has retained a security interest in goods for all or a part of their price may sue a third person who damages them.<sup>4</sup> Since the Code contains no cognate provision applicable to a

secured lender, the pre-UCC law, tempered by the philosophy and mechanics of Article Nine, would appear to control.

### A. Secured Seller

Uniform Commercial Code section 2-722, captioned "Who Can Sue Third Parties for Injury to Goods," provides that

Where a third party so deals with goods which have been identified to a contract for sale as to cause actionable injury to a party to that contract

- (a) a right of action against the third party is in either party to the contract for sale who has title to or a security interest or a special property or an insurable interest in the goods; and if the goods have been destroyed or converted a right of action is also in the party who either bore the risk of loss under the contract for sale or has since the injury assumed that risk as against the other;
- (b) if at the time of the injury the party plaintiff did not bear the risk of loss as against the other party to the contract for sale and there is no arrangement between them for disposition of the recovery, his suit or settlement is, subject to his own interest, as a fiduciary for the other party to the contract;
- (c) either party may with the consent of the other sue for the benefit of whom it may concern.

Section 2-722 applies only when the secured seller is a party to and the goods sold are identified to the same con-

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1. Regrettably, it was not. According to J. Bartlett, *Familiar Quotations* 311 (14th ed. 1968) it originated prior to Article Nine, sometimes being attributed to the Greek poet Homer.

2. See Uniform Commercial Code (1962 Official Text) §§9-203; 9-302; 9-401; 9-402 [hereinafter "UCC"]. Differences between this version of the UCC and the 1972 Official Text will be noted when significant.

3. See UCC §9-312(1).

4. See UCC §2-722. Concerning the relationship between the provisions of Articles Two and Nine, see UCC §§2-102; 9-206(2).

tract for sale. In effect, the goods contemplated by this provision are purchase money collateral.<sup>5</sup> The section is also not applicable until the goods have been identified to the contract. Prior to that time only the seller has a right of action.<sup>6</sup> Identification occurs when it is apparent that the goods in question are the ones to which the contract pertains.<sup>7</sup> After identification has occurred the seller may sue, even if the goods have been accepted by the buyer,<sup>8</sup> if the seller has a security interest in the goods or any other interest or status specified in section 2-722.<sup>9</sup> The term "security interest" is defined in Article One as "an interest in personal property or fixtures which secures payment or performance of an obligation."<sup>10</sup> Thus, section 2-722 applies to, but is not limited to, consensual security interests in personalty created pursuant to Article Nine. It also applies to security interests arising under Article Two.<sup>11</sup>

Section 2-722, which was intended to "extend somewhat the principle of the statutes which provide for suit by the real party in interest,"<sup>12</sup> changed or clarified the pre-Code law in a number of respects as it applied to secured sellers. It is not necessary that the buyer be in default in order for the secured seller to be a real party in interest with standing to sue for damage to the collateral.<sup>13</sup> The secured seller can sue for the total amount of damages to the collateral, even if those damages exceed the value of his security interest,<sup>14</sup> and even if the risk of loss passed to the buyer before the goods were damaged (as will often be the case),<sup>15</sup> because section 2-722 permits the seller to sue, subject to his own interest, as a fiduciary for the buyer.<sup>16</sup> A recovery by the secured seller should bar the buyer from bringing a second successful action against the tortfeasor.<sup>17</sup> The seller can sue in his own right for the full amount of damages to the goods if he assumes the risk of loss by permitting the buyer to cancel the contract after conforming goods are destroyed while the risk of loss is on the buyer.<sup>18</sup> Section 2-722 also specifically permits the secured party to sue on the debtor's behalf, with the debtor's consent, as well as on his own behalf. In such a case, the

parties should agree in advance on matters such as the division of litigation expenses and the disposition of any amount recovered.

Section 2-722 does not state whether a secured seller with an enforceable but unperfected security interest is a real party in interest for purposes of suing for damage to the collateral.<sup>19</sup> Arguably, his unperfected status should not of itself deprive the secured seller of standing because perfection is relevant to the rights of a secured party in the collateral as against the rights of third persons who might also claim an interest in the collateral.<sup>20</sup> But the unperfected secured seller's right to any recovery should be no better than his right to the collateral. Thus, if a secured seller holds an enforceable but unperfected security interest which is defeated by another person who has a perfected security interest also obtained prior to the damage to the collateral, the unperfected secured seller should also be subordinate to this other person with respect to any recovery obtained from the person who damaged the collateral. By a parity of reasoning, a secured seller who has an enforceable and perfected security interest should be subordinate with respect to such a recovery to any other perfected secured party who also obtained a security interest in the collateral before it was damaged and who has priority to the goods under an Article Nine priority provision.<sup>21</sup> Section 2-722 does not address these sorts of problems.

Section 2-722 is also not clear concerning whether a secured seller can be a real party in interest if his security interest is not enforceable. In the case of a nonpossessory security interest, nonenforceability is the result if the debtor did not sign a security agreement containing an adequate description of the collateral. If his Article Nine security interest is not enforceable, the seller will have no Article Nine or equitable right to possess the goods if the debtor defaults.<sup>22</sup> Thus, the question is whether the seller, with no in rem Article Nine rights in the goods sold and *sans* any other basis for standing under section 2-722,<sup>23</sup> is

5. See UCC §9-107. Presumably, pre-Code law would control the seller's right to sue for injury to nonpurchase money collateral. See UCC §1-103. See generally 3 L. Jones, *The Law of Chattel Mortgages and Conditional Sales* §1374 (1933) (hereinafter "Jones"); notes 32-41 and accompanying text *infra*.

6. UCC §2-722 Comment.

7. See UCC §2-501.

8. This was not always the case. See American Law Institute, National Conference of Commissioners on Uniform State Laws, *1956 Recommendations of the Editorial Board for the Uniform Commercial Code* 84-85 (1956) [hereinafter "1956 Recommendations"]; State of New York, *Report of the Law Revision Commission* 588 (1955) [hereinafter "1955 New York Rpt."].

9. See *Leist v. Schattie*, 197 Pa.Super. 456, 179 A.2d 277 (1962).

10. UCC §1-201(37).

11. See UCC §§9-113 and Comment 1; 9-102. See generally Hogan, *The Marriage of Sales to Chattel Security in the Uniform Commercial Code: Massachusetts Variety*, 38 Bost.U.L.Rev. 571, 571-88 (1958).

12. UCC §2-722 Comment. See generally F. James, *Civil Procedure* §§9.2; 9.6 [hereinafter "James"].

13. See generally Annot., 67 A.L.R.2d 582 §3(1959). Section 2-722 leaves intact the pre-Code rule that the contributory negligence of the buyer is no defense to an action by the secured seller. See *id.* §7.

14. See *id.* §9.

15. See UCC §§2-509; 2-510.

16. Concerning the fiduciary duty imposed by section 2-722(b), see *Greisler Bros., Inc. v. Packerland Packing Co.*, 392 F.Supp. 206, 17 UCC Rep. Serv. 1016 (E.D. Wis. 1975) and *Ninth Street East, Ltd. v. Harrison*, 259 A.2d 772, 7 UCC Rep. Serv. 171 (Conn. Cir. Ct. 1968).

17. *1955 New York Rpt.* at 718. See generally note 37 and accompanying text *infra*.

18. UCC §2-722(a). See *National Compressor Corp. v. Carrow*, 417 F.2d 97, 6 UCC Rep. Serv. 1240 (8th Cir. 1969). In such a case, title will revert in the seller. See UCC §2-401(4). Of course, if the goods are nonconforming, risk of loss may never leave the seller. See UCC §2-510.

19. See UCC §§9-203; 9-303.

20. See UCC §9-303 Comment 1. See generally 2 Jones §447a. The situation in which collateral has been damaged by a third person should be contrasted with the situation in which collateral has been acquired by a third person. In the latter case, the secured party may be required to show a perfected security interest to successfully sue the third party transferee of the collateral in conversion. See UCC §9-306 (2), Comment 3; *Strevell-Patterson Finance Co. v. May*, 77 N.Mex. 331, 422 P.2d 366, 3 UCC Rep. Serv. 1094 (1967).

21. See UCC §9-301(1) (a); §9-312.

22. See *Clark v. Vaughn*, 504 S.W.2d 550, 14 UCC Rep. Serv. 501 (Tex. App. 1973); UCC §9-203 Comment 5.

23. Title and risk of loss will have often passed to the buyer before the goods are damaged. See UCC §2-401; 2-509; 2-510. Unsecured creditors usually are said to not have an insurable interest in their buyer's property. See generally R. Keeton, *Insurance Law* §3.4(c) (1971). But see note 27 and accompanying text *infra*.

entitled to enforce a right to recovery for damage to the goods. A negative response could turn on the definition of "security interest" which is defined as "an interest in personal property . . . which secures payment or performance of an obligation."<sup>24</sup> An unenforceable security interest arguably does not secure because the seller has no right to the collateral. If he has no right to the collateral, it would follow that he would not be entitled to sue for damages to it. The seller *qua* unsecured creditor is, of course, "interested" in the collateral in a general sense because damage to it could impair his chances for payment, but it can hardly be said that the goods secure payment. A similar problem of interpretation arose in the New York Law Revision Commission when it considered enactment of the Code with respect to whether a seller with an unenforceable security interest has an insurable interest under the Article Two provision which provides that "[t]he seller retains an insurable interest in goods so long as title to or any security interest in the goods remains in him . . ."<sup>25</sup> The Commission believed that this provision would deny an insurable interest to a seller with an unenforceable security interest.<sup>26</sup> On the other hand, there is an argument which can be made in support of an interpretation of section 2-722 which would give a seller with an unenforceable security interest standing to sue. This argument would attack the notion that standing under this section necessarily turns on an in rem right in the goods sold. It has been argued that an unsecured seller should have an insurable interest in the goods sold to the buyer-debtor (and would thus be entitled to sue for damage to them under section 2-722) because damage to them may be economically disadvantageous to him.<sup>27</sup> A buyer obtains a right to sue under section 2-722 when he receives a "special property" which often will not give to him in rem rights in the goods purchased.<sup>28</sup> As a technical matter, the argument in favor of reading section 2-722 to require an enforceable security interest for real party in interest status is more persuasive.<sup>29</sup> As a practical matter, any seller, secured or unsecured, can initiate a lawsuit for damage to the goods sold. If it is determined that his alleged security interest is unenforceable and that he has no other basis for real party in interest status under section 2-722, the buyer, who could and probably would be a party under modern rules of joinder, could take over control of the litigation.<sup>30</sup> The tortfeasor could seek such joinder or related procedural protection.<sup>31</sup>

24. UCC §1-201(37).

25. UCC §2-501(2).

26. See 1955 *New York Report* at 464, 751; 1956 *Recommendations* at 54. See also Stockton, *An Analysis of Insurable Interest Under Article Two of the Uniform Commercial Code*, 17 *Vand.L.Rev.* 815, 821-27 (1964) [hereinafter "Stockton"].

27. See Stockton at 826-27. *But see* note 23 *supra*.

28. See UCC §§2-501; 2-502; 2-716.

29. It would follow that his security interest must also have attached to the collateral in order for the seller to be a real party in interest under §2-722 by virtue of a security interest in the goods sold. See UCC § 9-204; 9-203 (1972 Official Text).

30. See James §10. 12.

31. See Fed.R.Civ.P. 19; note 17 and accompanying text *supra*.

32. See UCC §1-103.

33. See generally Annot., 67 *A.L.R.2d* 599 §2, 4 (1959); 2

## B. Secured Lender

In the absence of a UCC provision applicable to secured lenders comparable to section 2-722, it is necessary as a preliminary to consult pre-Code law concerning the question of when a secured lender can sue third persons who damage the collateral.<sup>32</sup> The chattel mortgage provides such a starting point. A chattel mortgagee's interest in the collateral was conceptualized as title in some jurisdictions, but as a mere lien in others. In title jurisdictions a mortgagee out of possession was often entitled to sue a third person for damage to the collateral even if the mortgagor was not in default.<sup>33</sup> In lien jurisdictions, on the other hand, the mortgagee's right to sue was not certain even after a default by the mortgagor because the mortgagee would not get title until after foreclosure and sale. Even in lien jurisdiction, however, a postdefault right to possession in the mortgagee might enable him to sue without title.<sup>34</sup> Also under pre-Code law the best view was that a chattel mortgagee could sue a third party for the full amount of damage to the collateral even though it exceeded the amount of the debt.<sup>35</sup> Any recovery in excess of the debt was required to be held in constructive trust for the mortgagor.<sup>36</sup> There was also authority that a successful action or settlement by the mortgagee for the damage to the collateral was a bar to an action by the mortgagor.<sup>37</sup>

The pre-Code law concerning the right of a chattel mortgagee to sue a person who damages the collateral should not be applied in the context of Article Nine without considerable modification. Rather, it must be recognized that under Article Nine the secured lender has neither "title" nor a "lien" in the sense that those terms were used under the pre-Code law and that Article Nine greatly diminished the importance of title generally.<sup>38</sup> Instead, the lender with an enforceable security interest has an interest which secures payment of an obligation. The incidents of the interest, which may be operative before or after default, must be determined through reference to the security agreement and Article Nine.<sup>39</sup> Under this approach it is clear that a secured lender on default can take possession of the collateral, unless otherwise agreed.<sup>40</sup> The events which constitute default are determined by the parties and often include occurrences or failures which are technical or insubstantial. Prior to default any secured party may have, for his own protection, a sufficient interest in the collateral to justify a consensual right to "police" or otherwise assert dominion over the collateral.<sup>41</sup> It must

Jones §447a.

34. See *id.*

35. See *id.* §8.

36. See *Harvard Trust Co. v Racheotes*, 337 *Mass.* 73, 147 *N.E.2d* 817 (1958).

37. See generally 2 Jones at §447a.

38. UCC §9-202. See UCC §2-401.

39. See UCC §§1-201(37); 9-105(1)(h); 9-201.

40. See UCC §9-503.

41. Concerning defining default, see UCC §9-501(1). See generally 2 Gilmore, *Security Interests in Personal Property* §43.3 (1965) [hereinafter "Gilmore"]. The security agreement could define default to include the occurrence of damage to the collateral of the debtor's failure to insure the collateral. Concerning the secured party's need to police, see UCC §9-205 Comment 5. There may be a predefault right for the secured party to make collections. *Id.* §9-502 (1).

also be recognized in applying the pre-Code law concerning a secured lender's right to sue in the context of Article Nine that, absent default, the secured lender's "bundle of rights" under the security agreement and to payment of the debt secured may be worth less in the market place to a potential assignee if the debt is undersecured because the collateral is damaged and becomes worth less than originally anticipated. These rights may also be worth less to the secured lender if there ultimately is a default. Thus, the secured lender's Article Nine interest in the collateral, which commences when his security interest becomes enforceable and which continues until either payment of the debt or until the lender completes foreclosure after default, should be significant enough to constitute the secured lender a real party in interest with standing to bring an action against a person who damages the collateral before or after a default by the debtor. Section 2-722 provides persuasive analogic support for this proposition. Not all the pre-Code doctrine should be abandoned; the public policy against multiplicity of actions should persuade courts to continue to permit, if not require, that the secured lender sue for the entire damage to the collateral, pursuing recovery in excess of the debt secured as a fiduciary for the debtor. If the secured party sues, any judgment or settlement should protect the tortfeasor from a subsequent claim of the debtor. Here too, section 2-722 provides strong analogic support.

### III. Secured Party's Right to Succeed to Debtor's Claim

Situations may arise in which a secured seller or lender may be unable to sue, in his own right, a third person who damages or is responsible for a defect in collateral. For example, a court might come to the unfortunate conclusion that a secured lender is without "title" to the goods and is, therefore, not a real party in interest with standing to sue a tortfeasor.<sup>42</sup> As another example, the cause of action might be one which does not run to the secured party as a matter of substantive law or the particular facts of the case. Such causes of action would include an action for breach of an Article Two sales warranty. The statutory language which deals with these warranties expressly limits who may recover on them to a class of persons that would probably not include a secured party.<sup>43</sup> In such situations the secured party might argue that a cause of ac-

tion arising out of damage to or defects in the collateral and any rights derived from the cause of action such as rights under a settlement agreement, judgment, or in the fund produced as a result of the settlement or judgment are substitute collateral subject to his security interest as Article Nine proceeds. Under Article Nine, "[p]roceeds includes whatever is received when collateral or proceeds is sold, exchanged, collected or otherwise disposed of." Except where the Article provides otherwise, "a security interest . . . continues in any identifiable proceeds including collections received by the debtor."<sup>44</sup> Such an argument would first have to demonstrate that the particular cause of action is assignable. The Code does not address this question directly, but as a matter of extra-Code law it may generally be stated that all claims arising out of contract are assignable and that tort claims which are property related, as distinguished from those which arise out of injury to the person, are assignable.<sup>45</sup> If the secured party can get over this hurdle, he would next have to show that the particular cause of action against a third party which he is claiming as proceeds under his security agreement is a type of property that falls within the scope of Article Nine and can be the subject of an Article Nine security interest. The reason for this is that, except where Article Nine specifically provides otherwise,<sup>46</sup> property rights that cannot pass through the Article's "front door" as original collateral cannot enter via the "back door" as proceeds.<sup>47</sup> Finally, the secured creditor would have to demonstrate that the cause of action falls within the Article Nine definition of proceeds quoted above.

#### A. Debtor's Claim and Derived Rights and the Scope of Article Nine

All of the causes of action against third parties or derived rights which secured parties have sought to pursue as proceeds in the reported cases, including actions for breach of warranty, may be characterized as torts.<sup>48</sup> Thus, it must be determined whether tort claims are within the scope of Article Nine. The same question must be considered with respect to rights derived from a tort claim pursuant to a settlement agreement, judgment, or a fund ultimately produced by the tortfeasor or his insurer.

The relevance of Article Nine of the Uniform Commercial Code to the assignment of tort claims is not immedi-

42. Cf. *Hoffman v. Snack*, 2 UCC Rep. Serv. 862 (Pa. C.P. 1964) ("[P]etitioner does not fall within this category of permissible intervenors. It does not hold title to the demolished vehicle . . ."). This case is discussed at notes 85-90 and accompanying text *infra*.

43. See UCC §§2-313-15; 2-318; *In re Continental Trucking*, 16 UCC Rep. Serv. 526 (M.D.Fla. 1974), discussed at notes 88-95 and accompanying text *infra*. See generally 1 Anderson, *Uniform Commercial Code* §2-318:3 (1970). The secured party might argue that he is a kind of purchaser to whom the sales warranties should run. See UCC §1-201 (32), (33). But see *id.* §§2-102; 2-106(1). Query whether a secured party is an "ultimate user or consumer" within the meaning of section 402A of the *Restatement (Second) of Torts*. See *Restatement (Second) of Torts* §402A Tentative Draft No. 10, 1964).

44. UCC §9-306(1), (2).

45. See *Restatement of Contracts* §547 (1932); Weinberg, *Tort Claims as Intangible Property: An Exploration from*

*an Assignee's Perspective*, 64 Ky.L.J. 49, 74-78 (1975) [hereinafter "*Tort Claims*"].

46. "Proceeds" under Article Nine may include some property rights which are not within the scope of Article Nine as original collateral. See UCC §§9-104(k) 9-306(1), (4); 9-104(1) (1972 Official Text). See generally *Commercial Discount Corp. v. Milwaukee W. Bank*, 61 Wis.2d 671, 214 N.W.2d 33, 13 UCC Rep. Serv. 1202 (Wis. 1974).

47. The opposite conclusion would lead to anomalous results. Consider a properly perfected Article Nine security interest in a motor vehicle and proceeds, the vehicle then being exchanged by the debtor for an acre of realty without the permission of the secured party. Although the scope of Article Nine is expressly limited to personal property and fixtures, if "proceeds" were not limited to property which is within the scope of the Article, the secured party could claim a continuing Article Nine security interest in the realty. See UCC §9-102(1).

48. See W. Prosser, *Law of Torts* 635 (1971). The cases are discussed at notes 85-94 and accompanying text *infra*.

ately apparent. The Article broadly applies "to any transaction (regardless of its form) which is intended to create a security interest in personal property . . ."49 Thus, it might seem to control a security interest in a tort cause of action or derivative rights. However, rights "represented by a judgment" and transfers "in whole or in part of . . . any claim arising out of tort" are expressly excluded from the scope of Article Nine on the theory that these intangibles do not customarily serve as commercial collateral.<sup>50</sup> This decision by the Code's draftsmen appears correct when viewed in light of the types of intangible property, such as commercial accounts receivable, that are included within the scope of Article Nine. Moreover, it is consistent with the pre-UCC personal property security legislation in many jurisdictions which also did not include tort claims and judgments within its scope.<sup>51</sup> Excluding these intangibles from Article Nine may also evince an intent to have them handled on a state-by-state basis, each jurisdiction being free to apply its own public policies.<sup>52</sup> The appearance that Article Nine is not relevant to security interests in rights arising from the commission of a tort is further substantiated by its inapplicability "to a transfer of an interest or claim in or under any policy of insurance . . ."<sup>53</sup> Although this exclusion was intended to apply primarily to the assignment of life insurance policies,<sup>54</sup> it is arguably broad enough to exclude the assignment of a claim under a casualty insurance policy arising out of a tortious act by a third person.<sup>55</sup>

Although it appears that tort claims are outside the scope of Article Nine, a closer analysis reveals that a tort victim has the potential for obtaining property rights, derived from the tort, which might be subject to Article Nine. A typical sequence of events which could follow the commission of a tort will serve to illustrate the point. In considering the sequence of events, it must be kept in mind that property can become the subject of an Article Nine security interest in two ways: first, when the security interest is created directly in the property, in which case the property may be referred to as "original" collateral; and second, when the security interest is imposed on the "proceeds" of original collateral.<sup>56</sup> "Proceeds" are defined by Article Nine as including "whatever is received when collateral or proceeds is sold, exchanged, collected or otherwise disposed of."<sup>57</sup> Moreover, it should be

recalled that a security interest in property in which the debtor will have no ownership until a future time can be granted under Article Nine.<sup>58</sup>

In the typical sequence of events, settlement occurs at some point after suit is filed but prior to judgment. In the settlement a tort victim obtains a contractual right to payment from the tortfeasor, or his insurer, which constitutes a new form of intangible personal property derived from the original tort claim.<sup>59</sup> When the tortfeasor or his insurer issues a check to satisfy this obligation another form of derivative property has come into existence—the victim-payee's rights on the check. Still another intangible derivative right is produced when the check is cashed or deposited—the rights in the fund. While the security assignment of the original tort claim is not within the scope of Article Nine, derivative settlement rights are excluded only if they are "claim[s] arising out of tort."<sup>60</sup> Therefore, these rights could constitute original collateral within Article Nine. Security interests in instruments,<sup>61</sup> such as checks, are governed by Article Nine, and a tort victim's rights on a settlement check could constitute original collateral if not excluded as "arising out of tort." Additionally, a security interest in the monetary proceeds of the settlement could be original collateral within Article Nine, subject to this exclusionary language, if the funds are not deposited in a savings, passbook, or similar account maintained with a bank, savings and loan association, or like organization. Security interests in these deposit accounts are removed from the scope of Article Nine by another exclusionary provision.<sup>62</sup> But even if the monetary proceeds could not be "original" collateral within the scope of Article Nine because of this latter exclusion, once they go into such an account they might constitute Article Nine "proceeds" which are within the scope of Article Nine as are, arguably, the check and the settlement agreement rights.<sup>63</sup>

If Article Nine's exclusions do not embrace a security assignment of these present or future property rights derived from a tort cause of action, then these nonexcluded rights (and their proceeds) are subject to Article Nine through its broad scope provision.<sup>64</sup> Consistent with this conclusion are the Code's comments which suggest that the scope language should be broadly interpreted in keeping with Article Nine's main purpose: to provide a comprehensive scheme for all nonexcluded consensual security interests in

49. UCC §9-102(1).

50. See UCC §§9-104(h), (k), Comment 8. The exclusions contained in §9-104 do not, however, exclude from Article Nine security interests in all types of collateral which do not customarily serve as commercial collateral. For example, a security interest in a decedent's estate has been held to be within the scope of Article Nine. See *In re Bowen*, 5 UCC Rep. Serv. 261 (D.Ore. 1968). See generally 1 Gilmore §10.7.

51. See generally 1 Gilmore chs. 7, 8.

52. See generally Hawland, *The Proposed Amendments to Article Nine of the U.C.C.—Part IV: The Scope of Article Nine*, 79 Com.L.J. 79, 83 (1972). There are nonuniform statutes relating to the assignment of judgments and causes of action which might have required modification or repeal in order to avoid conflict with Article Nine. See *Tort Claims* at n.197 and accompanying text.

53. UCC §9-104(g).

54. See UCC §9-104, Comment 7. See generally 1 Gilmore §10.7.

55. See R. Henson, *Handbook on Secured Transactions Under*

*the Uniform Commercial Code* §6-8, at 150-51 (1973) [hereinafter "Henson"].

56. See generally Weiss, *Original Collateral and Proceeds: A Code Puzzle*, 42 N.Y.U.L.Rev. 785, 803-04 (1967).

57. UCC §9-306(1).

58. See UCC §9-204(3). It will not attach and cannot be perfected, however, until the debtor has rights in the collateral. *Id.* §9-204(1); 9-303(1).

59. It thus becomes possible to sue on a contract for what amounts to liquidated tort damages. See, e.g., *Greenleaf v. Minneapolis St. P. & S. Ste. M. Ry.*, 151 N.W. 879, 881 (N.D. 1915).

60. UCC §9-104(k).

61. See UCC §9-105(1) (g).

62. Such deposit accounts are excluded from the scope of Article Nine by §9-104(k).

63. See note 46 *supra*.

64. See UCC §9-102. The relationship between the scope provisions of Article Nine and its proceeds provision is discussed at notes 46-47 and accompanying text *supra*.

personality.<sup>65</sup> However, the one reported case that relates to this issue, *Arkwright Mutual Insurance Co. v. Bargain City U.S.A., Inc.*,<sup>66</sup> provides contrary authority.

In *Arkwright*, an insurer had issued a policy covering loss of rental income caused by property damage, including damage resulting from the impact of an aircraft. A United States Navy jet had crashed into one of the insured properties, causing a substantial loss of rental income. The insured's claim under the policy was held in abeyance pending his effort to recover from the United States by means of filing a claim with the Navy.<sup>67</sup> The Navy and the insured reached a settlement, and the Navy agreed to recommend to the Bureau of the Budget that the amount be paid. At this juncture, the insured requested that the insurer advance him funds, pending payment by the United States. The advance was made pursuant to an agreement which provided that the insured would, at the insurer's request, execute and deliver such instruments as would authorize the United States to make payment directly to the insurer; and that the insurer would pay to the insured any amount received from the United States in excess of the amount advanced.

After receiving the advance, the insured filed a petition under Chapter XI of the Bankruptcy Act.<sup>68</sup> The insurer did not formally appear or file a claim in the bankruptcy proceeding even though it was scheduled as an unsecured creditor for the amount of its advance and the claim against the United States was scheduled as an asset of the insured. After the arrangement was confirmed and terminated, the insurer refused to accept as an unsecured creditor a payment of fifteen percent of its total advance. Subsequently, the United States appropriated the amount of the settlement and the insurer instituted suit to recover its advance, initially succeeding in requiring the insured to deposit the fund into court.

The agreement between the insurer and its insured provided for an actual loan. The federal district court emphasized this,<sup>69</sup> and the circuit court of appeals indicated that the insured was to repay the difference if the amount received from the government was less than the amount advanced, and that the advance did not prejudice the insured's right to make a claim under the policy.<sup>70</sup> Since the transaction was a loan and not a payment pursuant to the policy, the insurer, if it was to have a claim to the appropriated fund, could not claim rights through subrogation.<sup>71</sup> Instead, its rights would have to be realized through a consensual assignment or some other means.

If there had been a consensual assignment to the insurer,

the rights assigned could have been either the insured's tort action against the Navy, the derivative contractual rights under the settlement agreement negotiated with the Navy, or the derivative rights in the fund appropriated by the government. As suggested, the assignment of such derivative rights for security is arguably within the scope of Article Nine, in which case Article Nine would apply to determine the rights of the insurer *qua* secured creditor in the Chapter XI proceedings.<sup>72</sup> The district court did not initially consider Article Nine because it found no assignment of any present or future property, but rather a mere agreement by the insured to pay a debt from a designated future fund.<sup>73</sup> Then, assuming that the insurer's claim against the insured was valid, the court concluded that enforcement of the claim against the insured was barred by the bankruptcy proceeding. Inexplicably, the lower court then declared that the insurer's claimed lien was unperfected under the Uniform Commercial Code, a seemingly unnecessary finding in view of the court's initial determination that there had been no assignment.<sup>74</sup> The court ignored the exclusions from the scope of Article Nine discussed above.

On appeal, the Third Circuit questioned the pertinence of the district court's declaration, stating in a footnote that the transaction was "beyond the pale" of Article Nine because the claim arose out of a tort.<sup>75</sup> The circuit court also referred to the Article's exclusion of transfers to an interest or claim in or under any insurance policy.<sup>76</sup> It did not, however, analyze the applicability of Article Nine beyond these observations. Most of the opinion was devoted to the determination that, assuming a non-Article Nine interest had been created, it had been extinguished in the Chapter XI bankruptcy proceedings when the insurer failed to assert its equitable rights.<sup>77</sup>

The fact pattern presented in *Arkwright* was not ideal for determining the scope of Article Nine in relation to tort-derived rights. It is clear from the facts that there had been no security assignment prior to the commencement of the bankruptcy proceedings, and, even assuming that there was a consensual assignment, the loan agreement did not specifically identify the collateral. However, even if rights such as those under the settlement agreement or in the future fund had been expressly secured prior to the bankruptcy proceedings, the court still should have concluded that Article Nine was inapplicable. If the scope provisions of Article Nine, with the accompanying official comments, are construed to include certain rights derived from a tort cause of action, the Code's exclusion of "any claim arising

65. See Comments to UCC §§9-101; 9-102; 9-104.

66. 251 F. Supp. 221 (E.D.Pa. 1966), *aff'd*, 373 F.2d 701 (3rd Cir.), *cert. denied*, 389 U.S. 825 (1967).

67. The claim was filed pursuant to the Military Claims Act of 1956, 10 U.S.C. §2733 (1959).

68. 11 U.S.C. §701 *et seq.* (1959).

69. 251 F. Supp. at 223.

70. 373 F.2d at 703.

71. See generally J. White & R. Summers, *Handbook of the Law Under the Uniform Commercial Code* §22-5 (1972). The insurance policy in *Arkwright* provided that the insurer could require the insured to assign all rights against third persons to the extent payment was made by the insurer, but no payment had been made under the policy.

72. 11 U.S.C. §701 *et seq.* (1959). The fact that the federal government was the tortfeasor and potential obligor under

the settlement agreement would not by itself remove the assignment from the scope of Article Nine. See generally 1 Gilmore §10.7, ch. 13. On appeal the Third Circuit stated that the equities of the parties would not be affected by the Federal Anti-Assignment Act, 31 U.S.C. §203 (1959), but would be determined by state law.

73. The parties authorized the district court to decide the case as if they had filed summary judgment motions. The court held that the fund was not impressed with a trust or equitable lien in favor of the insurer. 251 F. Supp. at 225-26. This determination was not necessary for the Third Circuit to hold against the insurer. See note 77 and accompanying text *infra*.

74. 251 F. Supp. at 228.

75. 373 F.2d 704 nn.7 & 9.

76. *Id.*

77. *Id.* at 706.



out of tort" would become meaningless due to the ease with which it could be circumvented by assignment of these rights. Placing these assignments outside Article Nine's coverage does no great violence to the exclusionary language, as such rights would never have existed but for the commission of a tort. Exclusion is appropriate for it was the more commercially familiar types of collateral and transactions which concerned the Code's draftsmen and which were the objects of their talents. The security assignment of a tort cause of action or derivative right was an unfamiliar commercial transaction involving unusual collateral. The tort claim exclusion, recommended in 1956 by the Editorial Board for the Uniform Commercial Code, was intended to achieve greater clarity and precision in defining the transactions "entirely" excluded from Article Nine.<sup>78</sup> Professor Gilmore, who was intimately involved in the development of the Article, has stated that the exclusion reflects the notion that such assignments are "beyond the pale with respect to a statute devoted to commercial financing."<sup>79</sup>

If further evidence is needed to demonstrate that Article Nine's draftsmen desired to leave the security assignments of tort causes of action and derivative rights to extra-Code law, it may be obtained by considering how the Article would apply to the security assignment of a derivative right. For example, a tort victim's rights under a contract of settlement can be characterized under Article Nine as a general intangible.<sup>80</sup> To perfect a security interest in a general intangible it is necessary to file a financing statement. Under two of the Article's three filing alternatives, filing would be in the office of the secretary of state or some other centralized location. The third alternative requires central filing and, in some situations, a filing in the county where the debtor resides or has a place of business.<sup>81</sup> In the case of tort-derived rights, however, it is debatable whether any filing should be necessary.<sup>82</sup> Even assuming that a filing requirement is warranted and litigation is pending or has been settled, would not a filing in court be more appropriate for giving public notice? It is unlikely that either Article Nine's draftsmen or the legislators who enacted the Code carefully considered these questions.<sup>83</sup>

#### B. Debtor's Claim and Derived Rights as Article Nine Proceeds

The foregoing analysis of the scope of Article Nine leads to the conclusion that the draftsmen did not intend the Article to apply to the security assignment of any rights resulting from the commission of a tort, leaving such assignments to the general common law and equitable doctrine of assignments.<sup>84</sup> This should be dispositive of any question as to whether such rights can be Article Nine pro-

ceeds. Surprisingly, the three reported cases in which this question has been presented have turned on the Article's definition of proceeds without reliance on its scope provisions.

In the first case, *Hoffman v. Snack*,<sup>85</sup> the secured party attempted to intervene in its debtor's trespass action for personal injuries and property damage against a defendant who had allegedly destroyed the collateral, an automobile. Through an oversight there was no insurance protecting the secured party against loss of or damage to the collateral. The court held that the security interest did not make the secured party a permissible intervenor and that Article Nine's definition of proceeds does not extend to situations where the collateral has depreciated in value through no fault of the debtor. The opinion was silent concerning possible Article Nine scope problems.

The second case, *In re Hix*,<sup>86</sup> reached the same general result. In it the attorney for the perfected secured party and the debtor had successfully negotiated a settlement with the insurer for the third person who had damaged the debtor's automobile. The debtor declared bankruptcy before the settlement was paid and the secured party claimed the insurance proceeds in the bankruptcy proceeding. Unfortunately, its theory was not clearly presented. It claimed the insurance proceeds as substitute collateral, but left it to the court to discover on its own the Article Nine proceeds provision. The trustee challenged the secured party's claim to the fund on the ground that the security agreement covered the automobile only. In holding for the trustee, the referee in bankruptcy reasoned that when the debtor became bankrupt there had been no assignment of his cause of action to the secured party and that there had been no sale, exchange, collection, or other disposition of the collateral within the Article Nine definition of proceeds. The referee noted the scope provisions excluding the transfer of an interest or claim in or under any policy of insurance and the transfer of claims arising out of tort, but expressly refused to consider their relation to the problem as a question "not before the court."<sup>87</sup>

In the third case, *In re Continental Trucking, Inc.*,<sup>88</sup> the purchaser of a dump truck had commenced an action against the truck's manufacturer, sounding in negligence and breach of implied warranty, and seeking damages arising from the faulty performance of the truck. An appeal was pending from a trial court judgment for the purchaser when it filed a voluntary petition for bankruptcy. The trustee defended the appeal and the judgment was affirmed with the resulting issuance of a check payable to the purchaser, its attorneys, and the bank that financed the purchase of the truck. The financier claimed the check as Article Nine proceeds of its enforceable and perfected se-

78. See 1956 Recommendations at 257-58; State of New York, Report of the Law Revision Commission 466 (1956).

79. See 1 Gilmore at 316.

80. See UCC §9-106. If a tort victim's right to payment was not yet earned by performance, such as where the tort victim has failed to deliver an executed release from liability required by the settlement agreement, then the collateral might be characterized as a "contract right." See *id.* Under UCC §9-106 (1972 Official Text) the term "contract right" has been eliminated. Rights under a settlement agreement must, under this version, be characterized as a general intangible.

81. See UCC §9-401.

82. Under some circumstances a tort victim's rights under a settlement agreement may be characterized as a contract right. See note 80 *supra*. No filing is required to perfect a security interest in an "isolated" assignment of contract rights. See UCC §9-302(1) (e).

83. There are certain additional problems which could result from the application of Article Nine to tort-derived rights. See *Tort Claims* at 88-89.

84. See *Tort Claims* at 92-97.

85. 2 UCC Rep. Serv. 862 (Pa.C.P. 1964).

86. 9 UCC Rep. Serv. 925 (S.D. Ohio 1969).

87. *Id.* at 928.

88. 16 UCC Rep. Serv. 526 (M.D. Fla 1974).

curity interest.<sup>89</sup> The court was initially troubled by this claim because the damages in the suit included lost profits and other elements which represented more than the proceeds from a hypothetical liquidation of the truck. However, the court assumed for the purpose of argument that the damages were a partial substitute for the truck and concluded, largely on the authority of *Hix*, that the bank's security interest did not extend to the recovery in that the suit for damages was not a disposition within the proceeds definition. As in *Hoffman* and *Hix*, the opinion in *Continental* was not explicit as to the extent to which the Article Nine formalities for creating and perfecting a security interest in proceeds had been complied with.<sup>90</sup>

All three of these cases, decided by courts of original jurisdiction, are consistent in reasoning and result with a more extensive and authoritative line of cases holding that a secured party cannot claim as proceeds the debtor's rights against the debtor's insurer or the fund created through the settlement with such an insurer.<sup>91</sup> If one reads Article Nine's proceeds provisions as requiring a voluntary disposition of the collateral by the debtor, there are two bases for arguing that the claim and other rights generated when the collateral is damaged by a third person are not proceeds: the disposition was neither voluntary nor by the debtor.<sup>92</sup> These provisions are even more troublesome when the claim is for defects in the collateral which existed before the security interest attached. In such a case it is hard to find any disposition of collateral. *Continental* properly found no merit in the argument that the lawsuit brought after the defect becomes patent is a disposition. It is not clear whether the secured parties in any of these three cases made any attempt to proceed on their own claim as real parties in interest. There was some indication by at least one of the courts that it might have concluded, incorrectly in the view of this writer, that such standing was lacking if that issue was presented to it,<sup>93</sup> however, it was not. The fact that a debtor becomes insolvent and goes into bankruptcy should have had no effect on the secured party's standing to sue in his own right for damage to or defects in the collateral occurring prior to bankruptcy because the trustee may succeed only to the bankrupt's claims or rights.<sup>94</sup>

#### IV. Conclusion

The Uniform Commercial Code does not provide adequate guidance with respect to a secured party's right to sue third persons for damage to or defects in collateral. Section 2-722 does indicate that a secured seller of goods can sue in his own right where a third party deals with the goods sold so as to cause actionable injury to the seller. However, this provision does not integrate clearly with Article Nine concepts such as enforceability and perfection and does not deal with goods in which the seller has retained a nonpurchase money security interest. The lack of a cognate provision applicable to the secured lender forces reference to doctrine which originated prior to the development of Article Nine and which, therefore, does not reflect the Article Nine concept of the secured party's bundle of rights called a security interest. The Code also does not provide adequate guidance with respect to the secured party's right to succeed to his debtor's claim. This is probably because the draftsmen never carefully considered the issue. If future draftsmen ever do address the problem, thought will have to be given to whether tort claims and derived rights should be types of personalty within the scope of Article Nine (and to closely related questions such as the proper method for perfecting a security interest in such property). If an affirmative answer is forthcoming, then thought must also be given to whether all or some portion of the debtor's claims resulting from damage to or defects in the collateral caused by a third person should be proceeds subject to a secured party's security interest. A decision not to subject such claims may be difficult to justify conceptually,<sup>95</sup> particularly since the 1972 Amendments to Article Nine redefine proceeds to include "[i]nsurance payable by reason of loss or damage to the collateral . . . except to the extent that it is payable to a person other than a party to the security agreement."<sup>96</sup> In the meantime, it is hoped that this article will provide some guidance for the secured party who discovers that his security is worth less than expected as a result of damage to or defects in the collateral not compensated by insurance. □

89. Although none of the three opinions discuss the possibility, it has been argued that Article Nine may require that proceeds be "received" by the debtor. See UCC §9-306(1); (2). This requirement could have been met in all three cases as the debtor initially received a cause of action, then rights under a settlement agreement or judgment, and so forth. See generally Henson §6-8 at 149, 153 n.18.; note 95 *infra*.

90. See UCC § 9-203; 9-306; 9-402. The 1972 Official Text amended these provisions.

91. See, e.g., *Quigley v. Caron*, 247 A.2d 94 (Me. 1968); *Universal C.I.T. Credit Corp. v. Prudential Inv. Corp.*, 222

A.2d 571 (R.I. 1966). But see *Firemen's Fund Am. Ins. Co. v. Ken-Lori Knits, Inc.*, 16 UCC Rep. Serv. 1407 (E.D.N.Y. 1975). See generally Henson §6-8.

92. Cf. Henson at 148.

93. See note 42 and accompanying text *supra*.

94. See 11 U.S.C. §110(1959).

95. See Hawkland, *The Proposed Amendments to Article Nine of the UCC, Part II: Proceeds*, 77 Com.L.J. 12, 13 (1972).

96. UCC §9-306(1) (1972 Official Text). The draftsmen had the debtor's insurance on the collateral in mind. See generally *Tort Claims* at 91-92.