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Bewitched, Bothered and Bewildered:* The Courts and Revised Article 9 of the Uniform Commercial Code Ten Years Later

*Margit Livingston***

Almost a decade has elapsed since the last major revision of Article 9 (Secured Transactions) of the Uniform Commercial Code (“U.C.C.”) went into effect in most states. Article 9, perhaps because of its sheer complexity, has been the most frequently litigated and the most frequently revised of all the U.C.C. articles. The drafters hoped that the 2001 revision would modernize Article 9 to fit a changing economic landscape and would resolve some vexing issues that had befuddled courts interpreting the old law. Now, almost ten years later, the case law reveals that despite the many improvements in the 2001 revision, Article 9 still perplexes the courts in various ways.

This Article presents a survey of secured transactions cases decided in the last couple of years that reveal a judiciary struggling to put meaning to the statutory language. This recent case law spans several different Article 9 topics, including, among others, the timeworn issues of secured transactions disguised as leases, the requisites for a valid financing statement, and priorities among competing claimants. In addition, this Article provides some reflections on best practices for counsel setting up secured transactions for their creditor clients. Finally, this Article previews some of the new amendments to Article 9 promulgated in 2010 as an anticipated solution to a number of ongoing problematic questions under the statute.¹

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1. For the text of the 2010 amendments, see NATIONAL CONFERENCE OF COMMISSIONERS ON UNIFORM STATE LAWS, AMENDMENTS TO UNIFORM COMMERCIAL CODE ARTICLE 9 (July 2010), http://www.law.upenn.edu/bll/archives/ulc/ucc9/2010am_approved.pdf. All references to Article 9 will be to the amended 2010 version unless otherwise indicated. Much of the 2001 version of Article 9 remains untouched by the 2010 amendments; significant changes between the 2001 and 2010 versions will be highlighted by the addition of the parenthetical “2001” or “amended 2010” to the statutory citation.

I. THE SCOPE OF ARTICLE 9: TRUE LEASES VS. DISGUISED SECURED TRANSACTIONS

Article 9 of the Uniform Commercial Code applies to any “transaction, regardless of its form, that creates a security interest in personal property or fixtures by contract.”² Thus, Article 9 covers all consensual security interests in chattels and fixtures unless one of the statutory exceptions applies.³ The term “security interest” is itself defined in Article 1 as “an interest in personal property or fixtures which secures payment or performance of an obligation.”⁴

Despite the seeming simplicity of this definition, one type of transaction has confounded courts for many years—the secured transaction disguised as a lease. True leases are not subject to Article 9, and true lessors do not need to file Article 9 financing statements or otherwise comply with Article 9.⁵ But for various business and tax reasons, purported lessors often create leases with their customers that, beneath the surface, look suspiciously like classic secured transactions.⁶ For decades, both the Code drafters and the courts have struggled to find the proper dividing line between transactions that are properly denominated true leases and those that are really disguised Article 9 transactions.⁷ A recent decision by the Indiana Court of Appeals,

2. U.C.C. § 9-109(a)(1). In addition to this catchall category of transactions, Article 9 now covers certain specific transactions that either were excluded from earlier versions of the statute or are included for policy reasons although they do not fit the classic notion of a secured transaction. In the former category are transactions involving agricultural liens and consignments. *Id.* § 9-109(a)(2), (4). In the latter are transactions involving sales of accounts, chattel paper, promissory notes, or payment intangibles. *Id.* § 9-109(a)(3). Agricultural liens are the first nonconsensual security interests to be included within Article 9. Although case law previously applied Article 9 to certain types of “security” consignments, consignments were not specifically included within Article 9 until the 2001 revision. Sales of accounts, chattel paper, promissory notes, or payment intangibles are included within the statute even though they do not involve “security interests” in the classic sense because of the difficulty experienced by third parties in determining whether certain assets of the debtor have been sold or merely given as collateral. *See id.* § 9-109 cmt. 4.

3. *See* U.C.C. § 9-109(c) (providing for preemption of Article 9 by certain federal and state laws); *id.* § 9-109(d) (specifically exempting certain transactions from Article 9).

4. U.C.C. § 1-201(b)(35) (2001).

5. *See id.* (“[T]he right of a seller or lessor of goods under Article 2 or 2A to retain or acquire possession of the goods is not a ‘security interest.’”). Article 2A of the Uniform Commercial Code covers true leases, which are defined as “a transfer of the right to possession and use of goods for a term in return for consideration.” *Id.* § 2A-103(1)(j) (2003).

6. *See* Michael J. Madison, *Reconstructing the Software License*, 35 *LOY. U. CHI. L.J.* 275, 312 (2003) (noting that owning an asset allows the lessor to claim it as an asset on its balance sheet and the lessee to expense the lease payments on its tax return).

7. *See In re Marhoefer Packing Co., Inc.*, 674 F.2d 1139 (7th Cir. 1982); *Aoki v. Shepherd Machinery Co. (In re J. A. Thompson & Son, Inc.)*, 665 F.2d 941 (9th Cir. 1982); *Cook Sales, Inc. v. Shores (In re Shores)*, 332 B.R. 31 (M.D. Fla. 2005); *In re QDS Components, Inc.*, 292 B.R. 313 (Bankr. S.D. Ohio 2002); *In re Taylor*, 209 B.R. 482 (Bankr. S.D. Ill. 1997); *Sharer v. Crea-*

Gangloff Industries, Inc. v. Generic Financing & Leasing Corp., reveals a court once again wrestling with this issue.⁸

In *Gangloff Industries*, the lessor, Generic Financing, entered into an agreement with Robert Bougher for a three-year lease of a truck in September 2005.⁹ Bougher's wife, Kathy, in turn entered into a contract with Gangloff Industries under which the Boughers were to haul goods for Gangloff using the leased truck.¹⁰ The second contract specified that the Boughers were to pay for all repairs to the truck.¹¹ Through an unfortunate series of events, the truck broke down, Gangloff paid for the repairs with the understanding that the Boughers would repay it, and Robert Bougher suffered a fatal heart attack while refueling the truck at a truck stop in July 2007.¹² Gangloff took possession of the truck and held it in storage, pending Kathy Bougher's payment of the repair and storage costs.¹³

In August 2007, the lessor Generic filed an action in Indiana state court to recover the truck from Gangloff, asserting that Generic was the true owner of the truck and that Gangloff was unlawfully holding the truck for debts owed by the Boughers to it.¹⁴ Generic sought treble damages and attorneys' fees for conversion as well as recovery of the truck. Gangloff then counterclaimed, alleging a possessory repairman's lien on the truck and also a claim for quantum meruit. Finding that the lessor Generic was likely to prevail at trial, the lower court ordered Gangloff to give immediate possession of the truck to Generic. After trial, the court found in favor of Generic and awarded it \$13,651 in damages and attorneys' fees.¹⁵ Gangloff appealed, and the Indiana Court of Appeals reversed the lower court's ruling.¹⁶

The Indiana appellate court first addressed the issue of whether the transaction between Generic and Robert Bougher was a true lease governed by U.C.C. Article 2A or a disguised secured transaction governed by Article 9.¹⁷ The court noted that under the definition of security interest in Article 1, this inquiry is a fact-bound

tive Leasing, 612 So. 2d 1191 (Ala. 1993); *Coleman v. DaimlerChrysler Servs. of N. Am., LLC*, 623 S.E.2d 189 (Ga. Ct. App. 2005); *U C Leasing, Inc. v. Laughlin*, 606 P.2d 167 (Nev. 1980); *FMA Fin. Corp. v. Pro-Printers*, 590 P.2d 803 (Utah 1979).

8. 907 N.E.2d 1059 (Ind. Ct. App. 2009).

9. *Id.* at 1060-61.

10. *Id.* at 1061-62.

11. *Id.* at 1061.

12. *Id.* at 1062.

13. *Gangloff Industries*, 907 N.E.2d at 1062.

14. *Id.*

15. *Id.* at 1062-63.

16. *Id.* at 1067.

17. *Id.* at 1063-64.

determination.¹⁸ Certain arrangements, however, are always classified as secured transactions even if the parties choose to call them leases:

A transaction in the form of a lease creates a security interest if the consideration that the lessee is to pay the lessor for the right to possession and use of the goods is an obligation for the term of the lease and is not subject to termination by the lessee, and:

- (1) the original term of the lease is equal to or greater than the remaining economic life of the goods;
- (2) the lessee is bound to renew the lease for the remaining economic life of the goods or is bound to become the owner of the goods;
- (3) the lessee has an option to renew the lease for the remaining economic life of the goods for no additional consideration or for nominal additional consideration upon compliance with the lease agreement; or
- (4) the lessee has an option to become the owner of the goods for no additional consideration or for nominal additional consideration upon compliance with the lease agreement.¹⁹

In all four presumptive categories, the lessee must have an obligation to pay rent for the lease term that “is not subject to termination by the lessee.”²⁰ This non-termination element requires that the lessee is bound to the lease for the entire lease term and cannot escape the obligation to make rental payments. In contrast, if the lessee can terminate the lease at will, it is not assuming the same type of unalterable financial obligation typically found in a secured transaction.²¹

The first presumptive category under U.C.C. section 1-203(b) comprises transactions in which the lease term swallows up the economic life of the leased goods.²² For example, if a piece of equipment has a

18. *Gangloff Industries*, 907 N.E.2d at 1064 (citing Indiana’s version of former U.C.C. § 1-201(37) (“Whether a transaction in the form of a lease creates a lease or security interest is determined by the facts of each case.”)). Former U.C.C. § 1-201(37) is substantively the same as new U.C.C. § 1-203(a). New Article 1 was first promulgated by the American Law Institute and the National Conference of Commissioners for Uniform State Laws in 2001 and has now been adopted, in whole or in part, by all but a handful of states. See NATIONAL CONFERENCE OF COMMISSIONERS ON UNIFORM STATE LAWS, http://www.nccusl.org/Update/uniformact_fact_sheets/uniformacts-fs-ucc1.asp (last visited July 27, 2010).

19. U.C.C. § 1-203(b) (2001); *Gangloff Industries*, 907 N.E.2d at 1064 (citing an earlier version of Article 1 (U.C.C. § 1-201(37)) that is substantively the same as U.C.C. § 1-203(b) (2001)).

20. U.C.C. § 1-203(b) (2001).

21. See *Crumley v. Berry*, 766 S.W.2d 7, 10 (Ark. 1989) (finding that a transaction was a true lease because the lessee could terminate it at any time).

22. See *Wheels, Inc. v. Otasco, Inc. (In re Otasco, Inc.)*, 196 B.R. 554, 559 (N.D. Okla. 1991) (holding that the first presumptive category did not apply where the lease was for 12 months and the leased goods had a useful life of 50 months); *In re Grubbs Constr. Co.*, 319 B.R. 698, 714 (Bankr. M.D. Fla. 2005) (stating that one of the hallmarks of a true lease is that the goods have some meaningful residual value at the end of the lease term); *In re QDS Components, Inc.*, 292

useful life of five years and the lease term is five years, the lessor most likely is requiring the lessee to pay the equivalent of the fair market value (plus interest) of the equipment. The hallmark of a true lease is that there is something of value to give back to the lessor at the end of the lease term.²³ In this example, such is not the case. Under the second presumptive category, the lessee is contractually bound to keep renewing the lease for the useful life of the goods or to become the owner of the goods.²⁴ Once again, the parties are contemplating that the lease term will parallel the useful life of the goods or that the lessee will end up owning the goods. These transactions are in reality disguised sales with the lessor's retention of "title" to the goods during the lease term serving as a security interest.

The essence of the third and fourth presumptive categories is that the lessee is under an economic compulsion to exercise the purchase option at the end of the lease.²⁵ In other words, no sensible lessee would fail to exercise the purchase option because it is so attractive.²⁶ If the lessee can purchase a machine with a fair market value at the end of the lease term of \$5,000 for \$1 or even \$500, the lessee will always exercise the option to buy.²⁷ Even if the lessee has no further use for the machine in its business, it can probably sell the item to someone else for more than the option price or even dispose of the item to a scrap dealer for more than the option price. Because the economic compulsion to buy is always present in these situations, the transactions are once again disguised sales with the lessor's reserving a security interest ("title") in the goods during the lease term. To assist courts in determining whether an option price is nominal, the drafters include definitions and examples of "nominal" and "non-nominal"

B.R. 313, 331 (Bankr. S.D. Ohio 2002) (noting that the touchstone of a true lease is that "the lessor retains an economically meaningful residual interest in the leased property").

23. *In re QDS Components, Inc.*, 292 B.R. at 331; *In re Double G Trucking of the Arklatex, Inc.*, 432 B.R. 789, 800 (Bankr. W.D. Ark. 2010).

24. U.C.C. § 1-203(b)(2) (2001). *See, e.g.*, *Key Equip. Fin. Inc. v. Zip, L.L.C.*, No. 06-CV-944, 2007 U.S. Dist. LEXIS 38700, at * 9 (N.D.N.Y. May 29, 2007) (finding that the lease was probably a secured transaction where the lessee was required to purchase the leased goods at the end of the lease term).

25. U.C.C. § 1-203(b)(3), (4) (2001).

26. *See In re Buehne Farms, Inc.*, 321 B.R. 239, 245-46 (Bankr. S.D. Ill. 2005) (discussing economic realities test for true leases and noting that an option price is nominal if "only a fool would fail to exercise the option").

27. *See, e.g., In re Southeastern Materials, Inc.*, 433 B.R. 177, 181 (Bankr. M.D.N.C. 2010) (holding that lease was a disguised secured transaction where the lease had the option to purchase the leased goods for \$1 at the end of the lease term).

consideration.²⁸ In applying the statutory standards to the transaction between Generic and Bougher, the Indiana Court of Appeals observed that the lessee Bougher was obligated to pay Generic a total of \$43,052 over thirty-eight months.²⁹ At the end of the lease term, Bougher had the option to purchase the leased truck for \$3,190, which was approximately 7.5 percent of the total payments made. The court held that that amount was nominal and that the agreement created a security interest, not a lease.³⁰

Once having found that the Generic-Bougher arrangement was a secured transaction, the court then ruled that Gangloff held a possessory repairman's lien that was superior to Generic's security interest.³¹ Article 9 provides that possessory statutory liens, such as a repairman's lien, have priority over all security interests, perfected or unperfected, unless the statute creating the lien provides otherwise.³² In this case, the Indiana statute creating the repairman's lien was silent as to priority.³³ Consequently, the repair company, Gangloff, had priority over the secured party, Generic.³⁴

The Indiana appellate court's decision in this case is most likely correct, but two points are worth noting. First, in sorting out the lease-secured transaction issue, the court determined that the purchase option price was nominal based on its relationship to the total amount paid by the lessee over the lease term.³⁵ More properly, one should examine the relationship between the option price and the anticipated fair market value of the leased goods at the time the option is to be exercised.³⁶ For example, if the lessee has paid \$50,000 over the lease term but the anticipated fair market value of the goods at the end of

28. See U.C.C. § 1-203(d) (2001) ("Additional consideration is nominal if it is less than the lessee's reasonably predictable cost of performing under the lease agreement if the option is not exercised."); *id.* § 1-203(d)(1), (2) (giving examples of non-nominal consideration).

29. *Gangloff Indus., Inc. v. Generic Fin. & Leasing Corp.*, 907 N.E.2d 1059, 1065 (Ind. Ct. App. 2009).

30. *Id.* at 1065-66.

31. *Id.* at 1066-67.

32. U.C.C. § 9-333.

33. *Gangloff Industries*, 907 N.E.2d at 1066.

34. *Id.* at 1066-67.

35. One court noted the error of this approach and stated that the courts must examine whether "at the end of the lease the lessor will receive either return of the leased goods or the reasonably predicted fair market value the goods will have at the time the option is to be performed." *Sankey v. ABCO Leasing, Inc. (In re Sankey)*, 307 B.R. 674, 682 (D. Alaska 2004). If so, then the transaction is a true lease. *Id.*

36. See *In re UNI Imaging Holdings, LLC*, 423 B.R. 406, 417 (Bankr. N.D.N.Y. 2010) (stressing that in determining nominality of the option price, the court should examine "the expectations of the parties concerning the projected value of the equipment at the time they entered into the agreement, rather than the actual value at the conclusion of the term.").

the term is \$2,000, an option price of \$1,500 would arguably not be nominal. The lessee might easily decide that there was no point in paying \$1,500 to own a machine worth little more than that.

In *Gangloff Industries*, however, the parties presented no evidence as to the truck's actual or anticipated fair market value, and therefore the court was unable to use that figure in assessing whether the option price was nominal. The putative lessor, Generic, could have preserved the transaction as a lease if it had shown that the truck had a projected fair market value close to the option price of \$3,190 at the end of the lease. Additionally, Generic would have had to show that the truck was anticipated to have some remaining useful life at that point³⁷ and that the lessee's projected cost of continued performance under the lease was less than the option price.³⁸

The second noteworthy point in *Gangloff Industries* is that the lease-versus-security interest issue arguably should have made no difference to the outcome of the case. If the Generic-Bougher transaction were a secured transaction, as the court found, then the statutory lienholder, Gangloff, would have had priority over the secured party, Generic.³⁹ But if in fact that transaction were a true lease, then arguably the lessor Generic would still have been responsible for the repairs as the truck's true owner. Gangloff, properly asserting a repairman's lien on the truck, would be able to have the lien satisfied by the true owner before relinquishing possession.⁴⁰

By incorporating purchase options into lease agreements, lessors always run the risk that the option price will be found nominal and that a court will hold that the agreement creates a security interest subject to Article 9 filing requirements. To avoid later trouble, a lessor should always file a precautionary financing statement listing itself as the secured party and the lessee as the debtor.⁴¹ In *Gangloff Industries*, filing a financing statement to perfect the security interest would not have changed the outcome because of the special provisions governing statutory liens. But, in most cases, filing a financing statement will

37. *In re QDS Components, Inc.*, 292 B.R. 313, 340 n.17 (Bankr. S.D. Ohio 2002).

38. *Id.* For example, if the option price is \$1,000 and it would cost the lessee \$2,000 to remove the leased goods from its premises and ship them back to the lessor, the lessee might well decide to exercise the option to purchase.

39. U.C.C. § 9-333.

40. Even if the contract between the lessor and the lessee had provided that the lessee was responsible for repairs to the leased goods, the repairman would still be able to retain possession of the goods until someone paid for the repairs. To retrieve the goods, the lessor would have had to pay the repairman and then pursue the lessee for the cost of repairs under the terms of the contract.

41. *See* U.C.C. § 9-505 (allowing precautionary filings by lessors).

protect the lessor/secured party from other secured parties, the trustee in bankruptcy, and other claimants. When in doubt, file.

II. PERFECTION OF SECURITY INTERESTS

A. *The Debtor's Name on Initial Financing Statements*

Once it is determined that a transaction is indeed subject to Article 9, it is then necessary to explore whether the secured party has properly perfected its security interest.⁴² Without proper perfection of their security interests, secured creditors will often lose priority over competing claimants to the debtor's property⁴³ and will see their security interests stripped away by the trustee in the event of the debtor's bankruptcy.⁴⁴ Filing of a financing statement in the appropriate public record is the most common method of perfection and is, in fact, required by Article 9 unless one of the statutory exceptions applies.⁴⁵ The key to perfection is getting the debtor's name right on the financing statement, and that task can sometimes prove more difficult than would first appear.⁴⁶ In some cases, the urge to put additional names by which the debtor may be known on the financing statement should be resisted.

Article 9 requires only three pieces of information on a financing statement: the debtor's name, the secured party's name (or the name of its representative), and an indication of collateral.⁴⁷ Financing

42. Perfection of a security interest consists of attachment of the interest and an act of perfection. U.C.C. § 9-308(a). Attachment involves three steps: the secured party gives value to the debtor, the debtor has rights in the collateral, and, ordinarily, the debtor authenticates a security agreement describing the collateral. *Id.* § 9-203(a), (b). Although perfection can be achieved in a number of ways, depending upon the type of collateral, the secured party's filing of a financing statement in the public record is the most common method of perfection. *Id.* § 9-310(a).

43. *See* U.C.C. § 9-322(a)(2) (affording perfected security interests priority over unperfected security interests); *id.* § 9-317(a)(2) (providing that lien creditors have priority over unfiled security interests); *id.* § 9-317(b) (giving certain buyers priority over unperfected security interests).

44. Under the so-called "strong arm" clause of the federal Bankruptcy Code, the trustee in bankruptcy has the power to avoid unperfected security interests. 11 U.S.C. § 544(a) (2006).

45. U.C.C. § 9-310(a).

46. For a review of the statutory and judicial approaches to the degree of exactitude required in setting forth the debtor's name on a financing statement, see Margit Livingston, *A Rose by Any Other Name Would Smell as Sweet (or Would It?): Filing and Searching in the Article 9 Public Records*, 2007 BYU L. REV. 111 (2007).

47. U.C.C. § 9-502(a). In addition to the three basic pieces of information, however, the filing officer must reject financing statements that do not also contain the parties' addresses, an indication as to whether the debtor is an individual or an organization, and if the debtor is an organization, the debtor's jurisdiction, type, and organizational identification number (or a statement that the debtor has none). *Id.* §§ 9-516(b)(4), (5); 9-520(a). The 2010 Amendments to Article 9 eliminate the filing office's ability to reject financing statements that do not contain the debtor's jurisdiction, type, and organization identification number (or a statement that the debtor has

statements are indexed according to the debtor's name,⁴⁸ and searching parties ordinarily search under the debtor's name. Consequently, the debtor's name is the gateway to the filing system and the single most significant bit of information on the financing statement. In insisting on exact and minimal precision by the secured party in filling out a financing statement, a recent bankruptcy court came to the somewhat surprising conclusion that a financing statement containing both the debtor's correct legal name and a putative trade name was invalid.⁴⁹

Revised Article 9, which went into effect in most jurisdictions on July 1, 2001,⁵⁰ adheres to the substantial compliance standard for measuring financing statement adequacy that existed under former Article 9. Under this standard, financing statements "substantially satisfying" Article 9 requirements are still effective even if they contain "minor errors or omissions, unless the errors or omissions make the financing statement seriously misleading."⁵¹ The revised statute still permits small mistakes by the secured party, provided that the financing statement gives adequate notice to third parties.⁵²

Regarding the specific issue of the debtor's name, however, Revised Article 9 takes a stronger stand than the old law.⁵³ In an apparent attempt to resolve any ambiguities in the old law, the revision states that "a financing statement that fails sufficiently to provide the name of the debtor in accordance with Section 9-503(a) is seriously misleading."⁵⁴ In other words, errors in the debtor's name are fatal to the financing statement's effectiveness, whether the error is minor or not.

none). *Id.* § 9-516(b)(5) (amended 2010). This information was not considered to be of sufficient utility to justify the cost and delay added to the filing process of requiring it.

48. *See id.* § 9-519(c) (requiring the filing office to index financing statements according to the debtor's name).

49. *Hastings State Bank v. EDM Corp. (In re EDM Corp.)*, No. BK08-40788-TLS, 2009 Bankr. LEXIS 202, at *10-11 (Bankr. D. Neb. Feb. 10, 2009).

50. Only four states adopted a non-uniform effective date: Connecticut, Alabama, Florida, and Mississippi. ALA. CODE § 7-9A-701 (2010) (making Revised Article 9 effective as of Jan. 1, 2002); CONN. GEN. STAT. § 42a-9-702 (2010) (making Revised Article 9 effective as of Oct. 1, 2001); FLA. STAT. § 679.701 (2010) (making Revised Article 9 effective as of Jan. 1, 2002); MISS. CODE ANN. § 75-9-701 (2010) (making Revised Article 9 effective as of Jan. 1, 2002).

51. U.C.C. § 9-506(a).

52. Providing that "[a] financing statement substantially satisfying the requirements of this part is effective, even if it has minor errors or omissions, unless the errors or omissions make the financing statement seriously misleading," Revised Article 9 emphasizes that the grievousness of any errors is to be judged by whether they render the financing statement as a whole seriously misleading as opposed to whether the errors themselves in isolation might be regarded as misleading. *Id.*

53. For a comparison of the old and new laws regarding the sufficiency of the financing statement, see Livingston, *supra* note 46, at 118-26.

54. U.C.C. § 9-506(b).

All debtor name mistakes presumptively render the financing statement seriously misleading.⁵⁵ This change in the law reinforces the pre-revision notion that the debtor's name is the essence of the financing statement.

But, despite this new emphasis on complete accuracy, the revisers recognized that secured parties may be excused some mistakes. Revised Article 9 provides a safe harbor that saves financing statements with errors in the debtor's name. If "a search of the records of the filing office under the debtor's correct name, using the filing office's standard search logic, if any, would disclose a financing statement that fails sufficiently to provide the name of the debtor . . . the name provided does not make the financing statement seriously misleading."⁵⁶ This provision might be denominated the "single search standard" in contrast to the pre-revision "reasonably diligent searcher standard."⁵⁷ Thus, under the new law, a third party must only search once for financing statements for any particular debtor. This "single search" should consist of entering the debtor's "correct" name into the filing office's database and observing whether that search produces any recorded financing statements.⁵⁸ If it does, then searchers must presumably take the further step of determining whether the financing statements found pertain to the person or entity with which they are dealing. If the search does not produce any matches, then under the "single search" standard, the searcher has completed its searching and

55. See JAMES J. WHITE & ROBERT S. SUMMERS, UNIFORM COMMERCIAL CODE § 22-12 (5th ed. 2000) (stating that "if the standard search logic . . . fails to find a financing statement because the name is incorrect, that renders the financing statement not only non-compliant with 9-502 and 9-503, but also means that it fails 'substantially' to satisfy the 'requirements of this Part' under 9-506 and so is 'seriously misleading.'").

56. U.C.C. § 9-506(c).

57. Under the pre-revision standard, courts examined whether or not a reasonably diligent searcher employing accepted search techniques would likely find the financing statement with the incorrect debtor name. See *Unsecured Creditors Comm. v. Marepcon Fin. Corp. (In re Bumper Sales, Inc.)*, 907 F.2d 1430, 1434-35 (4th Cir. 1990) (quoting *In re Bosson*, 432 F. Supp. 1013, 1017 (D. Conn. 1977) (citing JAMES J. WHITE & ROBERT S. SUMMERS, HANDBOOK OF THE LAW UNDER THE UNIFORM COMMERCIAL CODE 839 (1972)); *TMMB Funding Corp. v. Associated Food Stores, Inc.*, 523 N.Y.S.2d 161, 163 (App. Div. 1988) (citing JAMES J. WHITE & ROBERT S. SUMMERS, UNIFORM COMMERCIAL CODE § 23-16, at 957-58 (2d ed. 1980)).

58. See, e.g., *Myers v. Am. Exch. Bank (In re Alvo Grain & Feed, Inc.)*, No. BK08-80876-TLS, 2009 Bankr. LEXIS 4259, at *8-9 (Bankr. D. Neb. Nov. 20, 2009); *Miller v. Van Dorn Demag Corp. (In re Asheboro Precision Plastics, Inc.)*, 2005 Bankr. LEXIS 1091, at *25 (Bankr. M.D.N.C. 2005); *Receivables Purchasing Co., Inc. v. R & R Directional Drilling, Inc.*, 588 S.E.2d 831, 833 (Ga. Ct. App. 2003).

may assume that there are no filed financing statements recorded against that particular person or entity.⁵⁹

Revised Article 9 also elaborates on the question of what constitutes the debtor's "name" for filing and searching purposes. For registered organizations, such as corporations and limited partnerships, a financing statement "sufficiently" sets forth the debtor's name "only if the financing statement provides the name of the debtor indicated on the public record of the debtor's jurisdiction of organization which shows the debtor to have been organized."⁶⁰ The revised statute also sets forth the appropriate name to use for estates and trusts.⁶¹ Finally, in the catchall provision for "all other cases," the new law requires that the secured party set forth the individual or organizational name of the debtor, if the debtor in fact has a name.⁶² If the debtor does not have a name, then the secured party should list the names of the "partners, members, associates, or other persons comprising the debtor."⁶³

In *Hastings State Bank v. EDM Corp. (In re EDM Corp.)*, the secured party Hastings State Bank had filed a financing statement listing the debtor as "EDM CORPORATION d/b/a EDM EQUIPMENT."⁶⁴ The debtor's correct legal name was "EDM Corporation."⁶⁵ A later secured party, Huntington National Bank, filed a financing statement against the debtor setting forth its correct legal name.⁶⁶ Before filing, Huntington searched the Nebraska Secretary of State's records using the debtor's legal name and did not find Hastings's financing statement.⁶⁷

In the debtor's ensuing bankruptcy, Huntington argued that Hastings's financing statement was invalid because it was not revealed in a "single search" using the debtor's correct legal name.⁶⁸ Hastings, however, asserted that its financing statement did comply with Article 9 because it contained the debtor's legal name, EDM Corporation.⁶⁹

59. See, e.g., *First Cmty. Bank of E. Tenn. v. Jones (In re Silver Dollar, LLC)*, No. 06-50568, 2008 Bankr. LEXIS 3270, at *7-9 (Bankr. E.D. Tenn. Aug. 11, 2008); *In re John's Bean Farm of Homestead, Inc.*, 378 B.R. 385, 390 (Bankr. S.D. Fla. 2007).

60. U.C.C. § 9-503(a)(1) (2001).

61. *Id.* § 9-503(a)(2), (3).

62. *Id.* § 9-503(a)(4)(A).

63. *Id.* § 9-503(a)(4)(B).

64. *Hastings State Bank v. EDM Corp. (In re EDM Corp.)*, No. BK08-40788-TLS, 2009 Bankr. LEXIS 202, at *3 (Bankr. D. Neb. Feb. 10, 2009).

65. *Id.* at *5.

66. *Id.* at *3.

67. *Id.* at *4.

68. *Id.* at *8-9.

69. *Hastings State Bank*, 2009 Bankr. LEXIS 202, at *8.

Furthermore, one of the Official Comments to Article 9 specifically allows creditors to add a debtor's trade names to the financing statement.⁷⁰

The bankruptcy court noted that the reasonably diligent searcher standard under old Article 9 has been replaced by the "single search" standard of U.C.C. section 9-506(c).⁷¹ The court observed that a search of the Nebraska Secretary of State's records using the debtor's legal name, EDM Corporation, did not reveal Hastings's financing statement listing the debtor as "EDM Corporation d/b/a EDM Equipment."⁷² Under the "single search" standard, therefore, Hastings's financing statement was invalid.⁷³ In addition, the court remarked that the additional name, "EDM Equipment," did not appear to be a registered trade name or even necessarily a name commonly used by the debtor.⁷⁴ Thus, the later secured party, Huntington, was entitled to priority over Hastings.⁷⁵ The court itself commented on the seeming strangeness of this decision:

Hastings acted in a manner that many would consider prudent—it included on its financing statement the debtor's true legal name as well as another name by which the debtor was apparently known. Hastings tried to cover all its bases. Frankly, it is hard to understand why the Secretary of State search engine fails to find that financing statement.⁷⁶

One point, however, that the court arguably missed is that the "single search" standard of U.C.C. section 9-506(c) applies only if section 9-506(b) is not satisfied—in other words, only if the secured party's financing statement "fails sufficiently to provide the name of the debtor in accordance with Section 9-503(a)."⁷⁷ In this case, Hastings did

70. *Id.* (citing U.C.C. § 9-503 cmt. 2).

71. *Id.* at *9-10 (citing *Genoa Nat'l Bank v. Southwest Implement, Inc.* (*In re Borden*), 353 B.R. 886, 888-89 (Bankr. D. Neb. 2006)); *see also* U.C.C. § 9-506(c).

72. *Hastings State Bank*, 2009 Bankr. LEXIS 202, at *9.

73. *Id.* at *10.

74. *Id.* at *8.

75. *Id.* at *16-17.

76. *Id.* at *10. Another bankruptcy court expressed similar frustration at the rigidity of the official search logic where the filing system distinguished between "and" and "&" rather than treating them interchangeably:

I feel it is important to note that while I am compelled to make that decision, it is not at all an easy one to make. The evidence showed that over many years Debtor used the "and" and the "&" interchangeably. Clearly, Debtor considered it to be a distinction without significance. Frankly, it is hard to understand why the Secretary of State's search logic failed to recognize the "&" symbol as the equivalent of "and" since "&" literally means "and."

Myers v. Am. Exch. Bank (*In re Alvo Grain & Feed, Inc.*), No. BK08-80876-TLS, 2009 Bankr. LEXIS 4259, at *9 (Bankr. D. Neb. Nov. 20, 2009).

77. U.C.C. § 9-506(c).

place the debtor's correct legal name, EDM Corporation, on its financing statement although it went on to add a trade name.⁷⁸ Seemingly, then, Hastings complied with the Code sections requiring the debtor's name on a financing statement⁷⁹ and defining an organizational debtor's name as its officially registered name.⁸⁰ As a consequence, Hastings arguably did not violate the Code provision rendering financing statements invalid if they *fail* to provide the debtor's correct name.⁸¹

Ultimately, the court apparently felt trapped by U.C.C. section 9-506(c) and the "single search" standard. The subsequent secured party, Huntington, was not able to find the Hastings financing statement in conducting a search of the official database using the debtor's legal name.⁸² The manner in which Hastings set forth the debtor's name—i.e., the legal name followed by a putative trade name—caused the official database's search engine to pass over the Hastings financing statement. The flaw, it would seem, lies with the Nebraska Secretary of State and the rigidity of its search algorithm.⁸³

The holding in *Hastings State Bank* continues the judicial trend in favor of extreme exactitude in setting forth the debtor's name and the almost mechanical application of the "single search" standard. Article 9 requires only the debtor's correct name on the financing statement, which for registered organizations means "the name of the debtor indicated on the public record of the debtor's jurisdiction of organization which shows the debtor to have been organized."⁸⁴ Thus, to be

78. *Hastings State Bank*, 2009 Bankr. LEXIS 202, at *3.

79. U.C.C. § 9-502(a) (2001).

80. *Id.* § 9-503(a)(1).

81. *Id.* § 9-506(b).

82. *Hastings State Bank*, 2009 Bankr. LEXIS 202, at *7.

83. In another case involving an unforgiving search logic, the secured party had listed the debtor's name as "Tyringham Holdings" on the financing statement. Official Comm. of Unsecured Creditors for Tyringham Holdings, Inc. v. Suna Bros., Inc. (*In re Tyringham Holdings, Inc.*), 354 B.R. 363, 364 (Bankr. E.D. Va. 2006). The debtor's legal name was Tyringham Holdings, Inc. *Id.* Ordinarily, a search under the debtor's legal name in a typical computerized filing system would have revealed the secured party's financing statement because "Inc." is treated as a noise word and is ignored by both the filing and searching mechanism. *Id.* at 366. In this case, however, the Virginia filing office's search logic did not treat "Inc." as a noise word, and the secured party's financing statement was not found in a "single search." *Id.* at 368. The court found the filing insufficient. *Id.* Similarly, in another bankruptcy case, the court found the secured party's financing statement insufficient where the debtor's correct legal name was Alvo Grain and Feed, Inc., and the name on the financing statement was "Alvo Grain & Feed, Inc." Myers v. Am. Exch. Bank (*In re Alvo Grain & Feed, Inc.*), No. BK08-80876-TLS, 2009 Bankr. LEXIS 4259, at *8-9 (Bankr. D. Neb. Nov. 20, 2009). The standard search logic of the Nebraska filing system distinguished between "and" and "&," and thus the use of "&" in the debtor's name on the financing statement constituted a fatal error.

84. U.C.C. §§ 9-502(a)(1), 9-503(a)(1) (2001).

completely safe and to avoid the somewhat odd result in *Hastings State Bank*, a secured creditor should ascertain the debtor's legal name and put that name alone on the financing statement. If a creditor feels disposed to add the debtor's trade names,⁸⁵ it should then run a test search in the official public database under the debtor's legal name to determine whether the financing statement is disclosed.⁸⁶ If it is not, the creditor should refile using only the debtor's correct legal name.

The 2010 Amendments to Article 9 pursue the seemingly elusive goal of providing bright line rules regarding the debtor's name on the financing statement. One of the amendments, in particular, narrows the possible choice for setting forth the name of a debtor who is an individual. As mentioned previously, before the 2010 Amendments, Article 9 stated that a financing statement "sufficiently provides the name of the debtor . . . if the debtor has a name, only if it provides the individual or organizational name of the debtor."⁸⁷ The 2010 Amendments offer two alternative provisions applying to individual debtor names. Under Alternative A, the secured party is directed to use the name of an individual debtor as indicated on his/her unexpired driver's license issued by "this State."⁸⁸ If the debtor does not have an unexpired driver's license issued by "this State," then the secured party should provide the "individual name of the debtor or the surname and first personal name of the debtor."⁸⁹

Under Alternative B, the secured party may choose among the driver's license name, individual name, or surname/first name options. A financing statement will be sufficient if the secured party uses either (A) the debtor's individual name; (B) the debtor's surname and first personal name; or (C) the debtor's name as indicated on an unexpired driver's license issued by the state of the debtor's principal residence.⁹⁰ This alternative gives the filing creditor more flexibility: The secured party may appropriately use any of those three names on the financing statement. Obviously, employing the name on an unexpired driver's license from the debtor's home state may be the easiest way to comply with the statute—the creditor does not have to go through other papers offered by the debtor, such as a birth certificate, income tax return, or social security card, and possibly have to reconcile in-

85. *See id.* § 9-503(b)(1) (not requiring trade names on financing statements).

86. *See id.* § 9-523(c) (requiring the filing office to respond to requests for information about financing statements on file).

87. U.C.C. § 9-503(a)(4)(A) (2001).

88. U.C.C. § 9-503(a)(4) Alt. A (amended 2010).

89. *Id.* § 9-503(a)(5).

90. *Id.* § 9-503(a)(4) Alt. B.

consistent names on them. In cases where the debtor does not have a current driver's license from his/her home state, the creditor will find itself with the same options offered by Alternative A—the debtor's individual name or his/her surname and first personal name.

In addition, the amended provisions change debtor name requirements for registered organizations to pinpoint a single name for a corporation, limited liability company, limited partnership, or other registered organization.⁹¹ The pre-amendment version of Article 9 directed secured parties to use the name of a registered organization debtor as “indicated on the public record of the debtor's jurisdiction of organization which shows the debtor to have been organized.”⁹² The 2010 Amendments change this language so as to require creditors to file against a registered organization using the name “that is stated to be the registered organization's name on the public organic record most recently filed with or issued or enacted by the registered organization's jurisdiction of organization which purports to state, amend, or restate the registered organization's name.”⁹³ “Public organic record” is basically a new concept that refers to the organization's “birth certificate”—i.e., the actual record initially filed with the state or federal government to form the organization or to amend or restate the initial record.⁹⁴

These proposed changes, one can hope, will reduce the apparently never ending stream of cases litigating the sufficiency of the debtor's name on a financing statement. By attempting to specify and narrow the range of choices for filers and searchers, the amendments provide safe harbors for filing creditors in picking a debtor name for the financing statement while maintaining a very limited number of searching options for the party seeking accurate information from the public filing system.

B. *Seriously Misleading Debtor Name Changes*

Even if the original filing secured creditor gets the debtor's name completely accurate on its financing statement, a change in the debtor's name can render the financing statement seriously misleading

91. The amendments also set forth changes to debtor name requirements for estates and trusts. *See id.* § 9-503(a)(2), (3) (amended 2010).

92. U.C.C. § 9-503(a)(1) (2001).

93. U.C.C. § 9-503(a)(1) (amended 2010). The definition of “registered organization” is also amended to clarify that a registered organization is an organization formed or organized under state or federal law “by the filing of a public organic record with, the issuance of a public organic record by, or the enactment of legislation by the State or United States.” *Id.* § 9-102(a)(71).

94. *Id.* § 9-102(a)(68).

and almost impossible to find by later searchers.⁹⁵ In dealing with debtor name changes, Article 9 attempts to balance filers' interests in not having to monitor the debtor too closely and searchers' interests in having an accurate database to search. Thus, the Code drafters created a four-month rule with respect to seriously misleading changes in the debtor's name.⁹⁶ A recent bankruptcy decision, *Gugino v. Wells Fargo Bank Northwest, N.A. (In re Lifestyle Home Furnishings, LLC)*,⁹⁷ interpreted the four-month rule where the debtor breached its contractual obligation to inform the secured creditor in advance of changes in its name.

In *Gugino*, the Bank made a loan to the debtor, Factory Direct, LLC, and took a security interest in the debtor's inventory, accounts, equipment, and general intangibles. In November 2003, the Bank filed a financing statement in the appropriate public office, listing the debtor's correct name.⁹⁸ In early 2007, two individuals purchased the debtor and received additional loans from the Bank. On May 7, 2007, the debtor officially changed its organizational name from "Factory Direct, LLC" to "Lifestyle Home Furnishings, LLC."⁹⁹ The Bank did not file a new financing statement or amend the existing one to reflect the name change.¹⁰⁰ On April 7, 2008, Lifestyle filed a Chapter 7 petition in bankruptcy, and the bankruptcy trustee sought to avoid the Bank's unperfected security interest under the strong-arm clause of the federal Bankruptcy Code.¹⁰¹

The bankruptcy court in *Gugino* noted that Article 9 provides a four-month rule for debtor name changes:

If a debtor so changes its name that a filed financing statement becomes seriously misleading . . . (1) [t]he financing statement is effective to perfect a security interest in collateral acquired by the debtor before, or within four (4) months after, the change; and (2) [t]he financing statement is not effective to perfect a security interest in collateral acquired by the debtor more than four (4) months after the change, unless an amendment to the financing statement which renders the financing statement not seriously misleading is filed within four (4) months after the change.¹⁰²

95. See, e.g., Official Comm. of Unsecured Creditors Propex Inc. v. BNP Paribas (*In re Propex Inc.*), 415 B.R. 321, 332 (Bankr. E.D. Tenn. 2009); Continental Oil Co. v. Citizens Trust & Sav. Bank, 244 N.W.2d 243, 247 (Mich. 1976); Harry C. Sigman, *The Filing System Under Revised Article 9*, 73 AM. BANKR. L.J. 61, 80 (1999).

96. U.C.C. § 9-507(c).

97. No. 08-00629-TLM, 2010 Bankr. LEXIS 111 (Bankr. D. Idaho Jan. 14, 2010).

98. *Id.* at *3-4.

99. *Id.* at *4.

100. *Id.*

101. *Id.* at *5 (citing 11 U.S.C. § 544(a) (2006)).

102. *Gugino*, 2010 Bankr. LEXIS 111, at *7-8 (citing Idaho's version of U.C.C. § 9-507(c)).

In determining whether a debtor name change renders the filed financing statement “seriously misleading,” the court looked to the “single search” standard under section 9-506(c) and the basic debtor name provisions of section 9-503.¹⁰³ The court observed that for a registered organization such as this debtor, the financing statement must contain “the name of the debtor indicated on the public record of the debtor’s jurisdiction of organization which shows the debtor to have been organized.”¹⁰⁴ The court then concluded that the change in the debtor’s name from “Factory Direct, LLC” to “Lifestyle Home Furnishings, LLC” rendered the Bank’s original filed financing statement seriously misleading.¹⁰⁵ The Bank basically conceded that a search under the debtor’s new name would not have disclosed the Bank’s filing under the old name.¹⁰⁶

In applying the four-month grace period to the facts before it, the court in *Gugino* stated that the Bank’s security interest lost its perfection only in collateral acquired more than four months after the debtor’s name change.¹⁰⁷ The Code drafters deliberately crafted the rule to avoid loss of perfection in older collateral—i.e., collateral acquired by the debtor before the name change and within four months thereafter. The rule’s rationale is apparently to protect secured parties with static collateral, such as equipment financiers, and to require monitoring by secured parties with changing collateral, such as accounts and inventory financiers.¹⁰⁸ Because debtors only occasionally replace old equipment, the equipment secured party can be assured that its financing statement will remain effective for most of its collateral—most, if not all, of the debtor’s equipment will have been acquired before the name change when the parties originally entered into their secured transaction. Inventory and accounts financiers, on the other hand, must remain alert to possible debtor name changes because their collateral constantly turns over:¹⁰⁹ old inventory is sold

103. *Id.* at *8-9. The 2010 Amendments to Article 9 change section 9-507(c) to clarify that the predicate for a meaningful debtor name change is that “the name that a filed financing statement provides for a debtor becomes insufficient as the name of the debtor under Section 9-503(a).” U.C.C. § 9-507(c) (amended 2010).

104. *Gugino*, 2010 Bankr. LEXIS 111, at *8 (citing Idaho’s version of U.C.C. § 9-503(a)(1)).

105. *Id.* at *11.

106. *Id.* at *10-11 n.6.

107. *Id.* at *11-12 n.7.

108. See LYNN M. LoPUCKI & ELIZABETH WARREN, SECURED CREDIT: A SYSTEMS APPROACH 393 (6th ed. 2009) (noting the difference in the four-month rule’s application to equipment vs. inventory financiers).

109. Russell A. Hakes, *According Purchase Money Status Proper Priority*, 72 OR. L. REV. 323, 388 (1993); Mark B. Wessman, *Purchase Money Inventory Financing: The Case for Limited Cross-Collateralization*, 51 OHIO ST. L.J. 1283, 1289 (1990).

and replaced with new items, and old accounts are paid by customers and new accounts are created over the course of time.

In the drafters' view, inventory and accounts secured creditors have to monitor their debtors closely anyway to ensure that the debtor is maintaining proper levels of collateral.¹¹⁰ To ask them to take on the additional responsibility of tracking debtor name changes is not imposing a significant burden on them. Equipment secured parties, on the other hand, tend to be more passive and to not interact with their debtors unless the debtors' payments stop coming. Thus, asking equipment financiers to assume the responsibility to keep abreast of debtor name changes would place a substantial burden on them.

In *Gugino*, the Bank had taken a security interest in both types of collateral—equipment and inventory/accounts.¹¹¹ The court acknowledged that it would have to determine at trial which collateral had been acquired more than four months after the name change—i.e., on or after September 8, 2007.¹¹² Given the bankruptcy filing on April 7, 2008, it is likely that much of the debtor's inventory and accounts would have turned over after September 8, 2007. In that event, the Bank would have lost perfection of its security interest in a large portion of its collateral and have its unperfected security interest subject to avoidance by the bankruptcy trustee.

In a final, last-ditch effort to save its perfection, the Bank argued that the court should impose a constructive trust on the collateral in favor of the Bank.¹¹³ A constructive trust is an equitable remedy imposed in favor of the victim of fraud, duress, or other inequitable conduct.¹¹⁴ The trust provides that a wrongdoer holds property for the benefit of the victim.¹¹⁵ Once subject to a constructive trust, the property is immune to the claims of other creditors of the wrongdoer.¹¹⁶ The Bank in *Gugino* asserted that the debtor had breached its con-

110. See, e.g., *Transamerica Comm. Fin. Corp. v. Littleton (In re Littleton)* 942 F.2d 551, 552-53 (9th Cir. 1991) (describing inventory monitoring arrangement); *United States v. Steffen*, No. 4:10CR371JCH(MLM), 2010 U.S. Dist. LEXIS 119278, at *15 (E.D. Mo. Oct. 25, 2010) (describing inventory monitoring arrangement).

111. *Gugino*, 2010 Bankr. LEXIS 111, at *3-4.

112. *Id.* at *11-12 n.7.

113. *Id.* at *13-14.

114. See 1 DAN B. DOBBS, *LAW OF REMEDIES* 597-98 (2d ed. 1993) (listing embezzlement, fraud, duress, undue influence, and misuse to position or information as bases for the imposition of a constructive trust).

115. *Id.* at 595 (noting that in a constructive trust "the defendant has legal title and must therefore be treated as a 'trustee' who holds that title for the plaintiff.").

116. *Id.* at 594. The theoretical justification for giving the plaintiff who has been awarded a constructive trust over property in the defendant's possession priority over the defendant's other creditors is that the property in question was never really the defendant's; it was in fact being held in trust for the plaintiff. *Id.*

tractual obligation to inform the Bank of any debtor name changes.¹¹⁷ In addition, after changing its registered name, the debtor had continued to do business under its old name, thus creating the impression that the old name was still its official legal name.¹¹⁸ The court declined to rule on the constructive trust issue and stated that certain factual issues needed to be resolved at trial before a final determination could be made.¹¹⁹ The court noted, however, that bankruptcy courts are reluctant to use constructive trusts to save secured parties from loss of perfection as such remedies tend to upset the carefully crafted bankruptcy distribution scheme.¹²⁰

Dealing with debtor name changes can be a tricky problem for secured parties. The Bank in *Gugino* had the right idea in insisting on a contractual provision requiring the debtor to inform it in advance of any name changes.¹²¹ Breach of that provision was undoubtedly a default under the loan agreement and gave the creditor the power to accelerate the loan balance. Notwithstanding the incentives to behave, sometimes debtors run amok, drastically changing their names and not telling the secured party. The secured party should try to have in place certain monitoring systems, under which the creditor keeps track of the name that the debtor is using on its checks to the secured party, on its letterhead, and in its advertising. In addition, the secured party should run a routine check every four months in the state's corporate registry, which should reveal whether or not the debtor has changed its legal name. If a name change has occurred, the secured party should immediately refile using the new name. Finally, if the creditor does not learn of the name change despite its best efforts and the debtor goes into bankruptcy, it can always argue the equities in its favor and beg the court for a constructive trust.

C. Collateral Descriptions on Financing Statements

Filling out the financing statement should be a relatively straightforward task for the secured creditor. Getting the debtor's name set forth correctly and updating the record after substantial debtor name changes, however, can prove a challenging matter, as discussed above.

117. *Gugino*, 2010 Bankr. LEXIS 111, at *13.

118. *Id.*

119. *Id.* at *16.

120. *Id.* at *14-15. Compare *In re North American Coin & Currency, Ltd.*, 767 F.2d 1573, 1575 (9th Cir. 1985) (cautioning against the use of constructive trusts in bankruptcy) with *Sanyo Electric, Inc. v. Howard's Appliance Corp. (In re Howard's Appliance Corp.)*, 874 F.2d 88, 94 (2d Cir. 1989) (allowing a constructive trust in bankruptcy where the debtor had failed to inform the secured party that it had moved the collateral to another state).

121. *Gugino*, 2010 Bankr. LEXIS 111, at *13.

Further, adequately describing the collateral on the financing statement can apparently also elude the secured party.¹²² Collateral descriptions on financing statements pose particular concerns for secured parties because the debtor must authorize the filing against specified collateral.¹²³ In a recent decision, the Eighth Circuit Court of Appeals reversed the district court's ruling and held that the secured party's indication of collateral, although containing some errors and at least partially unauthorized, was legally sufficient.¹²⁴ The court emphasized the very general notice-giving function of the financing statement and the need for subsequent parties to inquire further about the exact nature of the security interest indicated in the financing statement.

In *ProGrowth Bank, Inc. v. Wells Fargo Bank, N.A.*, the plaintiff secured party, ProGrowth Bank, sought a declaratory judgment against an earlier secured party, Global One Financial, Inc., and its agent, Wells Fargo Bank, N.A., to the effect that the plaintiff's security interest in the debtor's annuity contracts had priority over the defendants' security interests.¹²⁵ Global had filed a financing statement through its agent, Wells Fargo, on September 8, 2005, listing the debtor as "Christopher J. Hanson" and the collateral as "[a]ll of Debtor's right, title, and interest in and to, assets and rights of Debtor, wherever located and whether now owned or hereafter acquired or arising, and all proceeds and products in that certain Annuity Contract No.: LE900015 issued by Lincoln Benefit Life in the name of Debtor. . . ."¹²⁶ The number and issuer for the annuity contract specified by the security agreement were incorrect on the financing statement. The actual number of the annuity contract was "L9E00015," and the actual issuer was Fidelity & Guaranty Life Insurance Company.¹²⁷

122. As mentioned previously, an effective financing statement need contain only three pieces of information: the debtor's name, the secured party's name (or the name of its representative), and an indication of the collateral. U.C.C. § 9-502(a). Article 9 gives secured parties two distinct ways to indicate the collateral: they can either describe the collateral in accordance with section 9-108 or use a supergeneric description such as "all assets" or "all personal property." *Id.* § 9-504. A description of collateral under section 9-108 is sufficient if "it reasonably identifies what is described." *Id.* § 9-108(a).

123. The secured party must obtain authorization to file a financing statement from the debtor, either in the security agreement or in a separate document authenticated by the debtor. U.C.C. § 9-509(a), (b). If the secured party is relying on the security agreement to provide authorization, the financing statement collateral description must track that on the security agreement. *Id.* § 9-509(b)(1).

124. *ProGrowth Bank, Inc. v. Wells Fargo Bank, N.A.*, 558 F.3d 809, 815 (8th Cir. 2009).

125. *Id.* at 811.

126. *Id.*

127. *Id.*

On September 16, 2005, Global filed a second financing statement through its agent listing the same debtor and containing an almost identical collateral description.¹²⁸ The only difference in the collateral description was the number of the annuity contract: “L9E00016,” the correct number for a second annuity contract encumbered by the parties’ security agreement.¹²⁹ The annuity issuer, however, was still incorrectly identified as “Lincoln Benefit Life” instead of “Fidelity & Guaranty.”¹³⁰

In February 2006, the debtor obtained a loan from ProGrowth and gave it a security interest in the same two annuity contracts.¹³¹ On February 14, 2006, ProGrowth filed two financing statements with the Missouri Secretary of State accurately describing the collateral as “Fidelity and Guaranty Life Insurance Annuity Contracts Number L9E00015 and Number L9E00016.”¹³² A year later ProGrowth instituted a suit for declaratory judgment to the effect that its security interests in the annuity contracts were superior to those of Global.¹³³ Specifically, ProGrowth argued that Global’s financing statements were seriously misleading by virtue of the collateral description errors and that therefore Global’s security interests in the annuity contracts were unperfected.¹³⁴ The district court granted the plaintiff’s motion for summary judgment, and the defendants appealed.¹³⁵

Before the Eighth Circuit Court of Appeals, the parties agreed that the priority issue turned on whether the defendants had properly perfected their security interests in the debtor’s annuity contracts.¹³⁶ The Court of Appeals began by noting that an indication of collateral is one of the three basic pieces of information that must be on a financing statement.¹³⁷ In fulfilling this requirement, secured parties may provide a description of collateral that complies with U.C.C. section 9-108 (providing a “reasonable identification” standard) or may list the collateral more generally as “all assets” or “all personal property.”¹³⁸ In assessing the sufficiency of financing statements, courts are to apply Article 9’s “substantial compliance” standard, which states that “[a] financing statement substantially satisfying the requirements of this

128. *Id.*

129. *ProGrowth Bank*, 558 F.3d at 811.

130. *Id.*

131. *Id.*

132. *Id.*

133. *Id.*

134. *ProGrowth Bank*, 558 F.3d at 811-12.

135. *Id.* at 812.

136. *Id.*

137. *See id.* (citing Missouri’s version of U.C.C. § 9-502(a)).

138. *See id.* (citing Missouri’s version of U.C.C. § 9-504).

part is effective, even if it has minor errors or omissions, unless the errors or omissions make the financing statement seriously misleading.”¹³⁹

The plaintiff argued that under the substantial compliance standard, the defendants’ financing statements were seriously misleading because they misidentified the annuity issuer for both annuity contracts and the annuity number for one of them.¹⁴⁰ The court indicated that if the annuity descriptions were the only collateral descriptions in the financing statements, it would “be inclined to agree” with the plaintiff’s argument.¹⁴¹ The financing statements, however, also contained a general “all assets” description of collateral, and this description, the court held, was sufficient to include the annuity contracts.¹⁴² The plaintiff tried to rebut that position by arguing that the “all assets” clause was modified by the subsequent specific language describing the annuity contracts by issuer and number.¹⁴³ But the court stated that “this interpretation . . . is unduly restrictive and ignores the plain language of the statements.”¹⁴⁴ The two clauses describing the collateral, the court observed, were joined by an “and” and thus independent of each other.¹⁴⁵ As a result, the “all assets” description was not narrowed by the subsequent language referring to the annuity contracts.¹⁴⁶

The court also noted that even if the plaintiff’s interpretation of the financing statement language were reasonable, the defendants’ interpretation was reasonable as well. Consequently,

[w]here a description can reasonably be interpreted in one of two ways—one of which may cover the collateral at issue and one of which does not—notice filing has served its purpose of alerting subsequent creditors to the possibility that a piece of collateral may be covered; the burden is then on the subsequent creditor to inquire further.¹⁴⁷

Further, although the specific description of the annuity contracts contained seriously misleading errors, an inquiring creditor would be alerted by the “all assets” clause to the possibility that the annuity

139. See *ProGrowth Bank*, 558 F.3d at 812 (citing Missouri’s version of U.C.C. § 9-506(a)).

140. *Id.* at 813.

141. *Id.*

142. *Id.*

143. *Id.*

144. *ProGrowth Bank*, 558 F.3d at 813-14.

145. *Id.* at 814.

146. *Id.*

147. *Id.*

contracts in question could be subject to a security interest in favor of Global.¹⁴⁸

The lessons offered by this case are harsh for both debtors and subsequent inquiring third parties. First, a secured party may file an “all assets” financing statement seemingly without the debtor’s authorization and end up in the senior position. On remand, the district court held that even if the “all assets” clause in the financing statement was not authorized as required by Article 9, the portion of that clause covering the annuity contracts was authorized by virtue of the security agreement signed by the debtor.¹⁴⁹ In other words, a secured party can exceed the scope of the agreed upon language in the security agreement by filing an “all assets” financing statement and not suffer any consequences beyond possible liability for statutory and actual damages.¹⁵⁰ Second, subsequent inquiring creditors must be on “high alert” when they see an “all assets” financing statement even when the financing statement describes specifically two annuity contracts in which the subsequent creditor has no interest. In this case, ProGrowth, the subsequent creditor, was interested in taking a security interest in two specific annuity contracts owned by the debtor. Upon conducting a search, ProGrowth would have seen Global’s financing statement covering “all assets” and two annuity contracts apparently unrelated to the ones shown to ProGrowth by the debtor. Given the human tendency to focus on the specific over the general, it is quite likely that ProGrowth would have concluded that the two annuity contracts in which it was interested were not covered by the financing statement.

Ultimately, the Eighth Circuit decision in *ProGrowth Bank* may leave one slightly uncomfortable: the senior secured party botched its description of the annuity contracts on the financing statement but saved its perfection by adding an unauthorized “all assets” clause. But despite the decision’s counterintuitive quality, it embodies a correct reading of Article 9.¹⁵¹ The check on overreaching collateral descriptions lies in Article 9’s damages provisions.¹⁵² In addition, the debtor could demand that the secured party file an amendment to the

148. *Id.*

149. *See* *ProGrowth Bank, Inc. v. Wells Fargo Bank, N.A.*, No. 07-1577, 2009 U.S. Dist. LEXIS 83805, at *33-34 (D. Minn. Sept. 14, 2009) (citing Missouri’s version of U.C.C. §§ 9-509(a), 9-510(a)).

150. *See* U.C.C. § 9-625(b), (e) (providing for actual and statutory damages for filing of an unauthorized financing statement).

151. *See id.* § 9-509 cmt. 1.

152. *Id.* § 9-625(b), (e).

financing statement to remove the “all assets” portion in exchange for giving up its damages suit against the creditor.¹⁵³

Attorneys setting up these types of transactions should make sure that the collateral description on the financing statement matches that on the security agreement and that both descriptions are accurate.¹⁵⁴ If the secured party wants to use a more general collateral description on the financing statement (e.g., “annuity contracts”) instead of the precise description used on the security agreement, the creditor should obtain separate authorization from the debtor to use the more general language. Finally, searching parties who run across a financing statement with an “all assets” clause or similar supergeneric language should investigate thoroughly the transaction behind that financing statement. Given the senior secured party’s ability under Article 9 priority rules to have the priority of a subsequent security agreement relate back to the time of the original filing,¹⁵⁵ the subsequent creditor should insist that the “all assets” clause be narrowed or run the risk of being junior to the earlier creditor in whatever collateral the subsequent party may take a security interest.

D. *Perfection of Security Interests by Control: Deposit Accounts*

Security interests in deposit accounts pose special problems under Article 9. First, the normal mechanism for perfecting a security interest—the filing of a financing statement in the public record—is not used for secured transactions involving deposit accounts.¹⁵⁶ Second, the ordinary chronological rules for prioritizing competing secured parties often do not apply either.¹⁵⁷ Thus, a secured creditor seeking to create, perfect, and enforce a security interest in its debtor’s deposit accounts must be mindful of the particular Article 9 provisions governing these types of transactions. A recent Nebraska Supreme Court decision reveals that depository banks that take security interests in their customers’ accounts enjoy a favored status under Article 9—a

153. *See id.* § 9-512 (providing for amendments to financing statements, including deletions of collateral). The debtor could also file a “correction statement” indicating that the financing statement was wrongfully filed with respect to certain collateral listed. *Id.* § 9-518.

154. *See id.* § 9-509(b) (providing that the debtor’s authentication of a security agreement authorizes the secured party to file a financing statement using the same collateral description).

155. U.C.C. § 9-322(a)(1).

156. *See id.* § 9-312(b)(1) (specifying that security interests in deposit accounts may be perfected only by control with the exception of cash proceeds placed into a deposit account).

157. *See id.* § 9-327(1) (giving secured parties with control over deposit accounts priority over secured parties that hold security interests in deposit accounts perfected through a proceeds analysis) and § 9-327(2) (awarding first priority to the depository bank unless the secured party has become the bank’s customer with respect to the account).

status that pushes other secured and lien creditors down the priority ladder.¹⁵⁸

Under Article 9, a deposit account is defined as “a demand, time, savings, passbook, or similar account maintained with a bank.”¹⁵⁹ Hence, a traditional checking or savings account held at a bank would qualify as an Article 9 deposit account. Because the term, however, does not include “investment property or accounts evidenced by an instrument,” negotiable certificates of deposit or money market-type accounts would seemingly not constitute a deposit account but would fall into another category of collateral.¹⁶⁰

Unlike the typical security interest, which is perfected by filing, deposit account security interests are perfected through a mechanism called “control.” Although one provision suggests that perfection by control is permissive for deposit accounts,¹⁶¹ in fact, security interests in deposit accounts “may be perfected only by control,” unless proceeds are involved.¹⁶² A secured party may achieve control of a deposit account in one of three ways: (1) by becoming the depository bank at which the account is maintained; (2) by entering into a tripartite agreement with the debtor and the depository bank that gives the secured party authority over the account; or (3) by becoming the “bank’s customer with respect to the deposit account.”¹⁶³ Obviously, for non-bank secured parties the first option is not available. The second option requires that the debtor, the secured party, and the depository bank authenticate a record specifying “that the bank will comply with instructions originated by the secured party directing disposition of the funds in the deposit account without further consent by the debtor.”¹⁶⁴ Under the third option, the secured party would become a named holder of the account, presumably jointly with the debtor.¹⁶⁵

A non-bank secured creditor choosing between the second and third options should note that the third option is ordinarily going to be the better choice for the creditor. As an account holder, the creditor could presumably withdraw the funds necessary to satisfy the defaulting debtor’s obligation with or without the depository bank’s active

158. See *Myers v. Christensen*, 776 N.W.2d 201 (Neb. 2009).

159. U.C.C. § 9-102(a)(29).

160. *Id.*

161. *Id.* § 9-314(a).

162. *Id.* § 9-312(b)(1). Deposit accounts are considered to be cash proceeds, and security interests in identifiable cash proceeds are afforded automatic continuation of perfection. *Id.* §§ 9-102(a)(9); 9-315(c), (d)(2).

163. U.C.C. § 9-104(a).

164. *Id.* § 9-104(a)(2).

165. *Id.* § 9-104(a)(3).

cooperation.¹⁶⁶ Under the second option, however, the bank might require that the secured party satisfy certain conditions before it could access funds in the debtor's account—for example, the creditor might have to demonstrate that the debtor was truly in default before the bank would transfer funds to the creditor.¹⁶⁷

Apart from control, the only other way for a secured party to achieve perfection of a security interest in a deposit account is through a proceeds claim. For example, a secured party may have a security interest in the debtor's inventory perfected by filing. If the debtor sells some inventory to customers and receives cash payments, the Code gives the secured party an automatic carryover interest in those payments as proceeds as long as they are identifiable.¹⁶⁸ In addition, the security interest in cash proceeds is automatically perfected for twenty days after the proceeds are generated and indefinitely beyond that point.¹⁶⁹ If the debtor deposits the payments into a bank account, they retain their character as cash proceeds.¹⁷⁰

Given the frequent presence of both secured parties with direct security interests in their debtor's deposit accounts and those with a proceeds interest, it is perhaps inevitable that a priorities contest will result. For security interests in deposit accounts, the normal chronological order of priority is sometimes followed.¹⁷¹ For example, security interests in deposit accounts perfected by control are generally ranked according to "priority in time of obtaining control."¹⁷² But there are important exceptions to the chronological ranking. For example, a security interest perfected by control always has priority over a security interest perfected by means of the automatic perfection in cash proceeds, regardless of the chronological order of the transactions.¹⁷³ In addition, a security interest of a depository bank in a customer's account will trump an earlier security interest in that account where the secured party achieved control by means of a tripartite

166. *See, e.g.*, *Nall v. Duff*, 805 S.W.2d 63, 65-66 (Ark. 1991) (holding that each joint tenant of a bank account may withdraw the entire amount in the account without the other tenants' permission); *Mich. Dep't of Treasury v. Comerica Bank*, 506 N.W.2d 283, 286-87 (Mich. Ct. App. 1993) (holding that each joint tenant of a bank account may withdraw the entire amount in the account without the other tenants' permission).

167. *See* U.C.C. § 9-104 cmt. 3.

168. *Id.* § 9-315(a)(2).

169. *Id.* § 9-315(c), (d)(2).

170. *See id.* § 9-102(a)(9) (defining cash proceeds as "money, checks, deposit accounts or the like.>").

171. *See id.* § 9-322(a)(1) (creating the first-to-file or perfect rule).

172. U.C.C. § 9-327(2).

173. *Id.* § 9-327(1).

agreement with the bank and the debtor.¹⁷⁴ If, however, the non-bank secured party attained control by becoming the bank's customer with respect to the debtor's account, it will have priority over the depository bank.¹⁷⁵

The most favored status afforded depository banks holding security interests in their customers' deposit accounts was reflected in the recent Nebraska Supreme Court decision in *Myers v. Christensen*.¹⁷⁶ In *Myers*, the depository bank, Charter West, held a perfected security interest in the debtor Gencon's deposit accounts with Charter West.¹⁷⁷ The trustee in bankruptcy of a judgment creditor of Gencon served a garnishment summons on Charter West, seeking to enforce a judgment of \$10,450.¹⁷⁸ At the time that Charter West received the summons, Gencon's deposit account contained \$30,702, and Gencon was in default to Charter West on loans exceeding \$400,000.¹⁷⁹ Charter West did not seek to enforce its security interest in the deposit account until after it was served with the garnishment summons.¹⁸⁰

In the ensuing action by the trustee against Charter West, the trustee argued that Charter West, once having received the garnishment summons, was bound by Nebraska law to hold the funds in the debtor's deposit account for the garnishor.¹⁸¹ The lower court agreed and held that Charter West was liable to the trustee in the full amount of the \$10,450 claim.¹⁸² Charter West appealed, and the Nebraska Supreme Court reversed the lower court's judgment.¹⁸³ The Nebraska Supreme Court held that the lower court had failed to give proper effect to Charter West's status as a perfected Article 9 secured party.¹⁸⁴ Unquestionably, perfected security interests have priority over unperfected security interests, over the interests of lien creditors, and over the interests of unsecured creditors.¹⁸⁵ The trustee as garnishor was at most some kind of lien creditor and was therefore

174. *Id.* § 9-327(3).

175. *Id.* § 9-327(4).

176. 776 N.W.2d 201 (Neb. 2009).

177. *Id.* at 205.

178. *Id.* at 203.

179. *Id.* at 203-04.

180. *Id.* at 204. Even after the garnishment summons was served, the bank continued to honor checks drawn by the debtor on the account based on the knowledge that the debtor had recently commenced a large construction project, the success of which would increase the bank's chances of repayment. *Myers*, 776 N.W.2d at 204.

181. *Id.* at 207.

182. *Id.* at 204.

183. *Id.* at 208.

184. *Id.* at 207.

185. See U.C.C. §§ 9-201(a) (affording secured parties priority over other creditors unless the U.C.C. provides otherwise), 9-317 (a)(2) (giving perfected secured parties priority over lien cred-

subordinate to the perfected security interest of the depository bank.¹⁸⁶ Because the debtor was in default to Charter West, the latter had the right to enforce its security interest in the debtor's account by applying the account balance to the secured obligation.¹⁸⁷

The Nebraska Supreme Court further held Charter West had not waived its security interest by continuing to honor some checks drawn on the deposit account even after the debtor's default.¹⁸⁸ The bank was allowed to make "a calculated business decision" to try to keep Gencon afloat in the hopes that it could revive its failing business.¹⁸⁹ In addition, Charter West was permitted to ignore the garnishment summons because, in essence, all of the funds in the debtor's deposit account were subject to the bank's superior security interest.¹⁹⁰

Until relatively recently, security interests in deposit accounts were outside the scope of Article 9 and governed by non-U.C.C. law.¹⁹¹ By bringing such transactions within Article 9, the drafters hoped to bring the benefits of the Code's straightforward and uniform scheme to the creation, perfection, and enforcement of security interests in deposit accounts.¹⁹² At the same time, the drafters recognized that the historic expectations of depository banks necessitated a carefully drawn set of specialized rules to sort out the priorities among the various claimants to this unique form of collateral.¹⁹³

E. Perfection of Security Interests in Fixtures: Chattel and Fixture Filings

As discussed earlier, to perfect security interests under Article 9, secured parties normally must file financing statements in the Secre-

itors), 9-322(a)(2) (providing for priority of perfected security interests over unperfected security interests).

186. See *Myers*, 776 N.W.2d at 203 (observing that the trustee was seeking to enforce a judgment received by one of debtor's unsecured creditors).

187. *Id.* at 206. See also U.C.C. § 9-607(a)(4) (stating that after default, a secured party that is the depository bank "may apply the balance of the deposit account to the obligation secured by the deposit account").

188. *Myers*, 776 N.W.2d at 207.

189. *Id.*

190. *Id.* at 207-08.

191. Bruce A. Markell, *From Property to Contract and Back: An Examination of Deposit Accounts and Revised Article 9*, 74 CHI.-KENT L. REV. 963, 968 (1999).

192. See Luize E. Zubrow, *Integration of Deposit Account Financing into Article 9 of the Uniform Commercial Code: A Proposal for Legislative Reform*, 68 MINN. L. REV. 899, 960-68 (1984) (noting the benefits of bringing deposit accounts fully into Article 9).

193. See Steven L. Harris & Charles W. Mooney, Jr., *How Successful Was the Revision of UCC Article 9?: Reflections of the Reporters*, 74 CHI.-KENT L. REV. 1357, 1364-67 (1999) (discussing disagreements among the drafters about whether to include deposit accounts within Article 9, given the numerous unique issues surrounding them).

tary of State's office (or equivalent central filing office) in the state where the debtor is located.¹⁹⁴ One of the important exceptions to this general rule involves perfection of security interests in fixtures. Fixtures span real and personal property and can be described as real property that starts out life as a chattel and could become a chattel once again.¹⁹⁵ Article 9 allows secured parties with security interests in fixtures to make an ordinary chattel filing or to make a fixture filing in the real estate records.¹⁹⁶ Each type of filing perfects the security interest but gives the secured party priority over different competing claimants.¹⁹⁷

In a recent bankruptcy decision, a court apparently misunderstood the distinction between chattel perfection and fixture filings and held that the secured party holding a security interest in a fixture was unperfected as against the trustee in bankruptcy.¹⁹⁸ In *Troutt*, the debtors had entered into a home improvement contract and had signed a security agreement with Energy Doctor of Illinois, LLC. Under the contract, Energy Doctor was to install an energy guard in the debtors' house and retained a security interest in the guard until full payment by the debtors.¹⁹⁹ Energy Doctor assigned the contract to American General Financial Services, Inc.²⁰⁰

Later the debtors filed a Chapter 13 bankruptcy petition and treated American's claim as unsecured.²⁰¹ American objected to confirmation of the debtors' plan and filed a secured claim.²⁰² The debtors asserted that the secured party had not filed either a conventional U.C.C. financing statement in the chattel records or a fixture filing in the real estate records.²⁰³ Without any filing, the secured party would hold only an unperfected security interest subject to avoidance under

194. U.C.C. §§ 9-301(1), 9-310(a), 9-501(a)(2).

195. See *Mayfair House Ass'n v. QBE Ins. Corp.*, No. 07-80628-CIV-HURLEY, 2008 U.S. Dist. LEXIS 66456, at *18 (S.D. Fla. Aug. 29, 2008) (discussing transformation of a chattel to a fixture); *Nationsbank of N.C., N.A. v. Capital Assocs. Int'l, Inc.*, 916 F. Supp. 549, 553-54 (W.D.N.C. 1996) (discussing removable status of trade fixtures); *Columbia County v. Kelly*, 548 P.2d 163, 167 (Or. Ct. App. 1976) (citing FULLER & BRAUCHER, BASIC CONTRACT LAW 806 (1964) for the proposition that a fixture is "real property with a chattel past and the fear of a chattel future.").

196. See U.C.C. §§ 9-501(a)(2), 9-502(a) (chattel filings); U.C.C. §§ 9-501(a)(1)(B), 9-502(b) (fixture filings).

197. See *id.* §§ 9-317, 9-320, 9-322 (chattel filing priorities); *id.* § 9-334 (fixture filing priorities).

198. *In re Troutt*, No. 09-40555, 2009 Bankr. LEXIS 2673 (Bankr. S.D. Ill. Sept. 4, 2009).

199. *Id.* at *1.

200. *Id.*

201. *Id.*

202. *Id.*

203. *In re Troutt*, 2009 Bankr. LEXIS 2673, at *2.

the “strong arm” clause of the federal Bankruptcy Code.²⁰⁴ American countered by arguing that it held a purchase money security interest in consumer goods, which was automatically perfected without filing.²⁰⁵ A properly perfected security interest cannot be avoided in bankruptcy under the strong arm clause.²⁰⁶

In *Troutt*, the bankruptcy court began by determining that the collateral, the energy guard, was a fixture under Illinois law.²⁰⁷ Article 9 itself does not define “fixtures” but instead defers to non-U.C.C. state law for determination of what is and what is not a fixture.²⁰⁸ Illinois law adopts the common three-part test for determining whether a chattel has become a fixture: (a) attachment, (b) adaptation, and (c) intention.²⁰⁹ Under the attachment factor, courts typically look at how firmly annexed the chattel is to the underlying real property.²¹⁰ The adaptation factor considers whether the chattel is uniquely adapted to the property to which it is affixed, and the intention element focuses on the annexing party’s intent to make a permanent accession to the real estate.²¹¹ Applying this test, the court found that the energy guard was indeed a fixture: it was an insulating blanket cut to conform to the homeowner’s attic space and secured in such a way that it could not be readily removed.²¹²

Once having found that the energy guard was a fixture, the court in *Troutt* then concluded that the secured party’s security interest was unperfected because of the creditor’s failure to make a fixture filing in the real estate records.²¹³ Once unperfected, the security interest could be avoided altogether under the strong arm clause. Thus the secured party was relegated to the lowly status of an unsecured creditor.²¹⁴

204. 11 U.S.C. § 544(a) (2006).

205. See *In re Troutt*, 2009 Bankr. LEXIS 2673, at *1-2 (citing U.C.C. § 9-309(1)).

206. See, e.g., *Neilson v. Chang (In re First T.D. & Inv. Inc.)*, 253 F.3d 520, 531 (9th Cir. 2001) (holding that trustee could not avoid perfected security interests under the strong arm clause).

207. *In re Troutt*, 2009 Bankr. LEXIS 2673, at *8.

208. See U.C.C. § 9-102(a)(41) (defining fixtures as “goods that have become so related to particular real property that an interest in them arises under real property law”).

209. *Nokomis Quarry Co. v. Dietl*, 775 N.E.2d 669, 673 (Ill. App. Ct. 2002); *Harrisburg Cmty. Unit Sch. Dist. No. 3 v. Steapleton*, 553 N.E.2d 76, 79 (Ill. App. Ct. 1990).

210. See, e.g., *C-Plant Fed. Credit Union v. Heflin (In re Heflin)*, 326 B.R. 696, 702 (Bankr. W.D. Ky. 2005) (holding that blinds were not fixtures because they could be easily removed); *City of Buffalo v. Michael*, 209 N.E.2d 776, 777 (N.Y. 1965) (finding a sign to be a fixture because of its firm annexation to the building).

211. *In re Troutt*, 2009 Bankr. LEXIS 2673, at *6.

212. *Id.* at *6-7.

213. *Id.*

214. *Id.*

One difficulty with the *Troutt* holding is the court's failure to consider whether the secured party might have been perfected in the energy guard as a chattel. The fixture filing under Article 9 is designed specifically to give the secured party priority over conflicting real estate claimants. For example, the secured party takes a security interest in the debtor's sprinkler system. The debtor then installs the system on its farm in such a way that it becomes a fixture. The secured party has the option under Article 9 to make a conventional chattel filing, a fixture filing, or both. In the typical chattel filing, the secured party will file a financing statement in the Secretary of State's office in the state where the debtor is located.²¹⁵ For a fixture filing, the secured party will file in the office where real estate mortgages are filed in the county in which the land to which the fixture is annexed is located.²¹⁶ The chattel filing will give the secured party priority over lien creditors, buyers, and other Article 9 secured parties.²¹⁷ The fixture filing will give the secured party priority over all those parties plus real estate claimants, such as holders of real property mortgages on the land to which the fixture has been attached.²¹⁸

In *Troutt*, the creditor made no filing, but it claimed automatic perfection as the holder of a purchase money security interest in consumer goods.²¹⁹ There is no question that the security interest was purchase money—it was taken by the seller of the energy guard to secure all or part of the purchase price.²²⁰ In addition, the energy guard would qualify as a consumer good since the debtor purchased it for “personal, family, or household purposes.”²²¹ Purchase money security interests in consumer goods are automatically perfected upon attachment and do not require a filing.²²²

Article 9 makes it clear, moreover, that a secured party who holds a security interest in a fixture and perfects by “any method permitted by this article” will have priority over the later holder of “a lien on the real property obtained by legal or equitable proceedings.”²²³ This provision was intended to allow secured creditors to achieve priority over the bankruptcy trustee, who has lien creditor status under the

215. U.C.C. §§ 9-301(1), 9-501(a)(2).

216. *Id.* § 9-501(a)(1)(B).

217. *Id.* §§ 9-317(a)(2), (b); 9-322(a).

218. *Id.* § 9-334(d), (e).

219. *In re Troutt*, 2009 Bankr. LEXIS 2673, at *1-2.

220. U.C.C. § 9-103(a), (b).

221. *Id.* § 9-102(a)(23).

222. *Id.* § 9-309(1).

223. *Id.* § 9-334(e)(3).

Bankruptcy Code.²²⁴ Therefore, even though the energy guard was a fixture under state law, the secured party's automatic perfection should have afforded it priority over the trustee in bankruptcy. It is not too surprising that the court did not adopt this line of reasoning. Article 9 has an entire provision devoted to fixture priorities,²²⁵ and that manner of statutory drafting creates the illusion that all security interests in fixtures require a fixture filing for priority over *any* competing claimants.

Transactional lawyers are known for their caution, and certainly, caution dictates that secured parties holding security interests in equipment items that might be classified as fixtures should file both a conventional U.C.C. chattel financing statement and a fixture financing statement. It is important to remember that each type of financing statement requires particular information (e.g., a fixture filing must include a description of the real property to which the fixture is annexed),²²⁶ and each is filed in a particular office.²²⁷ Given the relatively modest cost of filing,²²⁸ use of a "belt and suspenders" is highly recommended where fixtures are concerned.

III. PRIORITY OF SECURITY INTERESTS: DISPUTES AMONG COMPETING CLAIMANTS

The name of the game for the Article 9 secured creditor is perfection of its security interest, which, in most cases, leads to priority over competing claimants to the same property of the debtor.²²⁹ The reward for the secured party that goes to the trouble of taking and perfecting a security interest in particular assets of the debtor is the ability to trump most other competitors in the fight for the debtor's property. On the other hand, in a number of settings, Article 9 gives the competitors priority over even a perfected secured party for vari-

224. *Id.* § 9-334 cmt. 9.

225. *See* U.C.C. § 9-334 (entitled "Priority of Security Interests in Fixtures and Crops").

226. *See id.* § 9-502(a) (listing requirements for content of financing statements), (b) (providing for additional information for fixture filings).

227. *See id.* § 9-501(a)(2) (mandating central filing for most financing statements), (1) (requiring fixture filings to be filed in "the office designated for the filing or recording of a record of a mortgage on the related real property").

228. *See, e.g.*, Texas Secretary of State, Uniform Commercial Code Fees, <http://www.sos.state.tx.us/ucc/forms/feeschedule.pdf> (listing a filing fee of \$15 for paper financing statements of two pages or less and \$5 for electronic financing statements regardless of length).

229. *See* U.C.C. §§ 9-201(a) (affording secured parties priority over other creditors unless the U.C.C. provides otherwise), 9-317(a)(2) (giving perfected secured parties priority over lien creditors), 9-322(a)(2) (providing for priority of perfected security interests over unperfected security interests).

ous policy reasons.²³⁰ As several recent cases reveal, these pro-competitor provisions do not always disturb the vaunted position of the senior secured party, who is often able to repel even the most determined competitors.

A. *Maintaining Perfection and Priority in Proceeds*

Article 9 secured parties desire to maintain attachment and perfection of their security interests not only in their original collateral but also in proceeds generated from the disposition of their collateral. Article 9 of the Uniform Commercial Code helpfully provides that security interests continue in “identifiable proceeds” of original collateral.²³¹ Very often proceeds take the form of cash generated from the sale of inventory or the collection of accounts.²³² Cash proceeds consist of “money, checks, deposit accounts, or the like.”²³³ Article 9 further assists secured parties by continuing indefinitely perfection of security interests in “identifiable cash proceeds” if the security interest in the original collateral was properly perfected.²³⁴

Despite this pro-secured creditor treatment of cash proceeds, the Code puts at least one significant limitation on the secured party’s ability to recover cash proceeds upon the debtor’s default. If the debtor transfers cash proceeds to certain good faith transferees, those transferees take free of even perfected security interests.²³⁵ Article 9 takes the position that the traditional liquidity of cash and cash-like instruments (i.e., checks) should trump the secured party’s security interest in those assets as proceeds: “Broad protection for transferees helps to ensure that security interests . . . do not impair the free flow of funds.”²³⁶

The protection of good faith transferees was put to the test recently in a federal bankruptcy decision involving cash payments to an individual affiliated with the debtor.²³⁷ In *Montagne*, the secured party, Ag Ventures, lent \$457,000 to the debtor, Montagne Heifers, Inc.

230. *See id.* §§ 9-320(a) (providing that buyers in ordinary course of business take free of even perfected security interests), 9-332 (allowing certain good faith transferees of money or funds from deposit accounts to take free of security interests).

231. *Id.* § 9-315(a)(2). *See also id.* § 9-203(f) (providing that “attachment of a security interest in collateral gives the secured party the rights to proceeds provided by Section 9-315”).

232. *See id.* § 9-102(a)(64)(A) (defining proceeds as, among other things, “whatever is acquired upon the sale, lease, license, exchange, or other disposition of collateral”).

233. U.C.C. § 9-102(a)(9).

234. *Id.* § 9-315(c), (d)(2).

235. *Id.* § 9-332.

236. *Id.* cmt. 3.

237. *Ag Venture Financial Services, Inc. v. Montagne (In re Montagne)*, 413 B.R. 148 (Bankr. D. Vt. 2009). This bankruptcy case has resulted in several decisions over the past two years

("MHI"), a dairy farm operation, in exchange for a security interest in the debtor's "livestock" and "proceeds."²³⁸ Michael Montagne was the debtor's owner and president; his spouse, Diane Montagne, was the debtor's treasurer.²³⁹ Diane, as well as Michael, signed the security agreement with Ag Ventures in November 2005 in her individual and corporate capacities.²⁴⁰ Over the course of the next two years, Diane and Michael separated, Ag Ventures released Diane from liability for MHI's debt to it, and MHI sold a herd of milk cows for \$500,000.²⁴¹ Shortly after the sale of the cows, on November 28, 2007, MHI gave Diane a check for \$240,000, part of the sale proceeds, and Diane deposited the check into her attorney's client trust account.²⁴²

Ag Ventures brought a state court action against MHI, Michael, and Diane, alleging conversion and fraudulent transfer of the \$240,000 paid to Diane in November 2007.²⁴³ Michael filed a Chapter 12 bankruptcy petition and, as debtor-in-possession, removed the state court action to the federal bankruptcy court.²⁴⁴ The parties then filed cross-motions for summary judgment on the conversion and fraudulent transfer claims.²⁴⁵ In defending the conversion claim, Diane asserted that the secured party could not bring an action for conversion as it did not have an "ownership interest" in the cash proceeds from the sale of the cows.²⁴⁶ The court rejected that argument, noting that because the corporate debtor was in default, Ag Ventures, which held a perfected priority security interest in livestock, had a present right to the proceeds from the sale of its collateral.²⁴⁷ The court also found that money, although not traditionally a chattel at common law, constitutes property that may be the subject of a conversion claim.²⁴⁸

Having found that Ag Ventures was entitled to bring a conversion claim with respect to the livestock proceeds, the court went on to find that Diane had interfered with the secured party's right to immediate possession of the proceeds and thus could be held liable for conver-

concerning the transfer of funds to Diane Montagne, but the holding in the original case remains valid.

238. *Id.* at 151.

239. *Id.*

240. *Id.*

241. *Id.* at 152.

242. *Montagne*, 413 B.R. at 152.

243. *Id.* at 151.

244. *Id.*

245. *Id.*

246. *Id.* at 154.

247. *Montagne*, 413 B.R. at 154-56.

248. *Id.* at 157.

sion unless protected by a viable defense.²⁴⁹ The court held that Diane's substantial exercise of dominion and control over the proceeds and her refusal to release any of them to the secured party constituted substantial interference with Ag Venture's rights.²⁵⁰ In addition, Diane knew that the money in question came from the sale of the cows and that Ag Ventures had a security interest in the cows.²⁵¹ Even if she thought mistakenly that her claim to the funds was superior to the secured party's, she could still be liable for conversion under Vermont law.²⁵²

Despite the validity of the basic conversion claim, however, Diane would be shielded from liability if she qualified for protection under the "good faith transferee" defense of U.C.C. section 9-332. That section provides that a transferee of money or deposit account funds takes free of security interests "unless the transferee acts in collusion with the debtor in violating the rights of the secured party."²⁵³ This provision, of course, is highly protective of transferees of cash and allows secured parties to recover their cash proceeds only from palpably "bad actors."²⁵⁴ The Article 9 drafters recognized that in creating this standard, they would shield transferees who knew that the funds transferred to them were subject to perfected security interests.²⁵⁵ Nonetheless, policies supporting the "free flow of funds" and the "finality" of completed transactions dictate that the transferees be protected.²⁵⁶

In assessing whether Diane in fact acted in collusion with the corporate debtor, MHI, in receiving the check for \$240,000 from the live-stock sale, the court turned to section 876 of the Restatement (Second) of Torts, which sets forth three alternative tests for collusion:

For harm resulting to a third person from the tortious conduct of another, one is subject to liability if he—

249. *Id.* at 157-59.

250. *Id.* at 158.

251. *Id.*

252. See *Montagne*, 413 B.R. at 158 n.6 (citing *P.F. Jurgs & Co. v. O'Brien*, 629 A.2d 325, 329 (Vt. 1993)).

253. U.C.C. § 9-332(a), (b).

254. *Id.* § 9-332 cmt. 4.

255. The pre-2001 version of Article 9 did not directly address the issue of transfers of encumbered proceeds to third parties, but one of the Official Comments suggested that only transferees who received funds in the ordinary course of business would be protected. U.C.C. § 9-306 cmt. 2(c) (1999). Courts applying this Comment sometimes found that a transferee's knowledge of the security interest and/or of prejudice to the secured party would be enough to deprive the transfer of ordinary course status. *Brown & Williamson Tobacco Corp. v. First Nat'l Bank*, 504 F.2d 998, 1003-04 (7th Cir. 1974); *HCC Credit Corp. v. Springs Valley Bank & Trust*, 712 N.E.2d 952, 958 (Ind. 1999).

256. U.C.C. § 9-332 cmt. 3.

- (a) does a tortious act in concert with the other or pursuant to a common design with him, or
- (b) knows that the other's conduct constitutes a breach of duty and gives substantial assistance or encouragement to the other so as to conduct himself, or
- (c) gives substantial assistance to the other in accomplishing a tortious result and his own conduct, separately considered, constitutes a breach of duty to the third person.²⁵⁷

Once having identified this standard, however, the court held that the record was "not sufficiently developed" on either legal or factual matters "for the Court to determine whether § 9-332(a) applies in the first instance and, if it does, whether there was collusion."²⁵⁸ The court thus granted the creditor's motion for summary judgment on establishment of the basic claim for conversion and denied Diane's motion for summary judgment based on the transferee defense, "subject to her right to present evidence and further argument on the merits of this defense."²⁵⁹

Certainly, the court in *Montagne* was correct in ruling that the secured party had established the basic requisites for conversion. Diane had clearly exercised dominion and control over the creditor's cash proceeds although she may have done so in the belief that her rights were superior. Regarding its comments on the transferee defense, the court seems to be on somewhat shakier ground. The court's language in denying Diane's motion for summary judgment suggests that she has the burden of proof with respect to all elements of the transferee defense under U.C.C. section 9-332, including the collusion element.²⁶⁰ One could argue that, at a minimum, a party such as Diane should be required to prove that she is indeed a transferee of some kind, such as a purchaser, donee, or judgment creditor. But that element normally will have been established as part of the creditor's conversion claim—i.e., that the converter received funds subject to the secured party's security interest.

Beyond the mere fact of the transfer, however, it is unclear under the statute who has the burden of establishing the collusion element. Does the transferee bear the burden of showing that she was not acting in collusion with the debtor, or does the secured party have the burden of proving that the transferee was acting in collusion? The

257. See *Montagne*, 413 B.R. at 160 (quoting RESTATEMENT (SECOND) OF TORTS § 876 (1979)).

258. *Id.* at 160.

259. *Id.* at 161.

260. See *id.* at 161 (denying her motion for summary judgment "at this time, subject to her right to present evidence and further argument on the merits of this defense.").

wording of section 9-332 suggests that the secured party has the burden of establishing collusion—transferees of money take free of security interests unless they act “in collusion with the debtor in violating the rights of the secured party.”²⁶¹ That phraseology seems to indicate the drafters’ intent to protect all transferees of funds unless the creditor steps forward and shows some kind of collusive activity between the debtor and the transferee.

Possibly, the court’s inclination to place the burden of proving the transferee “defense” on Diane stemmed from her status as an insider. She was the former treasurer of the debtor corporation and the estranged spouse of the debtor’s president.²⁶² When she knowingly received a proceeds check from the debtor, it is natural to assume that she was somehow in cahoots with the debtor to evade the secured party’s proper claim to those proceeds. On the other hand, the secured party had previously released her from all liability on the debt, and she might have assumed that she was permitted to receive the monies in question. In any event, the court (and the statute itself) should probably have clarified its seeming choice to place the burden of proving lack of collusion on the transferee.

Secured parties are always scrambling to keep control over cash proceeds that can easily disappear into the hands of good faith transferees. One caution that emerges from the *Montagne* case is that secured parties with security interests in inventory or farm products should insist that in any large-scale sale of collateral, the debtor ask the buyer to make out its check jointly to the debtor and the secured party. This practice can go a long way towards ensuring that debtors do not dissipate the creditor’s proceeds before the creditor knows that they even exist.

B. *Priority between Secured Parties and Buyers in Ordinary Course of Business*

In the world of Article 9, the senior perfected secured party reigns supreme and will have priority over most competing claimants to the debtor’s property.²⁶³ One exception to that general rule is the buyer in ordinary course of business (“BIOCOB”), who takes free of even perfected security interests.²⁶⁴ In a recent federal district court case, the court tackled the issue of what it takes to be a BIOCOB in a situa-

261. U.C.C. § 9-332(a).

262. *Montagne*, 413 B.R. at 151.

263. See U.C.C. § 9-201(a) (providing that “a security agreement is effective according to its terms between the parties, against purchasers of the collateral, and against creditors.”).

264. *Id.* § 9-320(a).

tion where the buyer had not yet taken physical possession of the collateral at the time of the debtor's default and concluded that the buyer in question was not a BIOCOP.²⁶⁵

Under Article 9, a buyer in the ordinary course of business, "other than a person buying farm products from a person engaged in farming operations, takes free of a security interest created by the buyer's seller, even if the security interest is perfected and the buyer knows of its existence."²⁶⁶ The term "buyer in ordinary course of business" is defined in U.C.C. Article 1 as "a person that buys goods in good faith, without knowledge that the sale violates the rights of another person in the goods, and in the ordinary course from a person . . . in the business of selling goods of that kind."²⁶⁷ Reading sections 9-320(a) and 1-201(b)(9) together reveals that one can be a BIOCOP if one knows merely that the property purchased is subject to a perfected security interest but not if one knows that the sale violates some term of the seller's security agreement with the secured party.²⁶⁸ The purpose of the BIOCOP rule is to facilitate sales transactions between the debtor and its customers. If the debtor's customers can buy from the debtor freely, without having to worry about security interests, the debtor is likely to sell more inventory, receive more cash, and pay down the debt to the secured party more quickly than if the rule allowed secured parties to follow their security interests into the buyer's hands.²⁶⁹

In the *Sunbelt Grain* case, Security State Bank held a perfected security interest in Sunbelt's accounts, inventory, equipment, instruments, farm products, and other assets.²⁷⁰ In May 2007, Sunbelt agreed to sell Whitham Farms Feedyard five lots (500,000 bushels) of #2 yellow corn to be delivered in various shipments over several months beginning in December 2007.²⁷¹ On November 1, 2007, Whitham paid Sunbelt \$2,099,750 for the entire order.²⁷² On November

265. *Speth v. Whitham Farms Feedyard, L.P. (In re Sunbelt Grain WKS, LLC)*, 427 B.R. 896 (D. Kan. 2010).

266. U.C.C. § 9-320(a).

267. *Id.* § 1-201(b)(9) (2001). That provision also defines an "ordinary course" transaction as a sale comporting "with the usual or customary practices in the kind of business in which the seller is engaged or with the seller's own usual or customary practices." *Id.* Further, "[o]nly a buyer that takes possession of the goods or has a right to recover the goods from the seller under Article 2 may be a buyer in ordinary course of business." *Id.*

268. *Id.* § 9-320 cmt. 3.

269. *In re Darling's Homes, Inc.*, 46 B.R. 370, 377 (Bankr. D. Del. 1985).

270. *In re Sunbelt Grain WKS, LLC*, 427 B.R. at 900.

271. *Id.*

272. *Id.*

19, 2007, Whitham ordered an additional 80,000 bushels of corn from Sunbelt and paid \$326,400 for this order on November 20, 2007.²⁷³

In December 2007, Sunbelt went into default under its security agreement with the Bank.²⁷⁴ The Bank commenced state law foreclosure proceedings against Sunbelt and ultimately filed an involuntary Chapter 7 bankruptcy petition against Sunbelt in February 2008.²⁷⁵ The Chapter 7 trustee sold Sunbelt's existing grain inventory and brought an adversary action to determine the distribution of \$3.875 million in proceeds from the sale of grain at Sunbelt's facility.²⁷⁶ The Bank claimed priority to \$3.2 million of the proceeds; Whitham claimed priority to \$2.2 million.²⁷⁷ The Bank asserted priority based on its properly perfected security interest whereas Whitham argued that its interest was superior under the BIOCOCB rule or the doctrine of equitable subordination.²⁷⁸ The bankruptcy judge gave summary judgment in favor of the Bank, holding that Whitham was not a BIOCOCB, that the doctrine of equitable subordination did not apply, and that therefore the Bank's perfected security interest had priority in the proceeds.²⁷⁹ Whitham appealed.²⁸⁰

On appeal, the federal district court did not delve into issues of good faith, knowledge, or ordinary course status, but instead focused on whether Whitham was a "buyer" within the meaning of the Code.²⁸¹ The court observed that over the years, courts have examined five possible points in time at which a party to a sales transactions becomes a "buyer" under the U.C.C.: (1) the date of the initial contract; (2) the date the goods are identified to the contract; (3) the date title passes to the buyer; (4) the date the buyer gets delivery; and (5) the date the buyer accepts the goods.²⁸² In 1999, however, the U.C.C. drafters amended the definition of BIOCOCB in section 1-201(b)(9) to clarify that "[o]nly a buyer that takes possession of the goods or has a right to recover the goods from the seller under Article 2 may be a buyer in ordinary course of business."²⁸³ That amendment to Article 1 was part of the overall revision of Article 9, which became

273. *Id.* at 901.

274. *Id.*

275. *In re Sunbelt Grain WKS, LLC*, 427 B.R. at 901-02.

276. *Id.* at 902.

277. *Id.*

278. *Id.*

279. *Id.*

280. *In re Sunbelt Grain WKS, LLC*, 427 B.R. at 902.

281. *Id.* at 903-05.

282. *Id.* at 903 (citing *Daniel v. Bank of Hayward*, 425 N.W.2d 416, 419 (Wis. 1988)).

283. U.C.C. § 1-201(b)(9) (2001).

effective in most states, including Kansas, on July 1, 2001.²⁸⁴ In applying this amendment, the court in *Sunbelt Grain* noted that Whitham did not argue that it had a right to recover the grain under Article 2, only that it had “possession” of the grain at the time of the debtor’s default.²⁸⁵ Because Whitham did not have actual possession of the corn, it was constrained to argue that it had “constructive possession.”²⁸⁶

Finding a lack of Kansas case law on the issue of constructive possession in civil cases, the federal district court turned to decisions from other states and found that those decisions suggested that identification of goods to the contract is a fundamental requirement for constructive possession.²⁸⁷ The court stated that even where the buyer has paid for the goods, identification of specific goods to the contract is essential to establishing constructive possession.²⁸⁸ As the court noted, identification of goods to a contract occurs “when the contract is made if it is for the sale of goods already existing and identified” or “if the contract is for the sale of future goods . . . when the goods are shipped, marked or otherwise designated by the seller as goods to which the contract refers.”²⁸⁹ In one of Article 2’s Official Comments, the drafters further specify that the “mere making of the contract with reference to an undivided share in an identified fungible bulk is enough under subsection (a) to effect an identification if there is no explicit agreement otherwise.”²⁹⁰ Based on this Comment, the court then concluded that the corn had not been identified to the contract between Sunbelt and Whitham because the original contract did not identify a “fungible bulk” of corn in which Whitham would have an undivided share.²⁹¹ Consequently, Whitham did not attain BIOCOP status, and the Bank’s perfected security interest had priority over Whitham’s interest.²⁹²

284. *In re Sunbelt Grain WKS, LLC*, 427 B.R. at 904.

285. *Id.* at 905 n.22.

286. *Id.* at 905.

287. *Id.* at 906.

288. *See id.* (stating that “without identification the buyer can have no legitimate claim to possess or control the goods.”).

289. *In re Sunbelt Grain WKS, LLC*, 427 B.R. at 906 (citing Kansas’s version of U.C.C. § 2-501(a), (b)).

290. U.C.C. § 2-501 cmt. 5 (amended 2003).

291. *In re Sunbelt Grain WKS, LLC*, 427 B.R. at 906-07.

292. The court also rejected Whitham’s assertion of priority over the Bank based on the doctrine of equitable subordination. The court held that Whitham had not alleged facts that would support a finding of conduct by the Bank amounting to “fraud, misrepresentation, overreaching or spoliation, or moral turpitude.” *Id.* at 907-09.

One interesting facet of the *Sunbelt Grain* case is the buyer Whitham's failure to argue that it had the "right to recover the goods from the seller under Article 2" and thus qualified as a BIOCOB on that basis.²⁹³ Buyers may obtain possession of goods in a seller's hands in a number of ways under Article 2.²⁹⁴ Under the method most relevant to this case, the buyer may recover goods from its seller if the buyer had paid all or part of the purchase price of goods identified to the contract and "the seller becomes insolvent within 10 days after receipt of the first installment on their price."²⁹⁵ In *Sunbelt Grain*, the buyer Whitham prepaid the grain order on November 1 and November 19, 2007, and by December 7, 2007, the seller Sunbelt was in default to the Bank, which shut down Sunbelt's line of credit.²⁹⁶ Conceivably, Sunbelt became insolvent within ten days after Whitham's November 1 or November 19 payment.

Even so, Whitham would still have had to show that the corn had been identified to the contract, and the court found that it had not. But one can quarrel with the court's interpretation of identification to the contract as necessitating that the parties have identified a "fungible bulk" in their original contract. Identification of goods to a contract can occur at any time after contract formation. The record showed that as of November 19, 2007, Sunbelt had taken in 1.467 million bushels of corn though it was not established how much of that corn was actually on hand on that date.²⁹⁷ By December 14, 2007, Sunbelt "confirmed that Whitham's corn was in Sunbelt's inventory."²⁹⁸ Perhaps by strengthening the record, the buyer Whitham could have persuaded the court that Sunbelt had identified the corn to the Whitham contract and that Sunbelt's insolvency had occurred within the time period required by section 2-502.

Whitham made a fatal mistake in prepaying the entire order of corn well in advance of the first delivery, especially since the various segments of the order were to be delivered over a five-month period. If Whitham had any hint of Sunbelt's financial weakness, it should have paid in installments and demanded delivery upon tender of each installment. Alternatively, if Sunbelt was going to use Whitham's payment to acquire corn on the open market, then Whitham should have taken a purchase money security interest in the corn and assured itself

293. See U.C.C. § 1-201(b)(9) (2001) (defining buyer in ordinary course of business).

294. See U.C.C. §§ 2-502(1)(b); 2-716(1), (3) (amended 2003) (affording buyers a right of replevin or specific performance).

295. *Id.* § 2-502(1)(b).

296. *In re Sunbelt Grain WKS, LLC*, 427 B.R. at 900-01.

297. *Id.* at 901 n.6.

298. *Id.* at 901.

of a superpriority by complying with Article 9's requirements.²⁹⁹ Whitham trusted its seller and, as a result, received less than one-tenth of the grain for which it paid.³⁰⁰

C. *Priorities between Secured Parties and Non-BIOCOB Transferees of Collateral*

Secured lenders are always concerned about the possibility of losing their security interests if the debtor transfers collateral to a third party without permission. Article 9, however, helpfully provides that a security interest continues in collateral notwithstanding sale or other disposition of the collateral "unless the secured party authorized the disposition free of the security interest."³⁰¹ In other words, even though the debtor transfers collateral to a third party buyer, the security interest remains attached to the collateral unless the secured party voluntarily gives up its security interest. A recent Third Circuit opinion faced the issue of whether the secured party's passive acquiescence in the debtor's disposition of collateral could amount to an implied authorization of the "disposition free of the security interest" and concluded that it could not.³⁰²

In *Jersey Tractor*, the debtor Jersey granted a security interest in all of its assets to Wawel Bank as collateral for a loan in 2002.³⁰³ The Bank perfected by filing financing statements in the appropriate public offices.³⁰⁴ As part of its security agreement with the Bank, the debtor was prohibited from selling its accounts receivable for less than their full face value without the secured party's permission.³⁰⁵ In 2003, however, the debtor entered into a factoring agreement with Yale Factors, LLC, whereby it agreed to assign all of its accounts re-

299. See U.C.C. § 9-324(b) (affording a secured party holding a purchase money security interest in inventory a superpriority over earlier inventory secured parties provided that a proper financing statement is filed and individual authenticated notification to prior inventory secured parties is given before the debtor has possession of the inventory). Although the collateral involved in this case was corn, it would have been classified as inventory, not farm products, because farm products include only crops and livestock in possession of a farmer. *Id.* § 9-102(a)(34). The debtor in this case operated a grain storage facility and was not involved in "raising, cultivating, propagating, fattening, grazing, [or] any other farming . . . operation." *Id.* § 9-102(a)(35).

300. See *In re Sunbelt Grain WKS, LLC*, 427 B.R. at 901 (stating that the debtor delivered only 57,000 bushels of corn out of the 580,000 bushels promised).

301. U.C.C. § 9-315(a)(1).

302. *Wawel Savings Bank v. Jersey Tractor Trailer Training, Inc. (In re Jersey Tractor Trailer Training, Inc.)*, 580 F.3d 147, 154-55 (3rd Cir. 2009).

303. *Id.* at 150.

304. *Id.*

305. See *id.* (noting that the debtor agreed that it would not "settle any account for less than its full value without [Wawel's] written permission.").

ceivable to Yale in exchange for 70 percent of their face value (less an 8.5 percent fee).³⁰⁶ Starting in November 2003, Yale bought Jersey's accounts by wiring funds to an account that Wawel maintained at the Federal Home Loan Bank of New York ("FHLB") to receive wire transfers on behalf of customers, such as Jersey.³⁰⁷ After receiving a wire transfer from Yale, FHLB would notify Wawel by phone, by facsimile, by letter, and by a daily update on wires received.³⁰⁸ The fax and letter notifications clearly indicated that the party originating the wire transfers was "Yale Factors NJ LLC."³⁰⁹

In December 2005, Jersey notified Wawel's president of its factoring arrangement with Yale.³¹⁰ Wawel objected, and Jersey sought to end the arrangement by informing Yale in January 2006 that it would not be renewing the factoring agreement when it expired on March 20, 2006.³¹¹ On April 6, 2006, Jersey filed a voluntary petition for bankruptcy under Chapter 11 of the Bankruptcy Code.³¹² Wawel filed an action for declaratory relief against Jersey and Yale seeking to establish its right to the proceeds of Jersey's accounts receivable.³¹³ The parties agreed that the general Article 9 priority rule of "first-to-file-or-perfect" afforded Wawel priority over Yale in the accounts.³¹⁴ Yale argued, however, that Wawel had authorized the sale of the accounts free of Wawel's security interest and thus had waived its interest.³¹⁵

The bankruptcy court found in favor of Wawel, holding that neither the Bank nor its president had actual notice of the factoring agreement with Yale until Jersey specifically told Wawel's president about it in December 2005.³¹⁶ Because Wawel was unaware of the sale of accounts to Yale, it could not have authorized the sale free of Wawel's security interest.³¹⁷ Yale appealed the decision to the federal district court, and that court affirmed.³¹⁸ Yale pursued a further appeal to the Court of Appeals for the Third Circuit.³¹⁹

306. *Id.* at 150.

307. *In re Jersey Tractor Trailer Training, Inc.*, 580 F.3d at 151.

308. *Id.* at 151 n.7.

309. *Id.*

310. *Id.* at 151.

311. *Id.*

312. *In re Jersey Tractor Trailer Training, Inc.*, 580 F.3d at 149.

313. *Id.*

314. *See id.* (citing New Jersey's version of U.C.C. § 9-322(a)(1)).

315. *See id.* at 153-54 (citing U.C.C. § 9-315(a)(1)).

316. *Id.* at 149.

317. *In re Jersey Tractor Trailer Training, Inc.*, 580 F.3d at 152.

318. *Id.* at 149.

319. *Id.*

In affirming the lower courts' decisions, the Court of Appeals for the Third Circuit first noted that whether Wawel explicitly or implicitly waived its security interest in Jersey's accounts receivable was a factual issue to be evaluated under the clearly erroneous standard.³²⁰ Next, the court rejected Yale's argument that because Wawel's security agreement with Jersey did not expressly prohibit the sale of collateral, Wawel thereby waived its security interest.³²¹ The court observed that the security agreement did in fact restrict the debtor's ability to dispose of accounts for less than their full face value.³²²

The court also found that Wawel had not implicitly waived its security interest in the debtor's accounts through its course of dealing with the debtor.³²³ Departing from the bankruptcy court's decision on this issue, the court of appeals was "receptive" to Yale's argument that Wawel, through its officers, had actual knowledge that Jersey was making transfers to and receiving payments from a factor.³²⁴ Wawel's officers clearly received notification of Yale's wire transfers on an ongoing basis, and their awareness of the transfers could be imputed to their principal, Wawel.³²⁵ As a consequence, the court assumed that "Wawel was aware that JTTT was involved with a factor—and thus was selling its accounts receivable."³²⁶

Notwithstanding its assumption that Wawel knew of Jersey's sale of its accounts, the court held that Wawel never gave up its security interest.³²⁷ Under the pre-revision version of U.C.C. section 9-315(a)(1), some courts held that secured parties impliedly waived their security interests where they were aware of the debtor's repeated sale of collateral without permission and never objected to the practice.³²⁸ But the pre-revision case law was by no means uniform, and a number of courts found that the secured party had not waived its security interest simply because it knew of the debtor's unauthorized disposition of collateral and remained silent.³²⁹ The U.C.C. Permanent Editorial Board also weighed in on the question and stated that a secured party waived its security interest only where it specifi-

320. *Id.* at 154 n.14.

321. *Id.* at 154.

322. *In re Jersey Tractor Trailer Training, Inc.*, 580 F.3d at 154.

323. *Id.* at 154-55.

324. *Id.* at 154.

325. *Id.*

326. *Id.*

327. *In re Jersey Tractor Trailer Training, Inc.*, 580 F.3d at 154.

328. *See* former U.C.C. § 9-306(2) (1999); *LifeWise Master Funding v. Telebank*, 374 F.3d 917, 923 (10th Cir. 2004); *Neu Cheese Co. v. Fed. Deposit Ins. Co.*, 825 F.2d 1270, 1273 (8th Cir. 1987).

329. *See, e.g., J.I. Case Credit Corp. v. Crites*, 851 F.2d 309, 313 (10th Cir. 1988).

cally “authorized the disposition, by agreement or otherwise, *free and clear of the security interest.*”³³⁰

Noting that Revised Article 9 expressly referenced P.E.B. Commentary Number 3 in the Official Comments to new section 9-315(a)(1), the Tenth Circuit in *Jersey Tractor* held that passive acquiescence by the secured party of repeated sales of collateral by the debtor did not waive the creditor’s security interest.³³¹ A secured party does not so easily give up its bargained for security interest: “Because § 9-315(a)(1) does not require a secured party to take action to preserve its security interest, inaction alone may not lead to a finding of implied authorization.”³³² To be meaningful, a security interest must travel with the collateral wherever it goes, unless the Code provides otherwise or the secured party expressly releases its security interest.³³³

Having lost on the waiver issue, Yale then argued that it qualified for protection as a holder in due course or as a purchaser of instruments.³³⁴ Although the lower courts had found that Yale lacked the good faith necessary to qualify for protection as a holder in due course or purchaser of instruments, the court vacated that finding and remanded the case for further factual findings on the issue of good faith.³³⁵ The interesting twist is the apparent assumption that the invoices for the accounts receivable qualified as negotiable instruments under Articles 3 and 9.³³⁶ Generally, accounts are considered pure intangibles because they are not normally evidenced by an indispensable writing.³³⁷ In *Jersey Tractor*, there is nothing in the facts to suggest that the accounts in question were memorialized or embodied in any kind of special writing that had the attributes of negotiability.

In sum, secured parties can ordinarily be assured that they can follow their security interests in collateral transferred by their debtors to third parties. It will take more than mere inattention or inaction for a secured party to waive its security interest. At the same time, a pru-

330. AMERICAN LAW INSTITUTE AND NATIONAL CONFERENCE OF COMMISSIONERS ON UNIFORM STATE LAWS, P.E.B. COMMENTARY NO. 3 (1990).

331. *In re Jersey Tractor Trailer Training, Inc.*, 580 F.3d at 154-55.

332. *Id.* at 155.

333. *See id.* (citing 9B WILLIAM D. HAWKLAND, FREDERICK H. MILLER & NEIL B. COHEN, HAWKLAND U.C.C. SERIES § 9-315:1 (2008)).

334. *See* U.C.C. §§ 3-302(a) (defining holder in due course), 9-331(a) (reiterating the priority of holders in due course over even perfected security interests), 9-330(d) (affording priority to certain good faith purchasers of instruments).

335. *In re Jersey Tractor Trailer Training, Inc.*, 580 F.3d at 159.

336. *Id.* at 152.

337. *See* U.C.C. § 9-102(a)(2) (stating that accounts do not include “rights to payment evidenced by chattel paper or an instrument”).

dent secured party should be alert to possible unauthorized dispositions of collateral and call the debtor to account for such infractions of the security agreement. It is always better to forestall possible problems through reasonable monitoring of the debtor's activities than to end up trying to fight off competing claimants in litigation.

IV. CONCLUSION

Intricately and beautifully designed, Article 9 in many ways has accomplished its goal of simplifying and clarifying secured transactions. Originally formulated over half a century ago, it represented a vast improvement over the archaic, cumbersome, and disparate laws that covered secured transactions, many of them dating from the nineteenth century. Despite its elegance and clockwork construction, Article 9 has required several major revisions—its very complexity, as well as the changing face of modern commerce, has necessitated substantial statutory modifications. Although the last major revision in 2001 addressed the primary issues that divided pre-revision courts, the case law has continued to flow throughout the first decade of the new millennium. Recently, in 2010, the drafters have proposed yet another round of significant amendments to Article 9, a further grasp at the ever elusive object of perfecting this complicated statutory creation. Time will tell whether the drafters have moved closer to achieving that goal.

This review of recent state and federal cases interpreting Article 9 reveals that while the courts often “get it right,” they still fumble from time to time. In addition, although secured creditors have been operating under the 2001 version of the statute for almost a decade, surprisingly, they often make basic errors in perfecting their security interests, monitoring their debtors, and assuring themselves of the senior priority position. Given Article 9's firm stance in favor of secured parties, it is hard for senior secured creditors not to “rule the world,” but unfortunately, sometimes by virtue of their own mistakes, they do not.