

# CLARKS'

## SECURED TRANSACTIONS MONTHLY

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### NINTH CIRCUIT IMPAIRS SECURED CREDITOR'S RIGHT TO COLLECT FROM ACCOUNT DEBTOR

In an unfortunate decision, the Ninth Circuit has cast doubt on a secured creditor's ability to collect from an account debtor after the account debtor has improperly paid the debtor. *Ta Chong Bank Ltd. v. Hitachi High Technologies America, Inc.*, 610 F.3d 1063 (9th Cir. 2010).

**The facts.** In 2005, Hitachi High Technologies purchased a large number of DVD players from Cyberhome Entertainment, for \$1.2 million. Cyberhome assigned the resulting account (along with other accounts) to Ta Chong Bank, which failed to file a financing statement. The bank and Cyberhome promptly instructed Hitachi in writing to make payment to the bank, but despite this instruction Hitachi paid Cyberhome. If these were the only relevant facts, the result would be clear. Under UCC 9-406(a), Hitachi's payment to Cyberhome would not have discharged its obligation. Hitachi would remain liable to the bank and, upon paying the bank, could seek restitution from

Cyberhome. The bank's failure to perfect its interest would not be material to the analysis.

However, eight months after Hitachi paid Cyberhome, Cyberhome filed for Chapter 7 bankruptcy protection. The bank filed a secured claim for \$83 million but the trustee avoided the bank's unperfected security interest in Cyberhome's accounts. The bank then sued Hitachi in federal district court for the \$1.2 million that Hitachi was supposed to have paid to the bank. The district court dismissed the case for failure to state a claim, concluding that the bank was attempting an end-run around the bankruptcy court's avoidance order. The bank appealed.

The bank claimed that Cyberhome's bankruptcy estate could have no conceivable property interest in either the invoices or the bank's claim against Hitachi because Cyberhome had received payment in full prior to filing bankruptcy. Moreover, the bank argued, avoidance of its security interest was also irrelevant because avoidance applies only to property in which the debtor has an interest, and Cyberhome had no interest in Hitachi's liability to the bank.

**The Ninth Circuit decision.** The Ninth Circuit rejected these arguments. It agreed with the conclusion of the lower courts that Cyberhome's accounts receivable were part of the bankruptcy estate. While UCC 9-406(a) might require Hitachi to pay twice, "the second payment would be for the same obligation which Hitachi failed to discharge through its payment to Cyberhome." The court then cited UCC 9-318(b), which provides that as long as an account buyer's security interest is unperfected, "the debtor is deemed to have rights and title to the account...identical to those the debtor sold." The court also concluded that its decision was consistent with bankruptcy policy:

A finding that Hitachi is liable to the Bank may well affect the bankruptcy proceedings because Hitachi would likely then seek repayment of its \$1.2 million from CyberHome. Accordingly, a ruling on the Bank's claims here could potentially reorder the preference in which the creditors, including the Bank, are paid.

**Some thoughts about the decision.** Superficially, the court's decision seems sound. Hitachi's payment did not

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discharge its obligation, so the account must still exist. Because the bank's security interest was avoided, the account remained part of Cyberhome's bankruptcy estate. Accordingly, the bank's efforts to obtain payment from Hitachi would indeed be an end-run around the bankruptcy process and the bankruptcy court's rulings.

Nevertheless, the decision is definitely unsettling and seems flawed. Let's start at the end with the court's policy argument, which is particularly off the point. The court is correct that if Hitachi now pays, Hitachi will have a claim for reimbursement against the debtor. But that would not cause a drain on the estate because the bank's claim would be reduced by the same amount. In other words, the bankruptcy estate owes either the bank or Hitachi, but not both (and not neither). So, it does not matter to the bankruptcy proceeding whether Hitachi pays the bank or not.

The court's main analysis is premised on an almost metaphysical conclusion: that an account continues to exist after the account debtor pays the wrong person and thereby does not discharge the obligation. Admittedly, UCC 9-406(a) can be read to support that conclusion. But such an interpretation would also suggest that the debtor could continue to collateralize the account despite having been paid in full. Consider this scenario:

Debtor borrows against accounts, granting a security interest to Lender One, who fails to perfect. Debtor and Lender One instruct Account Debtor to pay Lender One. Account Debtor pays Debtor. Debtor then assigns the non-discharged obligation of Account Debtor to Lender Two. The court's analysis implies that Lender Two gets a valid security interest in the obligation of Account Debtor. Yet, once Debtor has received payment in full on the account, Debtor does not have any rights in the account to transfer.

Indeed, by concluding that Cyberhome retained a property interest in Hitachi's obligation, and treating the account as part of the estate, the court's analysis implicitly assumes that the trustee could enforce the account obligation by forcing Hitachi to pay a second time. But that can't be correct. After all, Hitachi would have a restitution claim for the full amount of any second payment; it would also have either setoff or recoupment rights that would allow it to net the two obligations against each other and thereby avoid making a second payment to the estate.

The court's reading of UCC 9-318(b) is also problematic. Although that provision says that the debtor "is deemed to have rights" in an assigned account if the assignee has failed to perfect, that language is there "[f]or the purposes of determining the rights of" creditors of the debtor and purchasers of the account. In other words, the debtor does not actually retain rights, but merely has the power to convey rights to someone else. (In a similar vein, UCC 9-203(b)

(2) provides that attachment of a security interest requires that the debtor have rights in the collateral or the power to convey rights in the collateral).

**Bottom line.** The Ninth Circuit decision is probably wrong. Fortunately, it should have little impact on account financing. The bank would not have suffered a loss had it properly perfected its interest. The case therefore presents one more reason – albeit an unfortunate one – for factors to make sure they file financing statements.

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## WILL A SECURITY INTEREST IN A TAX REFUND STAND UP IN BANKRUPTCY?

In a bad economy, net operating losses happen. The good news is that these losses can in some measure be recaptured by filing for a tax refund under the carryback provisions of the Internal Revenue Code. This procedure allows the taxpayer to obtain a refund of taxes paid in the prior two years, to set off against the losses incurred in the present year. For corporate debtors, these refunds can be very large and valuable assets.

What happens if a lender, prior to the taxpayer's bankruptcy, has retained a security interest in "all general intangibles, now owned or hereafter acquired"? As a UCC category, the term "general intangibles" has consistently been held to include tax refunds. As between the secured creditor and the bankrupt debtor, who gets the big tax refund? In a recent bankruptcy court decision from Florida, the court ruled that the security interest of the creditor was voidable as a preference because it did not attach until the last day of the debtor's tax year, which occurred within 90 days of the bankruptcy filing. As a result, the whopping \$207 million tax refund went to the debtor's estate and its unsecured creditors.

**The Florida bankruptcy case.** In *In re TOUSA, Inc.*, 406 B.R. 421 (Bankr. S.D. Fla. 2009), the debtor and its subsidiaries were involved in the homebuilding business in Florida. Because of the sharp economic downturn, the debtor filed Chapter 11 on January 29, 2008. On July 31, 2007, the

debtor had borrowed \$500 million in two syndicated term loans, agented by Citibank (first lien agent) and Wells Fargo (second lien agent). The loans were both secured by various assets of the debtor, including "All General Intangibles, Now Owned or Hereafter Acquired." Proper financing statements were filed on August 1, 2007.

For the taxable year 2005, the debtor had paid \$117 million in federal income taxes, and for taxable year 2006 it paid \$103 million. The financial situation of the debtor dramatically deteriorated in 2007, resulting in a net operating loss of \$643 million for 2007. After filing bankruptcy, the debtor filed for a tax refund to write off the 2007 losses against the 2005 and 2006 taxes that had been paid. This resulted in a \$207 million tax refund paid by the IRS to the bankruptcy estate on April 23, 2008. Not surprisingly, the banks claimed priority to the refund, based on their perfected security interest in the tax refund as a "general intangible."

The unsecured creditors sought to avoid the banks' security interests as preferences. Relying on Section 547(e)(3) of the Bankruptcy Code, they argued that the debtor could not "acquire rights" in the tax refund until the end of its 2007 taxable year, which was December 31, 2007. Until that time, the debtor's right to the refund remained contingent and the banks' security interests could not attach. Since December 31, 2007, was within 90 days of the bankruptcy filing, the security interests were voidable preferences.

**The court's analysis.** The Florida bankruptcy court agreed with the unsecured creditors. It concluded that the "transfer" of collateral did not occur until December 31, 2007. Section 547(e)(1) provides that a transfer of personal property for preference purposes "is perfected when a creditor on a simple contract cannot acquire a judicial lien that is superior to the transferee." By that test, the transfer would have taken place back on August 1, 2007, when the banks filed their financing statement. At that point, no lien creditor could gain priority to the tax refund over the banks. Yet, under Section 547(e)(3), the transfer could not occur until the debtor had "acquired rights in the property transferred," and that didn't happen under federal law until the debtor's tax year was completed on December 31. Until that moment, the debtor had no right to a tax refund under Section 172 of the Internal Revenue Code. The right to a net operating loss carryback and a corresponding refund is tied to a specific "taxable year." A taxpayer is not authorized to carry back mid-year or part-year losses. The court concluded: "Under these provisions, a net operating loss for any period less than the taxable year is a complete nullity and has no legal significance."

The court elaborated on the policy issues:

[A] mid-year claim to a federal tax refund necessarily entails speculation and forecasting about the course of

a debtor's business from the date the supposed mid-year right arises until the end of its tax year, meaning that any interest in a tax refund prior to the end of the tax year necessarily would be uncertain and contingent. Perhaps more to the point, Congress has defined the right to a net operating loss carryback as a function of complete and not partial tax years.

**Legislative history.** In relying primarily on Section 547(e)(3) of the Bankruptcy Code, with its rule that the transfer of property rights from a debtor to a secured creditor can't take place until the debtor "has acquired rights in the property transferred," the Florida court looked at the legislative history of that provision. It was enacted in 1978 specifically to overrule cases like *DuBay v. Williams*, 417 F.2d 1277, 6 UCC Rep. 885 (9th Cir. 1969) and *Grain Merchants of Indiana, Inc. v. Union Bank and Savings Co.*, 408 F.2d 209, 6 UCC Rep. 1 (7th Cir. 1969), *cert. den.* 396 U.S. 827 (1969). Those cases held that a "floating lien" that attached to receivables collected during the preference period was protected from avoidance if the secured creditor had perfected its security interest with respect in both present and future receivables.

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As part of the same package of amendments, Congress enacted Section 547(c)(5), which protects the UCC floating lien on inventory, accounts, and proceeds that are constantly turning over unless the secured creditor "improves its position" during the 90 days prior to bankruptcy. The rule adopts a two-point test that requires determination of the creditor's position (1) 90 days prior to bankruptcy and (2) on the date of bankruptcy. The trustee measures the value of the collateral and the amount of the debt at both times. If the creditor's "insufficiency" (i.e. the amount by which the debt exceeds the value of the collateral) is less at the time of bankruptcy than it was 90 days prior, only this "improvement in position" is voidable as a preference. On the other hand, if new receivables arise that are not substitutions for the old ones in the "floating mass," they are not protected.

Although it is not crystal-clear from the opinion, the Florida court appears to be saying that (1) the \$207 million tax refund was not a "receivable" within the scope of the

two-point test of Section 547(c)(5), or (2) even if it was, it was not a replacement of a prior receivable so that there was indeed an improvement in position to the tune of the full \$207 million. Either way, the court was left with the general rule of Section 547(e)(3) that the debtor had not acquired rights in the collateral until December 31, 2007.

**Critique of the Florida decision.** The Florida decision is supported by other case law. See, e.g., *In re TMCI Electronics*, 279 BR 552 (Bankr. N.D. Calif. 1999)(bank's security interest in general intangibles didn't extend to tax refund because the debtor did not acquire rights in the refund until the end of its taxable year, which occurred after the bankruptcy filing; at time of filing, tax refund was mere "expectancy," so that security interest never attached under UCC 9-203; instead, the refund was a post-bankruptcy asset under Section 552 of the Bankruptcy Code).

In spite of this authority, we think there are some good arguments in favor of the secured creditor:

- In *Segal v. Rochelle*, 382 U.S. 375 (1966), the Supreme Court held that an operating loss carryback refund claim constituted "property of the estate" as of the time of the bankruptcy petition, even though the petition was filed before the end of the taxable year and the debtors did not then have a right to a tax refund. The expectancy of a tax refund was considered "property" that was "transferable" by the debtor on the date of the petition, so that it passed to the trustee as "property of the estate." The Supreme Court, speaking through Justice Harlan, concluded that the term "property" must be "construed most generously and an interest is not outside its reach because it is novel or contingent or because enjoyment must be postponed."
- If a loss carryback tax refund is "property of the estate" even though the bankruptcy filing predates the end of the tax year, why shouldn't it be considered "rights in the collateral" subject to attachment under UCC 9-203 if the secured transaction predates the end of the debtor's tax year? If the Supreme Court views such an interest as "transferable" by the debtor, why shouldn't it be treated the same way for attachment purposes under Article 9? The law books are full of cases holding that contingent claims like lawsuits prior to judgment are attachable and perfectible under Article 9. The reach of the Article 9 security interest is broad, just as is the reach of "property of the estate" for purposes of Section 541 of the Bankruptcy Code.
- The term "receivable" is broadly defined in Section 547(a)(3) as a "right to payment whether or not such right has been earned by performance." That could include a tax refund. If so, why couldn't the court use the two-point test? The asset at issue in the Florida case

was not like a receivable newly acquired by the debtor, so that it depleted the assets of the estate shortly before bankruptcy. Instead, it seems likely that the potential tax refund for 2007 had substantial value by September 1, 2007, when the banks filed their financing statements. It was an identifiable and lienable asset, properly described as a "general intangible" in the security agreements and financing statements. Given the housing market in late 2007, that value would be even greater by the end of October, 90 days before the bankruptcy petition was filed. To the extent there was an "improvement in position" between the end of October and the filing date of January 29, 2008, based on the increasing value of the tax refund, that amount could be avoided, but the amount would be dependent on expert testimony.

**Bottom line.** Given the horrible economy and the increased importance of loss carryback tax refunds, we expect to see more case law in this area. Secured creditors should not give up.

## JUDICIAL DECISIONS CLASH ON A SECURED LENDER'S DUTY TO SELL SECURITIES FALLING IN VALUE

What duty does a secured lender have to sell collateral such as securities if the market is falling and the debtor is in default on its secured loan? The key UCC provision is Section 9-207. That provision imposes a duty of care with respect to pledged collateral, both before and after default. In construing it, the courts have differed as to whether the secure creditor breaches its duty of care by failing to sell pledged securities falling in value.

**Some courts protect the secured creditor from liability.** A number of judicial decisions protect the secured creditor. One of the leading cases is *Hutchison v. Southern Cal. First Nat'l Bank*, 103 Cal. Rptr. 816, 11 UCC Rep. 274 (Cal. Ct. App. 1972). In that case, pledgors of 40,000 shares of Kentucky Fried Chicken (KFC) stock, worth \$1.7 million on the open market at the time they were given to secure a \$972,000 loan, sued the pledgee under UCC 9-207 for failure to use reasonable care in custody and preservation of the stock. Sometime after the debtor had fallen into default on the loan, but prior to any disposition by the pledgee, KFC stock started to plummet. The debtor contacted a broker, who advised (1) selling six-month call options on 20,000 shares for \$5 per share to generate an immediate \$100,000 in cash in exchange for the lender's forbearance during the option period and (2) selling the other 20,000 shares "short" for immediate cash.

Given that the total proceeds from both transactions would be less than the loans outstanding, the court held that there was no violation of UCC 9-207 when the lender refused to go along with the debtor's plan. The court concluded that the duty of reasonable care is limited to the physical object or instrument pledged, and that the pledgee is not liable for decline in value of pledged securities, even if timely action could have prevented such decline.

An interesting aspect of the *Hutchison* case is that, because default had already occurred when the debtor's proposal was made, the case also fit under the "commercial reasonableness" standard governing Article 9 foreclosure sales. The court thus concluded that the eventual sale at a lower price was commercially reasonable; a foreclosure sale is not commercially unreasonable just because a better price could have been obtained by sale at a different time or in a different manner from that selected. This two-prong analysis underscores the parallel standard of care for the pledgee before and after default.

Other leading cases protecting the secured creditor include *Tepper v. Chase Manhattan Bank, N.A.*, 376 So.2d 35, 27 UCC Rep. 1104 (Fla. Dist. Ct. App. 1979); *Capos v. Mid-America Nat'l Bank of Chicago*, 581 F.2d 676, 24 UCC Rep. 1019 (7th Cir. 1978) (bank has no duty to its borrower, under either common law or UCC 9-207, to sell pledged stock of declining value; moreover, pledgor was guilty of contributory negligence insofar as he was aware of the declining price of the stock and had failed to instruct the bank to sell.); *Layne v. Bank One, Kentucky, N.A.*, 395 F.3d 271, 55 UCC Rep.2d 704 (6th Cir. 2005); *Beal Bank, SSB v. Sarich*, 2008 WL 4902514, 67 UCC Rep.2d 281 (Wash. Ct. App. 2008).

#### Other courts impose liability on the secured lender.

In sharp contrast to the decisions described above, some courts have thrown the book at the secured creditor. The leading case is *FDIC v. Caliendo*, 802 F. Supp. 575, 18 UCC Rep.2d 899 (D.N.H. 1992). In that case, Maine National Bank made a \$35,000 loan to Caliendo secured by a pledge of 1,890 shares of Fleet/Norstart common stock. When MNB sought payment of the loan under its demand note, Caliendo defaulted. At the time of default, July 31, 1990, the pledged stock was valued at \$52,841; when sold by the bank on August 17, 1990, the value of the stock had plummeted to \$28,914, leaving the loan undersecured. It was not clear whether a demand had been communicated from the borrower to the secured lender to sell the stock immediately following the declaration of default.

When the bank sued Caliendo for the deficiency, the borrower defended on the ground that the bank had breached a duty to preserve the collateral by selling in a rapidly falling market. Subsequently, the bank failed and the FDIC stepped into the role of plaintiff. The FDIC moved for summary

judgment on the ground that a pledgee has no duty to sell collateral in a falling market, even when the borrower makes a demand that it do so. In rejecting the FDIC's motion, the New Hampshire federal court became the first court in the country to impose a duty on secured lenders to sell pledged securities in a falling market, at least under some circumstances. The court did put some limits on its sweeping pronouncement: (1) a duty to sell only applies when the borrower makes a demand. (2) The duty only kicks in after the borrower has defaulted. (3) The duty applies only when the secured lender is over-collateralized. (4) The secured lender may be able to limit its duty by proper language in the security agreement. A Third Circuit decision that is somewhat similar to *Caliendo* is *Solfanelli v. Corestates Bank, N.A.*, 203 F.3d 197, 40 UCC Rep.2d 914 (3d Cir. 2000).

Another line of cases that impose liability are those in which the pledgee makes an obvious and blatant mistake—a failure to convert debentures by the option deadline when the market price for the common stock greatly exceeds the value of the debentures as debt, and the pledgee is aware of the conversion feature. See, e.g., *Reed v. Central Nat'l Bank of Alva*, 421 F.2d 113, 7 UCC Rep. 113 (10th Cir. 1970). But these "failure to convert" cases are a far cry from putting the secured lender into the position of involuntary investment advisor, which is what the New Hampshire and Third Circuit cases do.

**Some suggested strategies for the secured lender.** In light of the conflicting law in this area, secured lenders should consider a number of strategies:

- If litigation ensues, the lender should argue strongly that UCC 9-207 has no bearing on the issue of the falling market. By its terms, it is limited to physical care of pledged collateral, such as keeping tabs on certificated securities. UCC 9-207 refers to § 17 of the Restatement of Security, which contains a comment making it clear that the section does not impose any duty on pledgees to sell quickly in a falling market.
- The big fights will be fought in terms of the secured lender's duty to hold a "commercially reasonable" foreclosure sale under UCC 9-610(b). Is it "commercially reasonable" to delay sale of pledged securities while the bottom is falling out of the market? The answer will depend on all the surrounding facts and circumstances.
- The toughest judicial decisions for secured lenders are *Caliendo* and *Solfanelli*. Revised Article 9 makes no mention of these cases in the Official Comments, so they are still a problem for pledgees in a falling stock market. We think the decisions go overboard by deputizing the secured lender as an involuntary "investment adviser." Yet the two cases remain on the books.

- In light of language from the two hard-line cases, if the debtor defaults when a surplus still exists, the safest strategy is to sell the securities quickly, even though the debtor contends that a turnaround is likely.
- If a sale is delayed while the market continues to drop, be ready to give the court a reasonable explanation. For example, the stock may be thinly traded, so that a sudden dump of the shares on the market could depress it even further. Or the debtor might be insisting that the pledgee give the stock time to rebound—an admission that should be duly noted by the secured lender.
- If litigation or arbitration ensue, emphasize the need for the secured lender to exercise its independent business judgment in these cases.
- Particularly with closely traded stock, seek the advice of brokers as an element of “commercial reasonableness.”
- Consider inserting language in your security agreement giving you latitude in the timing of sales in a falling market, with recitals for why this may be necessary. UCC 9-603(a) allows the parties to “determine by agreement the standards measuring the fulfillment of the rights of a debtor or obligor and the duties of a secured party...if the standards are not manifestly unreasonable.”

### SECURITY AGREEMENT IN FAVOR OF CORPORATION DOES NOT AUTOMATICALLY GRANT SECURITY INTEREST IN FAVOR OF AFFILIATES

In a variation of the old theme that “floating secured parties are all wet,” a New York bankruptcy court has ruled that a security interest must be granted *to* an affiliate of a corporate secured party. Express conveyancing language is required. It is not enough that the “obligations secured” include obligations due the affiliate. The New York decision also strikes down a financing statement that does not identify the affiliate as a secured party.

**The New York case.** In *In re Adirondack Timber Enterprise, Inc.*, WL 1741378, 71 UCC Rep.2d 722, 2010 (Bankr. N.D.N.Y. 2010), the debtor was in the business of planting, maintaining, and selling evergreen trees and tree-related products in upstate New York. In 2002, the debtor entered into a revolving line of credit with Farm Plan, a federally chartered savings bank which was a subsidiary of Deere & Company. The line of credit also granted Farm Plan a purchase-money security interest in all merchandise purchased with the credit card evidencing the line of credit.

Thereafter, the debtor bought goods and services with the credit card at a farm implement store, Giroux Brothers.

In 2004, the debtor bought a new John Deere tractor and a used Deere loader from Giroux Brothers. These purchases were financed by Deere (not Farm Plan) under the terms of a security agreement executed by Deere and the debtor the same day. A financing statement was filed referencing the debtor and the collateral, and identifying the secured party as “Deere & Company.”

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Unfortunately, the debtor filed a voluntary Chapter 11 bankruptcy petition in August 2008, and continued to run his business as a Chapter 11 debtor-in-possession. The debtor listed Deere on its petition as a creditor holding a claim in the amount of \$17,000 secured by the tractor and loader. Farm Plan was listed as an unsecured creditor with a claim in the amount of \$5,100 in connection with credit card purchases. Concerned about depreciation of its collateral, in March 2009 Deere filed a motion to lift the stay so that it could repossess and liquidate the collateral; the unpaid debt was \$15,580 and the collateral had a fair market value of \$29,400. The court gave an adequate protection order directing the debtor to pay Deere an amount equal to its secured claim of \$15,580, plus interest, over the next three years.

In April 2009 Farm Plan and Deere filed another motion for relief from the stay, with respect to the tractor and loader, to protect the \$5,100 still owing to Farm Plan under the revolving line of credit. The debtor challenged this motion on the ground that Farm Plan had no security interest in the tractor and loader that required adequate protection.

**The dueling arguments.** Deere and Farm Plan contended that Farm Plan held a valid security interest in the tractor and loader based on the plain language of the 2004 security agreement:

SECURITY AGREEMENT: To secure the obligation evidenced by the contract and any other obligation that I may owe to [Deere] or to [Deere's] affiliates, I grant [Deere] a Security Interest in the Goods described above and all parts and accessories now or hereafter incorporated in or on such Goods by way of addition, accession or replacement. I also grant you a Security Interest in all proceeds, including insurance proceeds and refund of

insurance premiums financed hereunder. I agree that all security granted on any other Contract between myself and [Deere] or any of [Deere's] affiliates shall also secure the obligations described in this Contract.

Deere and Farm Plan argued that the reference to “any other obligation that I may owe to [Deere] or [Deere's] affiliates” was sufficient to grant a security interest in the equipment to Farm Plan. Deere and Farm Plan also contended that the financing statement filed in 2002 perfected Farm Plan's security interest even though it didn't identify Farm Plan as the secured party.

The debtor countered that it never granted to Farm Plan a security interest in the tractor and loader that it financed through Deere. The debtor also argued that, even if a security interest attached, it was not perfected because the financing statement never mentioned Farm Plan and Deere did not file the financing statement in a representative capacity for its subsidiary; rather, it filed to protect its own purchase-money security interest in the tractor and loader. Finally, the debtor argued that the Adequate Protection Order Deere previously obtained from the court was *res judicata*, barring Deere and Farm Plan from seeking additional adequate protection payments.

**Court rules that security agreement didn't contain adequate granting language.** The New York bankruptcy court sided with the debtor on all issues. As to whether Farm Plan had a security interest in the equipment, the court concluded that the granting language in the security agreement did not do the job:

According to the plain meaning of the Security Agreement, the Debtor granted a security interest to Deere and not Farm Plan. Farm Plan relies upon the references to “[Deere's] affiliates” contained in the portion of the Security Agreement conveying the security interest to support its argument that the security interest somehow extends to Farm Plan. While the Security Agreement references obligations owed to Deere and Deere's affiliates, a security interest is only expressly conveyed to Deere. Nowhere in the Security Agreement is there any granting language in favor of “Farm Plan” specifically, or to “Deere's affiliates” generally. Farm Plan is not a person in whose favor a security interest was created or provided for under the Security Agreement, nor does it meet any of the other definitions of secured party under UCC section 9-102(a) (72). While the UCC does contemplate “floating collateral” (security interest attaching to after-acquired property) and “floating debt” (collateral securing future advances), there is no provision for “floating creditors.” N.Y. U.C.C. § 9-204(a), (c); see...*In re E.A. Fretz Co.*,

565 F.2d 366, 369 (5th Cir. 1978). A security agreement executed solely between a debtor and creditor does not grant an affiliate of the creditor a security interest in the collateral.

**Financing statement also inadequate.** The court also ruled that, even if Farm Plan had a security interest in the equipment, the 2004 financing statement did not perfect that security interest. UCC 9-502(a) provides that, to be effective, a financing statement must include (1) the name of the debtor, (2) the name of the secured party or a representative of the secured party, and (3) the collateral. It was undisputed that Farm Plan was not listed as a secured party; Deere was the only secured party listed. Farm Plan argued that, under UCC 9-503(d) and Comment 3, “failure to indicate the representative capacity of a secured party or representative of a secured party does not affect the sufficiency of a financing statement.”

The court rejected Farm Plan's argument. Under former Article 9, when a loan was made by a syndicate of secured lenders with one lender acting as agent for the others, issues of disclosure arose when the financing statement listed only the agent as secured party. UCC 9-502(a) and 9-503(d) were included in Revised Article 9 to clarify these disclosure issues. For example, Comment 3 to UCC 9-503 poses a case where the debtor grants a security interest to a group of secured parties, but not to their representative, the collateral agent. The agent is not a secured party. A financing statement is effective if it names the collateral agent as secured party, and even if it omits any reference to the agent's representative capacity. In the present case, however, there was no evidence that the purchase-money loan made by Deere to the debtor was a “joint loan” with Farm Plan, with Deere designated as the representative or collateral agent. Instead, the record indicated that the claim of Deere against the debtor was distinct from Farm Plan's claim against the debtor.

#### Two thoughts about the case.

- With respect to the financing statement, the court should have focused on whether, as a factual or legal matter, Deere was in fact acting as a representative of its affiliates in their secured transactions with the debtor. The issue isn't whether the loans were “joint loans” or otherwise related.
- With respect to the security agreement, secured creditors should include express language by which the debtor directly grants a security interest not only to the secured creditor, but also to its affiliates (identified specifically or as a group). Such language should satisfy the concerns expressed in such cases as *Adirondack Timber*.

## THE "BAILEE WITH NOTICE" MECHANISM REMAINS ALIVE, BUT LIMITED

The old version of Article 9 provided a handy method of perfecting a security interest on certain types of tangible collateral. It was called the "bailee with notice" device. Although Revised Article 9 has eliminated the device in most cases, it still remains alive for two special financing arrangements.

**The old rule.** For tangible collateral other than goods covered by a nonnegotiable document of title, the secured party was deemed to have possession of the collateral from the time a bailee—who was not an agent of either the secured party or the debtor—received notification of the secured party's interest. Old UCC 9-305. The bailee-with-notice mechanism served as a simple method for perfecting a security interest in goods, negotiable documents, certificated securities instruments, and other tangible collateral. The device allowed the secured party to maintain a perfected status without having its own hands on the collateral. It was used in a variety of commercial settings, but it generated mountains of litigation.

**The new rule.** Revised Article 9 generally eliminates the bailee-with-notice device and instead provides that a security interest in collateral in possession of a third party is perfected only when the third party *acknowledges* in an authenticated record that it holds the property for the benefit of the secured party. UCC 9-313(c). Mere notice to the third party is no longer sufficient. Moreover, the third party is not *required* to make such an acknowledgment. As something of a trade-off for loss of the bailee-with-notice device, Revised Article 9 provides that an instrument or certificated security can be perfected by filing, which was not allowed under the old law.

**Old rule remains alive for real estate warehouse lending...** In an accommodation to the real estate mortgage warehouse lending industry, a secured party need *not* obtain an acknowledgment from a bailee to whom the secured party delivers the collateral if the secured party instructed the bailee *before or at the time of delivery* to hold possession of the collateral for the secured party's benefit, or to redeliver it. UCC 9-313(h).

The policy behind this exception to the general rule is stated in Comment 9 to UCC 9-313:

[Warehouse lenders] typically send mortgage notes to prospective purchasers under cover of letters advising the prospective purchasers that the lenders hold security interests in the notes. These lenders relied on notification to maintain perfection under former 9-305. Requiring them to obtain authenticated acknowledgments from each prospective purchaser...could be unduly burdensome and disruptive of established practices.

...and for commodities financing. Also excepted from the general rule under UCC 9-313(h) are lenders to commodity brokers. For example, a cotton broker may buy raw cotton from producers in Texas and sell it to textile companies in North Carolina. The broker's bank extends a line of credit secured by negotiable warehouse receipts issued by cotton warehouses in Texas. The bank sends these warehouse receipts to the issuers, with instructions to release the cotton to designated carriers for the journey to North Carolina. Even though the bank releases the negotiable warehouse receipts, it seeks to maintain its perfected status by sending each warehouse a transmittal letter designating the warehouse as bailee for the bank. In the cotton brokerage transactions, the various warehouses may serve as bailees with notice because they receive the notice at the same time they receive the warehouse receipts, and the warehouses are not controlled by the borrower, nor are they competing secured lenders.

**Bottom line.** A secured party can perfect a security interest in tangible collateral by (1) taking possession of the collateral itself, (2) taking possession through its agent (though the debtor can never serve as the secured party's agent), or (3) by having a third-party bailee acknowledge that it holds the collateral for the benefit of the secured party. (4) In the case of real estate warehouse financing or commodities financing, notice to the third party without acknowledgment is sufficient. In all of these possessory scenarios, the filing of a financing statement is a good back-up, particularly against the debtor's trustee in bankruptcy.

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