SECURED TRANSACTIONS

Xuan-Thao Nguyen

Gerald L. Bepko Chair in Law
Director, Center for Intellectual Property Law and Innovation

Robert H. McKinney School of Law
Indiana University

International Finance Corporation
WORLD BANK GROUP

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CHAPTER ONE

A. WHY DO WE NEED SECURED TRANSACTIONS?

Imagine living in a country where the labor cost is extremely low but the overall cost to make a product is much higher than in a neighboring country where the labor cost is much higher but the overall cost to complete the same product is much lower. The two countries then try to compete in the marketplace both domestically and internationally. Obviously, both domestic and international buyers prefer to pay less for the same product. At the end, the neighboring country will export more products and enjoy economic advantages. As the cycle repeats, the neighboring country is leaving the other country behind. What could be one of the leading causes of such disparity between the two countries? Credit. Access to low-cost credit that is. Without access to low-cost credit, businesses simply cannot operate and compete. That also means limited opportunity to innovate, grow, and prosper.

Consider these different examples. Imagine buying new vehicles with cash only. Certainly, very few people or businesses can afford to purchase new vehicles, and the auto manufacturers will consequently make fewer of them. That means fewer jobs. Fortunately, with the availability of auto financing, businesses and individuals can purchase vehicles of their choice, drive to work, meet partners, and conduct their activities with ease. The auto manufacturers can also obtain financing for operation and production, as they can produce more vehicles to meet demand. That means more jobs, opportunities for innovation, and growth.

Heard of film financing? Without access to credit, very few films would ever be made. It is hard to fathom living without movies, music, and other entertainments. Name a sector, a business, you will see that sector or business is always in need of financing. Typically, the financing is referred to as a secured transaction.

Secured transactions are everywhere. Secured transactions come in many forms. Some are easily recognizable:a straight loan secured by the vehicle purchased or a credit line secured by account receivables. Others are a little harder to spot: for example, sales on credit or conditional sales where the vendor sells the goods on credit and retains title in the goods. Actually, that transaction really means the goods are serving as security for the credit provided by the vendor. Another example is a business, in need of capital today, that decides to assign some of its account receivables to a finance company at a discount. That "factoring" is now under the umbrella of secured transactions law.

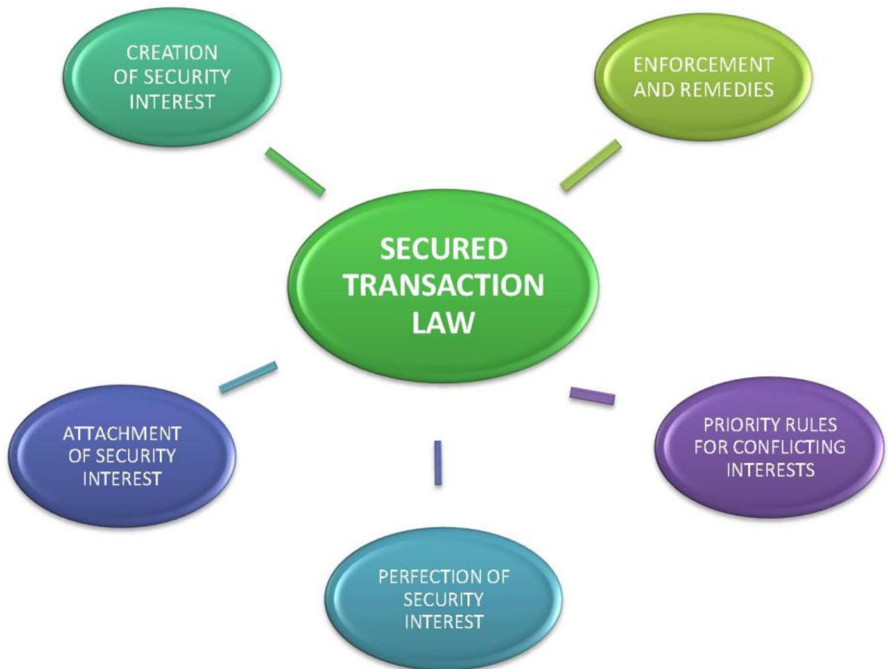
What happens if the buyer of goods or the borrower of a loan or the debtor of a credit line fails to make a payment? What happens if each of these actors use the same property as collateral in different financing transactions with different creditors? What happens if the actors file for bankruptcy? What happens if the federal government files a tax lien against the same property? What happens if some third party buys from the debtor the same property that the debtor has used as security in its prior transactions with its creditors? All of these questions and more suggest that a legal framework or a body of law must exist to appropriately addresssecured transactions in a way that achieves the goal of having accessibility to lowcredit

for businesses and individuals. Fortunately, both the United States and the United Nations have already provided the necessary law.

B. LEGAL FRAMEWORK

In the United States, the law that governs secured transactions is Article 9 of the Uniform Commercial Code. Internationally, UNCITRAL provides a model law and legislative guides on secured transactions for member nations to adopt. UNICITRAL Secured Transactions are similar to UCC-9.

Figure 1: A UNITARY SYSTEM



1. UNCITRALSecured Transactions Project

As more nations gained independence in the twentieth century, the world began to look different. Trading between

and among nations became indispensable to the growth and development of old and new nations. The United Nations General Assembly recognized the need for a set of rules and standards to harmonize national and regional regulations, by passing Resolution 2205 (XXI) of 17 December 1966 "to promote the progressive harmonization and unification of international trade law" and to establish the United Nations Commission on International Trade Law (UNCITRAL).

Currently more than sixty nations are members of UNCITRAL. With its goal of increasing opportunities through commerce worldwide, UCITRAL focuses on formulating modern, fair, and harmonized rules on commercial transactions.There are many important UNCITRAL conventions that have been ratified by member states.[1]

---

[1] The following UNCITRAL conventions are available at its website:

- the Convention on the Recognition and Enforcement of Foreign Arbitral Awards (1958)
- the Convention on the Limitation Period in the International Sale of Goods (1974)
- the United Nations Convention on the Carriage of Goods by Sea (1978)
- the United Nations Convention on Contracts for the International Sale of Goods (1980)
- the United Nations Convention on International Bills of Exchange and International Promissory Notes (1988).
- the United Nations Convention on the Liability of Operators of Transport Terminals in International Trade (1991).
- the United Nations Convention on Independent Guarantees and Stand-by Letters of Credit (1995).
- the United Nations Convention on the Assignment of Receivables in International Trade (2001).
- the United Nations Convention on the Use of Electronic Communications in International Contracts (2005).
- the United Nations Convention on Contracts for the International Carriage of Goods Wholly or Partly by Sea (2008).

In addition to the conventions, UNCITRAL has also drafted many model laws for member states to enact as part of their national law.

- UNCITRAL Model Law on International Commercial Arbitration (1985)
- UNCITRAL Model Law on International Credit Transfers (1992)
- UNCITRAL Model Law on Procurement of Goods, Construction and Services (1994)
- UNCITRAL Model Law on Electronic Commerce (1996)
- UNCITRAL Model Law on Cross-Border Insolvency (1997)
- UNCITRAL Model Law on Electronic Signatures (2001)
- UNCITRAL Model Law on International Commercial Conciliation (2002)
- Model Legislative Provisions on Privately Financed Infrastructure Projects (2003)
- UNCITRAL Model Law on Secured Transactions (2016)
- UNCITRAL Arbitration Rules (1976) —revised rules will be effective August 15, 2010; pre-released, July 12, 2010
- UNCITRAL Conciliation Rules (1980)
- UNCITRAL Arbitration Rules (1982)

- the United Nations Convention on Transparency in Treaty-based Investor-State Arbitration (2015).

- UNCITRAL Notes on Organizing Arbitral Proceedings (1996)

To assist member states in their enactment of the model laws, UNCITRAL provided detailed analysis of the issues, best practices, and recommendations associated with a specific model law in Legislative Guides. Here are the Legislative Guides:

- UNCITRAL Legislative Guide on Privately Financed Infrastructure Projects (2000)
- UNCITRAL Legislative Guide on Insolvency Law (2004)
- UNCITRAL Legislative Guide on Secured Transactions (2007)
- UNCITRAL Legislative Guide on Secured Transactions: Supplement on Security Rights in Intellectual Property (2010)

With respect to Secured Transactions, UNCITRAL finalized the Model Law on Secured Transactions in 2016, the Legislative Guide on Secured Transactions in 2007, and the other Legislative Guide on Secured Transactions Supplement on Security Rights in Intellectual Property in 2010. This comprehensive legal body of the Model Law and the two Legislative Guides are the result of UNCITRAL's efforts that began in the 1970s. It reflects the international commitment to providing low-cost credit to businesses and individuals throughmodernizing all old security devices, replacing them with a comprehensive, clear, and concise unitary system that facilitates the availability of credit through leveragingdebtor's movable assets.In drafting the Model Law and the Legislative

Guides, the drafters looked to the success of Article 9 of the Uniform Commercial Code.

2. Uniform Commercial Code Article 9

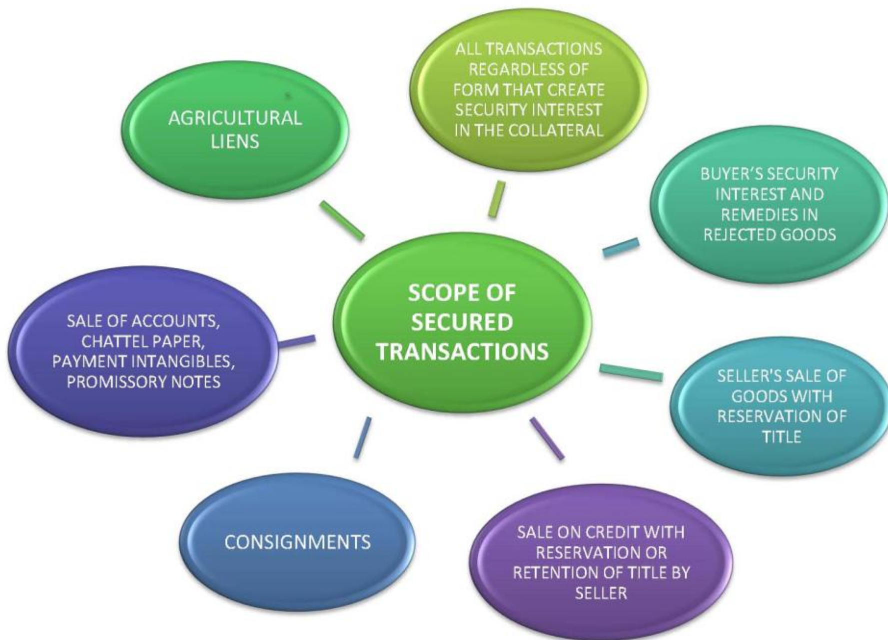
The rich history of Article 9 of the Uniform Commercial Code traces its roots back to the 1700s when chattel mortgages–a security interest in personal property–were used as a form of financingto meet local needs. The laws were non-uniform and varied from state to state. With technological changes in the 1900s, lending activities expanded beyond local levels, going across state boundaries. Non-uniform chattel mortgage law could not accommodate the expansion of commercial and lending transactions. The National Conference of Commissioners on Uniform State Laws formed in 1892, the predecessor of the Uniform Law Commission or ULC, responded to the changes by becoming a co-sponsor of the Uniform Commercial Code. By 1932, the American Law Institute (ALI) was established and later joined forces with the ULC to co-sponsor the UCC. In 1942, the two co-sponsors began the daunting task of drafting the Uniform Commercial Code. They aimed to establish uniformity of commercial laws across state boundaries. Nine years later, in 1951, they promulgated the first official text of the Uniform Commercial Code. They published the Uniform Commercial Code in 1952. The first article encompassed general provisions. The subsequent eight articles encompassed substantive areas of commercial law, namely, Sales; Negotiable Instruments; Bank Deposits; Letters of Credit;Bulk Transfers & Bulk Sales; Warehouse Receipts, Bills of Lading, and other Documents of Title; Investment Securities; and Secured Transactions. After the first ten years, the sponsors released an improved version of the entire Uniform Commercial Code in 1962. Individual

revisions occurred in subsequent years. Article 9 added significant amendments in 1972.

With the arrival of computers, networking, banking deregulations, increasing mobility of debtors and collateral, and multistate transactions, Article 9 requirements became obsolete. That led to efforts for additional revisions of the Article in the 1990s and the subsequent adoption of Revised Article 9 in most states on July 1, 2001. Later amendments to clarify some of the issues in Article 9 were approved by the sponsors, ULC and ALI, in 2010. Most states adopted the 2010 Amendments in 2013.

The leading figure behind Article 9 is Professor Grant Gilmore. Professor Gilmore drafted Article 9 and was also one of the principal drafters of the Uniform Commercial Code. Article 9 replaces all pre-Code security devices, such as, pledge, chattel mortgage, assignments, field warehousing, and factoring, among others. The security devices were a hindrance, as they were inefficient, redundant, and costly. Article 9 is a unitary system encompassing all transactions, regardless of form, that create interests in personal property which secure payment or performance of obligations. Article 9 is fundamental to lending and facilitating credit availability. It is important to the economy. It is viewed as the most novel, even the most revolutionary, part of the Uniform Commercial Code.

Figure 2: SCOPE OF SECURED TRANSACTIONS



C. CREATION OF A SECURITY INTEREST

A business or an individual with a desire to create a security interest must have "Collateral." There must be a security agreement, written or oral, to create or provide for a security interest between the secured party and the debtor. Whether an agreement creates a security interest depends not on the intent of the parties but rather on whether the transaction falls within the definition of "security interest."

The secured party is typically the party that provides the loan or extends credit. The secured party can also be the assignees or buyers of account receivables, chattel papers, payment intangibles, and promissory notes.

The debtor is the entity or person having either ownership or rights in the personal property that is used as "Collateral" to secure payment or performance of an obligation.

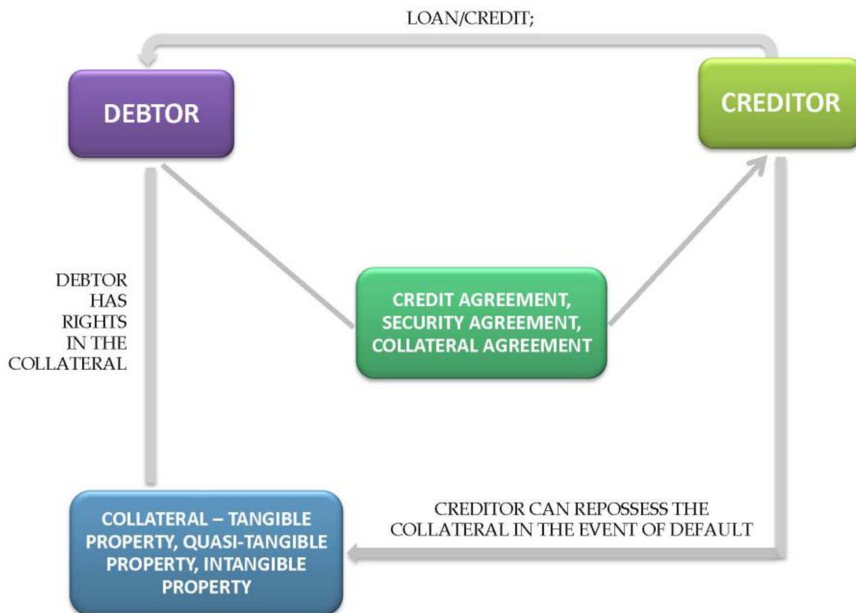
The debtor may or may not be the obligor. The obligor is the entity or person with the obligation to pay the loan or the credit. See Official Comment 2 to UCC § 9-102; Official Comment 3 to UCC § 9-102.

Let us explore "Security Interest" and "Collateral" further.

1. From Personal Property to Collateral in Secured Transactions

A secured transaction is any transaction, regardless of its form, that creates a security interest in personal property. A security interest means an interest in personal property or fixtures, which secures payment or performance of an obligation. The law also provides that "security interest" includes any interest of a consignor and a buyer of accounts, chattel paper, a payment intangible, or a promissory note.See UCC § 1-201. Article 1 of the UCC contains general provisions applicable to a transaction to the extent that it is governed by another article of the Uniform Commercial Code.

Figure 3: CREATION OF A SECURITY INTEREST



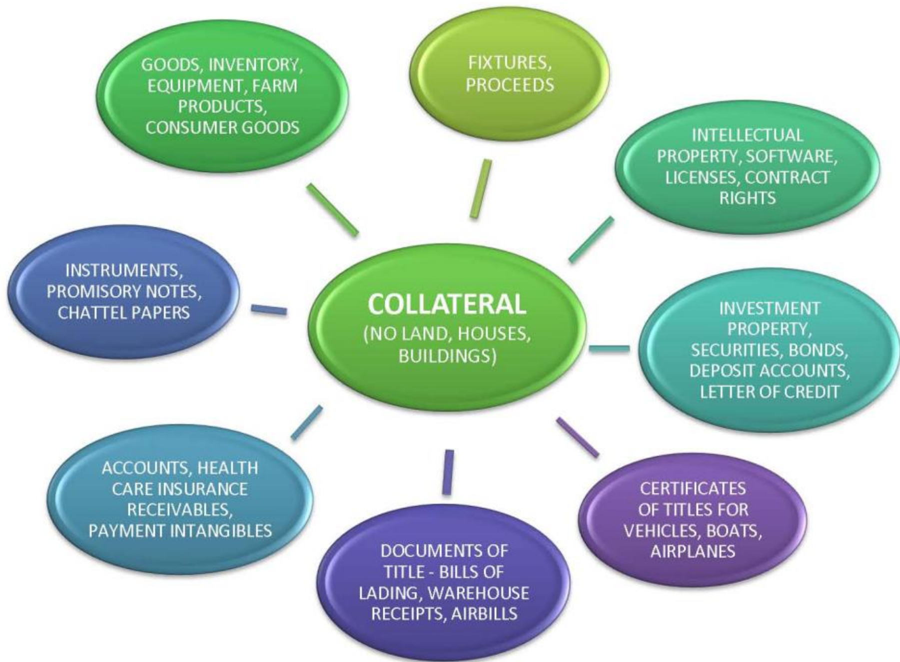
The term "personal property" refers to any property that is not real property (houses, buildings, lands). Personal property covers tangible property, such as goods (inventory, equipment, consumer goods, and farm products); quasi tangible property, such as documents, instruments, chattel papers, and investment property (stocks, bonds, and securities);and intangible property, such as accounts, payment intangibles, and general intangibles (patents, copyrights, trademarks, trade secrets, database, software, domain names, and licenses).

When personal property is used to secure a debt, a credit line, or a repayment obligation, that personal property is referred to as "Collateral." Collateral also covers proceeds subject to a security interest. Proceeds mean (i) whatever is acquired upon the sale, lease, license, exchange, or other disposition of the original collateral; (ii) whatever is collected on, or distributed on account of, the original collateral; (iii) rights arising out of collateral; (iv) to the extent of the value of the collateral, claims arising out of the loss, nonconformity, or interference with the use of, defects or infringement of rights in, or damage to, the collateral; (v) to the extent of the value of the collateral and to the extent payable to the debtor or the secured party, insurance payable by reason of the loss or nonconformity of, defects or infringement of rights in, or damage to, the collateral. In other words, the definition of proceeds is extensive.

Additionally, *Collateral* includes accounts, chattel paper, payment intangibles, and promissory notes that have been sold. Though the sales of these types of personal property do not involve security interests (i.e. these types of personal property are not used to secure obligations or payments), nevertheless, Article 9 includes them within the scope of the law. Why?

Collateral also covers goods that are the subject of a "consignment."

Figure 4: PROPERTY SERVE AS COLLATERAL



2. Definitions for Different Types of Personal Property to be Used As Collateral

UCC § 9-102 provides an extensive list of definitions. As debtors have many different types of personal property, the law allows the debtors to leverage them as collateral in obtaining financing. Let's have a closer look at the wide range of personal property that can be used as collateral, extracted from 9-102 with numberings as it appears in the originals. Read the definitions with care to appreciate how extensive, numerous, mobile, and lackingin physical form many types of personal property that are now used as collateral in today's secured transactions.

(2) "**Account**", except as used in "account for", means a right to payment of a monetary obligation, whether or not earned by performance, (i) for property that

has been or is to be sold, leased, licensed, assigned, or otherwise disposed of, (ii) for services rendered or to be rendered, (iii) for a policy of insurance issued or to be issued, (iv) for a secondary obligation incurred or to be incurred, (v) for energy provided or to be provided, (vi) for the use or hire of a vessel under a charter or other contract, (vii) arising out of the use of a credit or charge card or information contained on or for use with the card, or (viii) as winnings in a lottery or other game of chance operated or sponsored by a State, governmental unit of a State, or person licensed or authorized to operate the game by a State or governmental unit of a State. The term includes health-care-insurance receivables. The term does not include (i) rights to payment evidenced by chattel paper or an instrument, (ii) commercial tort claims, (iii) deposit accounts, (iv) investment property, (v) letter-of-credit rights or letters of credit, or (vi) rights to payment for money or funds advanced or sold, other than rights arising out of the use of a credit or charge card or information contained on or for use with the card.

(6) "**As-extracted collateral**" means:

(A) oil, gas, or other minerals that are subject to a security interest that:

(i) is created by a debtor having an interest in the minerals before extraction; and

(ii) attaches to the minerals as extracted; or

(B) accounts arising out of the sale at the wellhead or minehead of oil, gas, or other minerals in which

the debtor had an interest before extraction.

(9) "**Cash proceeds**" means proceeds that are money, checks, deposit accounts, or the like.

(10) "**Certificate of title**" means a certificate of title with respect to which a statute provides for the security interest in question to be indicated on the certificate as a condition or result of the security interest's obtaining priority over the rights of a lien creditor with respect to the collateral. The term includes another record maintained as an alternative to a certificate of title by the governmental unit that issues certificates of title if a statute permits the security interest in question to be indicated on the record as a condition or result of the security interest's obtaining priority over the rights of a lien creditor with respect to the collateral.

(11) "**Chattel paper**" means a record or records that evidence both a monetary obligation and a security interest in specific goods, a security interest in specific goods and softwareused in the goods, a security interest in specific goods and license of software used in the goods, a lease of specific goods, or a lease of specific goods and license of software used in the goods. In this paragraph, "monetary obligation" means a monetary obligation secured by the goods or owed under a lease of the goods and includes a monetary obligation with respect to software used in the goods. The term does not include (i) charters or other contracts involving the use or hire of a vessel or (ii) records that evidence a

right to payment arising out of the use of a credit or charge card or information contained on or for use with the card. If a transaction is evidenced by records that include an instrument or series of instruments, the group of records taken together constitutes chattel paper.

(13) "**Commercial tort claim**" means a claim arising in tort with respect to which:

(A) the claimant is an organization; or

(B) the claimant is an individual and the claim:

(i) arose in the course of the claimant's business or profession; and

(ii) does not include damages arising out of personal injury to or the death of an individual.

(14) "**Commodity account**" means an account maintained by a commodity intermediary in which a commodity contract is carried for a commodity customer.

(15) "**Commodity contract**" means a commodity futures contract, an option on a commodity futures contract, a commodity option, or another contract if the contract or option is:

(A) traded on or subject to the rules of a board of trade that has been designated as a contract market for such a contract pursuant to federal commodities laws; or

(B) traded on a foreign commodity board of trade, exchange, or market, and is carried on the books of

a commodity intermediary for a commodity customer.

(23) "**Consumer goods**" means goods that are used or bought for use primarily for personal, family, or household purposes.

(29) "**Deposit account**" means a demand, time, savings, passbook, or similar accountmaintained with a bank. The term does not include investment property or accounts evidenced by an instrument.

(30) "**Document**" means a document of title or a receipt of the type described in Section 7-201(2).

(31) "**Electronic chattel paper**" means chattel paper evidenced by a record or records consisting of information stored in an electronic medium.

(33) "**Equipment**" means goods other than inventory, farm products, or consumer goods.

(34) "**Farm products**" means goods, other than standing timber, with respect to which the debtor is engaged in a farming operation and which are:

(A) crops grown, growing, or to be grown, including:

(i) crops produced on trees, vines, and bushes; and

(ii) aquatic goods produced in aquacultural operations;

(B) livestock, born or unborn, including aquatic goods produced in aquacultural operations;

(C) supplies used or produced in a farming operation; or

(D) products of crops or livestock in their

unmanufactured states.

(41) "**Fixtures**" means goods that have become so related to particular real property that an interest in them arises under real property law.

(42) "**General intangible**" means any personal property, including things in action, other than accounts, chattel paper, commercial tort claims, depositaccounts, documents, goods, instruments, investmentproperty, letter-of-credit rights, letters of credit, money, and oil, gas, or other minerals before extraction. The term includes payment intangibles and software.

(44) "**Goods**" means all things that are movable when a security interest attaches. The term includes (i) fixtures, (ii) standing timber that is to be cut and removed under a conveyance or contract for sale, (iii) the unborn young of animals, (iv) crops grown, growing, or to be grown, even if the crops are produced on trees, vines, or bushes, and (v) manufactured homes. The term also includes a computer program embedded in goods and any supporting information provided in connection with a transaction relating to the program if (i) the program is associated with the goods in such a manner that it customarily is considered part of the goods, or (ii) by becoming the owner of the goods, a person acquires a right to use the program in connection with the goods. The term does not include a computer program embedded in goods that consist solely of the medium in which the

program is embedded. The term also does not include accounts, chattel paper, commercial tort claims, deposit accounts, documents, general intangibles, instruments, investment property, letter-of-credit rights, letters of credit, money, or oil, gas, or other minerals before extraction.

(46) "**Health-care-insurance receivable**" means an interest in or claim under a policy of insurance which is a right to payment of a monetary obligation for health-care goods or services provided.

(47) "**Instrument**" means a negotiable instrument or any other writing that evidences a right to the payment of a monetary obligation, is not itself a security agreement or lease, and is of a type that in ordinary course of business is transferred by delivery with any necessary indorsement or assignment. The term does not include (i) investment property, (ii) letters of credit, or (iii) writings that evidence a right to payment arising out of the use of a credit or charge card or information contained on or for use with the card.

(48) "**Inventory**" means goods, other than farm products, which:

(A) are leased by a person as lessor;

(B) are held by a person for sale or lease or to be furnished under a contract of service;

(C) are furnished by a person under a contract of service; or

(D) consist of raw materials, work in process, or

materials used or consumed in a business.

(49) "**Investment property**" means a security, whether certificated or uncertificated, security entitlement, securities account, commodity contract, or commodity account.

(51) "**Letter-of-credit right**" means a right to payment or performance under a letter of credit, whether or not the beneficiary has demanded or is at the time entitled to demand payment or performance. The term does not include the right of a beneficiary to demand payment or performance under a letter of credit.

(53) "**Manufactured home**" means a structure, transportable in one or more sections, which, in the traveling mode, is eight body feet or more in width or 40 body feet or more in length, or, when erected on site, is 320 or more square feet, and which is built on a permanent chassis and designed to be used as a dwelling with or without a permanent foundation when connected to the required utilities, and includes the plumbing, heating, air-conditioning, and electrical systems contained therein. The term includes any structure that meets all of the requirements of this paragraph except the size requirements and with respect to which the manufacturer voluntarily files a certification required by the United States Secretary of Housing and Urban Development and complies with the standards established under Title 42 of the United States Code.

(58) "**Noncash proceeds**" means proceeds

other than cash proceeds.

(61) "**Payment intangible**" means a general intangible under which the account debtor's principal obligation is a monetary obligation.

(64) "**Proceeds**", except as used in Section 9-609(b), means the following property:

(A) whatever is acquired upon the sale, lease, license, exchange, or other disposition of collateral;

(B) whatever is collected on, or distributed on account of, collateral;

(C) rights arising out of collateral;

(D) to the extent of the value of collateral, claims arising out of the loss, nonconformity, or interference with the use of, defects or infringement of rights in, or damage to, the collateral; or

(E) to the extent of the value of collateral and to the extent payable to the debtor or the secured party, insurance payable by reason of the loss or nonconformity of, defects or infringement of rights in, or damage to, the collateral.

(65) "**Promissory note**" means an instrument that evidences a promise to pay a monetary obligation, does not evidence an order to pay, and does not contain an acknowledgment by a bank that the bank has received for deposit a sum of money or funds.

(76) "**Software**" means a computer program and any supporting information provided in connection with a transaction relating to the program. The term does

not include a computer program that is included in the definition of goods.

(79) "**Tangible chattel paper**" means chattel paper evidenced by a record or records consisting of information that is inscribed on a tangible medium.

Reading the above list, some of you may wonder why intellectual property (patents, copyrights, trademarks, and trade secrets), data, and licenses are missing, given the fact that intellectual property assets are businesses' most valuable assets. From Google, Uber, and Apple to Merck, Pfizer, Viacom and many other businesses, intellectual property assets are key to competition. Article 9 recognizes intellectual property and licensesby the definition "General Intangible," which is a residual, catchall of intangible personal property and "things in action" that are not included in the other defined types of collateral—accounts, chattel paper, commercial tort claims, deposit accounts, documents, goods, instruments, investment property, letter-of-credit rights, letters of credit, money, and oil, gas, or other minerals before extraction. The Official Comments clarifies that "things in action" includes rights that arise under a license of intellectual property, including the right to exploit the intellectual property without liability for infringement. As seen in the cases and examples of security agreements included in this book, parties use the above list as a guide; they draft the security agreement with their own definition of collateral to include intellectual property and other personal property not identified in UCC § 9-102.

PROBLEM 1:

Before you continue, pause here and test your understanding of the

different types of Collateral.

1.1 Right to payment for 5 Android phones sold on credit ____________________.

1.2 Lexus cars on the dealer's floor _____________________.

1.3 Pigs raised by farmers for later sale ___________________

1.4 Android phones distributed by the Marketing Director to each member of her marketing team __________________.

1.5 Trademarks and logos of a company _________________.

1.6 Fifty shares of Facebook _______________________.

1.7 A note to promise to pay the bank a certain amount of money next year _______________________.

1.8 A television bought for family use ___________________.

1.9 Televisions bought for the waiting areas at the airport ____________________.

1.10 A paper evidencing a document of title ________________.

1.11 All things that are movable when a security interest attaches _______________.

1.12 Whatever is acquired upon a sale or a lease of collateral __________________.

D. CERTAIN TRANSACTIONS RELATING TO FINANCING ARE COVERED BY UCC-9

As stated above, a security interest means an interest in personal property or fixtures, which secures payment or performance of an obligation. The law expands the definition of "security interest" further to provide that "security interest" also includes any interest of a consignor and a buyer of accounts, chattel paper, a payment intangible, or a promissory note in a transaction that is subject to Article 9. UCC § 1-201. Let us look closely at this coverage.

1. Sale of Accounts, Chattel Papers, Payment Intangible, and Promissory Notes

There is a very large market for the buying and selling of accounts, chattel paper, payment intangibles, and promissory notes. These assets are highly liquid. If a buyer purchases these assets and a lender also wants to extend credit to the seller of the assets, it would be best to have the buyer inform the whole world through filing (other countries use the term registration) the necessary papers. That means the rules of perfection and priority will apply to these sales transactions. The Official Comments recognize that including these sales transactions within the scope of Secured Transactions law "has been successful in avoiding difficult problems of distinguishing" between transactions where the receivables secure an obligation from transactions where the receivables were sold outright. See Official Comment 4 to § 9-109.

2. Consignments

Article 9 includes consignments within its scope. That means when a transaction falls within the definition of consignment pursuant to § 9-102, the consignor must follow the rules pertaining to attachment, perfection, priority, and enforcement. Moreover, the

consignor who delivers goods to a consignee is treated as having a purchase-moneysecurity interest in inventory. See§ 9-103(d). This will have an impact on the super-priority rule under § 9-324(b) discussed later in this Book.

3. A True Lease or Disguised Security Interest

There are tax reasons why a person or entity may wish to characterize a transaction as a lease instead of a sale subject to a security interest. If the transaction is in the form of a security interest, the seller must follow UCC-9 with respect to perfection of its security interest, for example, filing the financing statement with the Secretary of State.

UCC § 1–203, addresses whether a transaction creates a true lease or a disguised security interest. It states that "[w]hether a transaction in the form of a lease creates a lease or security interest is determined by the facts of each case." UCC § 1-203(a). A transaction creates a security interest if the lessee has an obligation to continue paying consideration for the term of the lease, if the obligation is not terminable by the lessee, and if one of four additional tests is met. The UCC § 1–203(b)(1)-(4) additional tests focus on the economics, not the intent of the parties, in determining whether the transaction is a true lease or a disguised security interest:

> (b) 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.

In summary, there is a two-step test for determining whether an agreement is a true lease or a disguised security interest. The first step is a bright-line test, codified in Section 1–203(b), whether the "lease" is not subject to termination by the lessee and that at least one of the four conditions is satisfied. If the lease is not terminable by the lessee and one or more of the enumerated conditions is present, then the contract is a *per se* security agreement. If the bright-line test of Section 1–203(b) is not satisfied, then a security interest will not be conclusively found to exist, and the court will need to consider other factors. *See In re* Southeastern Materials, Inc. 433 B.R. 177 (M.D. NC 2010).

We will return to the subject of true lease-disguised security interest later in the Priority Chapter.

E. LIMITS ON THE SCOPE OF SECURED TRANSACTIONS LAW

Secured Transactions law does not cover security interests in real property. Real property law has its own recordation system regarding mortgages, titles, transfers, and liens.

UCC § 9-109(c) provides that secured transactions law does not apply to the extent that a statute, regulation, or treaty of the United States expressly preempts it or if there is another statute of the same State or of another State that expressly governs the creation, perfection, priority, or enforcement of a security interest. In other words, Article 9 is not going to step back in most cases.

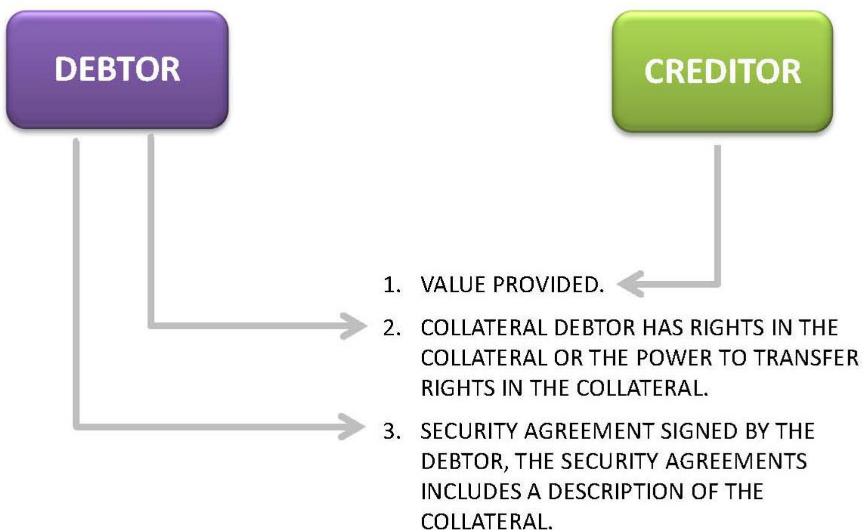
There are certain transactions not governed by Article 9. Thirteeninapplicable transactions are listed in UCC § 9-109(d)(1)-(13). They are, for example, landlord's lien; statutory lien for services or materials with an exception for priority under § 9-333; an assignment of a claim for wages; a sale of accounts, chattel paper, payment intangibles, or promissory notes as part of a sale of the business out of which they arose; an assignment of accounts, chattel paper, payment intangibles, or promissory notes which is for the purpose of collection only;and an assignment of a claim arising in tort, other than a commercial tort claim, among others.

CHAPTER TWO

A. ATTACHMENT OF SECURITY INTEREST: CREATING AN ENFORCEABLE SECURED TRANSACTION BETWEEN THE PARTIES

When will attachment of a security interest occur?A security interest attaches and is enforceable against the debtors and others when (1)value has beengiven by the creditor, (2) the debtor has rights in the collateral or power to transfer rights in the collateral, and (3) the debtor authenticates a security agreement providing a description of the collateral or the creditor has possession of the collateral. See UCC §9-203(b). All three requirements must be satisfied in order for the security interest to attach and beenforceable against the debtor. Missing any of the three requirements means attachment of the security interest does not occur, and that means the secured party cannot enforce the security interest in the collateral when the debtor is in default.

Figure 5: ATTACHEMENT OF SECURITY INTEREST



1. "Value has been given" by the secured creditor

"Value" means extension of credit, loans, past debt, preexisting claim, and consideration. The definition of"value" is in UCC § 1-204. As you read the cases included in this book, you will appreciate the broad meaning of "value" given by the creditor to create an enforceable security interest between the parties.

2. "The debtor has rights in the collateral or power to transfer rights in the collateral to the secured party"

Consistent with the goal of encouraging secured transactions, UCC-9 does not require the debtor to have ownership of the property to be used as collateral in the secured transactions. As long as the debtor has rights in the collateral or power to transfer that right, the debtor can engage in a secured transaction. This is very common as we witness every day individuals and businesses purchase vehicles with little or zero down payments. The debtors in these secured transactions don't have ownership of the vehicles. They have rights in the vehicles that they purchase on credit. They can drive the vehicles out of the dealer's lot and use the vehicles for their personal or business purposes. They will make payments in accordance with the schedule. If they fail to pay, the financing company has the right to repossess the car, sell the car, and seekany deficiency. Imagine if UCC-9 imposes the requirement of ownership, there will be very few secured transactions; automobile manufacturers will be in trouble; employment in the automobile manufacturing industry, insurance, and financing will be reduced; and individuals and businesses will not have access to efficient modes of transportation.

Some countries, due to the lack of a strong legal enforcement system, have opted for an ownership of the collateral requirement in the creation of enforceable security interests. It is a policy choice of a particular country.

If the debtor does not have rights in the property to be used as collateral, the creditor cannot have an enforceable security interest against the debtor. For most transactions, it is easy to tell whether the debtor does or does not have rights in the collateral. Some cases require a better understanding of property law relating to the sale of goods.

The next case covers whether the debtor Fidelity has rights in the peanuts collateral upon the growers' delivery of the goods in order for Farm Credit to create an enforceable security interest in the peanuts against the debtor Fidelity. As to the security agreement between the secured creditor Farm Credit and the debtor Fidelity, look at the description of the collateral. The case also focuses on seller on credit with reservation of title in the goods (in this case, the peanut growers who sold the peanuts on credit to Fidelity) that also serve as collateral in a secured transaction between the buyer (Fidelity) and third-party creditor (Farm Credit).

Tips for reading cases: Identify the secured transactions in the case. For each secured transaction, identify who is the debtor. Who is the secured party? Which property is used as the collateral? Does the debtor have right in the collateral? Does the secured party provide value and in what form? Do the parties have a security agreement?

Farm Credit of Northwest Florida, ACA v. Easom Peanut Co.

718 S.E.2d 590 (Ga.Ct. App. 2011)

McFADDEN, Judge.

This dispute arises out of the bankruptcy of a peanut broker, Fidelity Foods. At issue are competing claims to proceeds from the sale of 2008 peanut crops. Easom Peanut Company, which warehoused and processed the peanuts, brought this action against multiple peanut growers and Farm Credit of Northwest Florida, ACA, which had loaned money to Fidelity, the now-bankrupt broker….

In January 2008, Farm Credit, a cooperative bank, extended a $5 million line of credit to Fidelity to fund its operations. In exchange, Fidelity granted Farm Credit a security interest in its inventory, accounts, and other assets, including collateral, defined as "[a]ll peanuts of every kind and description shelled and unshelled, and wherever located and including but not limited to all peanuts owned by Debtor and stored at and/or processed by companies listed on 'Exhibit A.'" [emphasis added] Listed on Exhibit A were six companies, including Easom. On January 10, 2008, Farm Credit filed UCC financing statements in the applicable jurisdictions. The financing statements described the property in which Farm Credit had a security interest in the same words as those used in the security agreement. In March 2008, Fidelity entered agreements with Easom for the shelling and storage of peanuts.

Later in 2008, Fidelity entered contracts with the growers for the purchase of their 2008 peanut stock. Most of the contracts provided that the Seller retains all beneficial interest thus having control and title in the Peanuts until such time as title to said Peanuts is transferred to [Fidelity] and the warehouse receipt(s) relating to such Peanuts are delivered to [Fidelity]. Until such time, any damage to the Peanuts remains the responsibility of the Seller.

The contracts did not specify how title would transfer, nor how or where the peanuts would be delivered. No warehouse receipts were ever delivered.

…

Fidelity directed that the peanuts be delivered to Easom and sent trucks to the farms for that purpose. Some of the growers were only partially paid and others were never paid at all. Fidelity paid Easom $547,134.87 of the $1,109,802.09 invoiced for its services in processing and storing the peanuts. Fidelity filed for bankruptcy protection on April 14, 2009. The bankruptcy court allowed Easom to sell the peanuts, and the proceeds were put in escrow pending the resolution of this lawsuit. The parties have agreed that any rights they may have had in the peanuts have become equivalent rights in the proceeds.

Easom filed this lawsuit against Fidelity, Farm Credit, and 17 growers, seeking to recover the reasonable value of its services. The growers answered and filed cross-claims against Farm Credit. Farm Credit answered and filed motions for summary judgment against four growers. The growers moved for partial summary judgment against Farm Credit, and Easom moved for summary judgment. The trial court granted summary judgment to Easom for the full value of its claim and to the growers, awarding them their proportionate shares in the proceeds remaining after Easom is paid. It denied Farm Credit's summary judgment motion on the growers' cross-claims. Farm Credit filed this appeal.

…

Georgia and Florida law both require that the "debtor [have] rights in the collateral or the power to transfer rights in the collateral

to a secured party" before a security interest will attach to the collateral. OCGA § 11–9–203(b)(2); Fla. Stat. § 679.2031(2)(b). "[I]t is self-evident that in the absence of special circumstances a security interest can attach only to the extent of the interest of the debtor.... One cannot encumber another man's property in the absence of consent, estoppel, or some other special rule." First Nat. Bank & Trust Co. v. Smithloff, 167 S.E.2d 190, 197 (1969). Contrary to Farm Credit's argument, Fidelity had to have rights in the peanuts for Farm Credit's security interest to attach, notwithstanding the broad language in the security agreement and UCC financing statement purporting to grant Farm Credit a security interest in "[a]ll peanuts of every kind and description shelled and unshelled, and wherever located and including but not limited to all peanuts owned by Debtor...."

However, we agree with Farm Credit that, in fact, the growers transferred title to the peanuts to Fidelity—and Farm Credit's security interest thus attached—when the growers delivered the peanuts to Easom. The trial court held that the growers did not transfer title to the peanuts to Fidelity because Fidelity never paid for or possessed the peanuts and because the contracts between Fidelity and most of the growers expressly reserved to the growers all "beneficial interest" until title was transferred to Fidelity and warehouse receipts were delivered to Fidelity, events which, the trial court found, did not happen.

Under Georgia's enactment of the Uniform Commercial Code, Fidelity took title to the peanuts upon the growers' tender. Diamond Crystal Brands v. Food Movers Intl., 593 F.3d 1249, 1266 (11th Cir.2010). OCGA § 11–2–401(2) provides that "[u]nless otherwise explicitly agreed title passes to the buyer at the time and place at which the seller completes his performance with reference to the

physical delivery of the goods...." Florida law is the same. Fla. Stat. § 672.401(2). The agreements between the growers and Fidelity do not define how title passes. Therefore, when the growers completed their performance under the contracts with Fidelity by delivering the peanuts to Easom, title passed to Fidelity.

3. The debtor authenticates a security agreement providing a description of the collateral or the creditor has possession of the collateral

The third requirement of attachment states that there must be a written security agreement signed by the debtor. Obviously, both the secured party and debtor will authenticate the security agreement as best practice. The security agreement must contain a description of the collateral.

a. Security Agreement

Creating an enforceable security interest also requires that the parties enter into a security agreement. If the agreement is written, the parties should pay attention to whether the agreement identifies any security interest in connection with the loan or credit provided, in addition to the description of the collateral discussed in the latter case and the debtor's authentication of the agreement. The case below is instructive.

Barnes v. Northwest Repossession, LLC

210F.Supp.3d 954 (N.D. Ill. 2016)

On July 10, 2012, Plaintiff Nicole Barnes ("Plaintiff") purchased a used 2003 Buick Park Avenue from Austin Car Credit, Inc. ("Austin"). The cash price for the vehicle was $2,600. After added costs for delivery and handling, sales tax, and license plates, the total amount owed to Austin equaled $3,000.

The same day, Plaintiff traded in a used 2000 Mercedes Benz for a $2,000 credit towards the purchase of the Buick, which reduced her amount owed to $1,000. In addition to the trade-in, Plaintiff provided $200 in cash, resulting in a final unpaid balance of $800. Plaintiff agreed to pay the remaining $800, interest free, in four, bi-weekly payments of $200 starting on August 1, 2012 and ending on September 26, 2012. The "Memorandum of Installment Sale" provided to Plaintiff at the time of her purchase stated that Austin would impose a $50 late charge on every late payment.

Between July 11, 2012 and late January 2013, Plaintiff failed to make any additional payments to Austin. As a result, Austin imposed $50 late fees at the beginning of August, September, October, November, December, and January, which, according to Austin's account ledger, increased Plaintiff's overall balance to $1100.

On January 3, 2013, Austin mailed Plaintiff a "Final Notice of Intent to Collect Payment." The Final Notice identified the 2003 Buick Park Avenue and stated the following:

> This notice is intended for above named or parties with the security/property listed above. This notice is to inform you that the above named or parties are behind on their payments for the sum of $1050.00. Failure to comply will result in repossession of the property and the opportunity to cure the breach. Thank You.
>
> …

On or about January 29, 2013, Austin hired Northwest to repossess the Buick from Plaintiff. [Plaintiff alleges that Northwest's repossession was unlawful and now brings suit

under both federal and state statutory and common law.] [The Court ruled in favor of the Plaintiff on the motion for summary judgment].

…

Generally speaking, a security agreement is an agreement that creates or provides for a security interest. It is the security agreement itself which creates or provides for the security interest. Under Illinois law, a security interest attaches only to property described in the security agreement. By extension, a security interest cannot exist in the absence of a security agreement.

As applied to this case, a security interest is enforceable under the Illinois Commercial Code only if the debtor has authenticated a security agreement that provides a description of the collateral. Under the Illinois Motor Vehicle Retail Installment Sales Act ("IMVRISA"), every retail installment contract for the purchase of an automobile must be in writing and "clearly state and describe any security taken or retained by the seller." 815 ILCS 374/3-374/4. Furthermore, every vehicle retail installment contract must disclose, as applicable, a "description or identification of the type of any security interest held or to be retained or acquired by the seller in connection with the extension of credit, and a clear identification of the property to which the security interest relates." Id. at 375/5.

The "burden of proving that an item of property is subject to a security interest is on the party asserting the interest." In re Standard Foundry Prod., Inc., 206 B.R. 475, 478 (Bankr.N.D.Ill.1997)…. Here, Northwest fails to present sufficient evidence of a security agreement that complies with the Illinois Commercial Code, Motor Vehicle Retail Installment Sales Act, or relevant case law. The record before the Court contains only one written "agreement" between Plaintiff and

Austin. The document, which describes itself as a "Memorandum of Installment Sale" ("the Memorandum"), lists the 2003 Buick purchased by Plaintiff and outlines its total price, Plaintiff's trade-in allowance and $200 down payment, and her final $800 unpaid balance. The document further details the four $200 biweekly installments Plaintiff agreed to pay beginning on August 1, 2012. The Memorandum, however, fails to identify any security interest held by Austin in connection with its extension of credit.

Admittedly, the Memorandum does reference other potentially relevant documents. For example, the Memorandum mentions a separate "Retail Installment Contract" and "Bill of Sale" associated with Plaintiff's purchase. Additionally, the Memorandum states that Plaintiff's unpaid balance and other charges "are secured by a retail installment contract and judgment note executed by the undersigned on this date." Northwest, however, fails to provide copies of these collateral agreements.

Of course, "where an instrument is lost or destroyed, its contents may be proved by secondary evidence." Orne v. Cook, 31 Ill. 238, 242–43 (1863). To this end, documents in the record imply the possible existence of Austin's security interest. In addition to the Memorandum of Installment Sale, the Final Notice sent in January 2013 states that "[f]ailure to comply will result in repossession of the property and the opportunity to cure the breach." Similarly, the Buick's Certificate of Title lists Austin as a lienholder, at least until its supposed release on March 11, 2013. These tangential references in the record, however, are not sufficient to create a triable issue. Even though oral agreements to create a security interest have been found valid where other documents relating to the transaction evidenced the intent of the parties, no evidence of such a verbal contract is presented here. To the contrary, the Memorandum of Installment Sale states that

together, the Memorandum and Retail Installment Contract "constitute the entire agreement" between Plaintiff and Austin.

In the end, the "mere possibility that a factual dispute may exist, without more, is an insufficient basis upon which to justify denial of a motion for summary judgment. Northwest fails to adequately prove that Austin held a valid security interest in Plaintiff's Buick at the time it was repossessed. Absent a secured interest in the vehicle, Northwest does not qualify as a secured party, and thus cannot invoke § 9-609(b)(2)[right to repossess the collateral upon default] of the Commercial Code.

b. Description of the Collateral in the Security Agreement

UCC-9 requires that the description of the collateral must reasonably identify the collateral. Sufficient description of the collateral can be by specific listing; category; type of collateral as defined in UCC§ 9-102; quantity; computational or allocational formula or procedure; and any other method, if the identity of the collateral is objectively determinable.UCC § 9-108(b). Supergeneric phrases such as "all the debtor's assets" or "all the debtor's personal property" are not sufficient. UCC § 9-108(c).

The case above, Farm Credit of Northwest Florida, ACA v. Easom Peanut Co., illustrates how collateral can bedescribed by types such as "inventory," "account," and also by a longer description: "[a]ll peanuts of every kind and description shelled and unshelled, and wherever located and including but not limited to all peanuts owned by Debtor and stored at and/or processed by companies listed on 'Exhibit A.'" Essentially, the law is quite flexible.

i. Anticipated Attorney's Fees

The case below addresses "anticipated attorney's fees"

that the debtor expected to receive. Can the "anticipated attorney's fees" be used as collateral in the debtor's secured transaction? UCC § 9-102 does not specifically include "anticipated attorney's fees" in its listing of various types of personal property. Does it mean "anticipated attorney's fees" cannot be used as collateral?

Granata v. Broderick

143 A.3d 309 (N.J. Super.Ct. 2016)

Although no reported New Jersey case has considered whether an attorney's pledge of an anticipated counsel fee can be considered a receivable under UCC Article 9, other courts have uniformly held that contracts for legal fees, including fees in pending contingency fee cases, are accounts for Article 9 purposes. See Cadle Co. v. Schlichtmann, 267 F.3d 14, 18–19 (1st Cir.2001) (amounts to be paid under contingent fee agreements are accounts under Article 9), cert. denied, 535 U.S. 1018(2002); In re Holstein Mack & Klein, 232 F.3d 611, 614–15 (7th Cir.2000) (fees to be earned from personal injury and class action suits by law firm considered receivables); U.S. Claims, Inc. v. Yehuda Smolar, P.C., 602 F.Supp.2d 590, 597 (E.D.Pa.2009) (assignment of amounts owed under contingent fee agreement governed by Article 9); U.S. Claims, Inc. v. Flomenhaft & Cannata, LLC, 519 F.Supp.2d 515, 521 (E.D.Pa.2006) (fee contracts created rights to receive payment for services to be rendered by law firm on behalf of clients and thus fell squarely within definition of account).

We agree with these decisions and hold that, under certain circumstances, an attorney's pledge of anticipated counsel fees can be considered an account receivable and secured under Article 9.

OKS met the requirements of [New Jersey UCC §]9–203 for its security interest to attach to Acciavatti's counsel fees. The OKS security agreement described the collateral as Acciavatti's attorney's fees in this case and Acciavatti had a transferrable interest to the collateral, as the anticipated attorney's fees qualified as an account under [New Jersey UCC§]9–102(a)(2).

OKS also complied with the requirements to perfect its security interest under[New Jersey UCC §]9–310(a) and –315(a)(2) by filing a financing statement covering the collateral of Acciavatti's anticipated counsel fees. When OKS filed its financing statement on December 2, 2010, it perfected its security interest in Acciavatti's anticipated legal fees, whether owed to Acciavatti or Acciavatti, LLC. As such, OKS's security interest was perfected before Gourvitz or Rotenberg obtained their liens and, therefore, OKS enjoyed priority over both.

ii. After-Acquired Collateral

It is common to see a security agreement include the phrase after-acquired inventory, after-acquired accounts, after-acquired equipment, etc. in the description of the collateral. UCC § 9-204(a) provides that a security agreement may create or provide for a security interest in after-acquired collateral. That means no further action needs to be taken by the secured party. The secured party does not have to file an amendment to the original security agreement. The secured party also does not have to file an amendment to the registration of the security interest. This certainly reduces transaction costs and the burden on the secured party. According to Official Comment 2 to § 9-204, the rule "validates a security interest in the debtor's existing and (upon acquisition) future assets, even though the debtor has liberty to use or dispose of collateral without being required to account for proceeds or substitute new collateral."

Most importantly, a security interest in after-acquired collateral will not attach to the collateral until the collateral comes into existence and the debtor acquires rights as to the collateral. SeeUCC §§ 9-203(b)(2); 9-204 cmt. 2. The term "attach" denotes "the point at which property becomes subject to a security interest." UCC § 9-308 cmt. 2.

Official Comment 3 to UCC § 9-108 acknowledges that much litigation has arisen over whether a description in a security agreement is sufficient to include after-acquired collateral if the agreement does not explicitly so provide. The Code leaves the question as one of contract interpretation and not of statutory rule.

Consequently, the security agreement is important in determining whether the security interest covers after-acquired collateral. How the parties defined collateral or various types of personal property to serve as collateral will control the scope of the security interest, as seen in the case below. In the case, an employment agreement signed by an inventor employee was classified as "general intangibles," "receivables," and "after-acquired collateral" pursuant to the security agreement.

Advanced Video Technologies LLC v. HTC Corporation

2016 WL 3434819 (S.D.N.Y. June 14, 2016)

Hsiun's Employment Agreement

In January 1992, Hsiun signed an employment contract with Infochips (the "Employment Agreement"). Section 2 of the Employment Agreement is entitled "Retaining and Assigning Inventions and Original Works." Section 2.b, under the subheading "Inventions and Original Works Assigned to the Company," provides as follows:

I agree that I will promptly make full written disclosure to the Company, will hold in trust for the sole right and benefit of the Company, and will assign to the Company all my right, title, and interest in and to any and all inventions, original works of authorship, developments, improvements or trade secrets which I may solely or jointly conceive or develop or reduce to practice, or cause to be conceived or developed or reduced to practice, during the period of time I am in the employ of the Company.

I agree that my obligation to assist the Company to obtain United States or foreign letters patent, copyrights, or mask work rights covering inventions, works of authorship, and mask works, respectively, assigned hereunder to the Company shall continue beyond the termination of my employment, but the Company shall compensate me at a reasonable rate for time actually spent by me at the Company's request on such assistance. If the Company is unable because of my mental or physical incapacity or for any other reason to secure my signature to apply for or to pursue any application for any United States or foreign letters patent, copyrights, or mask work rights covering inventions or other rights assigned to the Company as above, then I hereby irrevocably designate and appoint the Company and its duly authorized officers and agents as my agent and attorney in fact, to act for and in my behalf and stead to execute and file any such applications and to do all other lawfully permitted acts to further the

> prosecution and issuance of letters patent, copyrights, and mask work rights with the same legal force and effect as if executed by me. I hereby waive and quitclaim to the Company any and all claims, of any nature whatsoever, which I now or may hereafter have infringement [sic] of any patents, copyrights, or mask work rights resulting from any such application assigned hereunder to the Company.

Section 6.d of the Employment Agreement, entitled "Successors and Assigns" further provides that the agreement will be for the benefit of the Company, its successors, and its assigns.

Section 7 of the Employment Agreement is entitled "List of Inventions" and states that "Pursuant to Section 2(a) of this Agreement below is a list of my prior inventions and original works of authorship." The Employment Agreement goes on to say "IF NO PRIOR INVENTIONS OR ORIGINAL WORKS OF AUTHORSHIP ARE LISTED IN THIS SECTION 7, I HEREBY AFFIRM THAT THERE ARE NO SUCH INVENTIONS OR ORIGINAL WORKS OF AUTHORSHIP." (Id. at AVT0000124.) No such prior inventions or works of authorship are listed. It would thus appear that as of January 1992, Hsiun and her co-inventors had yet to create the invention that forms the basis for the '788 patent.

<u>The Assignment of the Employment Agreement to LMS</u>

Over a year before Hsiun signed the Employment Agreement, Infochips had entered into a financing agreement (the "Security Agreement") with Lease Management Services ("LMS"). The Security Agreement granted LMS a secured interest in Infochips' "Receivables," defined in the agreement as:

> Accounts, Instruments, Documents, Chattel Paper and General Intangibles (as defined in the Uniform Commercial Code) and all other rights arising from the sale of Debtor's Inventory; all of Debtor's rights and remedies relating to the foregoing, including guaranties or other contract rights; all books and records; including ledger cards, relating to the foregoing and all proceeds of the foregoing.

The Security Agreement was expressly governed by California law, so California's Uniform Commercial Code ("UCC"), as incorporated into the California Commercial Code, defines the term "General Intangibles." "'General intangibles' means any personal property (including things in action) other than goods, accounts, chattel paper, documents, instruments, and money." Cal. Comm. Code § 9106 (version in effect in 1990).

Defendants argue that the assets pledged to LMS do not include Hsiun's Employment Agreement because the Employment Agreement, while falling within the definition of "General Intangibles," was executed after LMS and Infochips signed the Security Agreement. But as discussed briefly in the 2015 Decision, a secured interest in inventory or receivables typically reaches after-acquired property – otherwise the flow of inventory out would quickly turn a secured interest into an unsecured interest. That is the case under California law.

Under § 9204 of the California Commercial Code as it stood in 1990 – the year the Security Agreement was executed – security agreements could provide that "any or all obligations covered by the ... agreement are to be secured by after-acquired collateral." The commentary to § 9204 clarified that, "An after-acquired property clause in an inventory lien agreement is valid

in California, provided that the merchandise is from time to time ... designated in one or more separate written statements dated and signed by the borrower and delivered to the lender." *Id.* (internal citation omitted). Thus, California has expressly sanctioned "the concept of the floating lien as it may be applied as a security device with respect to a debtor's present and future assets." *Biggins v. Sw. Bank*, 490 F.2d 1304, 1309 (9th Cir. 1973).

To determine whether the parties intended for their security agreement to apply to after-acquired collateral, courts parse the language of the agreement. The Security Agreement plainly provided that it reached after-acquired "Receivables." Section b of the Security Agreement stated that "Debtor shall submit to Secured Party current monthly "aging" reports of its Receivables containing the following information and such other information as Secured Party shall require to evaluate the status of the Receivables individually and in the aggregate." The required information included:

(i) The name and address of the Customer with respect to each Receivable,

(ii) The invoice number or other identification of each outstanding Receivable,

(iii) The outstanding amount of each Receivable and the aggregate of the Receivables as at the end of the month; and

(iv) The "age" of each Receivable (i.e., the time which has transpired since the invoice was issued)...

(*Id.*) Section b. also required that the "monthly aging report ... be submitted to Secured Party no later than the tenth day after the end of such month covered by the aging report." (*Id.*)

The Security Agreement clearly contemplated the inflow

and outflow of Receivables. Indeed, it expressly required the type of report envisioned in the commentary to § 9204 – a report that would only make sense if the Security Agreement reached after-acquired property.

It is true that one does not ordinarily think of an Employment Agreement as a "receivable;" in the ordinary course, that term applies to things like accounts payable. But the contract most certainly is a "General Intangible," and per the terms of the Security Agreement "General Intangibles" are "Receivables." Ergo, Hsiun's Employment Agreement is a Receivable for purposes of the Security Agreement. And since the Security Agreement extends to after-acquired Receivables, it does not matter that the Employment Agreement was signed after Infochips pledged its assets to LMS.

c. Future Advances

Parties in a secured transaction know that in many instances, after the parties signed the security agreement, the secured party may provide future advances or additional value to the debtor. Anticipating such instances, parties in a secured transaction often draft a security agreement with a provision to allow the collateral to secure future advances or other values. See UCC § 9-204(c). That means the collateral secures future as well as past or present advances. That means the parties are free to agree that a security interest secures any obligation the parties wish.Again, this rule reduces the burden on the parties that each time when the secured party allows an advance to the debtor, the parties don't have to enter a new security agreement. The rule on both after-acquired collateral and future advances is limited to the security agreement. That means there is no need to refer to after-acquired property or future advances or other obligations secured in a financing statement. See Official Comment 7 to UCC §

9-204(c). A financing statement, as discussed in detail in Chapter III, is what the secured party files with the appropriate office to put everyone on notice to enforce the secured party's rights in the collateral against third parties. The case below is instructive.

****

First Bancorp, Inc. v. U.S.

945 F.Supp.2d 802 (W.D. Ky. 2013)

This case concerns approximately $200,000 that the Internal Revenue Service (IRS) levied from Tantus Tobacco, LLC. Brian Cooper purchased Tantus Tobacco, along with some real property and interests in several other businesses, from Kenneth Catron in 2008. Cooper agreed to pay Catron in 36 monthly payments of $18,404.34, plus interest. These payments are referred to in this litigation as the "Cooper Payments."

First National loaned substantial sums of money to Catron for the purpose of developing and launching a new business. First National secured the funds it loaned Catron by entering into several security agreements with Catron. The first of these security agreements was entered into on June 29, 2007 (the "2007 Security Agreement"). That agreement secured "[a]ll present and future debts, even if this Agreement is not referenced, the debts are also secured by other collateral, or the future debt is unrelated to or of a difference type than the current debt." (Docket No. 11–3.) The 2007 Security Agreement went on:

> SECURITY INTEREST. To secure the payment and performance of the Secured Debts, Debtor gives Secured Party a security interest in all of the Property described in this agreement that Debtor owns or has

sufficient rights in which to transfer an interest, now or in the future, wherever the property is or will be located, and all proceeds and products of the Property....

PROPERTY DESCRIPTION. The Property is described as follows:

☒ Accounts and Other Rights to Payment: All rights to payment, whether or not earned by performance, including, but not limited to, payment for property or services sold, leased, rented, licensed, or assigned....

☒ Inventory:....

☒ Equipment: ....

☒ Specific Property Description: The Property includes, but is not limited by, the following ...: ALL EQUIPMENT, ACCOUNTS RECEIVABLE AND INVENTORY

First National filed a financing statement, also on June 29, 2007, with the Kentucky Secretary of State (the "2007 Financing Statement")….

[Legal Analysis]

Under Kentucky's version of Article 9 of the Uniform Commercial Code (UCC), a security interest attaches to collateral when it becomes enforceable against the debtor with respect to the collateral.A security interest becomes enforceable against the debtor and third parties with respect to the collateral when (1) value has been given, (2) the debtor has rights in the collateral or the power to transfer rights in the

collateral to a secured party, and (3) the debtor has authenticated a security agreement that provides a description of the collateral. [A]"description of personal or real property is sufficient, whether or not it is specific, if it reasonably identifies what is described."[A]"description of collateral reasonably identifies the collateral if it identifies the collateral by: ... category [or] a type of collateral defined in this chapter." However, "[a] description of collateral as 'all the debtor's assets' or 'all the debtor's personal property'" is insufficient. The majority of courts, including this Court, have determined that the sufficiency of a collateral description is a question of law, not of fact.

A. The Cooper Payments Are Properly Categorized as "Accounts."

"Accounts" is defined as a type of collateral under Kentucky's version of the UCC to mean "a right to payment of a monetary obligation, whether or not earned by performance ... [f]or property that has been or is to be sold, leased, licensed, assigned, or otherwise disposed of." However, "accounts" does not mean "[r]ights to receive payment evidenced by chattel paper or an instrument." In this regard, "chattel paper" refers to "a record or records that evidence both a monetary obligation and a security interest," and "instrument" refers to "a negotiable instrument or any other writing that evidences a right to the payment of a monetary obligation, is not itself a security agreement or lease, and is of a type that in ordinary course of business is transferred by delivery with any necessary indorsement or assignment." Ky. Rev. Stat. § 355.9–102(1).

Pursuant to the agreement executed on November 7, 2008, Catron agreed to sell his interest in certain limited liability

companies, his stock in certain corporations, and certain interests in real estate in exchange for the Cooper Payments. Under Kentucky law, a person's stock in a corporation or interest in a limited liability company is considered personal property. In the language of Kentucky's UCC, Catron received "the right to payment of a monetary obligation ... [f]or property that has been or is to be sold." The November 7 agreement is not "chattel paper" because it does not evidence a security interest. Nor does that agreement meet the definition of an "instrument." Accordingly, the Court finds that the Cooper payments are properly categorized as "accounts."

B. The 2007 Security Agreement Identified the Cooper Payments as Collateral.

The United States argues that the 2007 Financing Statement does not describe the Cooper Payments because the Cooper Payments did not come into existence until November 2008 and because the 2007 Financing Statement's collateral description does not include an after-acquired property clause. To this end, the United States posits that the 2007 Financing Statement's mention of "accounts receivable" is insufficient to satisfy the "inquiry test" under Kentucky law. Therefore, the United States reasons that First National did not perfect any interest it might have had in the Cooper Payments via the 2007 Financing Statement. The United States further argues that even if the financing statement need not contain an after-acquired property clause, the 2007 Security Agreement did not create an interest in after-acquired property because that agreement does not include an after-acquired property clause. The Court disagrees with each of these contentions.

1. A financing statement need not necessarily contain an after-acquired property clause to perfect an interest in after-acquired property.

The Court has found no controlling Kentucky authority on whether a financing statement must contain an after-acquired property clause to perfect a security interest in after-acquired accounts. However, the Kentucky General Assembly has stated that the "[o]fficial comments to the Uniform Commercial Code ... represent the express legislative intent of the General Assembly and shall be used as a guide for interpretation of this chapter." Ky.Rev.Stat. § 355.1–103(3). In regard to after-acquired property, the official comments to UCC § 9–204 (which corresponds to Ky.Rev.Stat. § 355.9–204) advises:

> The effect of after-acquired property and future advance clauses as components of a security agreement should not be confused with the requirements applicable to financing statements under this Article's system of perfection by notice filing. The references to after-acquired property clauses and future advance clauses in this section are limited to security agreements. There is no need to refer to after-acquired property or future advances or other obligations secured in a financing statement.

UCC § 9–204 cmt. 7. This commentary is consistent with the approach taken by a number of courts. … Therefore, in accordance with the above-referenced Kentucky case- and statutory law, and with the persuasive authority of the approach taken by other jurisdictions that have confronted this question, the Court finds that a financing statement need not necessarily contain an after-acquired property clause to perfect

an interest in after-acquired property.

2. The 2007 Security Agreement contains language sufficient to indicate First National's interest in Catron's after-acquired accounts.

The 2007 Security Agreement states that Catron gives First National "a security interest in all of the Property described in this agreement that [Catron] owns or has sufficient rights in which to transfer an interest, now or in the future, wherever the Property is or will be located." (Docket No. 11–3.) The United States would read the phrase "now or in the future" as "merely ... a test to determine property ownership" and limited to property owned on June 27, 2007, that Catron was then "able to transfer an interest either presently or in the future." The Court disagrees with this reading. As mandated by Ky.Rev.Stat. § 355.1–103(1), the UCC "shall be liberally construed and applied." Section 355.9–204 sets forth no requirement for particular language in order to create an interest in after-acquired collateral. Therefore, while the traditional "hereafter acquired" language is not present, the language that is present clearly indicates that future assets were intended to be secured. For this reason and those discussed infra Part I.B.3, the Court is satisfied that this language was sufficient to provide notice of First National's interest in Catron's after-acquired accounts. See In re Taylor, 45 B.R. at 645 ("Once notice is provided as to the type of the collateral in the financing statement there is duty to make inquiry of the secured party's agreement in order to determine the extent of the security interest.").

****

Notes: Seller on Credit; Seller with Retention of Title in the Goods

A seller on credit may attempt to rely on the sales contract

to assert that the seller has expressly reserved all rights, title, and interest in the goods until title istransferred to the buyer. Or the seller may argue that the seller did not transfer title to the goods to the buyer because the buyer never paid for or possessed the goods. These arguments are no help when the buyer uses the goods, upon delivery from the seller, as collateral in a secured transaction with a secured creditor who perfects the security interest in the goods.

UCC § 1-201 provides that the right of the seller of goods to retain or acquire possession of the goods is not a security interest, but a seller may also acquire a security interest by complying with Article 9. Also, the "retention or reservation of title by a seller of goods notwithstanding shipment or delivery to the buyer … is limited in effect to a reservation of a 'security interest.'"

What a seller who retains title in the goods has is an unperfected security interest in the goods. What should the seller do to protect its right? It should perfect its security interest in the goods by filing a financing statement before it delivers the goods to the buyer.

****

Back to the Farm Credit of Northwest Florida, ACA v. Easom Peanut Co. case, the peanut growers sold the peanuts to Fidelity on credit and did not perfect the security interest in the peanuts by filing the financing statement in the appropriate office. The peanut growers attempted to rescue the situation by availing to an exception—seller with retention of title. The following excerpt from the case on the exception is instructive.

Farm Credit of Northwest Florida, ACA v. Easom Peanut Co.

718 S.E.2d 590 (Ga. Ct. App. 2011)

[T]he [peanut] growers' attempted reservation of title [in the peanuts] amounted to a security interest. That statute provides in part, "[a]ny retention or reservation by the seller of the title (property) in goods shipped or delivered to the buyer is limited in effect to a reservation of a security interest."

The fact that the seller retains title to the collateral that has been sold to the debtor does not give the seller any right beyond an unperfected security interest in the goods, with the result that if there is no perfecting of the seller's interest in a manner specified by the Uniform Commercial Code, the interest of the seller is merely an unperfected security interest and therefore is subordinate to any perfected interest.

It is uncontested that the growers never perfected their security interests. And Farm Credit's security interest was perfected, as it had filed financing statements and the security interest had attached. Therefore, Farm Credit's perfected security interest had priority over the growers' unperfected security interests, absent some exception. OCGA § 11–9–322(a)(2); Fla. Stat. § 679.322(1)(b)….

The trial court found applicable the exception based on the debtor's lack of possession. Farm Credit challenges that finding. We agree with Farm Credit.

Under OCGA § 11–9–110 and Fla. Stat. § 679.1101, the growers, as sellers, retained a reservation of a security interest in the peanuts. Further, "until the debtor obtain[ed] possession of the goods ... [t]he security interest ha[d] priority over a conflicting security interest created by the debtor." OCGA § 11–

9–110(4); Fla. Stat. § 679.1101(4). In other words, the trial court found that until Fidelity obtained possession of the peanuts, the growers' reserved security interest in the peanuts had priority over Farm Credit's security interest, which had been created by debtor Fidelity.

The trial court's reasoning depends upon the assumption that possession means "actual possession." We conclude that it does not. The code provision at issue does not define possession at all, much less as limited to actual possession. No Georgia case defines possession in the context of § 9–110 of the Uniform Commercial Code. In another context—involving the preservation of creditors' rights—Georgia courts have concluded that constructive possession is sufficient to allow a lien to attach. We therefore construe the term "possession" in Uniform Commercial Code § 9–110 to include constructive possession. See United Bank of Iowa v. Independent Inputs, 538 F.3d 858, 863–865 (8th Cir.2008) (construing "possession" in another provision of Iowa's version of the Uniform Commercial Code, § 9–109, to include not only physical possession but also constructive possession). See also Hong Kong & Shanghai Banking Corp. v. HFH USA Corp., 805 F.Supp. 133 (W.D.N.Y.1992) (holding delivery to warehouse amounted to possession); O'Brien v. Chandler, 107 N.M. 797, 765 P.2d 1165, 1169 (1988) (holding that debtor had possession of cattle when unpaid seller, who had not perfected any security interest in cattle, delivered cattle to feedlot pursuant to parties' agreement, and therefore bank's perfected security interest in cattle had priority).

Because the peanuts were delivered to Easom at Fidelity's direction where Fidelity had the right to control them, Fidelity exercised constructive possession. "[B]oth the power and the

intention at a given time to exercise dominion or control over a thing" amounts to constructive possession. Lockwood v. State, 257 Ga. 796, 797, 364 S.E.2d 574 (1988). Accordingly, the growers' unperfected security interests did not have priority under OCGA § 11–9–110(4) or Fla. Stat. § 679.1101(4).

B. DEBTOR'S USE OR DISPOSITION OF THE COLLATERAL

During the term of the security agreement, can the debtor use or dispose of the collateral? UCC § 9-205 provides that a security interest is not invalid or fraudulent by reason of the debtor's use or disposition of the collateral without being required to account to the secured party for proceeds or substitute new collateral. The secured party protects its rights by filing the financing statement, putting the public on notice and overcoming any potentially misleading effects of the debtor's use, disposition, or control of the collateral. In practice, the secured party includes provisions in the security agreement to monitor and restrict the debtor's dominion of the collateral.

You should take a look at the sample Security Agreement in the Appendix. Should you add new provisions to or exclude any provisions from the security agreement? Why does the sample Security Agreement include many terms not required by UCC § 9-203(b) for the creation of an enforceable security interest between the parties? Best practices dictate the parties to include many terms not required by UCC-9. The parties, in drafting the security agreement, anticipate potential concerns and wish to avoid disputes by including such terms or provisions.

C. ACCOUNT RECEIVABLE FINANCING OR FACTORING

An "account" includes a right to payment of a monetary

obligation, whether or not earned by performance, for services rendered or to be rendered. *See* UCC § 9-102(a)(2)

In need of financing, a business may assign its account receivables to a finance company. The parties will enter into an account receivable financing agreement or a factoring agreement. The buyer will insist on having a first priority security interest in all the account receivables and a personal guaranty from the business owner. Remember that UCC-9 covers the sale of account receivables. The buyer will file a financing statement covering the account receivables. Below is a factoring arrangement from *In re O'Donnell*, 523 B.R. 308, 312-13 (Bankr. D. Mass. 2014):

> Grove Electronics, LLC d/b/a Chip Partners ("Grove"), a limited liability company organized under Massachusetts law, engaged in the business of purchasing and reselling computer parts on a wholesale basis. Juliann and her husband, Brian O'Donnell ("Brian"), owned and operated Grove.
>
> Associated Receivables Funding, Inc. ("ARF") and Grove entered into a factoring agreement or account receivable financing arrangement.
>
> Under the factoring arrangement, Grove agreed to assign its rights to receive payment from its customers to ARF in exchange for immediate upfront payments from ARF. Juliann and Brian both executed a personal guaranty agreement in which they each agreed to be held jointly and severally liable for all such obligations. Additionally, the agreement provided ARF with a first priority

security interest in all receivables generated by Grove, as well as any products returned to Grove.

In the course of selling shipments of computer parts, Grove generated customer invoices which embodied Grove's rights to receive payment from its customers. In order to assign these invoices to ARF, an authorized Grove signer would stamp the physical invoices with a special stamp provided by ARF ("ARF Assignment Stamp"). The authorized Grove signer would then sign the stamped invoices and submit them to ARF for funding. The only authorized Grove signers were Juliann and Brian. The ARF Assignment Stamp contained the following representations:

For value received, we hereby assign and transfer this invoice and its proceeds to Associated Receivables Funding, Inc., who is the owner of this invoice unencumbered by any other security or claims, and pursuant to the master agreement. The undersigned does herewith assign all lien rights, chooses [sic] in action, chattel paper or contract rights. We further clarify that the goods have been shipped and/or services have been rendered in agreement with all terms and conditions.

Upon receipt of stamped Grove Invoices and certain supplemental documentation, collectively referred to as "funding packages," ARF would take possession of the invoices and remit immediate payments to Grove. ARF would then proceed to collect the invoice amounts directly from Grove's customers.

****

Assets-backed Securities (ABS) and Secured Transactions

Financial institutions like banks, credit card providers, auto finance companies, and consumer finance companies, originate loans. Many of these loans are secured by debtor's collateral. The financial institutions then use a process known as securitization to turn the loans into marketable securities. These securities are called Asset-Backed Securities (ABS), as the securities are backed by the loans. The loan originators are the "sponsors" of ABS.

The financial institutions sell pools of loans to a special purpose vehicle (SPV). SPV is a corporation with the sole purpose of buying the pools of loans and sellingthem to a trust. The trust then repackages the loans as interest-bearing securities. The sale of the loans from the sponsors to SPV is a "true sale," which provides "bankruptcy remoteness" protection for the trust. Creditors of the sponsors cannot reach the trust. The trust typically relies on investments bank for underwriting the securities, which are typically being "credit enhanced" with additional protection to attract investors. Investors then purchase the securities that have been divided in accordance with different risk levels. When payments on the loans are received, investors with the lower risk, lower interest securities will get paid first. Investors with higher-risk securities will be next in line.

PROBLEM 2:

Test your understanding before going to the next chapter.

2.1 What are the requirements for attachment of a security interest?

2.2 When does attachment occur in a transaction where the debtor receives *after-acquired collateral*?

2.3 When does attachment occur in a transaction where the secured party periodically provides *future advances*?

2.4 Why attachment does not require the debtor to have ownership in the collateral?

2.5 What provisions must be included in the written security agreement?

2.6 What provisions should be included in the written security agreement? Why?

2.7 If there are a separate credit agreement and security agreement, how are they related?

CHAPTER THREE

PERFECTING SECURITY INTEREST

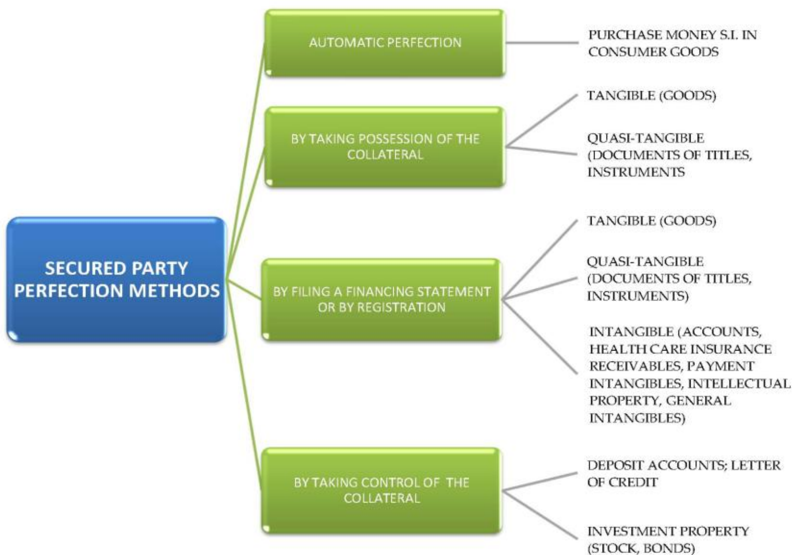
PUTTING THE WORLD ON NOTICE OF SECURED PARTY'S SECURITY INTEREST IN DEBTOR'S PROPERTY

A. OVERVIEW

After creating an enforceable security interest between the secured party and the debtor, the secured party will take the necessary steps to protect its rights against third parties. This process is called perfection. Remember that without attachment—creating an enforceable security interest against the debtor—there will be no perfection.

Depending on the type of collateral, the secured party can select the optimal method of perfection. There are several methods of perfection: registration or filing, taking possession of the collateral property,taking delivery, taking control, and automatic perfection.

Figure 6: PERFECTION OF SECURITY INTEREST



The purpose of requiring perfection through either recordation or possession is to put all creditors, bona fide purchasers, and other third parties on fair notice of the encumbrance. Also, perfection prevents the creation of secret liens.

UCC-9 provides that a purchase money security interest (PMSI) in consumer goods is automatically perfected upon attachment. That means the PMSI is enforceable against the consumer debtor when the three requirements of attachment under UCC § 9-203 are present. The secured party in this case does not have to file a financing statement yet still has a perfected security interest. Though perfection is automatic, a secured party in extending credit to the consumer debtor for the purchase price of an expensive consumer good will typically file a financing statement because one of the priority rules discussed later favors the secured party who files the financing statement. When a debtor incurs an obligation for all or part of the purchase price of the collateral or for value given to enable the debtor to acquire rights in or the use of the collateral if the value is in fact so used, the obligation is called a "purchase money obligation." In other words, the secured party in this special circumstance receives a purchase money security interest from the debtor. UNCITRAL Legislative Guide on Secured Transactions, however, does not include the concept of automatic perfection in relation to a "purchase money security interest."

1. **Registration or Filing the Financing Statement**

The secured party can register its security interest in the collateral by filing a financing statement with the appropriate office where the debtor is deemedto be located.Filing is the

most common method of perfection and is typically employed in many countries. Filing can be done electronically and cost effectively. The financing statement will be indexed under the debtor's name. Third party can easily search in the appropriate database using the debtor's name to ascertain whether the debtor's property has already been encumbered.

Also, filing is most appropriate when the collateral is intangible and possession is not a practical method of perfection. As explained above, intangible property can be licenses, payment rights under an insurance policy, any payment intangibles, account receivables, health-care receivables, and intellectual property, among others. Intangibles have become exceedingly valuable as we are moving into the knowledge-based, digital economy. That means intangibles are commonly used as collateral in secured transactions.

In the United States, each state has designated the filing of the financing statement or UCC-1 form with the Secretary of State's Office. *See* Texas Secretary of State, Filing Instructions, http://www.sos.state.tx.us/ucc/instructions.shtml. In other countries, the government may designate a specific filing office. For example, in Vietnam, registration of a security interest is with the National Centre for Registration of Transactions and Assets (NRAST) under the Secured Transaction National Registration Department of the Ministry of Justice.

UCC § 9-515 provides that the financing statement has an effectiveness of five years. That means the perfected security interest will become unperfected at the end of the five-year filing period. If the secured party wants to maintain perfection, it should file a continuation statement before the five-year

period lapses. It has six months before the lapse date to file the continuation statement. Other countries may have different rules on the effectiveness of the filing. For instance, Vietnam does not put a time limit on the effectiveness of the registration of security interests.

a. *Is The Right Debtor on the Filing Form?*

UCC-§ 9-503 provides different alternative approaches for determining the correct name of the debtor to be included on the financing statement. For example, if the debtor is a registered organization or if the collateral is held in a trust that is a registered organization, the financing statement must state the name of the registered organization as it appears on the most recently filed public record.

If the debtor is an individual, the debtor's name is the name as it appears on the debtor's most recently issued driver license. Obviously, if the debtor does not have a driver's license, the financing statement should have the debtor's surname and first personal name. If the debtor is an organization, the financing statement must include the organization's name. If the debtor is a partnership, the names of the partners must be on the financing statement. If the debtor does not have a name, the financing statement must include the names of members, associates, or other persons comprising the debtor, in a manner that each name provided would be sufficient if the person named were the debtor.

b. *What If Debtors Change Names, What If the Original Debtors are Acquired by Others*

In some instances, after the financing statement has been filed, the original debtor changes its name and the filed financing statement becomes seriously misleading. *See*§ UCC 9-

507. Likewise, a new entity may become bound by the security agreement when the original debtor is acquired by or merged with the new entity. *See* UCC 9-508. The new debtor's name may cause the filed financing statement to become seriously misleading.

UCC § 9-506 provides that a seriously misleading financing statement means that it is ineffective even if it is disclosed by (i)using a search logic other than that of the filing office to search the official records, or (ii) using the filing office's standard search logic to search a database other than that of the filing office. When a filed financing statement becomes seriously misleading after the debtor's name change, a new financing statement must be filed with the new debtor's name to ensure the continuation of the perfected security interest. The new financing statement can be filed within four months of the name change.*See* UCC § 9-507.

If no new financing statement is filed, the perfected security interest in collateral acquired by the debtor before or within four monthsof the name change remains perfected. The security interest in collateral acquired by the debtor more than four months after the name change is not perfected. In other words, the secured party should monitor and maintain its perfection when it learns the debtor has changed its name. UCC § 9-507 and UCC § 9-508.

Not all name changes may cause a problem withperfection. A financing statement is not misleading, after the debtor's name change, if a search of the records of the filing office under the debtor's new name, using the filing office's standard search logic, would still disclose a financing statement that provides the debtor's old name.

c. What to Do if Debtors Have Multiple Locations

A debtor may incorporate in one jurisdiction, have its headquarters in another jurisdiction, and have stores or distribution centers in multiple jurisdictions. UCC § 9-307 governs how todetermine where a debtor is deemed to be located for purposes of filing the financing statement in the correct state.

If a debtor is an individual, the debtor is located at his or her principal residence. If a debtor is an organization and has only one place of business, the debtor is located at its place of business. If a debtor is an organization with multiple places of business, the debtor is located at its chief executive office.

If a debtor is a registered organization, the debtor is located in the state of organization.In the United States, many companies are registered in Delaware. That means Delaware is also the jurisdiction for filing financing statements for secured transactions.

The United States itself is deemed to be located in the District of Columbia.

d. Non-U.S. Debtors

If a debtor is located in a jurisdiction "whose law generally requires information concerning the existence of a nonpossessory security interest to be made generally available in a filing, recording, or registration system as a condition or result of the security interest's obtaining priority over the rights of a lien creditor with respect to the collateral," the jurisdiction will be the debtor's place of business for purposes of filing. That means if a non-U.S. debtor is in a country that does not have a filing system similar to UCC-9, that debtor's place of

business is deemed to be the District of Columbia. Filing the financing statement with the Secretary of State's Office in the District of Columbia is required.

GMRI, Inc. v. Independence Bank of Georgia

212 F. Supp. 3d 1306 (N.D. Ga. 2016)

GMRI is a Florida corporation which is a subsidiary of Darden Restaurants. Defendant is a Georgia community bank founded in 2008 ("Independence Bank" or "the Bank"). Non-party Benchmark Building Contractors ("Benchmark") is a Georgia corporation. Benchmark built many restaurants for Darden/GMRI "over the years" with estimates ranging from 20-50 projects, including Olive Garden, Red Lobster and LongHorn restaurants. Benchmark was a Bank customer.

…

Benchmark had numerous general deposit accounts1 at the Bank. The deposit agreements stated:

> You each agree that we may (without prior notice and when permitted by law) set off the funds in this account against any due and payable debt owed to us now or in the future, by any of you having the right of withdrawal, to the extent of such persons' or legal entity's right to withdraw. If the debt arises from a note, "any due and payable debt" includes the total amount of which we are entitled to demand payment under the terms of the note at the time we set off, including any balance the due date for which we properly accelerate under the note.... We will not be liable for the dishonor of any check when the dishonor occurs because we set off a debt against this

account.

On December 16, 2010, Benchmark executed two Notes: one for a $600,000.00 line of credit, to be paid in full by December 16, 2011, and one for $250,000.00, to be paid in full by November 20, 2013. Both of these Notes were renewals; the line of credit was obtained originally in December 2008 and the $250,000 loan was a renewal of an earlier loan made at an unspecified time. Calvin Jones guaranteed the payment of both loans. Under the terms of the Notes, default occurred if Benchmark was insolvent, if it experienced an adverse change, or if the Bank deemed itself to be insecure. The definition of "adverse change" included a material adverse change in Benchmark's financial condition, or if the Bank believed the prospect of payment or performance on the Note was impaired. "Insecurity" was defined as "Lender in good faith believes itself insecure." The Bank reserved the right to set off Benchmark's accounts in the event of default.

Contemporaneously with signing the Notes, Benchmark executed security agreements which pledged to the Bank as collateral:

> All Chattel Paper, Accounts and General Intangibles; whether any of the foregoing is owned now or acquired later; all accessions, additions, replacements, and substitutions relating to any of the foregoing; all records of any kind relating to any of the foregoing; all proceeds relating to any of the foregoing (including insurance general intangibles and other accounts proceeds).

The Bank perfected its security interest through a UCC financing statement which was filed in Gwinnett County,

Georgia on December 11, 2008, covering all chattel paper, accounts, and general intangibles owned "now or acquired later."

In June and July 2011, GMRI entered into two contracts with Benchmark: one to construct an Olive Garden Restaurant in Owings Mills, Maryland for $1,453,059.00 ("the Owings Mills projects"); and another to construct an Olive Garden Restaurant in Henrico, Virginia for $1,199,679.00 ("the Henrico project"). Both were standard form contracts. Neither contract required Benchmark to obtain a surety bond to guarantee payment of subcontractors. No surety bond was obtained for these projects. Both contracts stated that GMRI had the right "at its sole option" to make checks jointly payable to Benchmark and a subcontractor or to withhold payment from Benchmark when Benchmark did not properly pay subcontractors.

…

On or about December 6, 2011 GMRI made an electronic deposit of $312,005.78 to Benchmark's account at the Bank; an electronic deposit of $513,816.76 was made on December 8, 2011.

…

On Monday, December 12 and Tuesday, December 13, 2011 the Bank exercised its right to set off and foreclose on all of the funds in Benchmark's accounts. The Bank's loans to Benchmark were satisfied in full.

Benchmark did close its business and let its employees go later that week.

On December 21, 2011 GMRI's counsel wrote to the Bank demanding return of the two deposits GMRI had made to

Benchmark's account. Counsel for the Bank responded on December 30, refusing to return the funds.

…

On September 18, 2014, GMRI filed the instant complaint against the Bank, seeking damages "in excess of $75,000" for breach of trust, conversion of the deposits GMRI made to Benchmark's account, and money had and received.

[Legal Analysis]

In this case, Independence Bank was a secured creditor of the general contractor Benchmark and held a perfected security interest in Benchmark's receivables….Independence Bank had a perfected, first priority security interest in Benchmark's receivables. Georgia law controls on this issue. Ga. Code Ann. § 11–9–301 (stating, in part, that "[w]hile a debtor is located in a jurisdiction, the local law of that jurisdiction governs perfection, the effect of perfection or nonperfection, and the priority of a security interest in collateral"). Benchmark's location was in Georgia. Also, the security agreements specify that Georgia law controls.

As of June-July 2011, the Bank had a perfected security interest in Benchmark's current and future accounts receivable. The security agreements signed by Benchmark in 2010 were enforceable against Benchmark because "value" had been given (the Bank had loaned money to Benchmark); the debtor (Benchmark) "had rights in the collateral" (Benchmark had granted a security interest in its future accounts receivable to 2008 and had signed contracts with GMRI for the Henrico and Owings Mills projects in June and July 2011). *See* Ga. Code Ann. § 11–9–203 (a), (b). The Bank's security interest in Benchmark's future accounts receivable was perfected through the filing of its

financing statement in 2008. Pursuant to Georgia Code Ann. § 11–9–502(d), "A financing statement may be filed before a security agreement is made or a security interest otherwise attaches." Also, the effectiveness of the 2008 financing statement had not lapsed as of December 2011. *See* Ga. Code Ann. § 11–9–515 (filed financing statement effective for five years).

…

The Clerk is DIRECTED to enter judgment in Independence Bank's favor.

2. Secured Party Taking Possession of the Collateral Property

Perfection may be achieved when the secured party takes possession of the property that serves as collateral. This method is available for negotiable documents, goods, instruments, money, or tangible chattel paper.

UCC § 9–313(a) provides that a secured party may perfect a security interest in negotiable documents, goods, instruments, money, or tangible chattel paper by taking possession of the collateral. Perfection by taking possession is called "pledge" under common law, as explained below:

> § 9–313 deals with the availability of the common law pledge as a method of perfection. Under former § 9–203, such a pledge as was available under the section did not have to be accompanied by an agreement. The language of the present provision, § 9–203, however, makes it clear that in order for a pledge to attach and be enforceable, it must be pursuant to an agreement.... § 9–308(c) provides that if there has been a filing for perfection and thereafter

> perfection by taking possession (a pledge), the perfection is deemed to be continuous for the purpose of priority so long as there is no intervening period during which the security interest is unperfected. One should also be reminded of the common law principle that in the case of a pledge, the debtor or the debtors [sic] agent cannot be the one in possession of the collateral.

27B Herbert Lemelman, UCC Forms Annotated, Mass. Practice Series, § 9–313 (3d ed.2013).

> The difference between possessory and non-possessory security interests provides a basis for a flexible approach in finding whether a security agreement exists. It should be noted that such an agreement is required even if possession, or control, is transferred; in that, such event must be pursuant to an agreement. What may not be necessary is an authenticated document.

25A Herbert Lemelman, Manual of Uniform Commercial Code, § 9:54 (3d ed.2011).

As recalled, UCC § 9–203(b)(3)(B) renders“the security agreement of a possessing creditor enforceable even though there is no signed writing or other authenticated record,” that means, taking possession of the collateral can achieve “two functions: enforceability (9–203) and perfection (9–313).” 4 James J. White, Robert S. Summers, & Robert A. Hillman, Uniform Commercial Code § 31–8 (6th ed.2013).

a. Goods Covered by Negotiable Document

Goods are transported across state lines and national

boundaries. Goods are stored in warehouses. There are times that goods are in possession of a bailee who has issued a negotiable document covering the goods. In this situation, the goods are viewed as being locked up in the negotiable documents. A secured party who wants to perfect its security in those goods may do so by perfecting the security interest in the negotiable document. That means the secured party may perfect by taking possession of the negotiable document or by filing a financing statement. The perfected security interest in the negotiable document has priority over any security interest that becomes perfected in the goods by another method. *See*§ 9-312(c). The two examples below illustrate the rule:

Example 1: While wheat is in a grain elevator and covered by a negotiable warehouse receipt, Debtor creates a security interest in the wheat in favor of SP-1 and SP-2. SP-1 perfects by filing a financing statement covering "wheat." Thereafter, SP-2 perfects by filing a financing statement describing the warehouse receipt. That means SP-2's security interest is perfected and senior to SP-1's.

Example 2: The facts are as in Example 1, but SP-1's security interest attached and was perfected ***before*** the goods were delivered to the grain elevator. Thereafter, SP-2 perfected by filing a financing statement describing the warehouse receipt. That means SP-2's security interest did not become perfected during the time that the wheat was in the possession of a bailee. Rather, the first-to-file-or-perfect priority rule applies. *See*§9-322.

b. Goods Covered by Nonnegotiable Document

Goods can be stored in a warehouse but the person who is in charge of the warehouse issues a nonnegotiable document.

In this situation, title to the goods is not deemed as being locked up in the document. The secured party may perfect the security interest in the goods by filing a financing statement covering the goods. Alternatively, the secured party may perfect the security interest in the goods by having the bailee issue a document in the name of the secured party (as consignee of the bill of lading or to the person to whom delivery would be made under a nonnegotiable warehouse receipt). Also, if the bailee receives a notification of the secured party's interest in the goods, the secured party is deemed to have perfected its security interest. Essentially, the bailee's receipt of the notification is effective to perfect the secured party's security interest, regardless of who sends the notification or how the bailee responds. *See*§ 9-312(d) and Official Comment 7.

c. Collateral in Possession of Person Other than Debtor

With respect to collateral other than certificated securities and goods covered by a document, a secured party can take possession of collateral in the possession of a person other than the debtor. Secured transactions law requires the person who is already in possession of the collateral to "authenticate[] a record acknowledging that it holds possession of the collateral for the secured party's benefit." Indirect possession also occurs when the person "takes possession of the collateral after having authenticated a record acknowledging that it will hold possession of collateral for the secured party's benefit." UCC § 9-313(c).An acknowledgment in this situation is effective, even if the acknowledgment violates the rights of the debtor, and does not create a duty on the person to the secured party. Obviously, the person is free to agree by contract with the secured party.

d. Delivery of Collateral to Third Party by Secured Party

Mortgage warehouse lenders may wish to deliver the mortgage notes (the collateral) to prospective purchasers (third party). The lenders will include a cover letter informing the prospective purchasers that the lenders hold a security interest in the notes. Such notification is sufficient under secured transactions law for the lenders to maintain perfection of the security interest in the mortgage notes. There is no need for the prospective purchasers to authenticate an acknowledgment. That would be too cumbersome. *See* 9-313(h) and (i). Moreover, the delivery of the collateral to the third party does not relinquish the secured party's possession in the collateral, even if the delivery violates the rights of a debtor. Also, the third party to which the collateral is delivered does not owe any duty to the secured party and is not required to confirm the delivery to another person unless the person otherwise agrees or law other than secured transactions otherwise provides.

e. Temporary Perfection When Secured Party Surrenders Possession of Documents, Goods, and Instruments

There are circumstances in whicha secured party may wish to surrender possession of the collateral, such as goods, negotiable documents, certificated securities, and instruments, to the debtor. What will happen to the perfection of the collateral now that the secured party no longer has possession of the collateral? UCC § 9-312(f) provides a temporary perfection of 20 days during which time the secured party can file a financing statement to perfect the collateral. This rule is only available if the secured party releases to the debtor the negotiable documents or the goods in possession of the bailee but not covered by a negotiable document, for the purpose of (i)

ultimate sale or exchange; or (ii) unloading, storing, shipping, transshipping, manufacturing, processing, or otherwise dealing with them in a manner preliminary to their sale or exchange.

If the secured party who has perfected its security interest in certificated securities and negotiable instruments by taking possession, delivers the collateral to the debtor for the purpose of (i) ultimate sale or exchange; or (ii) presentation, collection, enforcement, renewal, or registration of transfer, the secured party will have 20 days of temporary protection. The secured party should employ other methods of perfection before the grace period expires. *See*§ 9-312(g).

3. Secured Party Taking Control of the Collateral—Deposit Accounts, Investment Property, Letter of Credit Rights, and Electronic Chattel Papers

Deposit Accounts, Investment Property, Letter of Credit Rights, and Electronic Chattel Papers are special types of collateral whose optimal method of perfection is by having the secured party take control.

a. UCC §§ 9-104 and 9-304 --Deposit Accounts

Under UCC § 9-104, for deposit accounts at a bank that the debtor uses as collateral, the secured party perfects the security interest in the deposit account by having control if (1) the secured party is the bank with which the deposit account is maintained; (2) the debtor, secured party, and bank have agreed in an authenticated record 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; or (3) the secured party becomes the bank's customer with respect to the deposit account. The secured party is deemed to have control under (1) to (3), even if

the debtor retains the right to direct the disposition of funds from the deposit account. To understand this rule, we will read the next case.

The case below shows that the secured party perfected its security interest in the debtor's deposit account held at a bank by having the secured party, the debtor, and the debtor's bank enter into a Deposit Account Control Agreement that the bank would comply with the secured party's instruction. Further, the secured party filed a financing statement though it was not required. However, the filing of a financing statement is helpful, as seen in the court's analysis.

In re **Southeastern Stud and Components, Inc.**

2015 WL 7750209 (Bankr. M.D.Ala. Dec. 1, 2015)

In this complaint, … the trustee for the bankruptcy estate of Southeastern Stud and Components, Inc. (hereinafter "debtor"), contests the security interests of the Mill Steel Company, Mill Steel Birmingham, LLC, and MSSES Holdings, LLC (hereinafter "defendants")….

[The dispute centers on the debtor's bank accounts at Sterling Bank.] Those accounts at one time were subject to a Deposit Account Control Agreement (hereinafter "DACA") between the defendants and the debtor. The trustee argues that the DACA does not give the defendants an interest in the debtor's accounts at Sterling Bank. First, trustee contends that the DACA was cancelled in the summer of 2013 when the original debt owing to Mill Steel was paid off. Secondly, the trustee maintains the bank account numbers listed in the DACA were not the same as the account numbers for the accounts actually maintained by the debtor at Sterling Bank. As a result,

the trustee contends that accounts cannot be covered under the defendants' security agreement pursuant to Alabama law.

The defendants counter maintaining that the DACA was ratified by the debtor after the pay-off of the original debt and that the discrepancy in the account numbers was of the making of the debtor and Sterling Bank without the knowledge of the defendants. In addition, the defendants contend that the DACA was an agreement between the debtor, the defendants, and Sterling Bank. All of the parties to that agreement were aware that the DACA applied to the accounts actually maintained by the debtor even though those accounts had numbers that differed from the account numbers identified in the agreement….Therefore, according to the defendants, the funds in the debtor's deposit accounts at Sterling Bank are covered by their perfected security interest.

…

[T]he Code provides that "a security interest is enforceable against the debtor and third parties with respect to [deposit account] only if ... the secured party has control under ... 7–9A–104 ... pursuant to the debtor's security agreement." § 7–9A–104 provides "[a] secured party has control of a deposit account if ... the debtor, secured party, and bank have agreed in an authenticated record 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."

The trustee contends that in order to comply with § 7–9A–104 "a deposit account control agreement must specifically identify the debtor, bank and secured creditor and the specific account(s) subject to the deposit account control under this

section." The court, however, can find no provision of the law that would require the specific account to be identified in order for the creditor's security interest to attach to the account. Assuming that the court finds that the DACA had not been cancelled or if so, was thereafter ratified, the defendants had control of the debtor's deposit account as a result of the DACA. The record here clearly shows that the debtor and Sterling Bank were aware of the particular accounts to which the DACA applied, and the discrepancies between the account numbers contained in the DACA and those actually maintained by the debtor were of the making of the debtor and Sterling Bank and not of the defendants.

Finally, through a search of the record, a third party would have found that the defendants claimed an interest in the debtor's deposit accounts. *See* Exhibit D: defendants' October 2013 UCC Financing Statement ("The Financing Statement covers the following collateral: ... all Deposit Accounts with any bank or other financial institution; ..."). Charged with such knowledge, the third party would have at least been placed upon inquiry notice regarding the defendants' claimed security interest. That inquiry would have led the third party to the defendants, the debtor or to Sterling Bank. The overwhelming bulk of the record now before the court leads to the conclusion that none of the parties to the DACA would or could have denied the defendants' interest in the deposited funds. Therefore, the trustees' motion for partial summary judgment must be denied regarding the validity of the DACA.

b. Investment Property

"Investment property" means a security, whether certificated or uncertificated, security entitlement, securities

account, commodity contract, or commodity account. *See* UCC § 9-102. The optimal method of perfecting a security interest in investment property is by control. *See*UCC § 9-106; UCC § 8-106; UCC § 9-305. The case below illustrates perfection by control of the investment property collateral.

Del Moral v. UBS Financial Services Inc. of Puerto Rico

2016 WL 1275038 (D. P.R.Apr. 6, 2016)

In August 2006, Efrón and UBS Bank USA entered into a Credit Line Agreement. The line of credit was secured by a first priority lien in favor of UBS Bank USA, to be exercised against accounts held by Efrón with the security intermediary, which was UBS. The Agreement provided for UBS to abide by all entitlement orders and instructions given by the Bank regarding the collateral accounts, without need for consent from Efrón. Efrón, for his part, could trade financial assets within the collateral accounts and could also issue entitlement orders and instructions to UBS regarding those accounts, unless the Bank notified UBS that it was asserting exclusive control over the account, at which point UBS was prohibited from acting on orders or instructions from Efrón.

The Agreement gave the Bank the right to secure payment of the credit line obligations when the debt became due, by set-off against Efrón's UBS investments. The debt would become due in the event of a “demand” by the Bank for full or partial payment of the credit line obligations. That demand could be made at any time, at the Bank's absolute discretion. Moreover, the agreement provided that notification of demand could be made orally or in writing unless otherwise required by law. Docket No. 23, Exh. IS at Section 20.

…

To that end, the Bank had discretion to terminate or cancel the line, in which event Efrón would have to pay the totality of the credit line obligation. *Id.* at Section 2(h). Nevertheless, under Section 10, the entire obligation would come due if a collateral account was attached or subjected to a levy, at which time the Bank could, "in its sole and absolute discretion liquidate, withdraw or sell all or any part of the Collateral and apply the same [...] to any amounts owed to the Bank ..." *Id.* at Section 10(a).

…

A security interest in investment property may be perfected by control. Both Utah law (Utah Code Ann. § 70A-9a-313(1)), which governed the Credit Line Agreement with Mr. Efrón, and the UCC, so permit. In the case of investment property held through a securities intermediary (UBS), the secured party (UBS Bank USA) could perfect by control transferring securities to an account in its own name; becoming the entitlement holder, arranging for the securities intermediary to act on instructions from the secured party to dispose of the positions, even though the debtor remains the entitlement holder.

Puerto Rico has adopted the UCC articles applicable to investment property and secured transactions. *See*, Commercial Transactions Act, P.R. Laws Ann. tit. 19 §§ 401-2207, with relevant provisions similar to the Utah UCC. The Commercial Transactions Act provides that filing is not required to perfect "a security interest in investment property which is perfected without filing under § 2015 or § 2016 of this title."Instead, it recognizes that "[a] description of collateral in a security

agreement or financing statement is sufficient to create or perfect a security interest in a[n][investment property]," and that "[a] security interest in investment property may be perfected by control." And along the same line, it provides that control exists where the securities intermediary has agreed to comply with entitlement orders originated by the [secured party] purchaser without further consent by the entitlement holder. *See*Section 1706(d)(2).

These conditions appear to have been satisfied. As to the priority to be accorded this interest, the Commercial Transactions Act accepts that "[a] security interest of a secured party who has control over investment property has priority over a security interest of a secured party who does not have control over the investment property." Section 2015(5)(a)….

All in all, UBS Bank USA had a perfected interest in Efrón's collateral-account assets, had control over those assets, could liquidate the account without demand and apply the proceeds to pay off the credit line, and communicated with UBS to make sure that the loan on credit in Account 5V-50203 was paid.

B. SPECIAL CASE

Motor Vehicles (*Goods Covered by Certificate of Title*)

Typically, a security interest in motor vehicles is perfected when the Department of Transportation receives a completed application specifying the lienholder's name and address, the appropriate fee, and the manufacturer's statement of origin or the existing certificate of title. Once a security interest in a motor vehicle is perfected, a certificate of title is issued that lists the lienholder. That means the notation of a lien on a certificate of title of a vehicle reflects the

*perfection of the lien on the vehicle. See 75 Pa.Cons.Stat. § 1132.1(a) and (d); In re Pollilo, 2010 WL 235125, at *4 (Bankr. E.D.Pa. 2010). On the other hand, with respect to transfer of ownership of a motor vehicle, the owner must sign in a designated place on the certificate of title. See75 Pa.Cons.Stat.Ann. § 1111(a).*

If the debtor pays off the debt or fulfills its obligation in a secured transaction or when "a lien on a vehicle is satisfied" and where "there are no subsequent liens upon a vehicle," the following rules apply under Pennsylvania law:

> (1) The outstanding certificate of title shall be mailed or delivered immediately to the owner of the vehicle with proper evidence of satisfaction and release or the lienholder may apply for corrected title to be issued in the name of the owner.
>
> (2) The owner may mail or deliver the certificate of title with proper evidence of satisfaction of the security interest to the department which shall issue a corrected certificate of title without a statement of liens or encumbrances. The corrected certificate of title may also be issued when the outstanding certificate of title cannot be returned and proper evidence is produced that all recorded security interests have been satisfied.
>
> 75 Pa.Cons.Stat.Ann. § 1135(a).

Pennsylvania law further provides a remedy to the debtor if the secured party or a lienholder fails to comply with the above requirement within five days of the satisfaction of the lien. The secured party or the lien holder is deemed "guilty of a summary offense and shall, upon conviction, for a first offense be sentenced to

pay a fine of $50 and for a subsequent offense be sentenced to pay a fine of $100." 75 Pa.Cons.Stat.Ann. § 1135(c).

C. ASSIGNMENT OF PERFECTED SECURITY INTEREST

If the secured party decides to assign its perfected security interest to a third party for whatever purposes, must the third party enter into a new security agreement with the debtor? Must the third party file a new financing statement?

UCC § 9-310(c) provides that filing is not required to continue the perfected status of the secured interest against creditors and transferees from the original debtor. Official Comment 4 to UCC § 9-310(c) provides excellent examples:

> Subsection (c) concerns assignment of a perfected security interest or agricultural lien. It provides that no filing is necessary in connection with an assignment by a secured party to an assignee in order to maintain perfection as against creditors of and transferees from the original debtor.
>
> **Example 1:** Buyer buys goods from Seller, who retains a security interest in them. After Seller perfects the security interest by filing, Seller assigns the perfected security interest to X. The security interest, in X's hands and without further steps on X's part, continues perfected against Buyer's transferees and creditors.
>
> **Example 2:** Dealer creates a security interest in specific equipment in favor of Lender. After Lender perfects the security interest in the equipment by filing, Lender assigns the chattel paper (which includes the perfected security interest in Dealer's

equipment) to X. The security interest in the equipment, in X's hands and without further steps on X's part, continues perfected against Dealer's transferees and creditors. However, regardless of whether Lender made the assignment to secure Lender's obligation to X or whether the assignment was an outright sale of the chattel paper, the assignment creates a security interest in the chattel paper in favor of X. Accordingly, X must take whatever steps may be required for perfection in order to be protected against Lender's transferees and creditors with respect to the chattel paper.

Subsection (c) applies not only to an assignment of a security interest perfected by filing but also to an assignment of a security interest perfected by a method other than by filing, such as by control or by possession. Although subsection (c) addresses explicitly only the absence of an additional filing requirement, the same result normally will follow in the case of an assignment of a security interest perfected by a method other than by filing. For example, as long as possession of collateral is maintained by an assignee or by the assignor or another person on behalf of the assignee, no further perfection steps need be taken on account of the assignment to continue perfection as against creditors and transferees of the original debtor. Of course, additional action may be required for perfection of the assignee's interest as against creditors and transferees of the assignor.

PROBLEM 3:

Test your understanding before going to the next chapter.

3.1 Describe all methods of perfecting a security interest.

3.2 Where will the secured party file the financing statement?

3.3 If the debtor's main office is in Tokyo, where should the secured party file the financing statement?

3.4 If the secured party perfects the security interest by taking possession, what are some concerns for the debtor? For the secured party?

3.5 What is automatic perfection?

What is the difference between "control" and "possession" of the collateral? Perfection of security interests in patents, trademarks, and unregistered copyrights is accomplished by filing the financing statement. See__________ Perfection of security interests in registered copyrights is accomplished by filing with the Copyright Office. See __________. Where will you file for perfection of a security interest in trade secrets? Why do lawyers still file security interests in patents and trademarks with the USPTO?

CHAPTER FOUR

CHOICE OF LAW, CONFLICT OF LAW, MULTISTATE TRANSACTIONS IN SECURED TRANSACTIONS

In a security agreement, the parties can decide their choice of law and include a choice of law provision. UCC-9 provides specific provisions relating to choice of law. The case below illustrates how the court analyzed UCC § 9-304 for choice of law in a case involving security interests in a deposit account.

American Home Assurance Co. v. Weaver Aggregate Transport, Inc.

84 F.Supp.3d 1314 (M.D.Fla. 2015)

Before reaching the merits of this motion, the Court must first decide what law governs the security interest at issue in this case. A choice-of-law clause in the Loan Documents requires that the Court apply federal law applicable to the Bank and, to the extent not preempted by federal law, Illinois law.

Florida choice-of-law rules govern the effect of this clause because a federal court in Florida exercising diversity jurisdiction applies Florida state law. Liberty Mut. Ins. Co. v. Aventura Eng'g & Constr., 534 F.Supp.2d 1290, 1302 (S.D.Fla.2008).A contractual choice-of-law provision is valid under Florida law: "[a]n agreement between parties to be bound by the substantive laws of another jurisdiction is presumptively valid, and this Court will enforce a choice-of-law provision unless applying the chosen forum's law would contravene a strong public policy of this State." Southeast Floating Docks, Inc. v. Auto–Owners Ins. Co., 82 So.3d 73, 80 (Fla.2012). Because neither party argues that applying federal and Illinois law would contravene any public policy of Florida—let alone a strong

one—the Court applies federal and Illinois law.

As the Bank's interest in the deposit account arises under the Uniform Commercial Code ("U.C.C."), and as Illinois has adopted Revised Article 9 of the U.C.C., Article 9's choice-of-law provisions apply. Revised Article 9 provides that "the local law of a bank's jurisdiction governs perfection, the effect of perfection or nonperfection, and the priority of a security interest in a deposit account maintained with that bank." U.C.C. § 9–304; 810 ILCS 5/9–304(a).

In addition, § 9–304 provides rules for determining the bank's jurisdiction. See 810 ILCS 5/9–304(b). Relevant here is subsection (b)(1), which provides that "[i]f an agreement between the bank and the debtor governing the deposit account expressly provides that a particular jurisdiction is the bank's jurisdiction for purposes of this Part, this Article, or the Uniform Commercial Code, that jurisdiction is the bank's jurisdiction." Id. at 5/9–304(b)(1).

As noted above, the Loan Documents' choice-of-law clauses provide that the Agreements will be "governed by federal law applicable to Lender [the Bank] and, to the extent not preempted by federal law, the laws of the State of Illinois."Thus, the Loan Documents suggest that Illinois is the "bank's jurisdiction" pursuant to U.C.C. § 9–304. Accordingly, Illinois law governs perfection, the effect of perfection or nonperfection, and the priority of the Bank's security interest in a deposit account maintained with the Bank.

****

When a secured transaction is multistate, UCC § 9-301 resolves which law is applicable for perfection and priority. The case below is helpful to understand multistate transactions and choice of law.

In re **Semcrude, L.P.**

2015 WL 4594516(D. Del. July 30, 2015)

The present matter is a dispute between a group of oil producers ("the Producers")that sold oil to SemCrude, L.P., and two downstream purchasers ('the Purchasers') that subsequently repurchased that same oil from SemCrude.

...

On July 22, 2008, SemCrude and related entities ('the Debtors') filed voluntary petitions for relief under Chapter 11 of the Bankruptcy Code in the United States Bankruptcy Court for the District of Delaware. The Debtors provided midstream oil and gas services, primarily aggregating oil and gas from producers and reselling the product to downstream purchasers. The Debtors, through their CEO Tom Kivisto, traded financial oil derivatives on the New York Mercantile Exchange and on over-the-counter markets. Kivisto engaged in a trading strategy that proved unsuccessful, and eventually led to a liquidity crisis that caused the Debtors to file bankruptcy.

...

When the Debtors filed bankruptcy, they had not yet paid the Producers for oil they purchased on credit in June and July of 2008.

The Producers object to the bankruptcy court's proposed finding that the Purchasers took the disputed oil free and clear of all liens as buyers for value ('BFV') under § 9-317 of the Uniform Commercial Code ('U.C.C.').

...

The Producers first argue that summary judgment on the

BFV defense is improper because certain U.C.C. provisions specific to Kansas and Texas provide them with automatically perfected liens in the oil they delivered to the Debtors. They contend that the bankruptcy court erroneously found that the Producers' liens are unperfected because they failed to file U.C.C.-1 financing statements in Delaware or Oklahoma. In their view, the Automatic Perfection Provisions of Kansas and Texas provide them with automatically perfected liens in the disputed oil, thus the BFV defense cannot apply. A review of the bankruptcy court's earlier decisions, which were incorporated into the proposed FFCL, is necessary.

In two separate opinions, the bankruptcy court considered whether the Automatic Perfection Provisions granted the Producers a perfected security interest in their oil. Arrow Oil & Gas, Inc. v. SemCrude, L.P., 407 B.R. 112 (Bankr. D. Del. 2009); Mull Drilling Co. v. SemCrude, L.P., 407 B.R. 82 (Bankr. D. Del. 2013). Since multiple states had a connection to the case and those states' laws differed on the issue of perfection, the bankruptcy court first conducted a choice of laws analysis in both opinions. Applying the rule from the Second Restatement, the bankruptcy court concluded that the conflict of laws provision of its own state (Delaware) applied. That provision-6 Del. Code § 9-301 (1)—directs that the jurisdiction in which a debtor is located governs the issue of perfection. All three relevant debtor entities were locatedin either Delaware or Oklahoma; accordingly, the U.C.C. provisions of those states determined whether the Producers had properly perfected their liens. See Arrow Oil & Gas, Inc., 407 B.R. at 137; Mull Drilling Co., 407 B.R. at 109.

It follows that, since the debtor entities were not located in either Texas or Kansas, the Producers could not take advantage of the protection of the Automatic Perfection Provisions. Delaware and Oklahoma do not contain similar provisions;

those states require that a party perfect its lien by filing a U.C.C.-1 financing statement. Because the Producers did not file a financing statement as required by Delaware or Oklahoma law, they could not demonstrate as a matter of law that they had perfected their liens in the oil.

...

For the foregoing reasons, the court overrules all of the Producers' … objections, and will adopt the bankruptcy court's June 28, 2013 findings of fact and conclusions of law. The court confirms that the Purchasers have demonstrated that there are no disputed issues of material fact and that they are entitled to summary judgment.

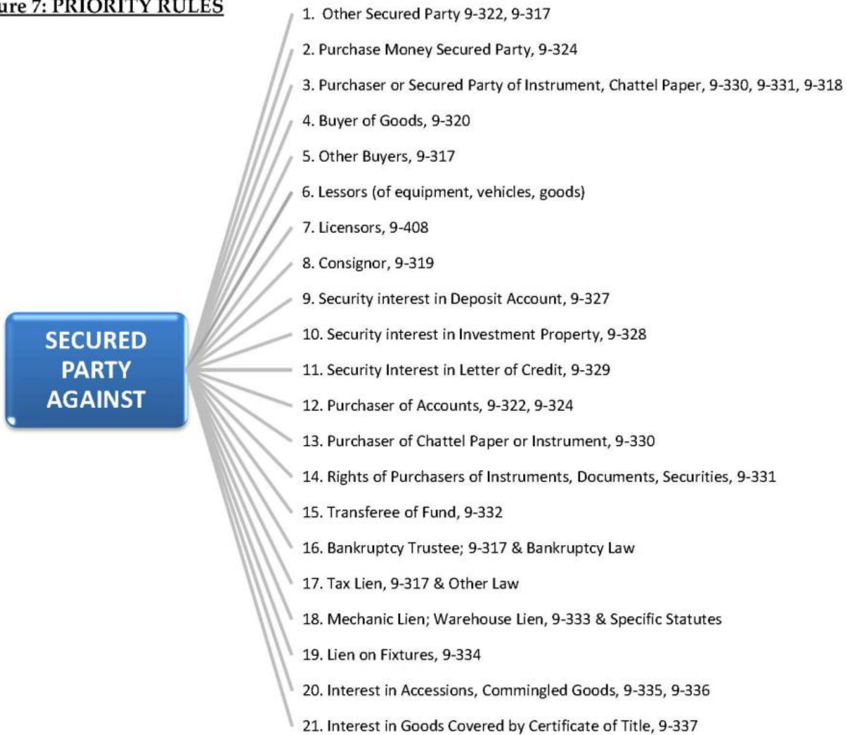
CHAPTER FIVE

DETERMINING PRIORITY BETWEEN SECURED PARTY AND OTHER COMPETING INTERESTS

1. First-in-time, First in Right

UCC § 9-322(a) provides priorities among conflicting security interests in the same collateral based on which security interest is firstin time of filing the financing statement or perfection, if both secured parties have engaged in filing or perfection. If one secured party perfects and the other secured party fails to perfect, the perfected security interest has priority over the unperfected. The rules are as follows:

> (1) Conflicting perfected security interests and agricultural liens rank according to priority in time of filing or perfection. Priority dates from the earlier of the time a filing covering the collateral is first made or the security interest or agricultural lien is first perfected, if there is no period thereafter when there is neither filing nor perfection.
>
> (2) A perfected security interest or agricultural lien has priority over a conflicting unperfected security interest or agricultural lien.
>
> (3) The first security interest or agricultural lien to attach or become effective has priority if conflicting security interests and agricultural liens are unperfected.



What if both secured parties failed to perfect their security interests in the same collateral? The case below applies the first-in-time rule between two secured parties with unperfected security interests. The party that attaches first has priority per UCC § 9-322(a)(3) above.

Farm Credit Services of the Midlands, PCA v. First State Bank of Newcastle, Wyoming

575 N.W.2d 250 (S.D. 1998)

During the 1990's, Chance and Neteri Reynolds (hereinafter "Debtor") obtained various loans from Farm Credit Services of the Midlands (Farm Credit) and First State Bank of Newcastle, Wyoming (Bank). On March 21, 1995, Debtor executed a security agreement in favor of Bank. The agreement

specifically describes two 1995 Dodge pickup trucks by their vehicle identification numbers. In return, Bank loaned Debtor the money for the purchase of the two trucks.

Approximately two years earlier, Debtor executed a security agreement in Farm Credit's favor, giving Farm Credit a security interest in various collateral, including accounts, livestock, equipment, and certain titled motor vehicles. Although the 1995 Dodge trucks were not described in the agreement, it stated that Farm Credit's security interest would attach to after-acquired property. Neither Bank nor Farm Credit perfected their security interests in the trucks by noting their liens on the certificates of title.

In March of 1996, Debtor defaulted on its loans with both Bank and Farm Credit….

Since both security interests are unperfected, "the first to attach has priority." SDCL 57A-9-312(5)(b). Both parties claim that their security interests in the trucks "attached" simultaneously and argue equitable principles to enforce their respective interests.We disagree, and affirm because we conclude that Farm Credit's security interest never attached to the trucks.

The requirements for attachment are provided in SDCL 57A-9-203:

> (1) ... a security interest is not enforceable against the debtor or third parties with respect to the collateral and does not attach unless:
>
> > (a) The collateral is in the possession of the secured party pursuant to agreement, or the debtor has signed a security agreement which

> contains a description of the collateral ...; and
>
> (b) Value has been given; and
>
> (c) The debtor has rights in the collateral.
>
> (2) A security interest attaches when it becomes enforceable against the debtor with respect to the collateral. Attachment occurs as soon as all of the events specified in subsection (1) have taken place unless explicit agreement postpones the time of attaching.

Under subdivision (1)(a), the requirement that the collateral be "in the possession of the secured party pursuant to agreement" is strictly construed, i.e., "possession" must be actual. Here, since neither creditor had possession of the trucks, this portion of SDCL 57A-9-203(1)(a) does not apply.

The alternative portion of subdivision (1)(a) requires "a security agreement which contains a description of the collateral" signed by the debtor. Bank's security agreement describes the trucks and includes their vehicle identification numbers, satisfying this section. The question is whether Farm Credit's after-acquired property clause describes the trucks.

Farm Credit's security agreement describes certain titled vehicles other than the 1995 Dodge trucks. It provides that the security interest would include

> ... all increases, additions, accessions thereto and substitutions therefor now owned or hereafter acquired, or held on consignment, including all proceeds and products thereof[.]

We agree with the conclusion reached in Long Island Trust Co. v. Porta Aluminum Corp., 354 N.Y.S.2d 134, 142 (1974):

> We do not interpret the general language in the after-acquired property clause of the security agreement to cover vehicles other than those therein specifically enumerated, unless they were given and accepted in replacement of specified vehicles.

The purchase orders for the two 1995 Dodge trucks indicate two trade-in vehicles-two 1995 Ford pickup trucks. The Fords are not listed in Farm Credit's security agreement; therefore, the Dodge trucks were not replacement vehicles for any of the vehicles in which Farm Credit had a security interest. Absent a writing specifically describing the collateral, Farm Credit's nonpossessory security interest never attached to the Dodge trucks under SDCL 57A-9-203(1)(a).

Since Farm Credit cannot establish a sufficient writing under the statute it is unnecessary to analyze whether it met the provisions of subdivisions (b) and (c). Bank's security interest meets all the conditions for attachment required under SDCL 57A-9-203(1): (a) Its security agreement, signed by Debtor, contains a description of the collateral; (b) Bank gave "value" by advancing the purchase price for the trucks; and (c) Debtor had rights in the collateral. Accordingly, Bank is entitled to the proceeds of the sale of the trucks. SDCL 57A-9-203(3).

****

It is an anomaly to say that two secured parties perfect their security interests by possession of the same collateral except when there is a fraudulent scheme, as shown in the case below. The court still has to apply the first-in-time priority rule; a secured party who is first in time to perfect its security interest or to file the financing statement has priority.

HSBC Bank USA v. Perez

165 So.3d 696 (Fla. Dist. Ct App. 2015)

On April 17, 2006, appellee Rolando Perez ("the Borrower") obtained a loan and mortgage from Federal Guaranty Mortgage Company ("FGMC"). The mortgage was recorded the following month in Broward County's public records. At closing, the Borrower executed two nearly identical promissory notes in FGMC's favor, both for the same amount and both secured by the same mortgage. The parties agree that the execution of two promissory notes was part of a larger fraudulent scheme that included other loans.

On June 30, 2006, appellant HSBC Bank USA, N.A. closed on a pooling and servicing agreement ("PSA") and took possession of one of the Borrower's "original" promissory notes. This transferred promissory note was specially endorsed from FGMC to American Home Mortgage Corp. and from American Home Mortgage Corp. to HSBC.

After HSBC's purchase, appellee LaSalle Bank entered into a separate PSA, which led to its taking possession of the Borrower's second "original" promissory note on August 8, 2006. Like HSBC's promissory note, the note obtained by LaSalle Bank contained special endorsements completing the chain of ownership.

The Borrower defaulted in 2008. At oral argument, it was suggested that someone other than the Borrower made some payments on one of the notes to keep the fraudulent scheme alive. After all payments stopped, both banks commenced separate foreclosure lawsuits and recorded assignments of mortgage. HSBC recorded its mortgage assignment on April 24,

2009. LaSalle Bank obtained an assignment of mortgage on June 5, 2009, which stated that the assignment was effective as of January 2, 2009; it recorded this assignment on August 12, 2009. LaSalle Bank recorded a second assignment of mortgage on October 8, 2010.

At the behest of a third mortgagee, the foreclosure cases were consolidated. Nevertheless, on March 20, 2012, HSBC—without naming or serving LaSalle Bank with its motion for summary judgment—obtained a final judgment of foreclosure and later sold the subject property to Juan H. Guerra and Esperanza Medina ("the Purchasers").

With the dual promissory note conundrum still unresolved, the banks entered into an October 1, 2012 agreed order vacating the final judgment, sale, and issuance of certificate of title. Frustrated by the divestment of title, the Purchasers intervened in the consolidated lawsuits and filed a counterclaim, seeking a declaratory judgment establishing "whether HSBC or LaSalle is the owner and holder of the FGMC Note and Mortgage which both parties seek to enforce." Should HSBC be determined the note's rightful holder, the Purchasers asserted the bank could ratify the prior sale and execute a new deed in their favor to allow them to retain possession of the property.

…

Perfection

One method of perfecting a security interest in a promissory note is by taking possession of the original promissory note. 4 J. White & R. Summers, supra, § 31–8. A note is an "instrument" and a security interest can be perfected by taking possession of it.

Perfection is significant because it serves two important purposes: (1) determining matters of priority and (2) providing third parties with notice of the transaction. Article 9's perfection requirements were "adopted to provide a notice system similar to that provided by the recordation of real estate conveyances."In re S. Props, Inc., 44 B.R. 838, 844 (Bankr. E.D. Va. 1984). As one commentator has explained:

> The basic idea is that the secured creditor must do something to give effective public notice of his interest; if he leaves the property in the debtor's possession and under his apparent control, the debtor will be ... enabled to sell the property to innocent purchasers or to induce other innocent persons to lend money to him on the strength of his apparently unencumbered assets.

Grant Gilmore, Security Interests in Personal Property § 14.1, at 438 (1965)).

Possession of a promissory note effectively gives notice to third-parties that the creditor has an interest in the collateral. "The debtor's lack of possession coupled with actual possession by the creditor, the creditor's agent or the bailee serves to provide notice to prospective third party creditors that the debtor no longer has unfettered use of (his) collateral." Heinicke Instruments Co. v. Republic Corp., 543 F.2d 700, 702 (9th Cir.1976). The Ninth Circuit has written that "the only notice sufficient to inform all interested parties that a security interest in instruments has been perfected is actual possession by the secured party, his agent or bailee." An inability to produce a note that is in a secured party's possession would effectively give notice of the secured party's interest. 4 J. White & R. Summers, supra, § 30–8.

[Once HSBC took possession of the note it had an Article 9

security interest in the note. HSBC's possession of the note gave it an attached security interest in the mortgage lien that secured the note. Once HSBC perfected its security interest in the note, the security interest in the mortgage lien likewise was perfected.]

Priority

Both the timing and the method of obtaining perfection are key to establishing priority. Pursuant to section 679.322(1)(a), Florida Statutes (2008), "[c]onflicting perfected security interests ... rank according to priority in time of filing or perfection." The "guiding principle" of section 679.322 "is that the secured party who ... perfects before the other person, wins." Section 679.330(4), Florida Statutes (2008), dictates that "a purchaser of an instrument has priority over a security interest in the instrument perfected by a method other than possession if the purchaser gives value and takes possession of the instrument in good faith and without knowledge that the purchase violates the rights of the secured party."

In this case, by taking possession of the promissory note before LaSalle Bank, HSBC was the first to perfect its interest in a note connected to the underlying mortgage.

Under these principles, …HSBC in this case established its priority in the note—and, by extension, the mortgage—by virtue of being the first to perfect its interest through possession. The Code does not leave LaSalle Bank without a remedy. Under section 673.4161(1), Florida Statutes (2014), LaSalle has an action for breach of warranty against the transferor of the note, a remedy more theoretical than practical given the existence of the scheme to defraud.

2. Secured Party v. Secured Party with Purchase Money Security Interest – The "Super-priority" Rule

The usual rule that conflicting security interests are ranked according to priority in time of filing or perfection, however, is subject to a "super priority" rule. Under UCC § 9–324(b), a perfected purchase money security interest in inventory has priority over a conflicting security interest in the same inventory and also has priority in identifiable cash proceeds of the inventory or identifiable chattel paper or an instrument constituting proceeds of the inventory. That means a purchase money security interest has priority over a prior conflicting security interest even though the purchase money security interest is later perfected. The purchase money secured party must perfect its security interest when the debtor receives possession of the inventory. The purchase money secured party must send a notification to the holder of the conflicting security interest in the inventory. The notification must state that the purchase money secured party acquires a purchase money security interest in the inventory of the debtor and describe the inventory. The holder of the conflicting security interest must receive the notification within five years before the debtor receives possession of the inventory. See§ 9-324(b).

a. Priority in Accounts that are Proceeds of Purchase Money Inventory

What if the inventory was sold, producing accounts? Remember that accounts have a specific definition per UCC § 9-102. Accounts are not cash proceeds. Therefore, the first-in-time priority rule under UCC § 9-322(a) will apply. Here are illustrative examples per Official Comment 9 to § 9-324(b).

Example 1: Debtor creates a security interest in its existing and after-acquired inventory in favor of SP-1, who files a financing statement covering inventory. SP-2 subsequently takes a purchase-money security interest in certain inventory and, under subsection UCC § 9-324(b), achieves priority in this inventory over SP-1. This inventory is then sold, producing accounts. Accounts are not cash proceeds, and so the special purchase-money priority in the inventory does not control the priority in the accounts. Rather, the first-to-file-or-perfect rule of Section 9-322(a)(1) applies. The time of SP-1's filing as to the inventory is also the time of filing as to the accounts under Section 9-322(b). Assuming that each security interest in the accounts proceeds remains perfected under Section 9-315, SP-1 has priority as to the accounts.

Example 2: In Example 1, if SP-2 had filed directly against accounts, the date of that filing as to accounts would be compared with the date of SP-1's filing as to the inventory. The first filed would prevail under Section 9-322(a)(1).

Example 3: *If SP-3 had filed against accounts in Example 1 before either SP-1 or SP-2 filed against inventory, SP-3's filing against accounts would have priority over the filings of SP-1 and SP-2. This result obtains even though the filings against inventory are effective to continue the perfected status of SP-1's and SP-2's security interest in the accounts beyond the 20-day period of automatic perfection. SeeSection 9-315. SP-1's and SP-2's position as to the inventory does not give them a claim to accounts (as proceeds of the inventory) which is senior to someone who has filed earlier against accounts. If, on the other hand, either SP-1's or SP-2's filing against the inventory preceded SP-3's filing against accounts, SP-1 or SP-2 would outrank SP-3 as to the accounts.*

b. Priority Between Two Purchase Money Secured Parties

There are two scenarios under UCC § 9-324(g). First, a security interest securing an obligation incurred as all or part of the price of the collateral has priority over a security interest securing an obligation incurred for value given to enable the debtor to acquire rights in or the use of the collateral. For example, Bank provided a small loan to Debtor for the purpose of purchasing certain equipment. Debtor indeed took the money and purchased the equipment. Seller sold the equipment to Debtor on credit because the cash payment was insufficient. Seller received a purchase money security interest in the same equipment. Between the Seller and the Bank, both of whom are purchase money secured parties, the Seller will have priority over the Bank. Can you think of possible reasons why the Seller has priority over the Bank?

Second, if both purchase money secured parties are the same, i.e. both gave value to enable the debtor to acquire rights in the collateral, the purchase money secured party who is first in time to perfect or file the financing statement has priority per § 9-322(a).

c. Super-priority rule in "Equipment"

With respect to purchase money security interests in "equipment," the super-priority rule UCC § 9-324(a) provides:

> (a) **General rule; purchase-money priority.** Except as otherwise provided in subsection (g), a perfected purchase-money security interest in goods other than inventory or livestock has priority over a conflicting security interest in the same goods, and, except as otherwise provided in Section 9–327, a perfected security interest in its identifiable proceeds also has

priority, if the purchase-money security interest is perfected when the debtor receives possession of the collateral or within 20days thereafter.

To take advantage of the super-priority rule above, a secured party with a purchase money security interest in "equipment" must promptly perfects its security interest within twenty days of the debtor receiving possession of the equipment. Remember that "equipment" is defined as goods other than inventory, farm products, or consumer goods. Typically, "equipment" is goods for long-term use in a debtor's business. The case below explains the importance of the twenty-day grace period for filing and distinguishes the difference between a lease and a security interest.

In re **Southeastern Materials, Inc.**

433 B.R. 177 (Bankr. M.D. N.C. 2010)

This case involves two issues. First, the Court must determine whether the contractual relationship created by the Master Agreement and Equipment Schedule No. 2 was a true lease or a disguised security interest. Second, if the transaction was not a true lease, and instead created a security interest, the Court must determine whether TCP's lien has priority over First Bank's lien.

A. The Debtor's Contract With TCP Created a Security Interest, Not a Lease

U.C.C. § 1–203, codified in N.C. Gen.Stat. § 25–1–203, addresses whether a transaction creates a true lease or a disguised security interest. It states that "[w]hether a transaction in the form of a lease creates a lease or security interest is determined by the facts of each case." N.C. Gen.Stat.

§ 25–1–203(a).

Section 1–203(b) states:

> (b) 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.

The official comments to U.C.C. § 1–203 state that "[s]ubsection (b) further provides that a transaction creates a security interest if the lessee has an obligation to continue paying consideration for the term of the lease, if the obligation is not terminable by the lessee ... and if one of four additional tests is met." "[A]ll of these tests focus on economics, not the

intent of the parties." Id.

U.C.C. § 1–203 creates a two-step test for determining whether an agreement is a true lease or a disguised security interest. The first step is frequently referred to as a bright-line test. To satisfy the bright-line test, codified in Section 1–203(b), a court must determine that the "lease" is not subject to termination by the lessee and that at least one of the four conditions is satisfied. If the lease is not terminable by the lessee and one or more of the enumerated conditions is present, then the contract is a per se security agreement, and the court's analysis may conclude. If the bright-line test of Section 1–203(b) is not satisfied, "then a security interest will not be conclusively found to exist, and the court will need to consider other factors." Id.; see also In re Pillowtex, Inc., 349 F.3d 711, 717 (3d Cir.2003) (finding that the former U.C.C. § 1–201(37) set out a bright-line test).

Thus, when a lease is not terminable by the lessee and there is a nominal purchase option, a security interest exists, and no further inquiry is necessary. See, e.g., In re Wing Foods, Inc., 2010 WL 148637, *4 (Bankr.D.Idaho Jan. 14, 2010) ("The Agreement ... may not be terminated earlier [than the full lease term] by Debtor [and] also gives Debtor the right to buy the goods at the conclusion of its term by payment of the nominal amount of one dollar. [Idaho's version of U.C.C. § 1–203] and pertinent case law require nothing more to deem this transaction a sale rather than a lease.").

North Carolina's version of U.C.C. § 1–203 has been applied in the same fashion…. Nevertheless, the court, looking to relevant decisions from other jurisdictions, found that Section 25–1–203 creates a bright-line test and operates in the

same manner as other states' versions of the statute.

The facts of this case are straightforward. The lease was not terminable by the lessee, and the Debtor had the option to purchase the equipment at the end of the lease term for $1.00—clearly a nominal value. Therefore, the bright-line test of N.C. Gen.Stat. § 1–203(b) is satisfied and the agreement created a security interest as a matter of law.

B. Since TCP Did Not File its UCC–1 Financing Statement Within Twenty Days After the Debtor Received Possession of the Equipment, First Bank Has a First Priority Security Interest in the Equipment

U.C.C. § 9–324, codified in N.C. Gen.Stat. § 25–9–324, addresses when a perfected purchase-money security interest has priority over a conflicting perfected security interest. Subsection (a) states:

> Except as otherwise provided in subsection (g) of this section, a perfected purchase-money security interest in goods other than inventory or livestock has priority over a conflicting security interest in the same goods, and, except as otherwise provided in G.S. 25–9–327, a perfected security interest in its identifiable proceeds also has priority, if the purchase-money security interest is perfected when the debtor receives possession of the collateral or within 20 days thereafter.
>
> The exceptions in subsection (g) govern priority among multiple purchase-money security interests in the same collateral, and therefore are not applicable. The rules under Section 9–324 are "quite straightforward ... [in that] the purchase money

> secured creditor need only perfect within 20 days after the debtor receives possession." 4 James J. White & Robert S. Summers, Uniform Commercial Code § 33–4 (6th ed.2009).

If the creditor holding a purchase money security interest fails to perfect within 20 days after the debtor receives possession, a pre-existing perfected creditor will have priority. See In re T & R Flagg Logging, Inc., 399 B.R. 334, 339 (Bankr.D.Me.2009) (by failing to perfect within twenty day grace period under Maine's version of Article 9, purchase-money lien holder lost its ability to trump the priority of bank's pre-existing blanket lien); Wild West World, LLC v. Larson Int'l, Inc., 2008 WL 4642266, *1–2 (Bankr.D.Kan. Oct. 17, 2008) (because creditor failed to perfect within 20 days of the delivery of equipment to debtor, it was not entitled to special priority under Kansas' version of Section 9–324(a)).

In this case, TCP did not perfect its security interest within the 20 days after the equipment was delivered to the Debtor. Perfection was accomplished by TCP 23 days after delivery. Therefore, TCP is not entitled to special priority under Section 9–324(a). Since First Bank perfected its security interest in the equipment before TCP, it has the senior security interest.

****

Again, the super-priority rule for purchase money security interests in inventory requires the secured party with the purchase money security interest to comply with certain steps described in UCC § 9-324(b):

> (b) **Inventory purchase-money priority.** Subject to subsection (c) and except as otherwise provided in subsection (g), a perfected purchase-money security

> interest in inventory has priority over a conflicting security interest in the same inventory, has priority over a conflicting security interest in chattel paper or an instrument constituting proceeds of the inventory and in proceeds of the chattel paper, if so provided in Section 9–330, and, except as otherwise provided in Section 9–327, also has priority in identifiable cash proceeds of the inventory to the extent the identifiable cash proceeds are received on or before the delivery of the inventory to a buyer, if:
>
> > (1) the purchase-money security interest is perfected when the debtor receives possession of the inventory;
> >
> > (2) the purchase-money secured party sends an authenticated notification to the holder of the conflicting security interest;
> >
> > (3) the holder of the conflicting security interest receives the notification within five years before the debtor receives possession of the inventory; and
> >
> > (4) the notification states that the person sending the notification has or expects to acquire a purchase-money security interest in inventory of the debtor and describes the inventory.

If the PMSP fails to comply, it will not have super-priority over the existing, perfected security interest. It will be second in time in accordance with the general rule of priority under UCC § 9-322. The case below is a good reminder of what a PMSP must promptly do.

Absolute Machine Tools, Inc. v. Liberty Precision Industries, Ltd

2009 WL 2858092 (Ohio Ct. App. Sept. 8, 2009)

Absolute contends that the trial court erred in its determination on summary judgment that Chase's blanket security interest in Liberty's assets had priority over Absolute's purchase money security interest in the 11 machines. Because the trial court correctly found that Chase had a priority security interest in the machines, this Court need not address the parties' dispute over whether Absolute retained a security interest in the proceeds.

…

Chase moved for summary judgment against Absolute, contending that it held a blanket security interest in all of Liberty's inventory and accounts receivable and that it had perfected its security interest before Absolute's purchase money security interest arose. Chase conceded that Absolute held a purchase money security interest in the 11 machines that it sold Liberty, but Chase maintained that Absolute had failed to take the steps necessary to give its purchase money security interest priority over Chase's prior blanket security interest in Liberty's after-acquired property.

Pursuant to R.C. 1309.324, a purchase money security interest in inventory will have priority over all other security interests in the same collateral, provided that the purchase money secured creditor takes certain steps to notify other creditors with conflicting security interests. Specifically, under the explicit terms of R.C. 1309.324, Absolute was required to send a detailed notification to Chase, the holder of a conflicting security interest, about its purchase money security interest in

the 11 machines and Chase was required to receive the notification "within five years before the debtor receives possession of the inventory." R.C. 1309.324(B)(3).

Although Absolute filed financing statements with the New York Department of State to perfect its security interests in the 11 machines, it concedes that it did not notify Chase that it held a purchase money security interest in the 11 machines until shortly before this litigation began. Thus, Chase maintained on summary judgment that Absolute had failed to comply with these notice requirements and, therefore, failed to achieve priority status as a secured creditor.

Absolute responded to this argument in the trial court and on appeal by maintaining that it was not required by R.C. 1309.324(B) to give notice to Chase, because Liberty never received "possession" of the machines. The parties' primary dispute on appeal focuses on whether Liberty was in "possession" of the machines when it performed its engineering work on them at the Metaldyne facility.

Absolute maintains that "possession" requires actual physical possession and, because the 11 machines were never located on property owned by Liberty, Liberty never possessed the machines. Absolute cites no authority, however, to support such a narrow construction of the term "possession."

The term "possession" is not defined in R.C. Chapter 1309, nor do the parties point to any Ohio case law that explicitly resolves this dispute. It is a basic rule of construction that words should be given their reasonable ordinary meaning. Black's Law Dictionary (8th Ed.2004) 1201 defines "possession" as "[t]he fact of having or holding property in one's power; the exercise of dominion over property." Absolute cites case law

from other jurisdictions that likewise focuses on the debtor's ability to exert physical control over the inventory. Absolute has failed to persuade this Court that "possession" also requires that the physical control be exerted at a location owned by the debtor. Although some case law focuses on actual, physical possession, it is the debtor's ability to physically control the inventory that is fundamental, not the place at which the debtor exerts that control.

The evidence was not disputed that Liberty exerted physical control over each of the 11 machines for a period of at least several weeks after they arrived at the Metaldyne facility in Greensboro. Although the original plan had been to ship the machines to Liberty's facility in New York, Douglas Woods, Liberty's then-president, testified that Metaldyne had a scheduling conflict with its customers and needed to rush Liberty's redesign work. In an effort to expedite delivery of the completed machines to Metaldyne, the machines were sent directly to Metaldyne's Greensboro facility and Liberty agreed to send its people there to modify the machines.

Liberty personnel came to the Greensboro Metaldyne facility where they spent weeks performing custom engineering work, which included programming the machines and adding tooling and fixtures. As Woods explained, although Liberty engineers would typically perform their work at Liberty's facility, "[t]he fact that it was [Metaldyne's] floor versus our floor just changed how our guys did the work." Although Woods could not recall exactly how long Liberty personnel worked on the machines at the Metaldyne facility, particularly because each machine required different modifications, he testified that it typically took approximately 16 weeks for Liberty personnel to complete these types of machine

modifications. Woods was certain that the Liberty employees were working on the 11 machines at the Metaldyne facility for at least several weeks.

Woods further explained that, although the machines were located at the Metaldyne facility, they were completely unusable by Metaldyne until Liberty had completed the reengineering work. Liberty considered each machine to be a "work in process" until the redesign work was completed. Gary Hugunine, Liberty's former chief financial officer, testified that, even though the machines were never at a facility owned by Liberty, Liberty treated them as inventory on its financial books. From the time that each machine arrived in California until Liberty completed its work on it, the machines were included as inventory on its financial books. After Liberty completed the work on each machine, Liberty transferred the asset on its books from inventory to accounts receivable.

Because the evidence was undisputed that Absolute failed to notify Chase of its purchase money security interest in the 11 machines before Liberty received possession of them, it failed to comply with the notice requirements of R.C. 1309.324 and Absolute's purchase money security interest did not have priority over Chase's blanket security interest in Liberty's inventory. Therefore, the trial court properly declared that Chase's security interest in Liberty's inventory had priority and that Chase was entitled to summary judgment on Absolute's claim against it.

3. Secured Party v. Buyer of Collateral

There are many different types of buyers. Some buyers are deemed as buyers in the ordinary course of business. Some buyers purchase goods from their neighbors or at a garage sale.

Other buyers purchase "hot" goods. Other buyers acquire the goods from someone who is not in the business of selling goods of that kind. Buyers may try to claim that they are "innocent" buyers. UCC-9 has rules for each type of buyer who purchases goods subject to a secured interest.

a. Secured Party v. Buyer in Ordinary Course of Business

The term "buyer in ordinary course of business" (BIOCB) is defined 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." UCC § 1-201(b)(9). The seller of the goods to the BIOCB often has acquired the goods either on credit or has granted a secured party a security interest in the goods. The secured party has most likely perfected its security interest by filing a financing statement with the Secretary of State where the debtor is deemed to be located. To facilitate the transactions between the BIOCB and the seller of goods subject to a security interest, UCC § 9-320(a) allows the BIOCB to take the goods free of the security interest created by the seller. Consequently, the BIOCB can buy the goods without any concern, the seller can sell more inventory, and the seller as the debtor can receive more revenue to pay off the debt, making the secured creditor happy and allowing more transactions to occur. The BIOCB takes free of the security interest created by the buyer's seller, even if the security interest is perfected and the buyer knows of its existence.

In addition, a buyer who purchases consumer goods from a neighbor or someone who buys goods for personal, family, or household purposes can take the goods free of existing security interests in the goods, if the secured party has not filed a

financing statement covering the goods. UCC § 9-320(b). However, if the secured party (a vendor, department store, appliance store, or electronic store) filed a financing statement when it sold the goods on credit to the neighbor for personal, family, or household purposes, then the individual who purchases the consumer goods from the neighbor takes the goods subject to the security interest. In other words, vendors of expensive consumer goods should file a financing statement covering the goods and a buyer should be careful when it buys goods from someone who is not in the business of selling goods of that kind.

The case below illustrates disputes concerning buyers who are not BIOCBs.

Hockensmith v. Fifth Third Bank

2012 WL 5969654 (S.D. Ohio 2012)

The dispute in this case centers on three vintage and very valuable Chevrolet Corvette automobiles, a 1967 project 435 Corvette, VIN# 194677S106186, a black 1967 Corvette Coupe, VIN# 194377S100405, and a white 1967 Corvette convertible, VIN# 194377S117307. The rival claimants for these cars are Plaintiff Randall Hockensmith, a citizen of Florida, and Defendant Fifth Third Bank ("Fifth Third"), a bank organized under the laws of the State of Ohio. The other important entity in this case is Performance Plus Motor Sports, Inc. ("Performance Plus"), which was a corporation formerly in the business of buying, restoring, and selling automobiles, particularly Corvettes.

Fifth Third provided floor plan financing to Performance Plus under an agreement dated August 3, 2007 ("Master Secured

Promissory Note"). As collateral for the loan, Performance Plus gave Fifth Third a security interest in a number of assets, including its inventory ("Dealer Floor Plan Agreement"). The Floor Plan Agreement defines "inventory" as:

> all now owned, or hereafter acquired, goods, supplies, wares, merchandises [sic], and other tangible personal property, including raw materials, work in progress, supplies and components, and finished goods, including but not limited to all new and used automobiles, trucks, vans and other motor vehicles, and all parts, accessories, additions or accessions thereto, whether held for sale or lease, or furnished or to be furnished under any contract for service, or used or consumed in business, and also including rents, issues, proceeds, products of and accessions to inventory, packing and shipping materials, and all documents of title evidencing any of the foregoing, whether negotiable or non-negotiable, representing any of the foregoing.

Fifth Third filed a U.C.C.–1 financing statement perfecting its security interest in Performance Plus's inventory on August 3, 2007.

Plaintiff is a self-described collector of classic and exotic automobiles. Although Plaintiff calls his car collecting activities a hobby, his affidavit and deposition reflect that he had an informal but nevertheless tangible business relationship with Performance Plus with respect to Corvettes. Noel Grace, the president of Performance Plus, would identify Corvettes he thought Plaintiff would be interested in buying. Plaintiff would send funds to Performance Plus, who would then buy the

Corvette on his behalf. Performance Plus would restore the Corvette to Plaintiff's specifications and then Performance Plus would sell the Corvette to another buyer on Plaintiff's behalf. Plaintiff and Performance Plus would split any profits resulting from the sale. Performance Plus usually retained Plaintiff's profits so they could be rolled into the purchase of another Corvette. On other occasions, Plaintiff and Performance Plus would simply trade one Corvette for another Corvette, or for another Corvette and cash. The rather ad hoc nature of the dealings between Plaintiff and Performance Plus is reflected in the convoluted provenance of the three Corvettes at issue in this case.

…

Performance Plus defaulted on its floor plan agreement with Fifth Third on or about August 2, 2009. At around this time, Grace informed Plaintiff that Fifth Third "was systematically putting him [Grace] out of business over his floor plan[.]" The Corvettes involved in this case were titled to Performance Plus at this time and were located on its premises. Plaintiff instructed Grace to transfer the titles to the three Corvettes to him immediately and move them from Performance Plus's property because "when they [Fifth Third] come in they're going to want everything and I don't want them having what's mine." Grace transferred the title to the three Corvettes to Plaintiff on August 10, 2009.

Grace, however, did not move the Corvettes from Performance Plus's property. Fifth Third obtained a judgment against Performance Plus on October 26, 2009. On December 21, 2009, Fifth Third executed its judgment against Performance Plus. The sheriff entered Performance Plus's property and

seized all the personal property there, including the three Corvettes. Plaintiff demanded that Fifth Third return the Corvettes to him, but Fifth Third has refused.

Plaintiff filed suit against Fifth Third in March 2011, asserting state law claims for replevin, conversion, and civil theft of the Corvettes. Fifth Third answered and filed counterclaims asserting that it has perfected security interests in the Corvettes and that Performance Plus's transfers of the Corvettes to Plaintiff violated its rights as a secured creditor. Fifth Third, therefore, seeks a judgment that it is entitled to liquidate the Corvettes and apply the proceeds to the obligations owed to it by Performance Plus. The Court has subject matter jurisdiction over this matter because the parties are diverse and the amount in controversy exceeds $75,000.

…

[*Legal Analysis*]

[A] security interest in motor vehicles being held as inventory is perfected by filing a U.C.C. financing statement on the debtor's inventory. Fifth Third perfected its security interest in Performance Plus's inventory by timely filing a U.C.C. financing statement. Therefore, a reasonable juror could conclude that Fifth Third has a perfected security interest in the Corvettes.

C. A Reasonable Juror Could Conclude that Plaintiff was not a Buyer of the Corvettes in the Ordinary Course of Business

Plaintiff argues that even if Fifth Third has a perfected security interest in the Corvettes, he was a buyer in the ordinary course of business of the Corvettes and, therefore, extinguished Fifth Third's security interest in them. A buyer of

goods in the ordinary course of business takes free of a perfected security interest in the goods created by his seller. Ohio Rev.Code § 1309.320(A). A "buyer in ordinary course of business" means:

> 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, other than a pawnbroker, in the business of selling goods of that kind. A person buys goods in the ordinary course if the sale to the person comports 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. A person that sells oil, gas, or other minerals at the wellhead or minehead is a person in the business of selling goods of that kind. A buyer in ordinary course of business may buy for cash, by exchange of other property, or on secured or unsecured credit, and may acquire goods or documents of title under a preexisting contract for sale. Only a buyer that takes possession of the goods or has a right to recover the goods from the seller under Chapter 1302 of the Revised Code may be a buyer in ordinary course of business. "Buyer in ordinary course of business" does not include a person that acquires goods in a transfer in bulk or as security for or in total or partial satisfaction of a money debt.

There are three problems with Plaintiff's contention that he was a buyer of the Corvettes in the ordinary course of business. First, although Plaintiff adduced evidence showing wire transfers of cash to Performance Plus, at least two of the

certificates of title indicate $0 as the purchase price of the car. In order to be a buyer in the ordinary course of business, however, the purchaser must give some value for the goods. See Ohio Rev.Code § 1301.201(B)(9) ("A buyer in ordinary course of business may buy for cash, by exchange of other property, or on secured or unsecured credit, and may acquire goods or documents of title under a preexisting contract for sale."); Ohio Rev.Code § 1302.01(A)(11) ("A 'sale' consists in the passing of title from the seller to the buyer for a price."); see also Ohio Rev.Code § 4505.07(B)(12) (requiring the purchase price of the motor vehicle to be reflected on the face of the certificate of title). Viewing the record in the light most favorable to Fifth Third, these certificates of title indicate that Plaintiff did not give value for at least two of the Corvettes. Additionally, as Fifth Third points out in its memorandum in opposition, Plaintiff has not adduced any bills of sale evidencing a purchase of the Corvettes from Performance Plus. A reasonable juror could conclude from these facts that Plaintiff did not give value to Performance Plus for the Corvettes.

Second, as Fifth Third correctly points out, Plaintiff never took possession of the Corvettes-indeed, he has never actually even seen them. Therefore, Plaintiff's failure to take possession of the Corvettes arguably disqualifies him from being a "buyer in the ordinary course of business." But see Ace Equip. Sales, Inc. v. H.O. Penn Mach. Co., Inc., 871 A.2d 402, 406 (Conn.Ct.App.2005) (buyer was buyer in the ordinary course of business, despite failure to take physical possession of rock crusher, because custom of the industry was not to take physical possession of heavy equipment because of prohibitive cost of transportation); In re Havens Steel Co., 317 B.R. 75, 87–88 (Bkrtcy.W.D.Mo.2004) (constructive possession sufficient to

confer “buyer in the ordinary course of business” status).

Plaintiff contends that he was a buyer in the ordinary course of business, even though he did not take actual possession of the Corvettes, because he had the right to take possession of the Corvettes from Performance Plus. Plaintiff cites for this proposition § 1301.201(B)(9) where it states that a purchaser may be a buyer in the ordinary course of business when he has “the right to recover the goods from the seller.” A full reading of this clause, however, shows that it is not conferring buyer in the ordinary course of business status on a purchaser who has a generalized right to take possession of the goods, which is what Plaintiff argues. Rather, § 1301.201(B)(9) states that a purchaser may be a buyer in the ordinary course of business where he has “a right to recover the goods from the seller under Chapter 1302.” … In other words, according to these provisions, in order to be a buyer in the ordinary course of business without taking possession of the goods, the buyer must have the right to recover the goods from the seller under either U.C.C. 2–502 or U.C.C. 2–716.

In turn, U.C.C. § 2–502 provides the buyer a right to recover the goods where the seller repudiates the sales contract and maintains possession of goods after the buyer makes a down payment for goods. U.C.C. § 2–716 provides the buyer a right to specific performance or replevin of the goods upon breach of contract by seller. These sections are not applicable in this case, however, because Performance Plus did not retain possession of the Corvettes in breach of a contract to sell them to Plaintiff. Plaintiff is not a buyer in the ordinary course of business merely because he could have taken possession of the Corvettes from Performance Plus whenever he desired.

Third, a buyer in the ordinary course of business only takes free of a security interest created by his seller. Ohio Rev.Code § 1309.320(A). In this case, while the evidence shows that Performance Plus created the security interests in the Corvettes, Plaintiff did not buy the Corvettes from Performance Plus. Rather, the evidence shows that Performance Plus located sellers of Corvettes for Plaintiff and bought or traded for Corvettes from third-parties on his behalf. Stated another way, Performance Plus acted as Plaintiff's purchasing agent for the Corvettes. Plaintiff's affidavit in fact states that he bought Corvettes through Performance Plus and not from Performance Plus. Thus, the record shows that the actual sellers of the Corvettes to Plaintiff were third parties, not Performance Plus. Since Performance Plus, and not the actual sellers of the Corvettes, created the security interests in the Corvettes, Plaintiff was not a buyer of the Corvettes in the ordinary course of business from Performance Plus. While Plaintiff might be a buyer of the Corvettes in the ordinary course of business vis-à-vis the third parties, a reasonable juror could find that he was not a buyer of the Corvettes from Performance Plus in the ordinary course of business.

…

As just discussed, viewing the record in the light most favorable to Fifth Third, it has a valid and perfected security interest in the Corvettes entitling it to possession of the Corvettes by virtue of Performance Plus's default. Accordingly, Plaintiff is not entitled to an order of immediate possession of the Corvettes.

b. Secured Party v. Other Buyers (Buyers of Unauthorized Sales of Collateral)

UCC § 9-317(b) provides that a buyer of tangible chattel

paper, documents, goods, instruments, or a certificated security takes free of a security interest if the buyer gives value and receives delivery of the collateral without knowledge of the security interest and before it is perfected. Obviously, when the buyer makes the purchase from someone who is not authorized to sell the collateral, disputes occur with respect to whether the person buys the collateral in good faith and without knowledge that the sale violates the rights of another person in the collateral. See UCC § 1-201 (b)(9). If the secured party has filed its financing statement covering the collateral or perfected its security interests by other means before the person takes delivery of the collateral, the secured party has several remedies, as discussed in the two cases below.

Bishop v. Alliance Banking Co.

412 S.W.3d 217 (Ky. Ct. App. 2013)

Richard Bishop brings this appeal from a September 7, 2012, summary judgment of the Estill Circuit Court in favor of Alliance Banking Company (Alliance Bank). We affirm.

On September 10, 2010, Timothy and Candace Elkins executed and delivered a promissory note in the amount of $122,764.21 to Alliance Bank. The promissory note was partially secured by a 1999 Case Backhoe as collateral. In 2010, Alliance Bank filed a financing statement with the Kentucky Secretary of State's Office to perfect its security interest in the Case backhoe pursuant to Kentucky Revised Statutes (KRS) 355.9–310. In the financing statement, the collateral was particularly described as a 1999 Case Backhoe 580L with the serial number of 1100249697.

Eventually, the Elkins defaulted under the terms of the

promissory note. On December 20, 2010, Alliance Bank instituted an action against the Elkins for breach of the promissory note and to obtain possession of the Case backhoe. The Elkins failed to appear or otherwise defend against the action. By Judgment and Order of Possession entered September 6, 2011, the circuit court awarded Alliance Bank a judgment against the Elkins for $32,617.21 and attorney's fees of $1,500. The circuit court also adjudicated that Alliance Bank held a prior and superior perfected security interest in the Case backhoe and granted Alliance Bank possession of the backhoe.

Unbeknownst to Alliance Bank, the Elkins had sold the Case backhoe to appellant Richard Bishop on October 18, 2010. Upon learning of this transaction, Alliance Bank also discovered that Timothy Elkins had provided Alliance Bank with an incorrect serial number for the Case backhoe at the time of the filing of the financing statement. Timothy represented the serial number of the Case backhoe to be 1100249697; however, the actual serial number of the Case backhoe was JJG0249697.

On October 10, 2011, Alliance Bank filed a motion to amend its complaint and to add Bishop as a defendant in the action against Elkins. In the amended complaint, Alliance Bank again asserted it held a prior and perfected security interest in the Case backhoe and sought possession thereof. Alliance Bank subsequently filed a motion for summary judgment, asserting that Bishop was not a bona fide purchaser without notice because its security interest in the Case backhoe was properly perfected. Additionally, Alliance Bank claimed that the incorrect serial number on the financing statement did not affect the validity of the security interest. Conversely, Bishop argued that he was a bona fide purchaser of the Case backhoe and did not have notice of Alliance Bank's security interest

because of the erroneous serial number set forth in the financing statement. Bishop argued that he purchased the Case backhoe in good faith, for value, and without knowledge of Alliance Bank's security interest thereon.

…

Bishop contends that the circuit court erred by determining that the financing statement sufficiently described the Case backhoe and that Alliance Bank held a perfected security interest in the Case backhoe. For the following reasons, we disagree.

Under the Kentucky Uniform Commercial Code (U.C.C.), a description of collateral is sufficient "if it reasonably identifies what is described" in the financing statement or security agreement filed with the Secretary of State. KRS 355.9–108(1)…. [T]he financing statement did correctly describe the collateral as a 1999 Case backhoe 580L. Upon these facts, we agree with the circuit court that the description of the Case backhoe was sufficient to have placed Bishop on notice, and when aided by further inquiry, he could have sufficiently identified the Case backhoe he purchased from the Elkins as the same collateral described in Alliance Bank's financing statement.

…

Bishop also argues in his brief and at oral argument that he contacted the Powell County Clerk and was told that there were no recorded liens against the Case backhoe. First, the Powell County Clerk would not be the proper location for filing a financing statement to perfect a security interest in equipment in Kentucky. Upon the revised Article 9 of the U.C.C. becoming effective in 2001, the proper place for filing a financing statement where the U.C.C. controls is the office of the

Kentucky Secretary of State. KRS 355.9–501(1)(b). Alliance Bank's financing statement was properly filed with the Kentucky Secretary of State and Bishop's reliance on any representations from the Powell County Clerk was misplaced, contrary to law, and otherwise did not create a disputed issue of material fact in this case, even if the county clerk checked the Secretary of State's records for Bishop.

Thus, we conclude that Alliance Bank held a prior and perfected security interest in the Case backhoe. Upon purchasing the Case backhoe from Elkins on October 10, 2010, Bishop was placed on notice as a matter of law of Alliance Bank's perfected security interest and thus was not a bona fide purchaser without notice of the security interest in the Case backhoe. Bishop had a duty to inquire further regarding the bank's lien claim in the backhoe, which in this case, he failed to do. The fact that Bishop may have contacted the Powell County Clerk does not satisfy this inquiry.

…

For the foregoing reasons, the summary judgment of the Estill Circuit Court is affirmed.

****

A buyer of an unauthorized sale of collateral may face a conversion claim asserted by the secured party, as shown in the case below.

Beach Community Bank v. Disposal Services

199 So.3d 1132 (Fla. Dist. Ct. App. 2016)

Appellant, Beach Community Bank (Beach), appeals the trial court's order granting final summary judgment in favor of

Appellee, Disposal Services, LLC (Disposal), with respect to Beach's claim of conversion….

Beach is the successor in interest of creditors that made loans to Solid Waste Haulers of Florida (Debtor), which were secured by 308 roll-off containers (Containers) worth a total of $400,800. The original creditor properly filed a UCC–1 with the Florida Secretary of State perfecting its security interest in the Containers. Through a series of transactions, and without notice to Beach, Debtor sold the Containers to Disposal; however, Debtor did not apply the sale proceeds to the loans and subsequently defaulted on its loan obligations to Beach. Following Disposal's acquisition of the Containers and Debtor's default on the loans, Beach made written demand to Disposal for either repayment of the loans in full or return of the Containers. When Disposal neither paid Beach nor returned the Containers, Beach filed a complaint against Disposal alleging that Disposal converted the Containers.

…

Generally, before a conversion can occur when a party was previously in rightful possession of another's property, the following three factors must be present: first, the party in possession must be informed that continued possession of the property is no longer permitted; second, the rightful owner must demand the return of the property; and third, the party holding the property must fail to comply with the demand. Black Bus. Inv. Fund, 178 So.3d at 937. In the context of secured transactions, once default has occurred, a secured creditor has the right to possess the collateral and is authorized to take possession of the collateral. Spellman v. Indep. Bankers' Bank of Fla., 161 So.3d 505, 508 (Fla. 5th DCA 2014)….

Here, the following six facts were pled by Beach in its complaint and not refuted in Disposal's motion for summary judgment: (1) Debtor borrowed $400,800, giving the Containers as security for the loan; (2) Beach, as the successor in interest of the creditor that made the loan, has a valid and enforceable lien in the Containers; (3) without Beach's authorization, Debtor sold the Containers to Disposal; (4) sometime after the unauthorized sale, Debtor defaulted on its loan; (5) after becoming aware of the sale of the Containers, Beach demanded that Disposal either turn over the Containers or pay the balance of the loan in full; and finally (6) Disposal failed to comply with Beach's demand. Taken as true, these allegations are sufficient to plead an actionable claim for conversion.

Regardless of whether Disposal acquired rightful possession of the Containers when it purchased them from Debtor, once the Debtor defaulted on its loan obligations, Beach gained the right to possess the Containers as collateral securing the debt. Once Beach informed Disposal that Beach was a creditor with rights to possess the Containers and demanded their return, Disposal had the opportunity to comply with the proper demand. By refusing to comply with Beach's lawful demand, Disposal took an overt action inconsistent with Beach's possessory rights, thereby completing the necessary elements for a claim of conversion.

When an unauthorized disposition of collateral occurs, a secured party has numerous cumulative remedies at its disposal; it is not forced to elect a single remedy. See Taylor Rental Corp. v. J.I. Case Co., 749 F.2d 1526, 1529 (11th Cir.1985). Furthermore, merely because Disposal still has the Containers in its possession and can return them to Beach does not preclude Beach from pursuing conversion. See Seibel v. Soc'y

Lease, Inc., 969 F.Supp. 713, 719 (M.D.Fla.1997) (holding that debtor's petition alleging that repossession agency wrongfully took their truck and had control over it for period of time stated cause of action under Florida law for conversion, even though agency did not permanently deprive debtors of their truck and returned it in the same condition as it was at the time of repossession); Mayo v. Allen, 973 So.2d 1257, 1258 (Fla. 1st DCA 2008) (noting the well-settled principle that "conversion is an unauthorized act which deprives another of his property permanently or for an indefinite time"). Here, once Disposal failed to comply with Beach's demand to either return the Containers or repay the balance of the loan, the alleged act of conversion was complete.

4. Secured Party v. Bankruptcy Trustee

Filing the financing statement covering the collateral protects the secured party in circumstances where the debtor is in dire financial condition after the secured party and the debtor have already entered into an enforceable secured transaction. If the debtor or its creditors files for bankruptcy, the secured party's perfected security interest via filing has priority over the bankruptcy trustee's interest in the collateral. UCC § 9-317(a)(2) and (e). The "lien creditor" referred to in the statutory provision is the bankruptcy trustee, a hypothetical lienor.

A few words about bankruptcy – a debtor can commence a voluntary bankruptcy case by filing a petition for liquidation under chapter 7 or reorganization under chapter 11. Chapter 13 covers individual bankruptcy and chapter 9 municipal bankruptcy. The debtor's creditors can force the debtor into bankruptcy by filing an involuntary bankruptcy petition. Generally, a debtor-in-possession in chapter 11 or a trustee in

other bankruptcy chapters will be appointed to manage the estate. When a bankruptcy petition is filed, all of the debtor's legal or equitable interests in property held on that date become property of the debtor's bankruptcy estate. See 11 U.S.C. § 541.The trustee has the power to avoid any transfer of property of the debtor that is voidable by a creditor who obtains a judicial lien on the debtor's property as of the commencement of the case. 11 U.S.C. §§ 544 and 541. The case below illustrates the importance of attachment and perfection by filing the financing statement before the debtor commences bankruptcy.

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***In re* Cable's Enterprise, LLC**

2015 WL 9412805 (Bankr. M.D.N.C.2015)

Under the Uniform Commercial Code as adopted by the state of North Carolina, a security interest attaches when it becomes enforceable against the debtor. A security interest becomes enforceable when: (a) value has been given; (b) the debtor has rights in the collateral; and (c) the debtor has authenticated a security agreement that provides a description of the collateral, or "[t]he collateral ... is in the possession of the secured party … pursuant to the debtor's security agreement[.]"

In this case, it is undisputed that the Defendant gave value to the Debtor in the sum of $9,920 on April 18, 2014. It is also undisputed that the Debtor has rights in the Excavator. Both parties further stipulated that the Debtor failed to authenticate a security agreement in support of the loan. Nevertheless, from early 2014 until the Court entered the Turnover Order, the Excavator remained in the Defendant's possession. Per the agreement of the parties, the Excavator acted as a pledge for the

repayment of the loan. Thus, the Defendant's security interest in the Excavator attached on the date of the parties' agreement, April 18, 2014….See19 Williston on Contracts § 53:43 (4th ed.) ("Because possession operates to provide a good substitute for the evidentiary role that a written security agreement plays, ... the [Commercial] Code [does not] require[] a written and signed ... security agreement where attachment, enforceability and perfection occur through possession....").

Because (1) the Defendant's security interest attached on April 18, 2014, and (2) the Defendant was in possession of the Excavator at this time, the interest may not be avoided in this case under 11 U.S.C. §§ 544 and 541.

Section 544(a) provides that the trustee or debtor-inpossession "may avoid any transfer of property of the debtor" that is voidable by a creditor who obtains a judicial lien on the debtor's property as of the commencement of the case, "whether or not such a creditor exists."Under North Carolina law, "conflicting perfected security interests ... rank according to priority in time of filing or perfection." N.C. Gen.Stat. § 25–9–322(a)(l). In this case, the Defendant's security interest attached and was perfected by possession on April 18, 2014. A hypothetical creditor with a judicial lien on the debtor's property as of the commencement of the case, July 9, 2014, would not be able to avoid this prior, perfected interest. Therefore, the Defendant's claim of lien may not be avoided under 11 U.S.C. §§ 544 and 541.

****

When a bankruptcy petition is filed, an automatic stay on all transactions and proceedings occurs. A secured party can seek relief from the stay by obtaining permission from the

Bankruptcy Court to lift the automatic stay for the purpose of foreclosing the secured party's security interest in the collateral. The Bankruptcy Court will grant the relief if the secured party can show "for cause", including the lack of adequate protection, in chapter 7 cases. 11 U.S.C. § 362(d)(1). Lack of adequate protection for the secured party's security interest in the collateral is the common "for cause" reason. If the secured creditor has a claim allowable under 11 U.S.C. § 507(a)(2), the secured creditor would have an administrative expense claim under § 503(b).

The secured creditor in the case below, who was oversecured (more collateral than needed to cover the debt amount at the bankruptcy petition date), sought "adequate protection" for the debt, costs, and fees. The secured creditor filed a motion in the Bankruptcy Court requesting "a superpriority administrative expense claim" for up to the value of its post-petition interest, costs, and fees. The secured party argued that the debtor's use of its accounts receivable (the collateral) during the debtor-in-possession period diminished the value of those accounts (collateral) such that the secured party no longer had an adequate equity cushion from which it could fully recover its expenses allowed under § 506(b).

***In re* Construction Supervision Services, Inc.**

2016 WL 2764328(E.D. N.C. 2016)

This matter is before the court on appeal by Branch Banking and Trust Company ("BB&T") from an order of the United States Bankruptcy Court for the Eastern District of North Carolina denying BB&T's motion for a "superpriority" administrative expense claim, made pursuant to 11 U.S.C. §

507(b); and BB&T's motion for post-petition interest, costs, and fees, including reasonable attorney's fees, made pursuant to 11 U.S.C. § 506(b).

BACKGROUND

A. Preliminary Proceedings in the Bankruptcy Court

On January 24, 2012 (sometimes the debtor's "petition date"), debtor, Construction Supervision Services, Inc., filed a voluntary petition for relief under Chapter 11 of the United States Bankruptcy Code, seeking reorganization. BB&T filed four claims against the estate totaling $1,265,868.55 in principal debt and matured interest as of the petition date. Those claims were secured by certain security agreements, a UCC financing statement, and a deed of trust. As relevant to this case, BB&T held a security interest in the debtor's accounts receivable, which were valued at $5,514,574.50 as of the petition date….

Also on January 24, 2012, the debtor filed a emergency motion requesting the authority to use the cash collateral in its possession to assist in its reorganization efforts, pursuant to 11 U.S.C. § 363 (the "first cash collateral motion"). The debtor admitted that it owed at least $1,236,107.00 to BB&T; however, it contended that it was entitled to use its cash collateral because BB&T's debt was secured by property "valued far in excess of the [debtor's] obligation." On January 26, 2012, BB&T opposed the debtor's first cash collateral motion and argued that its interest in the debtor's cash collateral, specifically its interest in the debtor's accounts receivable, was not "adequately protected," because "a substantial portion of the Debtor's accounts receivables are aged beyond 60 days or consist of retainage." In the alternative, BB&T argued that, if the court were to grant the debtor's motion, it was entitled to monthly

adequate protection payments to preserve its interest in the debtor's cash collateral. (Id.).

The bankruptcy court immediately conducted a hearing on the debtor's first cash collateral motion and, on January 31, 2012, granted the motion. However, the bankruptcy court found that BB&T's interest in the debtor's accounts receivable was not adequately protected and ordered the debtor to "make an adequate protection payment to BB&T in the amount of $5,000 by February 15, 2012." In addition, the bankruptcy court stated that "[t]o the extent that the adequate protection granted to ... BB&T herein is insufficient, ... BB&T shall be entitled to priority under 11 U.S.C. § 507(b)."

Between January 31, 2012, and September 14, 2012, the bankruptcy court granted eight additional cash collateral motions…. The court ordered the debtor to pay to BB&T adequate protection payments in various amounts, ranging from $5,000.00 to $10,000.00. The debtor's adequate protection payments totaled $62,900.00 over the relevant period.

B. Intervening Senior Liens

Meanwhile, by March 2012, various subcontractors and material providers (collectively "subcontractors") had filed claims against the debtor's estate. These subcontractors admitted that they had not perfected their various liens against the debtor, but, nevertheless, argued they had a sufficient "interest" in estate's property such that an exception to the bankruptcy code's automatic stay provision allowed them to perfect that interest post-petition. See generally 11 U.S.C. § 362(a)(4) (bankruptcy stays creditor's ability to perfect a lien in property); §§ 362(d)(3) & 546(b) (allowing limited exception to § 362(a)(4), where certain creditors have a pre-petition "interest in

property" arising under state law). On March 14, 2012, over BB&T's objection, the bankruptcy court allowed the subcontractors to serve the debtor with notice and thereby perfect their security interests. SeeIn re Constr. Supervision Servs., Inc., 8:12–BK–569, 2012 WL 892217, at *1 (Bankr. E.D.N.C. 2012), aff'd sub nom.Branch Banking & Trust Co. v. Constr. Supervisions Servs., Inc., (In re Constr. Supervision Servs., Inc.), 753 F.3d 124 (4th Cir. 2014). These liens were given priority over BB&T's secured claim in the debtor's accounts receivable under North Carolina law. See generally N.C. Gen. Stat § 44A–18.

C. Conversion, Payment of BB&T's Claim, and Subsequent Expense Litigation

From January 31, 2012 until October 1, 2012 (the "debtor-in-possession period"), the debtor used its accounts receivable to assist in its attempted reorganization. Between February 2012 and July 2012, the debtor made both credits and debits to its accounts receivable. As a result, the value of the debtor's accounts receivable, in which BB&T and the various subcontractors held perfected security interests, fluctuated. For example, in February 2012, the value of the debtor's accounts receivable reached its apex, $4,724,222.00. Later, in July 2012, the value of the debtor's accounts receivable reached its lowest point, $4,065,457.86. However, no discernable downward trend was evident over the relevant period of time.

On October 1, 2012, the bankruptcy court entered an order not approving the debtor's disclosure statement and supplemental disclosure statement, pursuant to 11 U.S.C. § 1125, thereby impairing the debtor's ability to propose a successful plan of reorganization. Following this setback, also

on October 1, the debtor voluntarily converted this case to one under Chapter 7 of the bankruptcy code, seeking liquidation of its assets. On October 5, 2012, appellee, Stephen L. Beaman (the "Trustee"), was appointed the Chapter 7 Trustee for this case. Over approximately the next year, the Trustee liquidated the debtor's assets. That liquidation brought BB&T, in addition to the $62,900.00 in adequate protection payments received from the debtor, $1,237,836.79, resulting in a total of $1,300,736.79 paid to BB&T from the debtor's estate. That amount exceeded BB&T's petition date claim by $34,868.24, leaving it with an "equity cushion" of that amount. BB&T applied its equity cushion toward its post-petition interest, costs, and fees, including attorney's fees. 11 U.S.C. § 506(b).

On October 31, 2013, BB&T filed a motion in the bankruptcy court requesting a superpriority administrative expense claim for up to the value of its post-petition interest, costs, and fees (the "superpriority motion," which requested a "superpriority claim"), pursuant to 11 U.S.C. § 507(b). BB&T argued that it was entitled to a superpriority claim for those expenses, where the debtor's use of its accounts receivable during the debtor-in-possession period diminished the value of those accounts such that BB&T no longer had an adequate equity cushion from which it could recover fully its expenses allowed under § 506(b)….

BB&T timely appealed the bankruptcy court's order, pursuant to Federal Rule of Bankruptcy Procedure 8003. This court has jurisdiction pursuant to 28 U.S.C. § 158(a)(1).

COURT'S DISCUSSION

A. Standard of Review

This court reviews the bankruptcy court's legal determinations

de novo….

B. The Bankruptcy Court Appropriately Denied BB&T's Superpriority Motion

The first issue on appeal is whether BB&T may rely on a superpriority claim to recoup its petition date equity cushion insofar as that equity cushion no longer exists in an amount sufficient to cover all of BB&T's post-petition interest, costs, and fees where BB&T otherwise would be entitled to such expenses, but where it recovered fully the principal debt and matured interest owed to it as of the petition date. As set forth below, the court holds that BB&T may not recoup its equity cushion for the purpose of recovering such expenses through a superpriority claim. The adequate protection payments provided to BB&T were not "inadequate," where BB&T recovered fully the principal debt and matured interest owed to it as of the petition date.

In the alternative, the court holds that BB&T failed to show it was entitled to a superpriority claim in light of the intervening subcontractors' liens. BB&T did not demonstrate that the collateral securing the debtor's obligation declined in value as a result of the debtor's beneficial use of such collateral during the debtor's Chapter 11 case. Moreover, BB&T is not entitled to recovery in the form of a superpriority claim for any diminution in the value of the collateral securing the debtor's obligation that occurred following the debtor's conversion of its case.

1. Statutory Framework

The purpose of a "superpriority" claim may be summarized as follows. In certain circumstances, a creditor, the value of whose petition date secured claim is negatively affected by the trustee or debtor's use of the collateral securing

the debtor's obligation, may be granted a “first priority” claim, senior to all but a select few other claims, to recoup its petition date secured claim up to the petition date value of principal debt and matured interest owed to it by the debtor. See generally Collier on Bankruptcy ¶ 507.14 (Alan N. Resnick & Henry J. Sommer eds., 16th ed.); see also generally § 507(a)(2) & (b). The requirements for a superpriority claim are governed by the bankruptcy code. Section 507(b) provides:

> If the trustee [or debtor-in-possession], under section 362, 363, or 364 of this title, provides adequate protection of the interest of a holder of a claim secured by a lien on property of the debtor and if, notwithstanding such protection, such creditor has a claim allowable under [11 U.S.C. § 507(a)(2)] arising from the stay of action against such property under section 362 of this title, from the use, sale, or lease of such property under section 363 of this title, or from the granting of a lien under section 364(d) of this title, then such creditor's claim under such subsection shall have priority over every other claim allowable under such subsection.

11 U.S.C. § 507(b). The Fourth Circuit has distilled this statute into three requirements. See Ford Motor Credit Co. v. Dobbins (In re Dobbins), 35 F.3d 860, 865 (4th Cir. 1994). “First, adequate protection must have been provided previously, and the protection ultimately must prove to be inadequate.” Id. “Second, the creditor must have a claim allowable under § 507(a)[(2)] (which in turn requires that the creditor have an administrative expense claim under § 503(b)).” Id. “And third, the claim must have arisen from either the automatic stay under

§ 362; or the use, sale or lease of the collateral under § 363; or the granting of a lien under § 364(d)." Id.

2. The "Value" of BB&T's "Interest" in The Debtor's Accounts Receivable Was Adequately Protected

A superpriority claim first requires that the "value" of a creditor's "interest" in the collateral be impaired. The relevant "interest" to be protected is the value of the creditor's "secured claim," as that concept is defined by § 506(a)(1). Thus, the relevant "interest" to be protected is not necessarily the value of the collateral. Nor does the relevant "interest" include any "unsecured claim," as an "unsecured" claim does not represent an "interest ... in property."

Under no circumstance may the "value" of creditor's "interest" to be adequately protected exceed the value of the principal debt and matured interest owed to the creditor as of the petition date. Generally, an oversecured creditor is allowed post-petition expenses, such as those listed in § 506(b), as part of its secured claim. However, such expenses are allowed only "to the extent" of the creditor's oversecurity. In the Fourth Circuit, as elsewhere, the extent of that oversecurity is gauged at or near the end of the case. See Dobbins, 35 F.3d at 870. Thus, including post-petition expenses in the basket of "interests" to be adequately protected is incongruent with the text and operation of the bankruptcy code.

Put differently, "adequate protection" payments ensure stability in the petition-date "value" of a creditor's "secured claim." *See Timbers*, 484 U.S. at 372 (reasoning that the "value" of a creditor's "claim" in § 506(a)(1) and "value" of a creditor's "interest in property" in § 361 are the same). The value of that claim is the lesser of the value of the collateral or the principal

debt and matured interest owed the creditor as of the petition date. *See* § 506(a)(1); *Timbers*, 484 U.S. at 372 (stating that, in the case of an undersecured creditor, the "'value of [a] creditor's interest' ... means 'the value of the collateral'"); *see also* S.Rep. No. 95–989, p. 68 (1978); H.R.Rep. No. 95–595, pp 181, 356 (1977).

Applied in the context of this case, BB&T, an oversecured creditor as of both the petition date as well as the date on which it requested adequate protection, was awarded adequate protection payments to compensate it in the event that the debtor's accounts receivable depreciated to such an extent that the value of the collateral sank below the value of the principal debt and matured interest owed to BB&T as of the petition date. In the language of § 361 and § 506(a)(1), BB&T was awarded adequate protection to prevent any portion of its allowed, oversecured petition date claim from becoming unsecured. See § 506(a)(1). Had the debtor's adequate protection payments failed BB&T, BB&T would have become an undersecured creditor. That did not happen here; thus, BB&T's superpriority motion appropriately was denied.

BB&T assumes that the "value" of its "interest" in the debtor's accounts receivable more properly is calculated as the value of those accounts receivable, either on the petition date or on the date its requested adequate protection payments. (Appellant's Br., DE 21, 18–23) (equating the decline in the value of BB&T's interest as the decline in the value of the debtor's accounts receivable). This notion apparently comes from Timbers, where the Court, in dicta, defined the "value" of an "[undersecured] creditor's interest [in property]" as "the value of the collateral. Timbers, 484 U.S. at 372. However, BB&T's assumption does not withstand scrutiny. That definition does not make sense in every case. In particular, it

cannot be applied where the creditor is oversecured at the time the interest to be protected is valued, as BB&T was in this case.

For example, equating the value of an oversecured creditor's “interest” or “claim” in an item of collateral with the value of the collateral securing the debtor's obligation is inconsistent with the text of the bankruptcy code. If the value of the collateral were the only germane consideration in assessing the value of a creditor's secured claim, much of § 506(b) would be superfluous; that statute refers separately to both the value of the oversecured creditor's claim and the value of the collateral. *See* § 506(b). If Congress had intended the value of a creditor's claim to be measured by the value of the collateral securing the debtor's obligation in every case it would have said so.

The bankruptcy code's legislative history also supports valuing differently an oversecured or fully secured creditor's claim, as opposed to an undersecured creditor's claim. The legislative history is relatively clear that the value of an undersecured creditor's claim, and thus the “value” of its “interest” in the collateral securing the debtor's obligation, is the value of that collateral itself. See H.R.Rep. No. 95–595, p. 180–81; see also § 506(a)(1) (“undersecured” creditor has secured claim up to the value of the collateral securing the debtor's obligation). The legislative history lauds the bifurcation of undersecured creditors' claims as a major advancement in bankruptcy law. By contrast, the relevant legislative history never ties the “value” of an oversecured creditor's claim to the value of the collateral securing the debtor's obligation.

Moreover, if the value of an oversecured creditor's secured claim was equivalent to the value of the collateral securing the debtor's obligation, such a construction would lead to an

absurd result. See Stone v. Instrumentation Lab. Co., 591 F.3d 239, 243 (4th Cir. 2009) (noting courts should interpret statutes so as to avoid an "absurd result"). Under BB&T's view, an oversecured creditor always is entitled a superpriority claim to assist in the collection of its post-petition interest, costs, and fees where the debtor's post-petition use of the collateral depreciates its value, irrespective of whether that creditor has recovered fully the principal debt and matured interest owed to it as of the petition date. However, such a construction unfairly impairs the ability of undersecured or unsecured creditors to recover on their claims; the unencumbered assets of the already depleted estate would need to be funneled toward the mounting post-petition interest, costs, and fees of the oversecured creditor in order to restore its equity cushion to an extent that allowed that creditor to recover its post-petition interest, costs, and fees.

In sum, BB&T is not entitled to a superpriority claim under § 507(b), because its adequate protection payments were not inadequate. From January 31, 2012, until present, the value of BB&T's secured claim was never altered. Thus, as the bankruptcy court put it, BB&T "recovered exactly what it [was] entitled to ... principal, interest, and various fees totaling $1,265,868.55, the full amount of its prepetition claim." Accordingly, the court affirms the bankruptcy court's order insofar as it denied BB&T's superpriority motion.

****

Bankruptcy law entrusts the trustee with the avoidance power. Under 11 U.S.C. § 547(b), the trustee may avoid any transfer of an interest of the debtor in property

(1) to or for the benefit of a creditor;

(2) for or on account of an antecedent debt owed by the debtor before such transfer was made;

(3) made while the debtor was insolvent;

(4) made—

(A) on or within 90 days before the date of the filing of the petition;

*****

(5) that enables such creditor to receive more than such creditor would receive if—

(A) the case were a case under chapter 7 of this title;

(B) the transfer had not been made; and

(C) such creditor received payment of such debt to the extent provided by the provisions of this title.

In other words, the trustee can avoid a transfer of an interest (that includes the grant of a security interest) of the debtor in property within 90 days before the filing of the bankruptcy petition that allowed the creditor to receive more than what it would have received in a hypothetical chapter 7 proceeding.

The next case is a typical situation where the secured party had a perfected security interest in the inventory that was subsequently sold and the proceeds became commingled with other funds in the debtor's bank accounts. The debtor subsequently filed for Chapter 7 bankruptcy. The Fourth Circuit relied on 11 U.S.C. §547(b)(5), stating that that provision "is not concerned with whether the preference payments can be traced to the proceeds of the collateral; rather that section calls for a comparison of the amount of the preference payments to

the amount the creditor would receive in a hypothetical Chapter 7 proceeding." The Circuit emphasized that a secured creditor's perfected security interest in commingled proceeds is calculated differently in a bankruptcy proceeding than it is before the bankruptcy filing, "such as at the time of the preference payments." The secured creditor's reliance on the 11 U.S.C. §547(c) exceptions to preferences failed.

In re **JKJ Chevrolet, Inc.**

412 F.3d 545 (4th Cir. 2005)

In 1991, a number of car dealerships owned and controlled by John W. Koons, Jr., filed bankruptcy petitions under Chapter 11 of the Bankruptcy Code. J.A. 561. The consolidated proceedings were subsequently converted to a Chapter 7 case with Richard Hall serving as trustee. Id. Hall commenced an adversary proceeding against Chrysler Credit to recover alleged "preference payments" made to Chrysler Credit by three of the debtor-dealerships, Koons Chrysler Plymouth, Inc. ("Koons"), Brandnewco, Inc., and JKJ Chrysler Plymouth, Inc. ("JKJ CP"), prior to the filing of those dealerships' Chapter 11 petitions. Id. The bankruptcy court held that the trustee was entitled to recover the payments from JKJ CP but not from Koons or Brandnewco. The district court affirmed the bankruptcy court's judgment as to the Koons and the Brandnewco payments. The district court initially decided to remand the dispute pertaining to the JKJ CP payments, but ultimately certified that issue for interlocutory appeal. For the reasons set forth below, we vacate the judgment of the district court as to the Koons and Brandnewco payments, and we remand the entire case for further proceedings consistent with this opinion.

I.

The disputed payments in the instant case arose from a "floor plan" financing arrangement between Chrysler Credit and the debtor-dealerships. As the bankruptcy court explained, the Chrysler Credit floor plan agreement operated in the following way:

> 1) As vehicles were shipped to the dealerships, Chrysler [Credit] paid the manufacturer for them and added the cost of those vehicles to the dealerships' line of credit. 2) The purchased vehicles became additional collateral. Interest accrued on each vehicle until Chrysler was repaid the principal. 3) Repayment was due five days after a vehicle was sold, and a dealership received purchase funds.... 4) A dealership could continue to add vehicles to its inventory as long as it did not reach the maximum amount of its loan and was not in default. 5) As Chrysler received payment for each vehicle the loan amount was reduced, which made room for additional inventory. Under this arrangement, the collateral security and the loan balance were constantly moving up and down as vehicles were added to inventory and sold.

In the ninety days preceding the Koons and Brandnewco bankruptcies, Chrysler Credit was paid $6,462,585.70 by those dealerships pursuant to the floor plan financing agreement. J.A. 437. The trustee sought to avoid those payments under 11 U.S.C. § 547(b), which provides as follows:

> Except as provided in subsection (c) of this section, the trustee may avoid any transfer of an interest of

the debtor in property

(1) to or for the benefit of a creditor;

(2) for or on account of an antecedent debt owed by the debtor before such transfer was made;

(3) made while the debtor was insolvent;

(4) made—

(A) on or within 90 days before the date of the filing of the petition;

*****

(5) *that enables such creditor to receive more than such creditor would receive if*—

(A) the case were a case under chapter 7 of this title;

(B) *the transfer had not been made*; and

(C) *such creditor received payment of such debt to the extent provided by the provisions of this title*.

11 U.S.C. § 547(b) (emphasis added). Section 547(g) provides that "the trustee has the burden of proving the avoidability of a transfer under subsection (b)." The parties agreed that the payments in question satisfied the first four elements of section 547(b), confining their dispute to whether the trustee had established that the payments satisfied the requirements of (b)(5).

Chrysler Credit maintained that the disputed payments did not exceed what it would have received in a Chapter 7 proceeding because the funds that formed the basis of those payments were proceeds from the sale of vehicles and, as such, under Virginia law adopting the Uniform Commercial Code,

Chrysler Credit acquired a security interest in those proceeds. See Va.Code Ann. § 8.9–306(2) (repealed 2001) ("a security interest ... continues in any identifiable proceeds" from the sale of collateral). Under Chrysler Credit's view, if the disputed payments had not been made, it would have retained that security interest and received priority in that amount in any Chapter 7 proceeding. In other words, according to Chrysler Credit, its security interest at the time of the preference payments was the same as it would have been in a Chapter 7 proceeding and thus the amount of the preference payments did not exceed what it would have received in a Chapter 7 proceeding.

The trustee, on the other hand, maintained that Chrysler received more from the preference payments than it would have for its undersecured claims in a Chapter 7 proceeding. The trustee alleged that the payments to Chrysler Credit came from bank accounts where the proceeds from vehicle sales had been commingled with other funds and that, as such, under Virginia law, Chrysler Credit could not establish a perfected security interest in the funds unless it could "trace" the payments it received from Koons and Brandnewco to the proceeds from the sale of the vehicles. See Va.Code Ann. § 8.9–306(2) (repealed 2001) ("a security interest ... continues in any identifiable proceeds") (emphasis added). Under this theory, because Chrysler Credit could not establish that it did, in fact, have a perfected security interest in the commingled funds, Chrysler Credit would have received far less in a Chapter 7 proceeding than it received from the pre-petition payments.

The bankruptcy court determined that the proceeds had been commingled, and that Chrysler Credit would normally bear the burden of "tracing" to establish a perfected security

interest in the commingled proceeds under the UCC and other state law, J.A. 493. The bankruptcy court concluded, however, that section 547(g) supplanted the state law burden of proof, expressly placing it on the trustee, and that the trustee had failed to satisfy that burden because he could not establish that the funds that formed the basis of the preference payments were not proceeds from the sale of collateral. J.A. 497. Because the trustee could not disprove the existence of Chrysler Credit's security interest, he could not establish that Chrysler Credit would have received less in a Chapter 7 proceeding. Id. The district court affirmed the bankruptcy court's judgment. J.A. 552–53 ("Tracing is a method for the Trustee to carry its burden; by tracing the funds, the Trustee may show that the transfers did not come from the secured creditor's collateral in the commingled account. The bankruptcy court correctly held that the trustee failed" to carry this burden.).

The parties and the lower courts are correct that section 547(b) calls for a comparison between the amount that Chrysler Credit received in alleged preference payments and the perfected security interest that it would have enjoyed in a Chapter 7 proceeding. See Hager v. Gibson, 109 F.3d 201, 210 (4th Cir.1997) ("Section 547(b) ... protects only those creditors, secure or unsecured, who can establish that they received no more by the payment than they would have received as claimants in a Chapter 7 liquidation."). The parties and lower courts are also correct that state law determines the extent of the perfected security interest that Chrysler Credit would enjoy in a Chapter 7 proceeding. See Butner v. United States, 440 U.S. 48, 55 (1979) (holding that "[u]nless some federal interest requires a different result," "property interests [in bankruptcy proceedings] are created and defined by state law."); In Re: The

Wallace & Gale Co., 385 F.3d 820, 830 (4th Cir.2004). But both the parties and lower courts are incorrect in asserting that the "tracing" principles that would have determined Chrysler Credit's perfected security interest at the time of the preference payments are relevant to the trustee's claims. Section 547(b)(5) is not concerned with whether the preference payments can be traced to the proceeds of collateral; rather that section calls for a comparison of the amount of the preference payments to the amount the creditor would receive in a hypothetical Chapter 7 proceeding. And, more importantly, a secured creditor's perfected security interest in commingled proceeds is calculated differently in an insolvency proceeding, such as a case under Chapter 7, than it is before the instigation of insolvency proceedings, such as at the time of the preference payments. Thus, the amount Chrysler Credit would have received in a Chapter 7 proceeding cannot be determined by reference to any security interest Chrysler Credit might have enjoyed at the time of the preference payments.

In a Chapter 7 proceeding, hypothetical or otherwise, the determination of Chrysler Credit's security interest in proceeds from the sale of collateral would have been determined by Va.Code Ann. § 8.9–306(4) (repealed 2001), which provided as follows:

> *In the event of insolvency proceedings instituted by or against a debtor, a secured party with a perfected security interest in proceeds has a perfected interest only in the following proceeds:*
>
> (a) in identifiable non-cash proceeds and in separate deposit accounts containing only proceeds;
>
> (b) in identifiable cash proceeds in the form of

money which is neither commingled with other money nor deposited in a deposit account prior to the insolvency proceedings;

(c) in identifiable cash proceeds in the form of checks and the like which are not deposited in a deposit account prior to the insolvency proceedings; and

(d) *in all cash and deposit accounts of the debtor in which proceeds have been commingled with other funds, but the perfected security interest under this paragraph (d) is*

> *(i) subject to any right to set-off; and*
>
> (ii) *limited to an amount not greater than the amount of any cash proceeds received by the debtor within ten days before the institution of the insolvency proceedings less the sum of (I) the payments to the secured party on account of cash proceeds received by the debtor during such period and (II) the cash proceeds received by the debtor during such period to which the secured party is entitled under paragraphs (a) through (c) of this subsection (4).*

Va.Code Ann. § 8.9–306(4) (repealed 2001) (emphasis added); see also In Re Bumper Sales, Inc., 907 F.2d 1430, 1438 (4th Cir.1990) (holding that section 9–306(4) "governs the extent of a creditor's interest in commingled proceeds only up to and including the instant of commencement of the insolvency proceedings" and thus "specifically deals with the cases in which funds are commingled prior to filing bankruptcy"). Because the bankruptcy court found that the trustee established that the debtor-dealerships commingled the proceeds of their vehicle sales with other funds, subsections (a) through (c) are

inapplicable. Accordingly, the extent of Chrysler Credit's security interest in a Chapter 7 proceeding in the funds commingled by the debtor-dealerships would have been exclusively determined by applying the formula set forth in section 8.9–306(4)(d), a formula that does not depend on identifying or tracing the proceeds of collateral.

As this comparison has never been performed, we vacate the judgment of the district court on this issue and remand the case so that the trustee may have an opportunity, consistent with his burden under section 547(g), to establish that Chrysler Credit received more from the pre-petition payments than it would have received in a Chapter 7 proceeding.

II.

As with Koons and Brandnewco, Chrysler Credit entered into a floor plan financing agreement with JKJ CP. In the ninety days preceding the JKJ CP bankruptcy, Chrysler Credit received $2,109,274.26 from JKJ CP. J.A. 243. Because Chrysler Credit failed to perfect its security interest pertaining to its financing arrangement with JKJ CP, J.A. 532, it conceded that the disputed payments were preferential as defined in section 547(b). Chrysler Credit maintained, however, that it was not obligated to return those payments because, subsequent to those payments, it continued to extend credit to JKJ CP. Chrysler contended that its subsequent extension of credit entitled it to the subsequent new value defense enumerated in section 547(c)(4), which provides as follows:

> *The trustee may not avoid under this section a transfer ... (4) to or for the benefit of a creditor, to the extent that, after such transfer, such creditor gave new value to or for the benefit of the debtor—(A) not secured by an otherwise*

unavoidable security interest; and (B) on account of which new value the debtor did not make an otherwise unavoidable transfer to or for the benefit of such creditor.

11 U.S.C. § 547(c)(4) (emphasis added). The bankruptcy court found that Chrysler Credit was not entitled to the defense because JKJ CP paid Chrysler Credit for its subsequent extensions of credit; in other words, it held that all of the new value was repaid by the debtor, thereby depriving Chrysler Credit of its section 547(c)(4) defense. J.A. 245 ("[T]he § 547(c)(4) defense is not available to a creditor that has received payment for the advances it contends represent subsequent new value."). In the view of the bankruptcy court and the trustee, subsequent new value must remain unpaid in order for a creditor to take advantage of the 547(c)(4) defense. See Kroh Brothers Development Co. v. Continental Construction Engineers, Inc., 930 F.2d 648 (8th Cir.1991) ("The debtor who makes a preferential transfer to a creditor who subsequently advances new value ... has not depleted the bankruptcy estate to the disadvantage of other creditors.... But when a debtor pays for new value ... there is in effect no return of the preference.").

The district court rejected the bankruptcy court's interpretation of section 547(c)(4). It determined that "the requirement that the new value remain unpaid is inaccurate and confusing paraphrase" and that "the proper inquiry is whether the new value has been paid for by an 'otherwise unavoidable transfer.'" While the district court initially indicated it would remand the case for a determination of "whether JKJ CP made otherwise unavoidable transfers to Chrysler Credit," it ultimately certified the dispute pertaining to the proper interpretation of section 547(c)(4) for interlocutory appeal.

The district court's initial interpretation of the statute was correct. A creditor is entitled to offset preference payments through the extension of new value to the debtor so long as the debtor does not make an otherwise unavoidable transfer on account of the new value. Thus, even if JKJ CP repaid all of the new value, under the plain terms of the statute whether those payments deprive Chrysler Credit of its new value defense depends on whether the payments were otherwise unavoidable. Appellant appears to concede that the trustee could have—but did not seek to—avoided these payments during the bankruptcy proceedings. Appellant's Br. at 34. Notwithstanding this concession, appellant nevertheless maintains that because the trustee did not in fact seek to avoid the payments and because the time has passed for such a challenge, that the payments are "otherwise unavoidable." Appellant contends that a contrary conclusion would frustrate the purpose of the statute by permitting Chrysler Credit both to offset the preference payments in the amount of the new value and to keep subsequent payments made on account of that new value.

Appellant's position is not supported by the statute. The trustee's failure to avoid JKJ CP's post-new value payments to Chrysler Credit does not convert those payments from avoidable to unavoidable transfers. Indeed, the plain and ordinary meaning of an "avoidable" transfer is a transfer "that can be avoided." See Webster's Third New International Dictionary 151 (1987) (emphasis added). Because the trustee could have avoided the transfers, those transfers were not "otherwise unavoidable," and thus have no bearing on Chrysler Credit's new value defense. And, even though such a result may frustrate the intended operation of section 547(c)(4), such is only the case because of the trustee's failure to recover the

avoidable post-new value payments.

Having determined that the district court's initial reading of the statute was correct, we remand this portion of the case so that the bankruptcy court, consistent with this opinion, may determine whether any of the repayments were "otherwise unavoidable transfers." While it appears that they were not, the bankruptcy court is in the best position to apply the foregoing interpretation of section 547(c)(4) to each individual transfer. Indeed, some of the challenged transfers occurred after JKJ CP filed for bankruptcy and these transfers may in fact be "otherwise unavoidable.

CONCLUSION

The judgment of the district court as to the Koons and Brandnewco payments is vacated and the entire case remanded for further proceedings.

VACATED AND REMANDED.

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Below is a more recent case in which the Fifth Circuit addressed preferences where the secured party's account receivables collateral was commingled in the proceeds of the lock-box controlled by another secured party. The Circuit Court applied the source rule to the transfers in and out of the lock-box. The Circuit Court also analyzed the exceptions to a bankruptcy trustee's avoidance power under 11 U.S.C. § 547(c).

***In re* Tusa-Expo Holdings, Inc.**

811 F.3d 786 (5th Cir. 2016)

This adversary action was brought by Appellant Marilyn

D. Garner (the “Trustee”) against Appellee Knoll, Incorporated (“Knoll”). Specifically, the Trustee seeks to avoid transfers from Tusa Office Solutions, Incorporated (“Tusa Office”), the debtor, to Knoll, its creditor, as preferences under § 547 of the Bankruptcy Code.

FACTS & PROCEEDINGS

For many years, Tusa Office was the largest retail dealer in new furniture manufactured by Knoll. Tusa Office and Knoll's relationship was embodied in several contractual arrangements, only one of which is relevant here. Under it, (1) a customer would order furniture from Tusa Office, (2) Tusa Office would then order that furniture from Knoll, (3) Knoll would deliver the furniture to Tusa Office, (4) Tusa Office would deliver the furniture to the customer and install it, (5) Tusa Office would invoice the customer, (6) the customer would pay Tusa Office, and (7) Tusa Office would pay Knoll. This arrangement was initially governed by an April 30, 2002, Payment Agreement between Tusa Office and Knoll. Under that agreement, Tusa Office granted Knoll a first-priority security interest in, among other things, all of its present and after-acquired assets, including its accounts receivable.

In 2005, Tusa Office acquired Office Expo, Incorporated (“Office Expo”), a dealer in used furniture. After a reorganization, Tusa Office and Office Expo became wholly-owned subsidiaries of Tusa–Expo Holdings, Incorporated. Although Tusa Office continued to operate profitably, Office Expo did not. To bolster Office Expo's flagging performance, Tusa Office began to transfer funds to Office Expo regularly, which caused Tusa Office problems of its own.

Tusa Office and Knoll eventually entered into an

Amended Payment Agreement (the "APA") in June 2008, which restructured Tusa Office's debt to Knoll. Under the APA, Tusa Office's current indebtedness to Knoll (that is, the part of its debt that was more than 90 days old) could not exceed $3.1 million until its past-due indebtedness (that is, the part of its debt that was more than 90 days old) was less than $1.9 million. The APA again granted Knoll a first-priority security interest in substantially all of Tusa Office's present and after-acquired assets, including its accounts receivable. When Tusa Office and Knoll entered into the APA, Tusa Office's current indebtedness to Knoll was $2,863,898.60 and its past-due indebtedness was $2,703,955.29.23.

In addition to restructuring its debt to Knoll, Tusa Office obtained financing from Textron Financial, Incorporated ("Textron"). Specifically, Tusa Office and Textron entered into an agreement (the "Loan Agreement") in July 2009, under which Textron provided Tusa Office with a $6.5 million revolving loan in exchange for a first-priority security interest in all of Tusa Office's current and after-acquired assets, including Knoll's collateral. The Loan Agreement also required Tusa Office to have its customers make payments directly to a bank deposit account (the "lockbox") that was controlled by Textron.

As a condition precedent to the Loan Agreement, Textron and Knoll entered a separate Subordination Agreement, under which Knoll retained a first-priority security interest in specified accounts receivable of Tusa Office and a second-priority security interest in all other current and after-acquired assets of Tusa Office. With the exception of those specified accounts receivable, Textron received a first-priority security interest in all remaining current and after-acquired assets of

Tusa Office. Textron and Knoll subsequently entered an Amended Subordination Agreement.

Under these several agreements, Tusa Office's accounts receivable were paid directly into the lockbox by its customers. Having control of the lockbox, Textron withdrew the deposited funds daily and applied them to increase the available credit to Tusa Office on its revolving loan. On request, Textron would advance new revolving loan funds to Tusa Office's operating account. Tusa Office used those funds to, among other things, pay Knoll. By paying Knoll, Tusa Office reduced its indebtedness under the APA, allowing it to fill new orders from its customers.

In November 2008, Tusa Office filed a voluntary petition for relief under Chapter 11 of the Bankruptcy Code. Shortly thereafter, Knoll filed its proof of claim in the amount of $6,929,783.87. In July 2009, the bankruptcy court granted Tusa Office's motion to convert its Chapter 11 petition for reorganization to a Chapter 7 petition for liquidation.

In November 2010, the Trustee filed a complaint, initiating this adversary action. She sought to avoid as preferences $4,592,483.90.55 in transfers made by Tusa Office to Knoll during the 90–day preference period, pursuant to 11 U.S.C. § 547(b). The bankruptcy court bifurcated the first and second counts of the adversary action in April 2012, then tried those counts over nine nonconsecutive days between August 2012 and January 2013. The next month, Knoll filed a motion for leave to amend its answer to assert an exception under § 547(c) as a new affirmative defense to the first count. The Trustee filed a response. Following a hearing, the court issued an order granting Knoll's motion, and the amended answer was entered

into the record.

The bankruptcy court issued its findings of fact and conclusions of law in August 2013. It entered its final judgment on the first count a year later. The Trustee then filed a timely notice of appeal in the bankruptcy court and, in the following days, filed an amended notice of appeal, but only sought review of the judgment on the first count.

In March 2015, the district court issued its order and judgment, affirming the bankruptcy court….

ANALYSIS

I. STANDARD OF REVIEW

We review the bankruptcy court's findings of fact and conclusions of law "under the same standards employed by the district court hearing the appeal from bankruptcy court; conclusions of law are reviewed de novo, findings of fact are reviewed for clear error, and mixed questions of fact and law are reviewed de novo." "Under a clear error standard, this court will reverse only if, on the entire evidence, we are left with the definite and firm conviction that a mistake has been made." "Strict application of the clearly erroneous rule is particularly important where, as here, the district court has affirmed the bankruptcy judge's findings."

II. THE REQUIREMENTS OF § 547(B)

A. THE VARIOUS ANALYSES

The Trustee complains that the bankruptcy court erred in holding that the transfers from Tusa Office to Knoll were not preferences under § 547(b) of the Bankruptcy Code. Section 547(b) specifies, in the conjunctive:

> [T]he trustee may avoid any transfer of an interest of the debtor in property—
>
> > (1) to or for the benefit of a creditor;
> >
> > (2) for or on account of an antecedent debt owed by the debtor before such transfer was made;
> >
> > (3) made while the debtor was insolvent;
> >
> > (4) made ... on or within 90 days before the date of the filing of the petition [viz., the preference period] ...; and
> >
> > (5) that enables such creditor to receive more than such creditor would receive if—
> >
> > > (a) the case were a case under chapter 7 of this title;
> > >
> > > (b) the transfer had not been made; and
> > >
> > > (c) such creditor received payment of such debt to the extent provided by the [Bankruptcy Code].

If a trustee establishes each of the requirements of § 547(b), the transfer is a preference, which must be returned to the bankruptcy estate unless the creditor establishes an exception to avoidance under § 547(c).

The instant dispute concerns the last of the § 547(b) requirements, namely, subsection (b)(5). "This is the requirement that before a trustee in bankruptcy can [sic] avoid a preferential [transfer], the trustee must establish that the [transfer] enabled the creditor to receive more than the creditor would have received upon liquidation under Chapter 7 of the

[B]ankruptcy [C]ode."

To determine whether a trustee has established this requirement, a court typically uses the so-called "hypothetical Chapter 7 liquidation analysis" inherent in § 547(b)(5) itself. To do so, the court (1) constructs a hypothetical Chapter 7 liquidation in which the creditor retains the disputed transfers, viz., the transfers-retained hypothetical, and (2) constructs another in which the creditor returns those transfers, viz., the transfers-returned hypothetical. To establish the requirement of § 547(b)(5) under this analysis, the sum of (1) the disputed transfers and (2) the creditor's distribution in the transfers-retained hypothetical must be "more" than the creditor's distribution in the transfers-returned hypothetical.

But a court may occasionally circumvent the often arduous hypothetical Chapter 7 liquidation analysis by employing the abbreviated El Paso Refinery analysis. This analysis considers only the disputed transfer itself. It is premised on the truism that, if a creditor receives a transfer which, by its very nature, would not have been available to any of the other secured or unsecured creditors, it could never receive "more" under the hypothetical Chapter 7 liquidation analysis. Specifically, the El Paso Refinery analysis states:

> To determine whether an undersecured creditor received a greater percentage recovery [read: "more"] on its debt than it would have under [C]hapter 7 the following two issues must first be resolved: (1) to what claim the [transfer] is applied and (2) from what source the [transfer] comes. Both aspects must be examined before the issue of greater percentage recovery can be decided.

These are referred to as the application aspect and the source aspect, respectively.

If the disputed transfer (1) reduced the creditor's collateral under the application aspect of the El Paso Refinery analysis or (2) was made from the debtor's collateral under the source aspect of that analysis, the trustee could never establish that the creditor received "more" under the hypothetical Chapter 7 liquidation analysis. But only in such an instance is the El Paso Refinery analysis dispositive. If, conversely, the disputed transfer (1) did not reduce the creditor's collateral under the application aspect and (2) was not made from the debtor's collateral under the source aspect, the trustee might still be able to establish that the creditor received "more" under the hypothetical Chapter 7 liquidation analysis. Simply put, the El Paso Refinery analysis provides a threshold. It is intended to aid the hypothetical Chapter 7 liquidation analysis under § 547(b)(5), not to replace it. Nor could it. As the hypothetical Chapter 7 liquidation analysis is embodied in § 547(b)(5), it must control.

Here, in a belt-and-suspenders approach, the bankruptcy court undertook both the El Paso Refinery analysis and the hypothetical Chapter 7 liquidation analysis. It began by determining that the Trustee had failed to establish the requirement of § 547(b)(5) under the El Paso Refinery analysis because she had not satisfied the source aspect. Although it did not need to have done so, the bankruptcy court went on to determine that the Trustee had also failed to establish the requirement of § 547(b)(5) under the hypothetical Chapter 7 liquidation analysis: Even if the transfers had not been made from Knoll's collateral, Knoll still did not receive "more."

The district court did not use either analysis, however. Instead it determined that, even if the Trustee had established all of the requirements of § 547(b), Knoll itself had established an exception to avoidance under § 547(c)(5).

B. THE *EL PASO REFINERY ANALYSIS*

We begin, as did the bankruptcy court, with the El Paso Refinery analysis. The Trustee contends that the bankruptcy court erred in deciding that the Trustee did not satisfy the source aspect of the El Paso Refinery analysis. This analysis specifies that "[e]ven if the [transfer] in question was applied to the unsecured portion of an undersecured creditor's claim, the creditor will not be deemed to have received a greater percentage [read: "more"] as a result of the [transfer] if the source of the [transfer] is the creditor's own collateral." Accordingly, "[a] creditor who merely recovers its own collateral receives no more as a result than it would have received anyway had the [transfer] been retained by the debtor, subject to the creditor's security interest."

The Trustee asserts that the transfers from Tusa Office to Knoll were not made from the proceeds of Knoll's collateral. Knoll disputes this. We note that "[p]roperty interests are created and defined by state law" and that, "[u]nless some federal interest requires a different result, there is no reason why such interests should be analyzed differently simply because an interested party is involved in a bankruptcy proceeding.""It is [therefore] common in the bankruptcy context to look to state law to define security interests created under state law." The parties do not contest the applicability of state law, here that of Texas.

Texas has adopted the Uniform Commercial Code ("UCC"), which governs this dispute. The term "proceeds" is defined under § 9.102 of the UCC as including "whatever is acquired upon the sale, lease, license, exchange, or other disposition of collateral." Under § 9.315, "a security interest attaches to any identifiable proceeds of collateral." Further, "[a] security interest in [those] proceeds is a perfected security interest if the interest in the original collateral was perfected." Knoll had a first-priority security interest in Tusa Office's accounts receivable, so they were Knoll's first-priority collateral. By extension, Knoll's first-priority collateral included both the accounts receivable and any proceeds of those accounts receivable. To determine whether the Trustee satisfied El Paso Refinery's source aspect, we must consider whether those accounts receivable and proceeds remained Knoll's collateral after being transferred (1) first into the lockbox by Tusa Office's customers, then (2) out of the lockbox by Textron, and finally (3) by Textron to Tusa Office's operating account.

1. Transfers from tusa office's customers into the lockbox

The Trustee does not dispute that the payments Tusa Office's customers deposited into the lockbox were proceeds of Tusa Office's accounts receivable. She argues instead that, because this constituted a transfer of money, Knoll's first-priority security interest in the payments was "stripped" by operation of § 9.332(a): "A transferee of money takes the money free of a security interest...." The comments explain that "the debtor itself is not a transferee," meaning that § 9.332(a) does not apply if such a transfer of money was made to the debtor. The Trustee therefore insists that Textron, not Tusa Office, was the transferee. In so doing, the Trustee contends that the lockbox was "owned and controlled by Textron."

Knoll disputes this contention. Specifically, Knoll explains that (1) the deposit by Tusa Office's customers into the lockbox corresponded with reductions in Tusa Office's accounts receivable and (2) the transfers out of the lockbox to Textron corresponded with reductions in Tusa Office's debt to Textron under the revolving loan. Knoll also observes that the bankruptcy court never expressly found that Textron owned the lockbox. The Trustee counters that Tusa Office's former controller testified that the lockbox "belonged to Textron" and that there is no reference to the lockbox in Tusa Office's bankruptcy schedules.

Regardless of the Trustee's and Knoll's competing assertions, the Loan Agreement is clear. It specifies that "[Tusa Office] shall utilize a lockbox arrangement for collection of Accounts at a bank designated by [Textron]...." and, as a condition precedent to the Loan Agreement, "[Tusa Office] shall have established a blocked account or lockbox ... for its collections and the transfer thereof to [Textron]...." The Loan Agreement also states that "[Tusa Office] shall have possession of [Textron's] Collateral" and "will cooperate with and assist [Textron] in obtaining control ... with respect to [c]ollateral consisting of ... Deposit Accounts...."

Because Tusa Office, not Textron, owned the lockbox, § 9.332(a) does not apply. Therefore, Knoll's first-priority security interest in the proceeds of Tusa Office's accounts receivable survived the deposit into the lockbox.

2. Transfers from the lockbox to textron

The Trustee next contends that Knoll's first-priority security interest in the proceeds of Tusa Office's accounts receivable, initially paid into the lockbox, did not then transfer

from the lockbox to Textron. She states specifically that § 9.332(b) of the UCC stripped Knoll's first-priority security interest when they were transferred from the lockbox to Textron.

Knoll responds that § 9.332(b) only concerns a security interest in the deposit account itself, not a security interest in the funds contained in it. Accordingly, Knoll insists that, even though § 9.332(b) would have prevented a security interest in the lockbox itself from transferring, it did not prevent the transfer of Knoll's first-priority security interest in the proceeds of its collateral.

The plain language of § 9.332(b) states that a "transferee of funds from a deposit account takes the funds free of a security interest in the deposit account." Although § 9.332(a)—which applies to transfers of "money"—and § 9.332(b)—which applies to transfers of "funds"—are similar, they are not identical. Specifically, § 9.332(a) provides that "[a] transferee of money takes the money free of a [read: any] security interest." By contrast, § 9.332(b) provides that "[a] transferee of funds from a deposit account takes the funds free of a security interest in the deposit account...." This difference must have been intentional. The drafters could have specified, but did not, that "a transferee of funds from a deposit account takes the funds free of a [read: any] security interest" as they did in § 9.332(a). Or they could have specified that "a transferee of funds from a deposit account takes the funds free of a security interest in the funds themselves." The comments to § 9.332 bolster this distinction between a deposit account itself and the funds contained in it. In particular, the comments explain that § 9.332(b) "applies to transfers of funds from [a] deposit account" but "does not apply to transfers of the deposit account itself or of [a security]

interest therein." (Of course, the question whether § 9.332(b) applies is distinct from the subsequent question whether § 9.332(b) then strips a particular security interest.)

The comments to § 9.332 further explain that "[b]road protection for transferees helps to ensure that security interests in deposit accounts do not impair the free flow of funds." It is clear to us that § 9.332(b) ensures that the funds in a deposit account remain unencumbered by a security interest in the deposit account itself. Section 9.332(b) does not even address, must less strip, a security interest that encumbers the funds contained in the deposit account. Stated simply, § 9.332(b) protects Knoll from Textron's first-priority security interest in the deposit account; it does not, however, protect Textron from Knoll's first-priority security interest in the funds contained in that account.

Because § 9.332 is a recent addition to the UCC, the jurisprudence interpreting it is scarce. Nevertheless, the Trustee and Knoll each proffer cases to support their respective positions. Knoll relies on Madisonville State Bank v. Canterbury, in which a state appeals court held that § 9.332 strips the security interests in the deposit account itself but not the security interest in the funds in it. By contrast, the Trustee notes that this holding was disregarded as "unsound" by a federal district court in City Bank v. Compass Bank, which determined that § 9.332 strips the security interest from both the deposit account and the funds in it. But, in doing so, that court disregarded the plain language of § 9.332 in favor of the comments. It reasoned that the comments to § 9.332 "specifically define[ ] encumbered accounts as being not only those subject to a direct security interest [in] the account itself, but also 'deposit accounts containing collections from accounts

receivable."

But this so-called "explicit statement of legislative intent" is nothing of the sort. In context, the comments merely explain that § 9.332 is justified because "payments of funds from encumbered deposit accounts (e.g., deposit accounts containing collections from accounts receivable) occur with great regularity." This simply suggests that transfers of funds from deposit accounts, "including deposit accounts containing collections from accounts receivable," are taken "free of a security interest in the deposit account." City Bank 's assertion, which may very well be dicta, is incorrect. In any event, it does not bind us.

The plain language of § 9.332(b) is unambiguous. Knoll's first-priority security interest in the proceeds of Tusa Office's accounts receivable survived the transfer from the lockbox to Textron. Not only is this consistent with § 9.332(b), but it is also consistent with the Subordination Agreement between Knoll and Textron.

3. Transfers from textron to tusa office

The Trustee also urges that, even if Knoll's first-priority security interest in the proceeds of Tusa Office's accounts receivable did survive the transfer into and out of the lockbox, it did not survive the transfer from Textron to Tusa Office's operating account. Specifically, the Trustee insists that the proceeds were commingled. Knoll responds that, unless the Trustee establishes that the proceeds were commingled, they are presumed to be identifiable. Knoll suggests that the Trustee never established, and the bankruptcy court never found, that the funds transferred by Textron into Tusa Office's operating account were commingled.

As a preliminary matter, § 9.315(b)(2) of the UCC specifies that "[p]roceeds that are commingled with other property are identifiable proceeds ... to the extent that the secured party identifies the proceeds by a method of tracing, including application of equitable principles, that is permitted under law...." Knoll argues that § 9.315(b)(2)' s requirement that "the secured party identif[y] the proceeds by a method of tracing" is inconsistent with the § 547(g)'s instruction that "the trustee has the burden of proving the avoidability of a transfer under [§ 547(b)]." Knoll relies on Batlan v. TransAmerica Commercial Finance Corp. (In re Smith's Home Furnishings, Inc.), in which the Ninth Circuit explained that "it is part of the trustee's § 547(b)(5) burden to trace the funds used to make the payments to [funds] not subject to [the creditor's] liens." In so doing, that court observed that "in bankruptcy, it is the trustee who accedes to the debtor's books and records and has easier access and a better ability to divine the financial activities of the debtor in its last months of operation." The Smith's court also clarified that, "[r]egardless of [whether the creditor or trustee] is better equipped to decipher the debtor's final financial actions, we hold that the language of [§ 547(g)] places the burden of demonstrating the source of such preferential payments squarely on the trustee."

The Trustee responds that this was merely dicta because the Ninth Circuit had already held that the debt owed to the creditor was completely secured, so the transfer could not be a preference. This, however, ignores the Ninth Circuit's clear signal to the contrary, viz., "we hold." It also ignores the fact that the Ninth Circuit relied on the same reasoning for its holdings that (1) the creditor was completely secured and (2) the trustee had the burden of tracing. In deciding that the debt

owed to the creditor was completely secured, the Ninth Circuit explained: "Under § 547(b)(5), the trustee must show that the amount of indebtedness under the floating lien was greater than the amount of collateral.... A floating lien does not shift the burden of showing avoidability to the creditor. The trustee still has to satisfy his burden under § 547(b)(5)." Thus, the Ninth Circuit's decision in Smith's stands for the proposition that a trustee has the burden of showing that the source of any transfers from a debtor to a creditor was not the proceeds of the creditor's collateral. That court's reasoning in this respect is strongly persuasive. The UCC applies "[u]nless some federal interest requires a different result."

The Trustee also suggests that the lockbox arrangement between the lender and debtor in Smith's was different from the one between Textron and Tusa Office. She argues expressly that, in Smith's, the lender swept the lockbox daily and advanced funds the next day, but that here Textron swept the funds daily, but only advanced funds at Tusa Office's request.

The Ninth Circuit's description of the arrangement in Smith's is broad enough to encompass the instant arrangement. There, the court explained that "[the lender] ... swept the [lockbox] accounts daily, leaving the accounts with overnight balances of zero," that "[t]he next day, the [lender] advanced new funds to [the debtor] if sufficient collateral was available," and that "[the debtor] then paid its operating expenses and creditors...." It observed that, "[b]ecause of these procedures, the allegedly preferential payments ... were not made directly from the proceeds of the sales of [the creditor's] collateral." The Trustee seems to suggest that, because Tusa Office did not request such transfers each day, and because Textron did not make such transfers each day, the arrangement in Smith's is

distinguishable. But this is not entirely relevant, especially because the contractual arrangement between Tusa Office and Textron expressly permitted Tusa Office to request funds more frequently than once a day.

Because § 547(g) is clear and Smith's is persuasive, we hold that it was the Trustee's burden to establish that the funds in the operating account were not the proceeds of Tusa Office's accounts receivable and that she failed to do so. The definition of "proceeds" in the UCC is broad. It includes "whatever is acquired upon the sale, lease, license, exchange, or other disposition of collateral," "whatever is collected on, or distributed on account of, collateral," and "rights arising out of collateral." Absent any reasonable indication to the contrary, it follows that, but for the transfers from the lockbox to Textron, no transfers from Textron to Tusa Office would have been possible. The bankruptcy court did not err in determining that "Tusa Office acquired funds from Textron upon the disposition of Knoll's Collateral."

Because the Trustee did not satisfy the source aspect of the El Paso Refinery analysis, testing under the hypothetical Chapter 7 liquidation analysis is unnecessary. The Trustee did not establish the requirement of § 547(b)(5), so we hold that the transfers from Tusa Office to Knoll were not preferences.

III. THE EXCEPTION UNDER 547(C)(5)

We would normally stop here without addressing the exception to avoidance under § 547(c)(5). However, the district court went on to consider that exception and to hold that Knoll had established it. As we shall explain, we disagree.

In pertinent part, § 547(c)(5) states that "[t]he trustee may not avoid under [§ 547] a transfer ... that creates a perfected security interest in inventory or a receivable or the proceeds of either...." As she did in the bankruptcy court and in the district court, the Trustee again argues that the exception under § 547(c)(5) does not apply to the disputed transfers from Tusa Office to Knoll because those transfers did not create any security interest. She also notes that neither the bankruptcy court nor the district court considered whether the transfers created such a security interest.

The Trustee properly distinguishes the Eleventh Circuit's decisions on which the district court relied. In *Galloway v. First Alabama Bank (In re Wesley Industries Inc.)*, the Eleventh Circuit applied § 547(c)(5) to determine that a debtor's transfer of a perfected security interest in its accounts receivable under a 'floating lien' was not avoidable because the creditor's position had not improved as a result. This allowed that court to use § 547(b)(5) to conclude that a debtor's transfer of the proceeds of the accounts receivable themselves was not a preference because the creditor merely received its own collateral. Although the decision is admittedly vague in its analysis, it did not hold that § 547(c)(5) applies to transfers of accounts receivable themselves. Instead, it expressly states that § 547(c)(5) "protects the transfer of a security interest in after-acquired property...."

In *Roemelmeyer v. Walter E. Heller & Co., Southeast, Inc. (In re Lackow Brothers, Inc.)*, the Eleventh Circuit determined the appropriate method of valuation of under § 547, but it did not consider whether § 547(c)(5) applies to transfers of accounts receivable. Further, § 547(c)(5) could not have applied to the transfers there because the creditor was fully secured. As this

court has held, "[i]t is ... commonplace that preference law exempts fully secured creditors from its grasp." We agree with the Trustee that, even if these opinions were binding on us, they are nonetheless inapplicable here.

In response, Knoll relies primarily on this court's decision in *Wilson v. Huffman(In reMissionary Baptist Foundation of America, Inc.)* for the proposition that the exception to § 547(c)(5) applies here. In that decision, we discussed the exception under § 547(c)(5) at some length, but remanded without deciding whether it applied to transfers of funds because the district court's analysis was so "conclusory and unilluminating" that we had "no basis for meaningful review at all." Despite this, Knoll advances that *Missionary Baptist* nonetheless held that if, on remand, the district court were to conclude that the creditor had not improved its position, then the transfers would be unavoidable pursuant to the exception under § 547(c)(5).

Regardless, this court's 1986 decision in *Missionary Baptist* and the Eleventh Circuit's 1985 decision in *Lackow* are inapplicable for another, more significant reason. In reciting § 547(c)(5), both courts stated that it applies to a transfer "of a perfected security interest in inventory or a receivable or the proceeds of either." Yet, as explained above, § 547(c)(5), as it now exists, applies only to a transfer "that creates a perfected security interest in inventory or a receivable or the proceeds of either." The amendment that replaced "of" with "that creates" was enacted in 1984 and codified in 1985. *Missionary Baptist and Lackow* might very well have interpreted the exception under § 547(c)(5) as it then existed to apply to a transfer of accounts receivable themselves and any proceeds thereof. But, as it now exists, the exception under § 547(c)(5) only applies to a transfer

that creates a perfected security interest in such things. As we recently held, "the Bankruptcy Code must be read literally...." Read literally—as it must be—the exception under § 547(c)(5) does not apply to the transfers at issue here. This does not, however, affect our outcome, which is grounded in the requirement of § 547(b)(5) and the attendant *El Paso Refinery analysis.*

CONCLUSION

For the forgoing reasons, we hold that the Trustee failed to establish the requirement of § 547(b)(5) because the source aspect of the *El Paso Refinery* analysis demonstrates that the transfer from Tusa Office to Knoll was made from the proceeds of Knoll's own collateral. The judgment of the district court, affirming the bankruptcy court, is AFFIRMED.

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Many countries do not permit individual bankruptcy filings for various policy reasons. In the United States, Chapter 13 governs personal bankruptcy or wage earner's plan. That means individuals with regular income develop a plan to repay all or part of their debts. The debtors will make installments to creditors over three to five years, depending on whether the debtor's current monthly income is less or greater than the applicable state median. Why would an individual debtor file under Chapter 13 instead of straight liquidation under Chapter 7? Chapter 13 allows individuals to save their homes from foreclosure, as the individuals may be able to pay delinquent mortgage payments over time under a Chapter 13 repayment plan. Below is a Chapter 13 casewhere a purchase money security interest in consumer goods and individual bankruptcy intersect.

In re Alesha Scarver

555 B.R. 822 (Bankr. M.D. Ala. 2016)

This Chapter 13 bankruptcy case is before the Court on the "Motion for a Determination of Secured Status" filed by 1st Franklin Financial Corporation ("1st Franklin"). The question presented is whether a Chapter 13 debtor acting in good faith may modify her confirmed plan to surrender collateral and reclassify any deficiency balance as an unsecured claim. For the reasons set forth below, the Court holds that a debtor may modify her confirmed plan for that purpose. Therefore, 1st Franklin's motion is DENIED.

I. FACTS & PROCEDURAL HISTORY

Alesha Scarver ("Scarver") obtained a loan from 1st Franklin on July 31, 2012, in the amount of $6,931.99 that was secured by her 2001 Toyota Corolla. Scarver filed Chapter 13 bankruptcy on January 28, 2014, and valued the Corolla at $4,125.00. 1st Franklin filed a secured proof of claim for $4,867.89, and Scarver proposed to keep the Corolla by paying 1st Franklin $99 per month at 4.25% interest; Scarver's plan classified 1st Franklin's claim as a "910-claim." Unsecured creditors would be paid nothing. The Court confirmed Scarver's plan on April 11, 2014.

Sometime in 2015, Scarver was involved in a traffic accident while driving the Corolla. On September 14, 2015, Scarver objected to 1st Franklin's claim. She explained that her insurer had declared the Corolla to be a total loss and was willing to pay $2,802.45 for it, and Scarver wanted 1st Franklin's claim to be deemed fully satisfied upon payment of the insurance proceeds. 1st Franklin did not respond and the Court

sustained Scarver's objection by negative notice on October 21, 2015. On November 4, 2015, Scarver moved to modify her plan by proposing to surrender the Corolla and the $2,802.45 in insurance proceeds to 1st Franklin. Again 1st Franklin did not respond and the Court granted Scarver's motion to modify her plan by negative notice on November 17, 2015.

1st Franklin filed the instant motion for determination of secured status on April 12, 2016. 1st Franklin argues that, after application of the insurance proceeds, the remaining balance on its claim should still be treated as secured….

II. LAW

This is a core proceeding pursuant to 28 U.S.C. § 157(b)(2)(L). This is a final order.

A. *Bifurcation and "Cramdown" of Secured Claims*

Before reaching the specific issue in this case, it is helpful to understand the nature of secured claims and a Chapter 13 debtor's options regarding their treatment prior to plan confirmation. "The general rule" under 11 U.S.C. § 506(a) "is that 'a claim is secured only to the extent of the value of the property on which the lien is fixed; the remainder of that lien is considered unsecured.'" *In re Moorer*, 544 B.R. 702, 704 (Bankr.M.D.Ala.2016). "Chapter 13 debtors enjoy broad power to modify the rights of the holders of secured claims." *American Gen. Fin., Inc. v. Paschen*, 296 F.3d 1203, 1205 (11th Cir.2002). A Chapter 13 debtor who wishes to keep collateral securing a claim may do so over the claimant's objection by paying the claimant the replacement value of the collateral, a process known as a "cramdown." 11 U.S.C. § 1325(a)(5)(B). If the collateral's value is less than the amount of the debt, a debtor

exercising a cramdown may bifurcate the claim into secured and unsecured portions under § 506(a) and pay only the secured amount.

There are certain exceptions to a Chapter 13 debtor's power to bifurcate an undersecured claim in a cramdown. One exception protects mortgages secured by the debtor's principal residence. *See Nobelman v. Am. Sav. Bank*, 508 U.S. 324, 327 (1993); 11 U.S.C. § 1322(b)(2). A second exception, more pertinent to this case, prohibits bifurcation and cramdown of a claim under § 506(a) ...

> if the creditor has a purchase money security interest securing the debt that is the subject of the claim, the debt was incurred within the 910-day period preceding the date of the filing of the petition, and the collateral for that debt consists of a motor vehicle ... acquired for the personal use of the debtor....

11 U.S.C. § 1325(a). A creditor obtains a purchase-money security interest ("PMSI") in collateral when the debtor incurs an obligation "as all or part of the price of the collateral or for value given to enable the debtor to acquire rights in or the use of the collateral if the value is in fact so used." ALA. CODE § 7–9A–103(a)(2). When a creditor holds a PMSI on the debtor's vehicle and the underlying debt was incurred within 910 days prior to the debtor's bankruptcy, the creditor holds what is called a "910-claim" and is entitled to full payment on its claim, regardless of the vehicle's value, if the debtor chooses to cram down the claim.

Scarver kept the Toyota Corolla and promised to pay the full amount of 1st Franklin's claim as a 910-claim. Now that she has wrecked the Corolla and experienced a shortfall on the

insurance proceeds, the question is whether she must pay 1st Franklin the full amount of its claim in order to obtain a Chapter 13 discharge in this case.

B. *Post-Confirmation Plan Modification*

Anytime after a Chapter 13 plan is confirmed, but before plan payments are completed, the debtor, trustee, or any unsecured creditor may seek to modify the plan. 11 U.S.C. § 1329(a). Post-confirmation plan modification entails three basic requirements. First, the modification must comply with one of the provisions of § 1329(a), which, as relevant to this case, requires the modifying plan to either:

> (1) increase or reduce the amount of payments on claims of a particular class provided for by the plan;
>
> (2) extend or reduce the time for such payments; [or]
>
> (3) alter the amount of the distribution to a creditor whose claim is provided for by the plan to the extent necessary to take account of any payment of such claim other than under the plan[.]

11 U.S.C. § 1329(a). Second, the modification must comply with the requirements for plan confirmation set out in 11 U.S.C. §§ 1322(a) and 1325(a), and may treat claims as permitted by 11 U.S.C. §§ 1322(b)(2) and 1323(c). 11 U.S.C. § 1329(b)(1). Third, the modification cannot extend the payment period beyond five years after the first plan payment was due, and cannot extend the original commitment period of the debtor's disposable income except for cause. A party seeking to modify a confirmed plan under § 1329 need not demonstrate an unforseen substantial change in the debtor's circumstances. *In re Thomas*, 291 B.R. 189, 193 (Bankr.M.D.Ala.2003). "The plan as modified

becomes the plan unless, after notice and a hearing, such modification is disapproved." 11 U.S.C. § 1329(b)(2).

Scarver's plan modification complies with § 1329(c). Whether it complies with §§ 1329(a) and (b)(1) depends on whether Scarver can reclassify 1st Franklin's secured claim after her payment plan has been confirmed.

C. Post-Confirmation Claim Reclassification

For more than twenty-five years, courts have been divided over whether a Chapter 13 debtor has the power to reclassify a secured claim after plan confirmation. The current minority view holds that a Chapter 13 debtor may not reclassify a secured claim after plan confirmation under any circumstances. The current majority view holds that a Chapter 13 debtor may surrender collateral and reclassify any resulting deficiency balance from a secured debt to an unsecured debt, if done in good faith. This has been the prevailing view for the past ten years.

1. The Minority View: Post-Confirmation Claim Reclassification is Prohibited

The leading cases of the minority camp are a pair of pre-BAPCPA decisions from the Sixth Circuit. *See Ruskin v. DaimlerChrysler Servs., N.A., LLC (In re Adkins),* 425 F.3d 296 (6th Cir.2005); *Chrysler Fin. Corp. v. Nolan (In re Nolan)*, 232 F.3d 528 (6th Cir.2000). In *Nolan*, the debtor owed $12,000 on a vehicle that she sought to cram down, and her confirmed plan bifurcated the claim into a secured portion of $8,000 and an unsecured portion of $4,000. *Nolan*, 232 F.3d at 529. When her vehicle became undependable due to high use and lack of proper maintenance, the debtor moved to modify her plan in order to surrender the vehicle and reclassify the deficiency

balance as an unsecured claim. Id. at 529–30. The Sixth Circuit held that the debtor's proposed modification was *per se* impermissible under § 1329, and articulated five rationales for its holding.

…

2. The Majority View: Post-Confirmation Claim Reclassification is Permissible

The majority view has attacked *Nolan* and *Adkins* with two separate lines of reasoning. The first line of reasoning directly rejects the Sixth Circuit's interpretation of § 1329 and is represented by *Bank One, N.A. v. Leuellen*, 322 B.R. 648 (S.D.Ind.2005), another pre-BAPCPA case. The debtors in *Leuellen* crammed down two claims secured by their vehicles in their confirmed plan. *Leuellen*, 322 B.R. at 650–51. When Mrs. Leuellen lost her job six months later the debtors could no longer afford two cars, so they sought to modify their plan by surrendering her vehicle and treating any deficiency balance as unsecured. *Id.* at 651.

In permitting the modification, the *Leuellen* court first explained that § 1322(b)(8), which is incorporated by § 1329(b)(1), "contemplates surrender of collateral as a form of payment, and section 1322(b) applies without qualification to modifications under section 1329(a)." *Id.* at 652. Section 1325(a)(5), continued the court, must be considered as a whole to be a "requirement" of plan confirmation that is also incorporated by § 1329(b)(1), and can be satisfied in one of three ways, including surrender of collateral under § 1325(a)(5)(C). *Id.* at 652–53. According to the court, therefore, § 1329(b)(1) permits a debtor to surrender collateral as part of a post-confirmation plan modification. *Id.* at 653. Pursuant to § 506(a), a debtor's

surrender of collateral "has the effect of transforming what had been a completely secured claim into a secured claim up to the value of the collateral," with any deficiency balance becoming unsecured. *Id.* at 654. Finally, the court concluded, the modification complied with § 1329(a) because, as allowed under § 1329(a)(1), it "'reduce[d] the amount of payments on the creditor's secured claim from the amount stated in the original plan...." *Id.* (quoting 11 U.S.C. § 1329(a)(1)) (brackets in original).

The *Leuellen* court also extensively criticized *Nolan*. First, the court argued that the Sixth Circuit's refusal to permit modification of "claims" as opposed to "payments" in § 1329(a)(1) "ignores the import of other companion [Bankruptcy] Code sections and reads an exception into section 1329 which simply does not exist." *Id.* at 656. Citing § 1323(c), which is incorporated by § 1329(b)(1), the court explained that Congress envisioned that "[a] secured creditor's rights in general may be affected by a modification." *Id.*

Second, the *Leuellen* court disagreed with the Sixth Circuit's argument that post-confirmation claim reclassification would violate § 1325(a)(5)(B)(ii), explaining that § 1325(a)(5)(C)'s surrender option was not subject to the same limitation as cramdown. The court acknowledged the Sixth Circuit's concerns that such a modification would shift the risk of post-confirmation depreciation loss from the debtor to the secured creditor, but criticized the suggestive tone of the Sixth Circuit's language as failing to "accurately present the issue" because the debtor could have good faith reasons for seeking the modification. The court further explained that "secured creditors are not as defenseless" as the Sixth Circuit implied because secured creditors can object to initial plan confirmation

to ensure that they will receive sufficient payment to compensate them for any depreciation of their collateral. Thus, to shift the burden of collateral depreciation completely onto debtors "upends th[e] balance" of competing Chapter 13 purposes (namely, payment of debts, avoidance of Chapter 7 liquidation, and fair distribution to creditors), according to the *Leuellen* court, "and grants a windfall to creditors by removing permanently the risk that collateral will depreciate more than expected." *Id.* at 660. This has "[t]he distorted effect[ ]" of forcing debtors "to foresee all contingencies at the time the plan is confirmed." *Id.*

Finally, the *Leuellen* court pointed out secured creditors would retain sufficient protection against abusive modifications (e.g., situations where the debtor abused the collateral) because under § 1325(a)(3), as incorporated by § 1329(b)(1), a modified plan must be proposed in good faith. *Id.* at 661. Thus, a *per se* prohibition on post-confirmation surrender of collateral and claim reclassification would not be necessary to protect secured creditors from abuse. *Id.*

The second line of reasoning by which the majority view has attacked *Nolan* and *Adkins* is through reconsideration of the claim under § 502(j), as articulated by *In re Zieder*, 263 B.R. 114 (Bankr.D.Ariz.2001). In *Zieder*, the debtors surrendered a vehicle they had previously crammed down when their minor son had a wreck on another vehicle because they could no longer afford their payments, and sought to treat the deficiency balance as unsecured. *Zieder*, 263 B.R. at 116. In permitting the modification, the *Zieder* court distinguished *Nolan* and explained that § 502(j) "permits reconsideration of claims 'according to the equities of the case.'" *Id.* at 117 (quoting 11 U.S.C. § 502(j)). The court reasoned that since the collateral no

longer existed for the claim to attach to, it was unsecured pursuant to § 506(a), and that this was adequate grounds for reconsideration of the claim under § 502(j). The court added that "because the Code provision deals extensively with the effect such reconsideration might have on distributions already made on claims, it contemplates that such reconsideration might occur after confirmation." *Id.* Having reconsidered the claim under § 502(j) and determined it to be unsecured, the court noted that a modification reducing payment on the secured claim would "'reduce the amount of payments on claims of a particular class provided for by the plan,'" which the court considered to be permitted both by the express language of § 1329(a)(1) and *Nolan*. *Id.* at 118 (quoting 11 U.S.C. § 1329(a)(1)).

Most of the recent decisions that have adhered to the majority view have relied on both § 502(j) and the *Leuellen* court's interpretation of § 1329 as grounds to permit modifications that surrender collateral and reclassify deficiency balances as unsecured.

III. ANALYSIS

After reviewing the leading cases on each side of the issue, this Court is persuaded that the majority view is correct. When liquidation of collateral securing a claim results in a deficiency balance, that claim is no longer secured under the plain language of § 506(a) and its secured status may be reconsidered under § 502(j). When such a claim is no longer secured, the debtor may modify the plan post-confirmation to treat the claim as unsecured and reduce payments to it under § 1329(a)(1). Or, if the collateral has not been liquidated, the debtor may modify the plan post-confirmation to surrender the collateral pursuant

to §§ 1325(a)(5)(C) and 1329(b)(1), may treat any deficiency as unsecured pursuant to § 506(a), and may reduce payment on it under § 1329(a)(1).

…

Analysis of Scarver's Modification

Having determined that post-confirmation surrender of collateral and reclassification of any deficiency balance is permissible, the Court turns to whether Scarver has satisfied the requirements to do so.

As discussed, Scarver initially promised to pay 1st Franklin $4,769.11 at 4.25% on a 2001 Toyota Corolla with a value listed generously at $4,125.00. She treated 1st Franklin as a 910-creditor and promised to pay $99 per month toward the note and $41 per month in adequate protection payments. The Court confirmed Scarver's plan in April 2014.

Scarver's case sailed smoothly until she wrecked the Corolla sometime around September 2015, and she received $2,800.00 in insurance proceeds for it. She objected to 1st Franklin's claim, seeking to surrender the insurance proceeds in full satisfaction of the claim; the Court will construe this as a motion for reconsideration of the allowance of 1st Franklin's secured claim pursuant to § 502(j). Based on the circumstances, there is cause to reconsider the secured status of 1st Franklin's claim. The Corolla has been declared a total loss and the insurance proceeds have been paid to 1st Franklin; there is no other collateral securing 1st Franklin's claim. Therefore, Scarver's motion should be granted insofar as it pertains to the secured status of 1st Franklin's claim. However, 1st Franklin indicates that there is still around $1,400 owed on its note; therefore, it still has an unsecured claim for that deficiency

balance and has not been fully satisfied.

Scarver also moved to modify her plan to stop payment on 1st Franklin's secured claim and to surrender the insurance proceeds (which have now been surrendered) to 1st Franklin. Her modification complies with §§ 1329(a)(1) and (a)(3) because Scarver intends to reduce payment on 1st Franklin's specially-classed secured claim and is seeking to offset payments made outside the plan on the claim (the insurance proceeds). Section 1325(a)(5) is no longer applicable because 1st Franklin no longer has a secured claim, and Scarver is permitted to pay 1st Franklin nothing on its now-unsecured claim pursuant to § 1322(b)(8). Regarding § 1325(a)(3)'s good faith requirement, there at first blush appears to be a steep drop in the Corolla's value from the time the plan was proposed until it was wrecked (roughly one-third of its value). The Court may look to its own experience and real-world knowledge in making this determination, however, and in this case the facially steep depreciation appears more to be the result of Scarver's excessive valuation of the Corolla at the start of the case than abusive treatment of the car. There is no other indication that Scarver has acted in bad faith and, considering the wreck, she has a legitimate reason to modify her plan (i.e., she is not doing this on a whim). The Court concludes that § 1325(a)(3)'s good faith requirement is met, as are the remaining requirements of § 1329(b)(1). Scarver's proposed modification complies with § 1329.

IV. CONCLUSION

Pursuant to the majority view on post-confirmation surrender of collateral and claim reclassification, which this Court now adopts, 1st Franklin's claim lost its secured status when its collateral was liquidated. Scarver properly moved to reconsider the allowance of 1st Franklin's secured claim and to

modify her plan. 1st Franklin retains an unsecured claim for its deficiency balance. Therefore, 1st Franklin's motion for a determination that its claim is still secured is DENIED.

5. Secured Party v. U.S. Federal Tax Lien

The United States government collects federal taxes. When a debtor is insolvent and the federal government is among the competing claimants, the federal government will get paid first under the Federal Priority Statute, 31 U.S.C. § 3713(a), which was enacted in 1797. The Federal Tax Lien Act of 1966, however, controls when the federal government claims a preference in the insolvent estate of a delinquent taxpayer. *United States v. Estate of Romani*, 523 U.S. 517 (1998). The Supreme Court held that prior judgment liens have priority over the United States' federal tax liens. The decision led to the IRS's Chief Counsel Advice of not to assert its priority over "perfected interests" that "otherwise ha[ve] priority under section 6323 of the Internal Revenue Code." IRS Chief Counsel Advice, 200210063. Under IRC § 6323(a), the creditors that prevail over the IRS include purchasers, holders of security interests, mechanic's lienors, and judgment lien creditors. The case below addresses the priority between the U.S. government's tax lien and the secured party's already perfected security interest in the collateral of the delinquent taxpayer.

United States v. Krasicky

2016 WL 1242387 (E.D. Mich. Mar. 30, 2016)

I. BACKGROUND

On or about April 5, 2007, National City Bank loaned $10 million dollars to Page Distribution, Inc. ("Page"). Thereafter, in 2008, the loan was increased to $12.5 million. These loans were

secured by a Commercial Security Agreement dated July 18, 2001, in which National City Bank was granted a security interest in all existing or later acquired assets, including inventory. National City Bank then filed a UCC-1 financing statement with the Ohio Secretary of State on February 22, 2001 reflecting this security interest.

Ultimately, Page defaulted on its obligations to National City Bank because it had insufficient assets to pay its liabilities. On March 9, 2009, the Court of Common Pleas of Lucas County, Ohio granted National City Bank's Motion for Appointment of Receiver (“Receiver Order”) and appointed Defendant Brian Krasicky as the Receiver of the business operations and assets of Page. The Court of Common Pleas of Lucas County also held that “National City has perfected security interests in all of [Page's] personal property, business operations, including its accounts receivables, contracts, and other intangibles.”

Pursuant to the Children's Health Insurance Program Reauthorization Act of 2009, P.L. 111-3, § 701(h) (2009), a floor stocks tax (“FST”) arose on tobacco products held by Page on April 1, 2009. See P.L. 111-3, § 701(h)(3)(A) (“A person holding tobacco products, cigarette papers, or cigarette tubes on April 1, 2009, to which any tax imposed by paragraph (1) applies shall be liable for such tax.”). This tax was due on August 1, 2009.

Defendant Krasicky, as Receiver, was responsible for filing returns and paying taxes that arose from the operations of Page.

On July 31, 2009, Defendant Krasicky sent an “unsigned and incomplete form entitled '2009 Floor Stocks Tax Return' to the Alcohol and Tobacco Tax and Trade Bureau.” This form was accompanied by a document entitled “Page Distribution Federal Excise Tax Ending Inventory 3-31-09” and a letter

signed by Defendant Krasicky which provided that Page owed a FST liability of $437,459.15.

It is undisputed that Defendant Krasicky, as Receiver for Page, did not make any payment towards the FST liability and Plaintiff asserts that as of April 1, 2015, Page is indebted to the United States for the tax, including penalties and interest, in the amount of $763,501.63. Plaintiff alleges that after April 1, 2009, and despite having notice of the FST liability, Defendant Krasicky distributed more than the amount owed for the FST to "creditors other than the United States, including PNC Bank."

On April 1, 2015, the United States filed the current action against Defendants Krasicky and PNC Bank, as a successor in interest to National City Bank. The United States alleges that Defendant Krasicky is personally liable for the FST and any penalties and interest pursuant to 31 U.S.C. § 3713(b) for "each distribution, to persons and entities other than the United States, of Page Distribution, Inc.'s assets, to which the United States was entitled to priority under 31 U.S.C. § 3713(a)." The United States also claims that Defendant PNC Bank is liable "for restitution for each distribution that it or National City Bank received of Page Distribution, Inc.'s assets to which the United States was entitled to priority under 31 U.S.C. § 3713(a), under Ohio law, or under the Receiver Order."

II. ANALYSIS

A. Defendant Krasicky

The Federal Priority Statute (also sometimes referred to as the Federal Insolvency Statute) provides:

> (1) A claim of the United States Government shall be paid first when –

(a) a person indebted to the Government is insolvent and –

(i) the debtor without enough property to pay all debts makes a voluntary assignment of property;

(ii) property of the debtor, if absent is attached; or

(iii) an act of bankruptcy is committed;

(b) the estate of a deceased debtor, in the custody of the executor or administrator, is not enough to pay all debts of the debtor.

(2) This subsection does not apply to a case under title 11.

(b) A representative of a person or an estate (except a trustee acting under title 11) paying any part of a debt of the person or estate before paying a claim of the Government is liable to the extent of the payment for unpaid claims of the Government.

31 U.S.C. § 3713(a).

…

The Federal Priority Statute "grants an unqualified priority of payment for all claims due to the United States from an insolvent debtor." *Straus v. United States*, 196 F.3d 862, 864 (7th Cir. 1999). The text of the statute has remained "virtually unchanged since its enactment in 1797." *United States v. Estate of Romani*, 523 U.S. 517, 524 (1998). However, the Supreme Court has concluded on several occasions that a specific policy set forth in a later federal statute should control over the Federal

Priority Statute, despite the fact that the Federal Priority Statute was not expressly amended. *Romani*, 523 U.S. 517, 530-31 (1998) (finding that the specific provisions of the Tax Lien Act of 1966 controlled when the United States claimed a preference in the insolvent estate of a delinquent taxpayer).

Here, Defendants rely upon the Supreme Court's decision in Romani to argue that Count I of the United States' claim against Defendant Krasicky fails as a matter of law because the Tax Lien Act of 1966, 26 U.S.C. § 6321, *et seq.* (the "Tax Lien Act") provides that Defendant PNC Bank's perfected security interest has priority over the United States' later tax lien.

The Tax Lien Act provides that:

> *If any person liable to pay any tax neglects or refuses to pay the same after demand, the amount (including any interest, additional amount, addition to tax, or assessable penalty, together with any costs that may accrue in addition thereto) shall be a lien in favor of the United States upon all property and rights to property, whether real or personal, belonging to such a person.*

26 U.S.C. § 6321. The Tax Lien Act further provides that: "[t]he lien imposed by section 6321 **shall not be valid** as against any purchaser, holder of a security interest, mechanic's lienor, or judgment lien creditor until notice thereof which meets the requirements of subsection (f) has been filed by the Secretary." 26 U.S.C. § 6323(a) (emphasis added).

Defendants argue that these provisions of the Tax Lien Act and the Federal Priority Statute result in a "plain inconsistency," because the Federal Priority Statute states that the United States shall be paid first when the debtor is insolvent, but the Tax Lien Act provides that a federal tax lien is

not valid against an earlier "holder of a security interest" such as Defendant PNC Bank. Defendant contends that pursuant to § 6321, the United States' FST liability became a tax lien upon Defendant Krasicky's failure to pay, and because Defendant PNC Bank was a "holder of a security interest" (as recognized by the Ohio State Court in its order granting the motion for appointment of a receiver), the FST lien was not valid against it without the required filing pursuant to § 6323(a). Defendants assert that the Supreme Court's decision of *United States v. Estate of Romani*, 523 U.S. 517 (1998), resolved this conflict and held that the Tax Lien Act controls.

In Romani, a court entered a judgment for $400,000 in favor of a third-party, Romani Industries, and against Francis J. Romani. This judgment was recorded and therefore was, as a matter of state law, considered a "perfected" lien on Romani's real property. Thereafter, the IRS filed multiple tax liens on the same property in the amount of $490,000.

When Romani died years later, his estate consisted of only $53,001. *Id.* Because Romani's property was "encumbered by both the judgment lien and the federal tax liens" the estate's administrator sought permission from the state court to transfer the property to the judgment creditor in lieu of execution.

The Federal Government acknowledged that its tax liens were not valid as against the earlier judgment lien; but giving new meaning to Franklin's aphorism that "in this world nothing can be said to be certain, except death and taxes," it opposed the transfer on the ground that the priority statute (§ 3713) gave it the right to "be paid first."

The state courts then denied the Government's objection to the transfer and found an inconsistency between the Federal

Priority Statute, that required that the United States be paid first over all competing claims, and the Tax Lien Act which stated that a federal tax lien is not valid against judgment lien creditors until certain notice is given.

In *Romani*, the Supreme Court examined the history of both the Tax Lien Act and the Federal Priority Statute and clarified that "the proper inquiry is how best to harmonize the impact of the two statutes on the Government's power to collect delinquent taxes." *Id.* at 523-30. The Supreme Court reasoned that "the 1966 amendments to the Tax Lien Act bespeak a strong condemnation of secret liens, which unfairly defeat the expectations of innocent creditors and frustrate 'the needs of our citizens for certainty and convenience in the legal rules governing their commercial dealings."' *Id.* at 534 (citation omitted). The Supreme Court ultimately held that the Tax Lien Act should control and the prior judgment lien had priority over the United States' federal tax liens.

The *Romani* decision resulted in an IRS "policy not to assert its priority under section § 3713(a) over a prior perfected interest that otherwise has priority under section 6323 of the Internal Revenue Code." IRS Chief Counsel Advice, 200210063, 2002 WL 368437. Indeed, the IRS Manual provides that "The Federal Priority Statute does not apply if, before the insolvency proceeding begins, another person has obtained an interest in the property that would prevail over the federal tax lien under IRC 6323." The IRS Manual goes on to clarify that:

> (b) Under IRC 6323(a), the following creditors prevail unless the IRS has filed a Notice of Federal Tax Lien: (a) purchasers, (b) holders of security interests, (c) mechanic's lienors, and (d) judgment

> lien creditors. Generally, creditors meeting the requirements in IRC 6323(a), (b), (c), or (d), will have a higher priority claim than the IRS if the creditor's interest arises prior to the insolvency proceeding and prior to the filing of the Notice of Federal Tax Lien.
>
> ...
>
> (d) The general rule is that if the creditor would prevail against the IRS under IRC 6323 outside of an insolvency, it will also prevail against the IRS in the insolvency.

The United States attempts to distinguish *Romani* by arguing that the FST liability is not a "tax lien" for purposes of § 6323(a), but rather must be considered an "administrative expense" that arose during the receivership. Therefore, the United States contends that the FST liability does not fit into one of the narrow provisions (i.e., purchaser, holder of security, mechanic's lienor, or judgment creditor) of the Tax Lien Act. The United States then argues that there is a difference between pre-receivership and post-receivership priority.

In *Romani*, it was agreed by the parties that by the terms of § 6323(a) the federal liens "were not valid against the lien created by the earlier recording of Romani Industries' judgment." *Id.* at 524. In the instant action, the United States does not concede that its FST liability is invalid against the earlier perfected security interest of Defendant PNC Bank – rather, the United States argues that the Tax Lien Act does not apply because the FST liability is an "administrative expense" versus a "tax lien."

At its base, the United States' argument rests upon finding the timing of the tax accrual dispositive. The United States

claims that because the FST accrued after the receivership order was entered, it must be classified as an "administrative expense," and pursuant to Ohio case law (all predating 1966) secured creditors are not protected from such an expense. The United States argues that the Tax Lien Act recognizes such a scheme in its definition of "security interest" which provides that a security interest exists "if, at such time, the property is in existence and the interest has become protected under local law..." 26 U.S.C. § 6323(h)(1). The United States contends that this indicates that the validity of the security interest is relative to whether it would be protected under local law from a similarly situated creditor. (ECF No. 13, Pl.'s Br. at 6-7.)

First, it appears from the clear terms of the Tax Lien Act that Defendant PNC Bank had a security interest in Page's assets. Its interest was recorded in 2001 and later recognized as "perfected" by an Ohio Court. The United States argues that a secured interest only exists to the extent that it is generally protected by local law, and here, local law would allow the payment of administrative expenses, and therefore, Defendant PNC Bank does not have a security interest against administrative expenses. This argument ignores the rest of the pertinent statutory definition that provides a "security interest" exists if "the interest has become protected under local law *against a subsequent judgment lien arising out of an unsecured obligation*." 26 U.S.C. § 6323(h)(1) (emphasis added). The statutory definition of "security interest" does not indicate that a security interest is dependent upon the relative position of the creditor. Rather, the definition states, clearly, that a security interest exists where the interest is protected under local law "against a subsequent judgment lien." Here, it is not disputed that Defendant PNC Bank's interest was protected against a

later arising judgment lien arising out of an unsecured obligation. Accordingly, the United States' reliance on this statutory definition does not further its case.

…

Accordingly, the Court finds that under the clear terms of the Tax Lien Act and *Romani*, the United States' claim against Defendant Krasicky fails as a matter of law.

B. Defendant PNC Bank

The Court notes that there is no dispute that the claim against Defendant PNC Bank is a derivative claim that rises and falls upon the liability of Defendant Krasicky. Accordingly, where the Court has found that the claim against Defendant Krasicky fails as a matter of law, the claim against Defendant PNC Bank also fails.

U.S. v. Balice

2015 WL 4251146 (D. N.J. July 10, 2015)

Under federal law, priority is determined according to the familiar principle that first in time is first in right. *McDermott*, 507 U.S. 447, 449 (1993) ("Federal tax liens do not automatically have priority over all other liens. Absent provision to the contrary, priority for purposes of federal law is governed by the common-law principle that the first in time is the first in right.") (internal quotations omitted). But the federal statute is a bit more specific than that. Under 26 U.S.C. § 6321, a tax lien arises when tax is assessed. Such a tax lien is not valid as against a competing "security interest," however, until notice of the tax lien is given—generally, by recordation with the county clerk. *See* 26 U.S.C. § 6323(f). As of the date of the tax lien's

recordation (subject to a 45–day grace period, discussed below), only an earlier "security interest" will be given priority.

To the extent the Amboy lien is prior in time to the federal tax lien, then, it is prior in right. The date of a lien sounds like a simple, ascertainable fact, and it often is—but not always. I next discuss, under federal priority standards, the priority date of the Amboy lien in relation to the federal tax lien.

…

Under applicable federal law, the priority date of a competing lien is the date that it becomes specific and perfected. That means that "the identity of the lienor, the property subject to the lien, and the amount of the lien [must be] established." *McDermott*, 507 U.S. at 449. Thus a lien is perfected, for purposes of its priority vis-à-vis a federal tax lien, when there is "nothing more to be done."*United States v. Equitable Life Assur. Soc. of U.S.*, 384 U.S. 323, 327–28 (1966).

As to Amboy's lien, "[1] the identity of the lienor" and "[2] the property subject to the lien" were indeed established as of March 12, 1991, when the lien was filed. But "[3] the amount of the lien" was contingent on future events. Amboy's HELOC gave the Balices the option to withdraw up to $35,000. (Credit Agrmt., 1) Unless and until the Balices actually did so, the "amount of the lien" was effectively zero. There was no debt for the mortgage to secure. But if, for example, the Balices borrowed $10,000 on the HELOC, that amount would be secured by the equity in their home. In short, the amount of the lien, at any given time, was equal to the amount disbursed and outstanding on the line of credit. In 1991, there was no way to know if there would ever be any outstanding balance—let alone the amount of that balance at any particular time in the future.

Until the Balices borrowed on the HELOC, the amount owed was uncertain; there was still something "more to be done"; the lien was not perfected for priority purposes. *See Equitable Life Assur. Soc.*, 384 U.S. at 327–28. Under a home equity line of credit, then, the amount of the debt does not become certain, and the accompanying lien does not become perfected, until the balance is known as of a particular date.

So "perfection" of the lien is one lens through which to view the question. Another such lens is the statutory definition of a "security interest." That alternative form of scrutiny yields the same answer.

Where, as here, a loan is disbursed over time, the issue of the priority date and the issue of the lien's dollar amount are intertwined. Section 6323(d), quoted above, provides that a tax lien shall not be valid as against "a security interest" that is prior in time. The same section defines a "security interest":

> The term "security interest" means any interest in property acquired by contract for the purpose of securing payment or performance of an obligation or indemnifying against loss or liability. A security interest exists at any time (A) if, at such time the property is in existence and the interest has become protected under local law against a subsequent judgment lien arising out of any unsecured obligations, and (B) to the extent that, at such time, the holder has parted with money and money's worth.
>
> 26 U.S.C. § 6323(a).

Thus a competing lien qualifies as a "security interest" only "at such time" and "to the extent" that the holder has

"parted with money and money's worth." "[M]oney" or "money's worth" are defined by regulation as "money ... and other consideration reducible to a money value. Money or money's worth also includes any consideration ... which was parted with before the security interest would otherwise exist ..." 26 C.F.R. § 301.6323(h)-l(a)(3). By contrast, however, "[a] firm *commitment* to part with money ... does *not*, in itself, constitute a consideration in money or money's worth." *Id.* (emphasis added).

In the case of a HELOC, the lender commits to part with money at the outset, but actually parts with money or money's worth only at the time, and to the extent, that it actually disburses funds. Thus Amboy's 1991 HELOC agreement was a commitment to advance funds to the borrower, but Amboy actually parted with money only later, when the Balices used the line of credit. Only "at such time," and "to that extent," did the Amboy lien qualify as a "security interest" for purposes of priority with respect to the tax lien. 26 U.S.C. § 6323(a).

The federal tax lien was filed as of July 12, 2005. Thus, at most, Amboy would have priority over the federal tax lien to the extent that Amboy had disbursed money to the Balices prior to that date. This statement, however, is subject to two caveats: First, federal law establishes a grace period pursuant to which additional disbursements within 45 days after the filing of the tax lien may enjoy priority. *See* Part I.b.3, *infra*. Second, the amount of Amboy's lien will naturally be reduced to the extent to which the Balices repaid their debt. *See* Part I.b.4, *infra*. Third, there may be interest and fees. *See* Part I.b.4, *infra*. I turn to those issues.

3. The 45–day grace period

The date of filing of the federal tax lien (July 12, 2005) is not quite the final cutoff date for competing liens. Following the recordation of the tax lien, there is a 45–day grace period. During that 45–day period (to simplify a bit), the creditor may make additional advances under an already-existing, secured line of credit, and such advances will enjoy priority over the tax lien. *See* 26 U.S.C. § 6323(d). For those purposes, it is just as if the federal tax lien became effective on the 46th day after its recordation. Here, the 46th day after the filing date of the federal tax lien is August 27, 2005.

Surprisingly, I have found just one case that demonstrates the operation of the grace period with respect to a HELOC. In *Bank of America, N.A. v. Fletcher*, 342 F.Supp.2d 1009 (N.D.Okla.2004), a homeowner entered into a HELOC agreement with Bank. The line of credit was secured by a mortgage on the home, recorded in 1996. Homeowner twice drew on the line of credit, and paid it off. (Like the Balices, Homeowner then transferred the home into a revocable trust.) On October 30, 2000, the IRS filed a lien for back taxes. Sixtyseven days later, on January 5, 2001, Homeowner borrowed $25,000 on the line of credit. Further disbursements on the HELOC and further tax liens followed. Homeowner thereafter defaulted on the HELOC. The Bank and the IRS, who both sought satisfaction of their claims from the property, disputed the relative priority of their liens.

District Judge Cook first reviewed 26 U.S.C. §§ 6321, 6322, and 6323, including the definition of a security interest and the 45–day grace period, quoted above. Pre-tax-lien advances on the HELOC were not at issue, because they had been repaid, so

Judge Cook considered loan disbursements that followed the recordation of the tax lien. As to these, Judge Cook wrote, the Bank would enjoy priority for 45 days, but "the Bank lost its priority lien status on December 15, 2000 which is the 46th day following the October 30, 2000, filing notice of the first tax lien on the real property here in question." *Id.* at 1012. Viewed from the government's perspective, "under the language of § 6323(d), the federal tax lien has priority over the mortgagee's security interest only as to the monies disbursed after the expiration of the 45–day grace period." *Fletcher*, 342 F.Supp.2d at 1011. In *Fletcher*, all of the Bank's relevant disbursements on the HELOC occurred after the expiration of the 45–day grace period. The court therefore held that the tax lien had priority, and granted summary judgment to the United States.

Of particular interest was the district court's explanation of the underlying legislative rationale. As the court explained it, the 45–day grace period (although Amboy seems to be fighting it here) actually represents a relaxation of the strict "first in time" rule, in order to avoid unfair surprise to lenders:

> Prior to the 1966 amendment to the federal tax code, a lien for Federal taxes would arise when a taxpayer's liability was assessed. The lien attached to all of the property held by the taxpayer or subsequently acquired. The assessment was made when the unpaid tax liability was voluntarily entered on the tax forms filed by the taxpayer. Prior to the amendment, secured creditors were given priority over the tax lien only up to the time the IRS filed its tax lien in the county record's office. The amendment allowed for the 45–day grace period to provide an opportunity for a secured creditor to check the

> country records to determine whether a tax lien had been filed. Any advances made during the 45–day grace period were given priority over the tax lien. *See*, S. 1708 I. For priority to exist during the 45–day grace period, there must be a written agreement entered into before the tax lien filing and the security interest must be protected under local law against a judgment lien arising as of the time of the tax lien filing. *See*, S. 1708 II A(4). The 45–day grace period was "designed to make it unnecessary for the holder of a security interest to search the records more often than once every 45 days where one or more disbursements are to be made by him." *Id.*

342 F.Supp.2d at 1012 (quoting S.Rep. No. 1708, 89th Cong., 2d Sess., reprinted in 1966 U.S.Code Cong. & Admin. News, pp. 3722, 3729).

It follows, then, that Amboy, like the Bank in *Fletcher*, "lost its priority lien status on [August 27, 2005] which is the 46th day following the [July 12, 2005] filing notice of the first tax lien on the real property here in question." *Fletcher*, 342 F.Supp.2d at 1012. If, however, there were any further disbursements on the HELOC in the grace period, July 12–August 26, 2005, they would take priority over the federal tax lien. The record does not disclose whether there were any disbursements within the grace period.

6. Secured Party v. Possessory Lienor and Warehouse Lienor

The scope of UCC-9 covers consensual liens. UCC § 9-109(d)(2) provides that UCC-9 "does not apply to [a] lien … given by statute or other rule of law for services or materials,

but section 9-333 applies with respect to priority of the lien." UCC § 9-333, providing priority for possessory liens, provides that a possessory lien means an interest which "secures payment or performance of an obligation for services or materials furnished with respect to goods by a person in the ordinary course of the person's business." With respect to priority, a *possessory* lien on goods has "priority" over a security interest in the goods "unless the lien is created by a statute that expressly provides otherwise." The possessory lien in the next case is the garagemen's lien. The subsequent case focuses on a warehouse's lien provided by statute.

In re Cam Trucking LLC

2014 WL 4639923 (Bankr. D. Ariz. Sept. 9, 2014)

The issue before the Court is whether Transwest Truck Trailer RV's ("Transwest") garagemen's liens are senior to Auto Title Loans USA, LLC's ("ATLU") consensual, purchase money lien.

The relevant facts are undisputed. ATLU is the holder of a purchase money Note and Security Agreement dated January 24, 2014, granting it a security interest in a variety of Debtor Cam Trucking, LLC's motor vehicles. Three of these motor vehicles are also subject to garagemen's liens in favor of Transwest for repairs performed in mid–2014. ATLU's security interest arose prior to Transwest's garagemen's liens.

The essential dispute between ATLU and Transwest is what law applies—Arizona law where the motor vehicles were titled, or Colorado law where Transwest performed the repairs. In reviewing this question, the Court concludes that under either Colorado or Arizona law, Transwest's garagemen's liens

do not prime ATLU's security interest.

Arizona's and Colorado's statutory schemes regarding garagemen's liens and their priorities over other security interests are substantively identical, albeit written and organized somewhat differently. First, both Arizona and Colorado allow for garagemen's liens. Colorado Revised Statute ("C.R.S.") section 38–20–106 provides as follows:

> Any mechanic or other person who makes, alters, repairs, or bestows labor upon any article of personal property, at the request of the owner of such personal property or his agent shall have a lien upon such property for the amount due for such labor done or material furnished and for all costs incurred in enforcing such lien.
>
> Arizona similarly allows for garagemen's liens pursuant to Arizona Revised Statute ("A.R.S.") section 33–1022(A):
>
>> (A) Proprietors of garages and repair and service stations shall have a lien upon motor vehicles of every kind ... for labor, materials, supplies and storage for the amount of the charges.
>>
>> (B)The lien shall not impair any other lien or conditional sale of record at the time the labor, materials, supplies and storage were commenced to be furnished, unless furnished with the knowledge and consent of the record lienor or vendor.
>
> Therefore, whether applying Arizona or Colorado law,

both states recognize Transwest's possessory lien in the vehicles it repaired.

The next question is whether Transwest's garagemen's liens prime ATLU's previously perfected security interest. Article 9, Title 4 of Colorado's Uniform Commercial Code, generally does not apply to statutory liens such as Transwest's garagemen's liens. However, section 4–9–109(d)(2) provides an exception when determining the priority of statutory liens:

> (d) This article does not apply to:
>
> (2) A lien, other than an agricultural lien, given by statute or other rule of law for services or materials, but section 4–9–333 applies with respect to priority of the lien.

Section 4–9–333, in turn, provides that a *possessory lien* created by statute has priority over a security interestin the goods if the lien is created by a statute that expressly so provides:

> (a) In this section, "possessory lien" means an interest, other than a security interest or an agricultural lien:
>
>> (1) Which secures payment or performance of an obligation for services or materials furnished with respect to goods by a person in the ordinary course of the person's business;
>>
>> (2) Which is created by statute or rule of law in favor of the person; and,
>>
>> (3) Whose effectiveness depends on the person's possession of the goods.

(b) A possessory lien on goods has priority over a security interest in the goods if the lien is created by a statute that expressly so provides.

[Arizona's corresponding statutory provisions are similar to Colorado's.]

…

[N]either state would allow Transwest's possessory interest to take priority over ATLU's security interest. Arizona law expressly forbids garagemen's liens from taking priority over security interests and Colorado law only allows garagemen's liens to take priority over a security interest if expressly allowed. One denies lien priming by the affirmative, and the other denies lien priming by the negative….

[*First Sec. Bank of Idaho v. Crouse*, 374 F.2d 17 (10th Cir.1967)] presents facts nearly identical to those here. An auto mechanic in Colorado provided repairs to a Mack truck that broke down while in Colorado. The bank had properly perfected its secured claim under Idaho law, where the loan to purchase the truck was made, prior to any repair work in Colorado. The parties agreed that under Colorado law, the precise source of which was not identified by the court, "the general rule is that a garageman's lien for work done on a vehicle will be subordinated to prior recorded mortgages." 374 F.2d at 18. The court rejected the argument that a "garageman's equitable lien for necessary repairs of ordinary wear and tear would take priority" because the repair work purportedly protects the holder of the recorded lien and, as such, implies consent to the repairs by the secured creditor. The court found support for this conclusion in Colorado's recent adoption of the U.C.C.:

> The conclusion that a prior recorded chattel mortgage is superior to a subsequent garageman's lien is also supported by the Colorado legislature's treatment of the problem in its enactment of the Uniform Commercial Code which became effective on July 1, 1966, after the instant facts occurred. As promulgated by the National Conference of Commissioners on Uniform State Laws, the applicable section provides that a repairman's lien takes 'priority over a perfected security interest unless the lien is statutory and the statute expressly provides otherwise.' The Colorado legislature changed this section so that the Colorado statute, Colorado Revised Statutes, 1963, § 155–9–310, expressly provides that the repairman's lien 'does not take priority over a perfected security interest unless a statute expressly provides otherwise.' This maintains the prior law by giving the repairman an inferior priority status.

For these reasons,IT IS HEREBY ORDERED that ATLU's security interest in the three vehicles identified in its motion takes priority over Transwest's garagemen's liens.

****

Statutory Lien – Warehouse Lien

M & I Marshall & Ilsley Bank v. Kinder Morgan Operating L.P.

368 S.W.3d 160 (Mo. Ct.App. 2012)

GARY M. GAERTNER, JR., Judge.

In this case, we are asked to determine the priority

between a warehouse lien and a perfected security interest. Kinder Morgan Operating L.P. "C" (KMO) and Kinder Morgan Amory, L.L.C. (KM Amory) (collectively, Kinder Morgan) appeal the trial court's grant of partial summary judgment granting M & I Marshall & Ilsley Bank's (M & I) perfected security interest priority over Kinder Morgan's two warehouse liens. Applying the Uniform Commercial Code (UCC), we conclude that under the facts presented here, the 2006 warehouse lien has priority over the 2007 perfected security interest, which in turn has priority over the 2008 warehouse lien. Affirmed in part, and reversed and remanded in part.

I. BACKGROUND

Kinder Morgan operates facilities, referred to as terminals, for the storage and transportation of various products. KMO is located in Arkansas, and KM Amory is located in Mississippi. Jomico L.L.C. (Jomico) is a distributor of coal with headquarters in St. Louis, Missouri. On January 11, 2006, KMO and Jomico entered into a terminal agreement (KMO Terminal Agreement), which provides as follows. KMO agreed to provide storage and handling for Jomico's coal and coal products at KMO's Arkansas terminal, for a fee of $67,083 per month through April 30, 2016. In the section entitled "Liens," the KMO Terminal Agreement states:

> At all times to the extent permitted by law, [KMO] shall have all applicable statutory liens upon all [coal] at any time in the Terminal for the charges set forth herein whether incident to [coal] then on the Terminal or otherwise and in connection with any and all other agreements between [KMO] and [Jomico]....

The KMO Terminal Agreement anticipated that Jomico would begin depositing coal on or about May 1, 2006. Todd Jones, Commercial Director for both KMO and KM Amory warehouses, attested that as of September 1, 2010, Kinder Morgan had been providing processing, storage, and transportation services to Jomico for four years.

On June 4, 2007, Jomico entered into a commercial security agreement (Security Agreement) with M & I, granting M & I a security interest in its collateral—described as, inter alia, all inventory, equipment, accounts, and money—to secure a bank loan. The Security Agreement provides as follows, in relevant part:

> **Location of the Collateral** Except in the ordinary course of Grantor's [Jomico's] business, Grantor agrees to keep the Collateral ... at Grantor's address [on Washington Avenue] or at such other locations as are acceptable to Lender [M & I]. Upon Lender's request, Grantor will deliver to Lender ... a schedule of real properties and Collateral locations relating to Grantor's operations, including without limitation the following ... (3) all storage facilities Grantor owns, rents, leases, or uses, and (4) all other properties where Collateral is or may be located.
>
> **Removal of Collateral** Except in the ordinary course of Grantor's business, including the sale of inventory, Grantor shall not remove the Collateral from its existing location without Lendor's prior written consent....
>
> **Transactions involving Collateral** Except for

inventory sold or accounts collected in the ordinary course of Grantor's business ..., Grantor shall not sell, offer to sell, or otherwise transfer or dispose of the Collateral. While Grantor is not in default under this Agreement, Grantor may sell inventory, but only in the ordinary course of its business and only to buyers who qualify as a buyer in the ordinary course of business. A sale in the ordinary course of Grantor's business does not include a transfer in partial or total satisfaction of a debt or any bulk sale. Grantor shall not pledge, mortgage, encumber or otherwise permit the Collateral to be subject to any lien, security interest, encumbrance, or charge, other than the security interest provided for in this Agreement, without the prior written consent of Lender....

Title Grantor represents and warrants to Lender that Grantor holds good and marketable title to the Collateral, free and clear of all liens and encumbrances....

Taxes, Assessments and Liens Grantor will pay when due all taxes, assessments and liens upon the Collateral.... Grantor may withhold any such payment or may elect to contest any lien if Grantor is in good faith conducting an appropriate proceeding to contest the obligation to pay and so long as Lender's interest in the Collateral is not jeopardized in Lenders' sole opinion. If the Collateral is subjected to a lien which is not discharged within fifteen (15) days, Grantor shall deposit with Lender cash, a sufficient corporate surety bond or other security

> satisfactory to Lender in an amount adequate to provide for the discharge of the lien ... that could accrue as a result of foreclosure or sale of the Collateral.
>
> GRANTOR'S RIGHT TO POSSESSION AND TO COLLECT ACCOUNTS ... Grantor may have possession of the tangible personal property and beneficial use of all the Collateral and may use it in any lawful manner not inconsistent with this Agreement....

On June 18, 2007, M & I filed a UCC Financing Statement with the Missouri Secretary of State identifying Jomico as the debtor and substantially describing Jomico's personal property, including, without limitation, all current and after-acquired inventory.

On February 15, 2008, KM Amory and Jomico entered into a terminal agreement (KM Amory Terminal Agreement), whereby KM Amory agreed to provide storage, handling, and processing for Jomico's coal and coal products in their Mississippi terminal, for a fee of $178,750 per month for the first two years and $294,938 per month for the next eight years. Similar to the KMO Terminal Agreement, the KM Amory Terminal Agreement also provides that "[a]t all times to the extent permitted by law, [KM Amory] shall have all applicable statutory ... liens upon all [coal] at any time in the Terminal for the charges set forth herein whether incident to [coal] then in or on the Terminal or otherwise and in connection with any and all other agreements between [KM Amory] and [Jomico]...."

Jomico defaulted on the Security Agreement with M & I, and failed to make payments to both KMO and KM Amory

under the respective terminal agreements. On or about February 2010, KMO was storing over 6,000 tons of coal and coal products in their Arkansas terminal, and KM Amory was storing over 2,300 tons of coal and coal products in their Mississippi terminal.

Kinder Morgan asserted warehouse liens against the coal, and stated its intent to sell the coal to cover the warehouse costs. M & I filed the underlying petition for declaratory judgment, contending it had a perfected security interest in the coal with priority over Kinder Morgan's warehouse liens, and objecting to the proposed sale. Both M & I and Kinder Morgan filed motions for summary judgment. The trial court granted partial summary judgment to M & I, finding that M & I's perfected security interest had priority over Kinder Morgan's warehouse liens. This appeal follows.

II. DISCUSSION

In its first point on appeal, Kinder Morgan argues that the trial court erred in finding that its warehouse lien did not have priority over M & I's perfected security interest, in that the trial court incorrectly determined the perfected security interest predated the warehouse liens. We agree in part and disagree in part.

…

[W]e do not view the 2006 warehouse lien between Jomico and KMO, and the 2008 warehouse lien between Jomico and KM Amory as a single warehouse lien. A warehouse lien is only available on goods for which a valid warehouse receipt has been issued. *In re Siena Publishers Assocs.*, 149 B.R. 359, 362 (Bankr.S.D.N.Y.1993). While a warehouse receipt need not be in

any particular form, it must contain certain essential terms, such as the location of the warehouse where the goods are stored, the date of the receipt, and the rate of storage. U.C.C. § 7–202 (2003); *see also* Section 400.7–202, RSMo. (2000); *Siena Publishers*, 149 B.R. at 362–63.

Here, the terminal agreements list the warehouse locations, the dates of the agreements, and the rates of storage, and thus constitute valid warehouse receipts. KMO is a Delaware limited partnership, while KM Amory is a Mississippi limited liability company, and thus they are separate legal entities. Further, the two receipts reflect different warehouse locations, were entered into on different dates, and charged different rates, and thus the KMO Terminal Agreement cannot serve as a warehouse receipt for the KM Amory warehouse, and vice versa. Moreover, the KM Amory warehouse had not even been built at the time of the KMO Terminal Agreement. A valid warehouse receipt is a condition precedent for a warehouse lien. *Siena Publishers*, 149 B.R. at 362. Because the KMO Terminal Agreement is not a valid receipt with respect to goods stored in the KM Amory warehouse, the KMO Terminal Agreement does not create a warehouse lien upon those goods.

Accordingly, our priority determinations are twofold: the 2006 KMO Terminal Agreement versus the Security Agreement, and the 2008 KM Amory Terminal Agreement versus the Security Agreement.

U.C.C. § 7–209 creates and defines a warehouse lien, and governs the order of priority between a warehouse lien and the rights of third parties, including persons holding a perfected security interest. Specifically, it provides as follows:

(a) A warehouse has a lien against the bailor on the goods covered by a warehouse receipt or storage agreement ... for charges for storage or transportation ... in relation to the goods.... If the person on whose account the goods are held is liable for similar charges or expenses in relation to other goods whenever deposited and it is stated in the warehouse receipt or storage agreement that a lien is claimed for charges and expenses in relation to other goods, the warehouse also has a lien against the goods covered by the warehouse receipt or storage agreement ... for those charges and expenses, whether or not the other goods have been delivered by the warehouse….

(c) A warehouse's lien for charges and expenses under subsection (a) ... is also effective against any person that so entrusted the bailor with possession of the goods that a pledge of them by the bailor to a good-faith purchaser for value would have been valid. However, the lien ... is not effective against a person that before issuance of a document of title had a legal interest or a perfected security interest in the goods and that did not:

> (1) deliver or entrust the goods ... to the bailor ... with:
>
> (A) actual or apparent authority to ship, store, or sell; …
>
> (2) acquiesce in the procurement by the bailor or its nominee of any document. …
>
> (e) A warehouse loses its lien in any goods that it voluntarily delivers....

See also Sections 400.7–209, RSMo. (2000), 400.7–503, RSMo. (2001). We apply U.C.C. § 7–209 to the two priority determinations as follows.

Priority between the 2006 KMO Terminal Agreement and M & I's Security Agreement

Under the plain language of the UCC, a warehouse lien is valid against the bailor (here, Jomico). U.C.C. § 7–209(a). With regards to a claim on the stored goods by a third party, however, the law is less clear. Several UCC provisions provide guidance. In general,U.C.C. § 9–322(a)(1) provides that conflicting perfected security interests rank according to priority in time of filing. U.C.C. § 9–322(a)(1) (2003); *see also* Section 400.9–322(a)(1), RSMo. (2001). U.C.C. § 9–333, however, provides that possessory, statutory liens—such as a warehouse lien—will have "priority over a security interest in the goods, unless the lien is created by a statute that *expressly provides otherwise*." (emphasis added) U.C.C. § 9–333 (2003); *see also* Section 400.9–333, RSMo. (2001). Because U.C.C. § 7–209 sets forth circumstances under which a warehouse lien will not take priority over a secured party, U.C.C. § 7–209 "expressly provides otherwise" within the meaning of U.C.C. § 9–333. *In re Sharon Steel Corp.*, 176 B.R. 384, 387–88 (Bankr.W.D.Pa.1995).

U.C.C. § 7–209 provides that a prior warehouse lien takes priority over subsequent claims upon the goods. The UCC's Official Comment explains that when a bailor grants a security interest in goods to a secured party while the goods are in the warehouse'spossession, the warehouse lien takes priority. U.C.C. § 7–209 cmt. 3, example 8 (2005); *Bracey v. Monsanto Co.*, 823 S.W.2d 946, 950 (Mo. banc 1992) (parties may look to UCC Official Comments for guidance). Thus, our first question is

whether the coal was in possession of the KMO terminal before M & I perfected its Security Agreement.

Warehouse liens are possessory, and delivery of the stored goods may cause a warehouse to lose its lien. U.C.C. § 7–209(a), (e). M & I seeks to distinguish the coal that was deposited between 2006 and June 18, 2007, from the coal that was deposited after June 18, 2007 (the date upon which M & I argues it would gain priority in time). M & I further claims that when Kinder Morgan agreed in its answer to M & I's initial petition that "coal was deposited into the KMO terminal after June 18, 2007," this constituted an admission either that the coal deposited between 2006 and June 18, 2007, had been delivered within the meaning of U.C.C. § 7–209(e), or that coal deposited after June 18 could be distinguished from coal deposited before June 18. The trial court agreed with M & I that the coal at issue in this suit was "limited to that coal delivered to [KMO's] warehouse after the filing of [M & I's] financing statement [on June 18, 2007]," and the coal delivered after June 18, 2007, was not first in time for priority purposes. We disagree.

The record shows that KMO provided warehouse services for Jomico's coal on an ongoing basis from 2006. KMO stored Jomico's coal in one-ton super sacks, silos, and piles. Coal is a fungible good, and coal stored in silos and piles would necessarily become intermingled. *See In re Wyoming Valley Collieries Co.*, 29 F.Supp. 106, 109 (M.D.Pa.1939) (coal is fungible good). There is nothing in the record demonstrating that KMO stored the coal it received separately, or that it would be possible to identify the particular coal delivered before June 18, 2007, from that delivered after. Black's Law Dictionary 684 (7th ed.1999) (fungible means commercially interchangeable with other property of same kind). On its face, we do not agree that

Kinder Morgan's admission that some coal was deposited after June 18, 2007, can be read as an admission that all coal deposited between 2006 and June 18, 2007, had been delivered and was no longer in KMO's possession. Without such an admission, this Court has no way to determine whether any coal deposited before June 18, 2007, remains in KMO's warehouse. Because the record does not definitively support the trial court's interpretation of this material fact, summary judgment was improper in this regard. *ITT Commercial Fin. Corp.*, 854 S.W.2d at 378, 382.

Even if the record did show that KMO had entirely replaced the coal deposited before June 18, 2007, with coal deposited after June 18, 2007, if the 2006 KMO Terminal Agreement created a "general" lien, then any coal deposited after June 18, 2007, was also subject to that warehouse lien. Under the UCC, a "specific" lien attaches automatically to the specific goods stored under the receipt or storage agreement. However, a warehouse may assert a "general" lien (sometimes referred to as a "spreading" lien) "for similar charges or expenses in relation to other goods whenever deposited ... whether or not the other goods have been delivered by the warehouse." U.C.C. § 7–209(a) & cmt. 1, para. 3; *In re Julien Co.*, 136 B.R. 743, 751 (Bankr.W.D.Tenn.1992) ("spreading lien"). The language of the UCC explicitly contemplates a situation where, as here, the warehouse lien may be secured by goods currently held for charges incurred for goods that have already been delivered.

To create a general lien, (1) the bailor must be liable for storage charges in relation to goods other than those at issue in the receipt, and (2) the receipt or storage agreement must state that the lien is claimed for charges in relation to those other

goods. U.C.C. § 7–209(a); *cf. Harbor View Marine Corp. v. Braudy*, 189 F.2d 481, 485 (1st Cir.1951) (in cases of non-negotiable receipts, customer may withdraw part of goods from warehouse without paying charges, so long as warehouse retains other goods of customer to serve as security for debt on general account); *Robinson v. Larrabee*, 63 Me. 116, 117 (Maine 1873) ("[t]here is no question but the voluntary relinquishment, by the bailee, of possession of the subject of the bailment discharges his lien, unless it is consistent with the contract, the course of business or the intention of the parties").

Applying this two-part test here, first, Jomico is liable for storage charges for all coal deposited with KMO, not simply the first deposit of coal following the KMO Terminal Agreement. Second, the language of the ten-year KMO Terminal Agreement states: KMO "shall have ... liens upon all Commodities at any time in the Terminal for the charges set forth herein whether incident to Commodities then on the Terminal or otherwise." While it would be preferable if KMO had included the specific UCC language, "in relation to other goods," *seeIn re Julien Co.*, 136 B.R. 765, 774 (Bankr.W.D.Tenn.1992), what matters is that the language in the warehouse lien shows that the lien claimed was for storage of goods other than those described on the receipt. *Cf. Matter of Celotex Corp.*, 134 B.R. 993, 997–98 (Bankr.M.D.Fla.1991) (although warehouse claimed general lien, warehouse receipt did "not specify a lien for charges for storage of goods not covered by the service bills"). We find that the language used here, "whether incident to Commodities then on the Terminal or otherwise," sufficiently claims a general lien for the storage costs incurred for all coal deposited with KMO, and thus complies with the elements set forth in U.C.C. § 7–209(a).

The 2006 KMO Terminal Agreement was first in time before the 2007 Security Agreement. The trial court's finding that it was possible to differentiate between coal deposited before and after June 18, 2007, is not supported by the record; further, the trial court failed to recognize that charges accrued for coal deposited and delivered between 2006 and June 18, 2007, could be and in fact were secured by a general lien against coal deposited after June 18. Therefore, the 2006 warehouse lien takes priority over M & I's perfected security interest.

This portion of Point I is granted.

Priority between 2008 KMO Terminal Agreement and M & I's Security Agreement

****

A prior secured party takes priority over a subsequent warehouse lien upon the goods. U.C.C. § 7–209 cmt. 3, example 10 (when bailor grants perfected security interest in goods to secured party prior to storage of goods with warehouse, then subsequent warehouse lien is not effective against secured party, subject to exceptions); U.C.C. § 9–322(a)(1) (conflicting perfected security interests rank according to priority in time of filing); *Curry Grain*, 815 P.2d at 1071 (because conflicting security interests rank according to priority in time of filing or perfection, and because bank perfected its interest in goods before goods were deposited with warehouse, bank's security interest has priority). Here, the 2007 perfected security interest was prior in time to the 2008 KM Amory Terminal Agreement, and thus takes priority, subject to our analysis in response to Points II and III. This portion of Point I is denied.

7. Secured Party v. Lienor

Secured parties sometimes face competing claims in the same collateral asserted by someone with a court judgment. It is best that the secured party perfects its security interest by

filing afinancing statement to put everyone on notice of its rights in the collateral. The secured party will then enjoy priority under UCC § 9-317(a)(2). The next case illustrates the priority between asecured party and judgment lienor. The case addresses whether the judgment lienor can rely on an exception provided in UCC § 9-323(b) to get priority over the prior recorded security interest.

Inwood National Bank v. Wells Fargo Bank, N.A.

463 S.W.3d 228 (Tex. Ct. of App. 2015)

Wells Fargo Bank, N.A., as Trustee (Wells Fargo) obtained a judgment against Charles Paschall Jr. and initiated a post-judgment garnishment proceeding against U.S. Trust, Bank of America Private Wealth Management (U.S.Trust), at which Paschall held an investment account, as well as against other institutions at which Paschall maintained accounts. U.S. Trust answered, asserting that, although it held assets belonging to Paschall, those assets were pledged as collateral for a debt he owed to Inwood National Bank (Inwood). Inwood filed a plea in intervention, contending it held a perfected security interest in the assets in the investment account, and a motion to dissolve the writ of garnishment as to those assets. The trial court denied Inwood's motion and rendered judgment awarding Wells Fargo the assets in the investment account. The trial court also ordered that U.S. Trust recover its costs in the garnishment proceeding, consisting of attorney's fees U.S. Trust incurred in the garnishment proceeding, from the assets in the investment account, but did not award U.S. Trust contingent attorney's fees on appeal.

In this appeal, Inwood asserts the trial court erred by

denying its motion to dissolve the writ of garnishment, while U.S. Trust argues the trial court erred by failing to award contingent attorney's fees on appeal. We conclude the trial court did not err by failing to award U.S. Trust contingent attorney's fees on appeal. However, because Inwood's security interest has priority over Wells Fargo's judgment lien, we reverse the trial court's judgment awarding Wells Fargo the assets in the investment account.

…

Analysis

The Texas Business and Commerce Code … provides that a perfected security interest in property generally has priority over all other claims to the property. *See* TEX. BUS. & COM. CODE ANN. § 9.201(a) & cmt. 2 (West 2011). The parties to a loan may structure a security agreement to provide that the security interest in the collateral will cover not only funds advanced at the time of the original loan, but also future advances to the debtor. TEX. BUS. & COM.CODE ANN. § 9.204(c). Pursuant to such an agreement, the lender's subsequent advances to the debtor attach to the collateral and enlarge the original security interest in the collateral. *See* TEX. BUS. & COM.CODE ANN. § 9.323(a) & cmts. 3, 4.

A judgment lien, such as the one held by Wells Fargo, is generally subordinate to a perfected security interest in the collateral. *See id*. § 9.317(a)(2)(A) (lien creditors are subordinate to prior perfected security interest). However, section 9.323(b) of the Texas UCC sets out a narrow exception to the priority of claims in order to protect a judgment lien creditor's right to property subject to a perfected security interest:

> Except as otherwise provided in Subsection (c), a security interest is subordinate to the rights of a person that becomes a lien creditor to the extent that the security interest secures an advance made more than 45 days after the person becomes a lien creditor unless the advance is made:
>
> > (1) without knowledge of the lien; or
> >
> > (2) pursuant to a commitment entered into without knowledge of the lien.

TEX. BUS. & COM.CODE ANN. § 9.323(b). The purpose of section 9.323(b) is to protect a judgment lien creditor who has successfully levied on a valuable equity subject to a security interest from being "squeezed out" by a later enlargement of the security interest by an additional advance. UNIFORM COMMERCIAL CODE, 1972 Official Text Showing Changes Made in Former Text of Article 9.

In this case, it is undisputed that Inwood had a perfected security interest in the assets in the investment account at the time Wells Fargo obtained its judgment lien and that Inwood's security interest had priority over Wells Fargo's judgment lien. It is also undisputed that Inwood and Paschall signed the 2012 Note more than forty-five days after Inwood had notice of Wells Fargo's judgment lien. Further, Inwood does not argue that it had a commitment, entered into without knowledge of Wells Fargo's judgment lien, to make an advance to Paschall. Therefore, whether the trial court properly determined Inwood's security interest became subordinate to Wells Fargo's judgment lien hinges on whether the 2012 Note was an "advance."

Because neither section 9.323(b) nor any other section of

the Texas UCC defines the term "advance," we look first to the common meaning of the term in determining the Legislature's intent. The term "advance" means "the furnishing of money or goods before any consideration is received in return," or "the money or goods furnished." BLACK'S LAW DICTIONARY 63 (10th ed.2010). This definition is consistent with the statute's purpose of preventing a secured party from increasing its interest in the collateral, thereby preventing a judgment lien creditor from levying on any equity in the property in excess of the security interest.

…

It has long been the law in Texas that the giving of a new note for a debt evidenced by a former note does not extinguish the old note unless it was the intention of the parties to do so. *Schwab v. Schlumberger Well Surveying Corp.*, 198 S.W.2d 79, 82 (1946); *see also Thompson v. Chrysler First Bus. Credit Corp.*, 840 S.W.2d 25, 29 (Tex.App.–Dallas 1992, no writ) (in case decided after adoption of Texas UCC, this Court stated, "unless it is proved that the parties intended to discharge the obligations under the existing note prior to renewal or extension, there is no discharge of the old note by the executing of an extension agreement"). An intention by the parties to enter into the novation of a debt is never presumed, and the burden of proving discharge or novation is on the party asserting it. *Barnett*, 549 S.W.2d at 430. "In general, the renewal merely operates as an extension of time in which to pay the original indebtedness. The debt is not thereby increased. It remains the same; it is in substance and in fact the same indebtedness evidenced by a new promise." *Id.*

Inwood and Paschall entered into the loan secured by the

collateral in the investment account in 2000. The record establishes that, beginning in May 2009 and continuing at least through the hearing on Inwood's motion, Inwood and Paschall entered into a series of promissory notes extending the time to pay the indebtedness. Each of these promissory notes appears identical to the others and specifically states it was a renewal and extension of the indebtedness, and not a novation. None of the promissory notes increased the amount of the indebtedness or the burden on the collateral. The balance owed on the note, or the amount of credit available to Paschall, was exactly the same before and after the execution of the 2012 Note. There is no evidence that Inwood and Paschall intended, through the 2012 Note, to novate the loan agreement to provide new credit to Paschall. Nothing about the 2012 Note, standing alone, placed an additional burden on the collateral in the investment account such that it would constitute an advance under section 9.323(b).

…

Finally, Wells Fargo contends the public policy underlying section 9.323(b), as well as equity, support the trial court's determination that Inwood's security interest is subordinate to Wells Fargo's judgment lien. Wells Fargo points out that Inwood chose to extend the loan evidenced by the 2012 Note, rather than declare a default and foreclose on the collateral, in order "to insulate itself from the effects of a global default by Paschall." Wells Fargo argues section 9.323(b) was enacted to prevent collusion between a lender and a debtor that prevents a judgment lien creditor from obtaining access to the debtor's assets and, therefore, both this policy and equity require that Wells Fargo's judgment lien have priority over Inwood's security interest.

We have found no authority addressing the question of whether an action by a lender, such as executing a renewal note, which, standing alone, is not an "advance" under section 9.323(b), is made an "advance" by other dealings between the lender and the debtor. However, we need not answer that question in this case because the evidence does not support such a scenario. There is no evidence that Paschall, as opposed to one of his "various entities," was the debtor on any other loan from Inwood or whether the assets available to pay those loans belonged to Paschall, as opposed to one of his "various entities." If the assets used to pay those other loans belonged to Paschall, Wells Fargo would have had the ability to seek to garnish those assets, just as it attempted to garnish the assets in the investment account. Nothing about the 2012 Note "squeezed out" Wells Fargo from imposing a judicial lien on Paschall's assets outside the investment account. Conversely, if the assets used to pay the other loans belonged to one of Paschall's "various entities," Wells Fargo did not have a right, under the judgment lien at issue, to garnish those assets, and there is no evidence Paschall could use assets belonging to his "various entities" to repay the loan at issue in this case. Regardless, Wells Fargo was in the same position before the execution of the 2012 Note as it was after its execution and was not subject to the "squeeze out" section 9.323(b) seeks to address.

Conclusion

The fundamental purposes of the Texas UCC are to "simplify, clarify and modernize the law governing commercial transactions," permit the "continued expansion of commercial practices through custom, usage, and agreement of the parties," and make the law among jurisdictions uniform. None of these

purposes are met by construing the term "advance" in section 9.323(b) to include a promissory note that the parties to an ongoing commercial relationship intended to be solely a renewal and extension of an existing indebtedness and that did not place any additional burden on the collateral securing the loan. Indeed, such a construction would materially impact the priority of interests carefully established by the UCC.

We conclude the trial court erred by determining the 2012 Note was an advance under section 9.323(b) of the business and commerce code. Accordingly, Inwood's perfected security interest in the assets in the investment account had priority over Wells Fargo's judgment lien in the same property, and the trial court erred by denying Inwood's motion to dissolve the writ of garnishment as to the assets in the investment account.

8. Secured Party v. Transferee of Fund from Deposit Account

Asecured party may have a perfected security interest in a deposit account. If a transferee of funds from the deposit account takes the funds from the account, does the secured party or the transferee have priority in the funds? UCC § 9-332(b) provides that "A transferee of funds from a deposit account takes the funds free of a security interest in the deposit account unless the transferee acts in collusion with the debtor in violating the rights of the secured party." Read the case below.

Orix Financial Services, Inc. v. Kovacs

83 Cal. Rptr.3d 900 (Cal. Ct. App. 2008)

This case presents a very narrow question—one of first impression in California: Is an unsecured judgment creditor, who satisfies its judgment from deposit account funds, included in the definition of "transferee" as contemplated by

section 9-332(b), such that it may take those funds free of any security interest?

Appellant, Orix Financial Services, Inc. (Orix), filed a complaint against defendants Mike Kovacs, and Marius Marta, doing business as Bay Technology, (collectively, Kovacs) for unjust enrichment and imposition of a constructive trust. The trial court, answering the foregoing question in the affirmative, sustained defendants' demurrer to the complaint without leave to amend….

ADA Machine Company, Inc. (ADA), defaulted on financial obligations to Orix, which were secured by interests in all of ADA's goods, chattels and property. Approximately $1.5 million remains owing on those obligations. Separately, Kovacs obtained a judgment against ADA for $157,468.11 and, thereafter, a writ of execution against ADA's deposit accounts. All of the funds contained in these accounts were derived from the proceeds of the sale of ADA's inventory and collection of its accounts receivable. Kovacs's satisfaction of its judgment from these funds is the basis of Orix's complaint.

Kovacs essentially concedes that Orix's position as a secured creditor is superior to Kovacs's own position as an unsecured creditor under a traditional creditors' priority analysis. However, Kovacs argues that such an analysis is irrelevant to the question of the satisfaction of a judgment from a deposit account, which it argues is wholly free of such a priority analysis in light of section 9332(b).

The provisions of the California UUC ("CUCC")are, in large part, identical to those of the UCC and versions adopted by jurisdictions around the country….

We quote at length from the UCC Comment to its section

9–332:

2. Scope of This Section. This section affords broad protection to transferees who take funds from a deposit account and to those who take money. The term 'transferee' is not defined; however, the debtor itself is not a transferee. Thus this section does not cover the case in which a debtor withdraws money (currency) from its deposit account or the case in which a bank debits an encumbered account and credits another account it maintains for the debtor.

A transfer of funds from a deposit account, to which subsection (b) applies, normally will be made by check, by funds transfer, or by debiting the debtor's deposit account and crediting another depositor's account.

3. Policy. Broad protection for transferees helps to ensure that security interests in deposit accounts do not impair the free flow of funds. It also minimizes the likelihood that a secured party will enjoy a claim to whatever the transferee purchases with the funds. Rules concerning recovery of payments traditionally have placed a high value on finality. The opportunity to upset a completed transaction, or even to place a completed transaction in jeopardy by bringing suit against the transferee of funds, should be severely limited. Although the giving of value usually is a prerequisite for receiving the ability to take free from third-party claims, where payments are concerned the law is even more protective. Thus, Section 3–418(c) provides that, even where the law of

restitution otherwise would permit recovery of funds paid by mistake, no recovery may be had from a person 'who in good faith changed position in reliance on the payment.' Rather than adopt this standard, this section eliminates all reliance requirements whatsoever. Payments made by mistake are relatively rare, but payments of funds from encumbered deposit accounts (e.g., deposit accounts containing collections from accounts receivable) occur with great regularity. In most cases, unlike payment by mistake, no one would object to these payments. In the vast proportion of cases, the transferee probably would be able to show a change of position in reliance on the payment. This section does not put the transferee to the burden of having to make this proof.

4. 'Bad Actors.' To deal with the question of the 'bad actor,' this section borrows 'collusion' language from Article 8. *See, e.g.*, Sections 8–115, 8–503(e). This is the most protective (i.e., least stringent) of the various standards now found in the UCC.

The prior version of Title 9 of the CUCC did not contain a section 9332. Similarly, the prior version of Article 9 of the UCC did not contain a section 9–332. These sections find their provenance in UCC, section 9–306, as it existed before the revision—specifically in comment 2(c) to that section, which read: "Where cash proceeds are covered into the debtor's checking account and paid out in the operation of the debtor's business, recipients of the funds of course take free of any claim which the secured party may have in them as proceeds. What has been said relates to payments and transfers in ordinary

course. The law of fraudulent conveyances would no doubt in appropriate cases support recovery of proceeds by a secured party from a transferee out of ordinary course or otherwise in collusion with the debtor to defraud the secured party." The scope of the exception found in Comment 2(c)—excepting fraudulent conveyances from the provision that a recipient of funds from a deposit account takes free from encumbrances—was the subject of litigation before the revision of the UCC.

…

Significantly, upon the revision of the UCC and the adoption of section 9–332, the language regarding "operation of the debtor's business" and "ordinary course" did not make the transfer from comment 2(c), only the language regarding "collusion" did so. As noted in the comment to section 9–332, the "collusion" standard is the standard most protective of transferees and is, thus, consistent with that suggested by Justice Breyer in *Harley–Davidson v. Bank of New England* and arguably more protective than the standard suggested by *General Elec. Capital* v. *Union Planters*. Thus, the history of the code and its amendments suggests that only those transferees who act in collusion with the debtor are excepted from the broad protections of section 9–332(b). Here, Orix did not allege that Kovacs acted in collusion with ADA to defeat Orix's interest. Instead, Orix contends that a judgment creditor is not the kind of transferee contemplated by section 9–332(b).

The broad language of the statute does not support Orix's contention. The drafters of the revised UCC, as well as our Legislature, had the opportunity to include the exception suggested by Orix in the language of the revised codes—the issue was certainly presented by the history of litigation on the

subject. They did not do so; we will not do so in the first instance.

We note that the lion's share of transferees from a deposit account are creditors of one form or another—secured, unsecured, judgment, etc. For instance, a landlord and a utility company are creditors and are, ordinarily, unsecured. They would not be excepted from the protections of section 9–332(b). Thus, any suggestion that the rights of a secured creditor cannot be compromised by junior creditors is not persuasive. Indeed, as the comment to section 9–332 quoted above makes clear, a protected transferee need not be a creditor at all, but may have been paid by mistake or otherwise have provided no value to debtor in exchange for the payment.

Orix makes a series of contentions, which are each belied by the foregoing analysis. First, it contends section 9332(b) should not extend to a lien creditor who took possession of the funds by garnishment rather than any activity or payment by the debtor. As noted, Kovacs's status as a creditor is irrelevant, and there is no requirement that the debtor actively or even voluntarily make a payment. In support of the notion that there must be a volitional act by the debtor, Orix notes that the comment to section 9–332 repeatedly uses the word "payment" rather than "transfer." Certainly, any potential distinction, in this context, between the two words is rendered moot by the use of the word "transferee" and not "payee" in the code itself. Finally, Orix cites the policy found in the UCC Comment to section 9–332 of preserving "completed transactions" and argues that what occurred here was not a transaction but a unilateral act. However, both the CUCC section 9332 and UCC section 9–332 require only a transfer, which indisputably occurred.

Our analysis and conclusion are consistent with those of the federal bankruptcy court in *In re Machinery, Inc.,* 342 B.R. 790, 798–799(Bank E.D. Mo.2006), which the trial court here relied upon in granting Kovacs's demurrer. Orix has at no time suggested it could allege collusion between ADA and Kovacs. Specifically, Orix never moved for leave to amend its complaint to so state. Indeed, its argument that ADA was passive and did not participate in the transfer (i.e., did not make a "payment") augers against any suggestion of collusion. Consequently, the trial court's order granting the demurrer without leave to amend was appropriate.

The judgment is affirmed.

9. Priority rules on fixtures

UCC-9 does not cover security interest in real property (land, houses, buildings). Fixtures are goods affixed toreal property that give rise to competing claims, including interests in the real property and security interests in the fixtures.*See*§ 9–102(41) (defining "fixtures" as "goods that have become so related to particular real property that an interest in them arises under real property law."). With respect to priority, UCC § 9-334 governs fixtures and crops, as follows:

(a) [Security interest in fixtures under this article.]

A security interest under this article may be created in goods that are fixtures or may continue in goods that become fixtures. A security interest does not exist under this article in ordinary building materials incorporated into an improvement on land.

(b) [Security interest in fixtures under real-property law.]

This article does not prevent creation of an encumbrance upon fixtures under real property law.

(c) [General rule: subordination of security interest in fixtures.]

In cases not governed by subsections (d) through (h), a security interest in fixtures is subordinate to a conflicting interest of an encumbrancer or owner of the related real property other than the debtor.

(d) [Fixtures purchase-money priority.]

Except as otherwise provided in subsection (h), a perfected security interest in fixtureshas priority over a conflicting interest of an encumbrancer or owner of the real property if the debtor has an interest of record in or is in possession of the real property and:

(1) the security interest is a purchase-money security interest;

(2) the interest of the encumbrancer or owner arises before the goods become fixtures; and

(3) the security interest is perfected by a fixture filing before the goods become fixtures or within 20 days thereafter.

(e) [Priority of security interest in fixtures over interests in real property.]

A perfected security interest in fixtures has priority over a conflicting interest of an encumbrancer or owner of the real property if:

(1) the debtor has an interest of record in the real property or is in possession of the real

property and the security interest:

(A) is perfected by a fixture filing before the interest of the encumbrancer or owner is of record; and

(B) has priority over any conflicting interest of a predecessor in title of the encumbrancer or owner;

(2) before the goods become fixtures, the security interest is perfected by any method permitted by this article and the fixtures are readily removable:

(A) factory or office machines;

(B) equipment that is not primarily used or leased for use in the operation of the real property; or

(C) replacements of domestic appliances that are consumer goods;

(3) the conflicting interest is a lien on the real property obtained by legal or equitable proceedings after the security interest was perfected by any method permitted by this article; or

(4) the security interest is:

(A) created in a manufactured home in a manufactured-home transaction; and

(B) perfected pursuant to a statute described in Section 9-311(a)(2).

(f) [Priority based on consent, disclaimer, or right to

remove.]

A security interest in fixtures, whether or not perfected, has priority over a conflicting interest of an encumbrancer or owner of the real property if:

(1) the encumbrancer or owner has, in an authenticated record, consented to the security interest or disclaimed an interest in the goods as fixtures; or

(2) the debtor has a right to remove the goods as against the encumbrancer or owner.

(g) [Continuation of paragraph (f)(2) priority.]

The priority of the security interest under paragraph (f)(2) continues for a reasonable time if the debtor's right to remove the goods as against the encumbrancer or owner terminates.

(h) [Priority of construction mortgage.]

A mortgage is a construction mortgage to the extent that it secures an obligation incurred for the construction of an improvement on land, including the acquisition cost of the land, if a recorded record of the mortgage so indicates. Except as otherwise provided in subsections (e) and (f), a security interest in fixtures is subordinate to a construction mortgage if a record of the mortgage is recorded before the goodsbecome fixtures and the goods become fixtures before the completion of the construction. A mortgage has this priority to the same extent as a construction mortgage to the extent that it is given to refinance a construction mortgage.

(i) [Priority of security interest in crops.]

> A perfected security interest in crops growing on real property has priority over a conflicting interest of an encumbrancer or owner of the real property if the debtor has an interest of record in or is in possession of the real property.

****

Whether a good is a fixture or mere building material is important because if the good is a fixture, UCC-9 will govern. The next case addresses whether the energy guards (consumer goods) are fixtures.

In re **Troutt**

2009 WL 2905923 (Bankr. S.D. Ill Sept. 4, 2009)

Prior to the filing of their Chapter 13 case in bankruptcy, the Debtors entered into a home improvement contract, which included a Uniform Commercial Code (UCC) security agreement, with Energy Doctor of Illinois, LLC for the installation of an energy guard for their house. The energy guard is an insulation blanket that is installed on the attic floor over existing insulation. It is cut to fit the contours of the attic floor and around roof support beams in the attic and is stapled down to prevent movement.

…

Section 9–102(41) of the UCC defines "fixtures" as "goods that have become so related to particular real property that an interest in them arises under real property law." 810 ILCS 5/9–102(41).

…

While the energy guard falls within the definition of "consumer goods," it also could fall within the definition of a "fixture." … To determine if the energy guard is a "fixture," state law needs to be considered. As is stated in White & Summers:

> Goods cross the line from pure goods to fixtures when they become sufficiently related to the real estate that they would pass in a deed under the local real estate law. What passes by deed in Minnesota may not pass in Wisconsin, and what is sufficiently related to a real estate interest in New York might not be sufficiently related in Georgia. Thus the general definition in 9–102(a)(41) is no more than a cross reference to state case law and state real estate statutes. What, then, are the state law principles governing when goods become fixtures?

James J. White & Robert S. Summers, UNIFORM COMMERCIAL CODE, Vol. I, (4th ed.1995).

In Illinois the term "fixture" is usually applied to articles which were once tangible personal property, but which have been physically attached to the real estate so that they become a part thereof. *Material Service Corp. v. McKibbin*, 380 Ill. 226, 43 N.E.2d 939 (1942). "Anything placed on the land and intended to remain permanently in place becomes a part of the realty." *A & A Market, Inc. v. Pekin Ins. Co.*, 713 N.E.2d 1199, 1202 (Ill.App. 1 Dist.1999). In determining whether an item is a fixture rather than a piece of personal property, the Illinois courts look at three factors: (1) the nature of the attachment to the real estate; (2) the item's adaptation to and necessity for the purpose for which the premises are devoted; and (3) whether or not it was

intended that the item should be part of the realty. *Nokomis Quarry Co. v. Dietl*, 775 N.E.2d 669, 673 (Ill.App. 5 Dist.2002). Intent is the crucial factor in determining whether an item constitutes a fixture rather than personalty. The intent at issue must be the intent to permanently improve the real estate. *B. Kreisman & Co. v. First Arlington Nat. Bank of Arlington Heights*, 415 N.E.2d 1070, 1074–75 (Ill.App. 2 Dist.1980).

For the following reasons this Court concludes that the energy guard is a fixture. As previously noted, the energy guard is an insulation blanket that is installed in the attic by conforming it to the size of the attic, cutting it to fit around the roof support beams and stapling it into place so it would not move. If removed, it would have no utility for any other attic. If removed, damage to the underlying ceiling would occur. These features of the installation make the energy guard a fixture.

****

A secured party with a security interest in fixtures must consider a fixture filing with the county clerk's office where the real property is located in order to put everyone who has an interest in the real property on notice. Filing a financing statement may not be sufficient. The priority rules stated in UCC § 9-334 governs conflicting interests in fixtures. The case below provides a good statutory analysis in determining priority between a secured party's security interest in the fixtures and a mechanic's lien in the real property.

Yeadon Fabric Domes, Inc. v. Maine Sports Complex, LLC

901 A.2d 200 (Me. 2006)

Yeadon Fabric Domes, Inc. appeals from a judgment entered in the District Court (Bangor, Gunther, J.) in favor of

Yeadon, Harriman Brothers, Inc., and Kiser & Kiser Company, against Maine Sports Complex, LLC (MSC). The judgment set the order of priority among MSC's creditors. Yeadon contends that the court erred when it held that Harriman's and Kiser's mechanic's liens had priority over its perfected security interest in a fixture attached to MSC's land.

…

I. BACKGROUND

In 2001, MSC entered into a series of business transactions for the purpose of building a sports complex in Hampden. It purchased real estate and gave a mortgage to the seller, H.O. Bouchard, Inc. It engaged Kiser to provide engineering services for the construction of the complex. MSC entered into a contract to purchase an inflatable, fabric dome from Yeadon, along with the materials and equipment required to erect and operate the dome. MSC contracted with Harriman to provide groundwork for the sports complex. MSC also obtained a loan from Bangor Savings Bank, giving the bank a mortgage, which was later assigned to Steven Hoksch. MSC defaulted on its obligations to these various entities, and litigation resulted.

Yeadon had filed a financing statement for the dome and equipment with the Secretary of State on July 22, 2002. It brought a forcible entry and detainer action for personalty pursuant to 14 M.R.S. § 6012 (2005) against MSC, seeking to recover the dome. The court (LaVerdiere, J.) dismissed the action after concluding that the dome was a fixture and not personal property. Subsequently, on February 27, 2004, Yeadon recorded a financing statement in the Penobscot County Registry of Deeds.

Yeadon filed a collection action against MSC, which was consolidated with other collection actions that had been filed by Harriman and Kiser. Both Harriman and Kiser had filed mechanic's lien claims, pursuant to 10 M.R.S. § 3253 (2005), and brought court actions to enforce their lien claims.

…

II. DISCUSSION

A. Statutes

Maine's version of the U.C.C. sets out requirements concerning security interests and how to perfect them. Generally speaking, a financing statement must be filed to perfect a security interest. 11 M.R.S. § 9–1310(1) (2005). A security interest is perfected by filing unless certain exceptions apply, none of which are applicable here. A security interest in fixtures may be perfected by filing the financing statement in either of two places: in the registry of deeds for the county where the related real property is located, or in the Secretary of State's office. 11 M.R.S. § 9–1501(1) (2005). The relevant portions of section 9–1501(1) provide:

> [T]he office in which to file a financing statement to perfect the security interest ... is:
>
> (a) The registry of deeds for the county in which the related real property is located, if:
>
> ....
>
> > (ii) The financing statement is recorded as a fixture filing and the collateral is goods that are or are to become fixtures; or
>
> (b) The office of the Secretary of State, in all other

> cases, including a case in which the collateral is goods that are or are to become fixtures and the financing statement is not filed as a fixture filing.

Thus, for goods that are, or are to become, fixtures, the secured party who wishes to perfect a security interest should file the financing statement in the county registry of deeds if the filing is to be a fixture filing, or with the Secretary of State.

A fixture filing is defined as "the filing of a financing statement covering goods that are or are to become fixtures and satisfying section 9–1502, subsections (1) and (2)." 11 M.R.S. § 9–1102(40) (2005). Section 9–1502 lists the information that a financing statement must contain to qualify as a fixture filing. 11 M.R.S. § 9–1502(1), (2) (2005).

The provision in Maine's version of the U.C.C. dealing with the priority of security interests in fixtures is 11 M.R.S. § 9–1334 (2005). The general rule is that "a security interest in fixtures is subordinate to a conflicting interest of an encumbrancer or owner of the related real property other than the debtor." 11 M.R.S. § 9–1334(3). An encumbrance is defined as "a right, other than an ownership interest, in real property." 11 M.R.S. § 9–1102(32) (2005). The term "includes mortgages and other liens on real property." 11 M.R.S. § 9–1102(32).

There are exceptions to the general rule and several alternatives by which a security interest in fixtures has priority over conflicting interests. The alternatives that are most likely to fit the factual situation of this case are found in 11 M.R.S. § 9–1334(4) and (5). The first of these alternatives is in section 9–1334(4), which gives a perfected security interest in fixtures priority when the debtor has an interest of record in, or is in possession of, the real property; the security interest in fixtures

is a purchase-money security interest; the encumbrancer's interest arose before the goods became fixtures; and the security interest was perfected by a fixture filing before or within twenty days of the time the goods became fixtures. Another alternative is section 9–1334(5)(a), which states that a perfected security interest in fixtures has priority if:

> (a) The debtor has an interest of record in the real property or is in possession of the real property and the security interest:
>
> > (i) Is perfected by a fixture filing before the interest of the encumbrancer or owner is of record; and
> >
> > (ii) Has priority over any conflicting interest of a predecessor in title of the encumbrancer or owner ....

There is also the alternative in section 9–1334(5)(c), which states that a perfected security interest in fixtures has priority if "[t]he conflicting interest is a lien on the real property obtained by legal or equitable proceedings after the security interest was perfected by any method permitted by this Article."

The final statute that bears on this case is in title 10, which contains the statute authorizing the mechanic's liens filed by Harriman and Kiser. *See* 10 M.R.S. § 3251 (2005). Specifically, 10 M.R.S. § 4012 states: "A security interest perfected in accordance with Title 11 has priority over any lien created or referred to by this Title unless the person claiming the lien has *possession* of the goods subject to the lien."

B. Application of the Statutes to the Facts

Yeadon filed a financing statement covering the dome and

equipment with the Secretary of State on July 22, 2002, and with the registry of deeds on February 27, 2004. The court determined that the dome with its equipment is a fixture. The claims of Kiser and Harriman are pursuant to the mechanic's lien statute. 10 M.R.S. § 3251. Kiser began work on December 3, 2001, filed its lien on November 18, 2002, and filed its enforcement action on February 10, 2003. Harriman began work on December 7, 2001, filed its lien on August 27, 2002, and filed the enforcement action on October 17, 2002.

The issue is whether the District Court correctly placed Yeadon's priority after Harriman and Kiser. The determination of the correct priority requires an interpretation and application of the statutes. Statutory interpretation is a question of law that we review *de novo*. *City of Bangor v. Penobscot County*, 2005 ME 35, ¶ 9, 868 A.2d 177, 180. The primary goal of statutory interpretation is to give effect to the intention of the Legislature. *Id.* To meet that goal we examine the plain meaning of the statute. *Id.* Only if the statutory language is ambiguous do we go beyond the plain meaning and look at the legislative history. *Temm v. S.D. Warren Co.*, 2005 ME 118, ¶ 8, 887 A.2d 39, 41.

Yeadon perfected its security interest when it filed a financing statement with the Secretary of State on July 22, 2002. This filing did not qualify as a fixture filing, but 11 M.R.S. § 9–1501(1)(b) provides that a security interest in goods that are, or are to become, fixtures can be perfected by filing with the Secretary of State. There is no requirement that a fixture filing be made in order to perfect a security interest in fixtures. Yeadon's later filing with the registry of deeds on February 27, 2004, qualified as a fixture filing.

The significance of a fixture filing, as compared to a filing

with the Secretary of State, is shown in 11 M.R.S. § 9–1334. A fixture filing is necessary for a security interest in fixtures to obtain priority pursuant to sections 9–1334(4) and (5)(a). In order for Yeadon to obtain priority over Harriman and Kiser pursuant to section 9–1334(4), which is one of the exceptions to the general rule that security interests in fixtures are subordinate, Yeadon's security interest had to be perfected by a fixture filing before the dome became a fixture or within twenty days thereafter. The record is not clear as to when the dome became a fixture, but it had obviously become a fixture before July 21, 2003, the date of the forcible entry and detainer hearing. As Yeadon's fixture filing was not made until February 2004, it was not made within twenty days of the time the dome became a fixture. Thus, section 9–1334(4) is of no help to Yeadon.

To obtain priority over Harriman and Kiser pursuant to section 9–1334(5)(a), Yeadon's security interest had to be perfected by a fixture filing before the Harriman or Kiser interests became of record. Because Yeadon's fixture filing was not made until 2004 and both Harriman's and Kiser's title 10 liens were of record in 2002, Yeadon does not have priority over Harriman and Kiser pursuant to section 9–1334(5)(a).

The final provision in section 9–1334 worth discussion is section 9–1334(5)(c), which gives priority to a security interest in fixtures over a conflicting interest that is a lien on the real property obtained by legal or equitable proceedings after the perfection of the security interest, regardless of whether the security interest was perfected by a fixture filing or a filing with the Secretary of State. This alternative does not assist Yeadon because the mechanic's liens held by Harriman and Kiser are not liens obtained by legal or equitable proceedings. Mechanic's liens are enforced by legal proceedings, but they are obtained

by operation of statute and the filing of the liens pursuant to the statute. *See* 10 M.R.S. §§ 3251, 3253, 3255.

Yeadon does not come within the alternatives in section 9–1334 that give priority to security interests in fixtures over conflicting interests. Thus, the general rule in section 9–1334(3) subordinating a security interest in fixtures to a conflicting interest of an encumbrancer applies, and Yeadon's security interest is subordinate to Harriman's and Kiser's mechanic's liens unless 10 M.R.S. § 4012 gives Yeadon priority.

Section 4012 plainly states that a security interest perfected in accordance with title 11 has priority over any non-possessory lien created by title 10. If the plain meaning of section 4012 controls, Yeadon's security interest takes priority over Harriman's and Kiser's mechanic's liens. On its face, section 4012 is in direct conflict with the rule in 11 M.R.S. § 9–1334(3) that security interests in fixtures are subordinate to conflicting interests of an encumbrancer. No cases interpreting section 4012 have been called to our attention, and our independent research has not uncovered any.

When two statutes appear to be inconsistent, we should harmonize them if at all possible. It is tempting to try to harmonize the statutes by interpreting the term "encumbrancer" in section 9–1334(3) as not applying to the holder of a mechanic's lien. A leading commentary on article 9 suggests such an interpretation. 9B WILLIAM D. HAWKLAND ET AL., UNIFORM COMMERCIAL CODE SERIES § 9–334:1 (2001). However, the term "encumbrance" is defined in 11 M.R.S. § 9–1102(32) as "a right, other than an ownership interest, in real property" and "includes mortgages and other liens on real property." Thus, an interpretation of section 9–

1334(3) that excludes holders of mechanic's liens from being encumbrancers appears disingenuous.

Another possibility for harmonizing the two statutes is to interpret section 4012 as giving a security interest in fixtures priority over any title 10 non-possessory lien only when the title 10 lien is created after the date the security interest is perfected. In other words, we could interpret section 4012 as giving priority to the creditor who is first in time. A first in time interpretation, however, requires additional language concerning when the security interest is "perfected" and when the title 10 lien is "created." This interpretation is not a reasonable one because it requires reading into section 4012 far more language than appears in it. Furthermore, because a detailed first in time priority for security interests in fixtures is contained in 11 M.R.S. § 9–1334(5)(a), the goal of harmonizing the statutes would be defeated unless the additional requirements of section 9–1334(5)(a) were also read into section 4012.

The most reasonable interpretation of section 4012 is that it does not apply to fixtures. There are several reasons why this interpretation is desirable. First, the chapter in which section 4012 is located appears to deal only with liens on personal property. *See* 10 M.R.S. § 4001 (2005) (referring to possessory liens on personal property); 10 M.R.S. § 4008 (2005) (allowing for sale of "the article on which the lien is claimed"); *see also* Horton & McGehee, Maine Civil Remedies § 24–6(d) at 450 (4th ed.2004) (stating that 10 M.R.S. §§ 4001–4012 apply to liens on personal property). Second, it is highly doubtful that the Legislature intended to enact a statute that is directly contrary to another statute. If section 4012 applies to fixtures, then section 4012 is directly contrary to 11 M.R.S. § 9–1334(3), a result we doubt the Legislature intended. Third, section 9–1334

contains considerably more detail regarding the situations in which conflicting interests in a fixture can arise than does section 4012, and it therefore makes sense to construe the more general section 4012 to fit with the more specific section 9–1334. *See Fleet Nat'l Bank*, 2004 ME 36, ¶ 10, 845 A.2d at 1185–86. Fourth, because section 4012 was included in the errors and inconsistencies legislation following the enactment of the Maine U.C.C., the Legislature itself saw section 4012 as consistent with the priorities established in title 11.

For these reasons, we conclude that interpreting section 4012 as not applying to fixtures is a reasonable interpretation that comports with the Legislature's intention and harmonizes section 4012 with section 9–1334(3). Under this interpretation of section 4012, the statute is not applicable to Yeadon's security interest in the fixture. The liens of Harriman and Kiser have priority over Yeadon's security interest because section 9–1334(3) subordinates Yeadon's security interest in the fixture to the mechanic's liens.

Problems

Test your understanding before going to the next chapter.

5.1 What are the purposes of priority rules?

5.2 Identify a general priority rule and its exception?

5.3 Why does secured transactions law give special priority to purchase money security interests?

5.4 Identify all priority rules relating to buyers of collateral. Are the rules missing other types of buyers?

5.5 Discuss priority rules involving the bankruptcy trustee.

5.6 Discuss priority rules involving federal tax liens.

5.7. What is amechanic lien, judgment lien, and warehouse lien? Discuss relevant priority rules related to these liens?

5.8 The set of priority rules involving fixtures is extensive. What are lessons to learn from priority in fixtures?

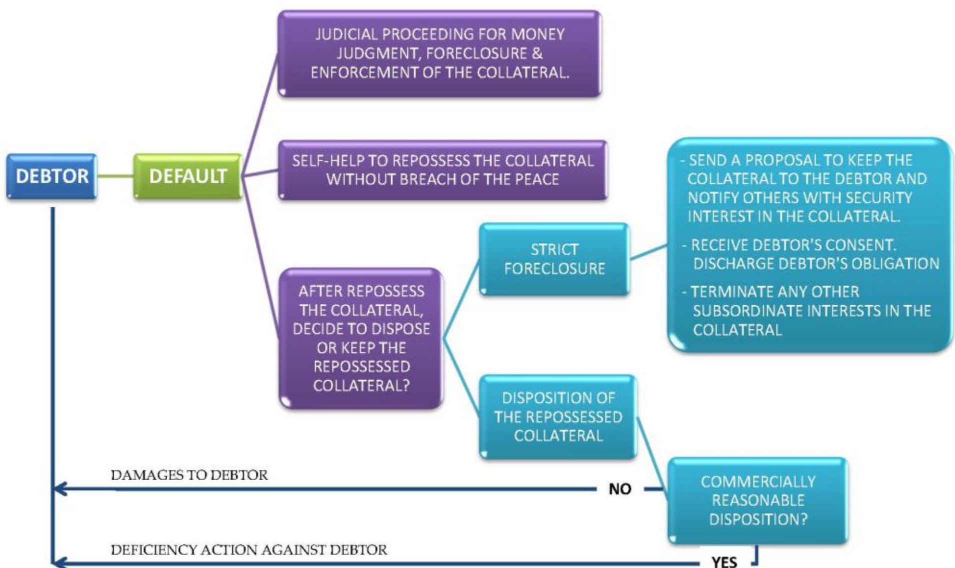
CHAPTER SIX

DEFAULT, ENFORCEMENT OF SECURITY INTEREST, AND REMEDIES

Secured transactions facilitate the availability of credit. That means when a debtor is in default there are rules protecting the secured party as well as safeguarding the debtor's rights. UCC-9 does not define "default"; it is up to the parties to decide in the security agreement what events would constitute default.

Upon default, the secured party can bring an action in court for the outstanding loans, interest, fees, and costs and to foreclose on the collateral. Instead of judicial means, the secured party can foreclose on the collateral by applying "self-help," as long as the secured party does not "breach the peace" while repossessing the collateral.

Figure 8: ENFORCEMENT/REMEDIES



1. Judicial Foreclosure

When the secured party seeks to enforce its security interest in a collateral property against the debtor via judicial means, such as a replevin, the court will consider relevant facts in determining whether the secured party has the right to repossess the collateral. The case below is illustrative of this issue.

Source One Financial Corp. v. Road Ready Used Cars, Inc.

2016 WL 1657226 (Conn. Super. Ct. Apr. 6, 2016)

While the court has determined that the plaintiff has an enforceable security interest in the Vehicle under the security agreement, this determination does not end the inquiry.

In Connecticut, replevin proceedings are governed by statute rather than by the rules that apply to common-law actions of replevin. General Statutes § 52–522 provides, in relevant part: "In an action of replevin, no cause of action, except of replevin or for a conversion of the goods described in the writ of replevin, may be stated." General Statutes § 52–515 states: The action of replevin may be maintained to recover any goods or chattels in which the plaintiff has a general or special property interest with a right to immediate possession and which are wrongfully detained from him in any manner, together with the damages for such wrongful detention."

A replevin action "is not a contract action and, thus, it is not within the court's power to determine which party has superior title to the [property]. Rather, this is a replevin action, which involves a comparison of the superiority and inferiority of competing rights to possess the [property]." *Angrave v. Oates*, 876 A.2d 1287 (2005). As our Supreme Court stated almost 130

years ago, "[t]he action of replevin is founded in tort. There must be a tortious taking or detention of property. A mere breach of contract is not sufficient. Hence, it is no remedy to enforce a contract or recover damages for its nonperformance ... This [action] seems to have been instituted originally for the sole purpose of enforcing specifically a contract, and to have been prosecuted solely for the purpose of recovering damages for its breach—a manifest departure from the object of a replevin [action]." *Mead v. Johnson*, 7 A. 718 (1886). "A court's finding of the right to immediate possession in a replevin action raises a question of fact ... [Which is] review[ed] ... under the clearly erroneous standard." *Angrave v. Oates*, *supra*.

It may be the case that ordinarily, a creditor with an enforceable security interest in property may be entitled to replevin of the property from a debtor who has not made the required payments under a security agreement. This is not the ordinary case. Here, the plaintiff, without disclosure to either the defendant or the court, withheld payments owed to Lopez Motors on unrelated accounts between the plaintiff and the Lopez Motors in order to satisfy the outstanding lien balance on the Vehicle. It was only after trial had already started that a representative of the plaintiff unknowingly disclosed this fact to the defendant in a voicemail message, an act which caused the defendant to petition this court to open testimony in this matter to hear additional evidence. The additional testimony provided to the court indicated that Lopez Motors had called a representative of the plaintiff to inquire about the status of amounts that Lopez Motors was owed on other accounts that Lopez Motors had with the plaintiff. In reply to the phone call, an employee of the plaintiff had called Lopez Motors to explain why Lopez Motors was not being paid on its other accounts. As

the employee of the plaintiff explained in the voicemail message (offered by the defendant, and accepted by the court, as Exhibit L), the plaintiff had withheld money from Lopez Motors' other accounts in satisfaction of the amounts which the plaintiff determined that Lopez Motors owed in connection with the security agreement for the Vehicle. As further proof of this fact, the defendant offered into evidence a monthly dealer statement for Lopez Motors from the plaintiff (offered by the defendant, and accepted by the court, as Exhibit M), which confirms that the plaintiff had indeed withheld funds from Lopez Motors' other accounts in satisfaction of the lien on the Vehicle under the security agreement. Lopez Motors was informed that there was a zero balance on the Laboy loan.

The plaintiff tried to explain away this fact by presenting evidence that the employee who left the defendant a voicemail was mistaken, a new-hire, and not knowledgeable about Lopez Motors' accounts. The court finds that this testimony was not credible. In this case, the court finds that the plaintiff availed itself to other funds which were rightfully owed to Lopez Motors in satisfaction of any amounts the plaintiff may have been owed under the terms of the security agreement. To the extent that the plaintiff can prove definitively that it never received the full amount that it was owed under the security agreement, that fact is more relevant for an action for breach of contract. Here, based on the evidence before the court and the credibility of the witnesses who testified, the court determines that the plaintiff does not have a superior right to possession of the Vehicle.

CONCLUSION

Based on the foregoing, the court finds for the defendant.

The plaintiff has not proven by a preponderance of the evidence that it has a superior right to possession of the Vehicle over that of the defendant.

2. Self-Help Repossession: Breach Of The Peace

The secured party can hire a third party to repossess the collateral. The secured party, however, cannot delegate to the independent contractor the statutory requirement that repossession must be conducted without breach of the peace. The debtor has a number of claims available against the secured party if there is a violation of the peace. The case below explains the well-established law on "without breach of the peace."

Ford Motor Credit Co. v. Ryan

939 N.E.2d 891 (Ohio App. Ct. 2010)

Ford Motor Credit Company ("Ford"), brought a breach-of-contract action against James and Ryan and Ryan, Inc. ("RRI"). Ford alleged that James and RRI had failed to pay amounts due under a motor-vehicle lease agreement that James and RRI had entered into when they coleased a 2002 Ford Windstar. [Ford also] alleged that James and RRI had failed to pay amounts due under (1) a retail installment contract that James and Ryan and Ryan Real Estate Company ("R & R") had entered into when copurchasing a 2004 Mercury Monterey, (2) a retail installment contract that James and R & R had entered into when copurchasing a 2004 Mercury Mountaineer, and (3) a retail installment contract that James and R & R had entered into when copurchasing a 2004 Mercury Mountaineer Premier.

…

Ford had hired Automobile Recovery Services of

Cincinnati, Inc. (“ARS”), to accomplish each of the repossessions. Ford and ARS had a contractual arrangement whereby ARS provided Ford with repossession services. In the contract, ARS agreed to (1) forgo any repossession that would involve a breach of peace and (2) indemnify Ford for all expenses incurred in connection with legal claims that related to ARS's performance of its contractual obligations.

ARS repossessed four of the Ryans' vehicles without incident. However, during the repossession of the Premier, James and the ARS agent engaged in a verbal and physical altercation. James's counterclaim had asserted multiple tort claims against Ford based on the actions of ARS's agent. Therefore, in addition to naming Carolyn, Ford's third-party complaint also named ARS as a third-party defendant. Ford alleged breach-of-contract and indemnity claims against ARS.

In response to Ford's amended and third-party complaints, James and Carolyn each filed an answer and counterclaim. James and Carolyn asserted claims against Ford for (1) conversion, (2) trespass, (3) assault, (4) breach of peace, (5) intentional infliction of emotional distress, (6) invasion of privacy, …

R.C. 1309.609 is virtually identical to Section 9–609 of the Uniform Commercial Code (“U.C.C.”). The General Assembly incorporated U.C.C. provisions into the Ohio Revised Code “[t]o make uniform the laws among the various jurisdictions.” R.C. 1301.02(B)(3). Accordingly, to supplement Ohio law, our analysis of R.C. 1309.609 relies upon precedent from other jurisdictions addressing U.C.C. 9–609 and similar state statutes. Additionally, this court looks to caselaw….

R.C. 1309.609 gives a secured party the right to attempt

self-help repossession if a debtor defaults. However, "[i]f the secured party, or a third party repossessing for the secured party, causes a breach of peace while repossessing the collateral, the repossession will be wrongful, and the debtor may sue the secured party in conversion for return of the collateral or damages." 9 Hawkland, Uniform Commercial Code Series (2001); McCall v. Owens (Tenn.App.1991), 820 S.W.2d 748, 752 ("When the repossessor uses force and breaches the peace, the repossessor may be liable for trespass, conversion, assault and battery and other torts"); 2 Anderson, Uniform Commercial Code (3d Ed.) 925, Section 9–609:7 ("Being unauthorized to repossess the collateral because of the breach of the peace, the secured party will be liable to the debtor in conversion for having wrongfully interfered with the debtor's possession of the collateral").

Normally, a conversion occurs if a person takes another's vehicle without the owner's permission. R.C. 1309.609 provides a defense to such a conversion claim because it permits a repossessor to take possession of the vehicle, rendering the repossession lawful. This defense, however, depends on the absence of a breach of the peace. If a breach of the peace occurs, the repossessor cannot rely on R.C. 1309.609 to excuse its actions. Marcus v. McCollum (C.A.10, 2004), 394 F.3d 813, 820 ("If a breach of peace occurs, self-help repossession is statutorily precluded"). At the point the peace is breached, the repossessor's exercise of dominion over the vehicle becomes wrongful, exposing the repossessor to liability for conversion.

A breach of peace is:

> [A] violation of public order, a disturbance of the public tranquility, by any act or conduct inciting to

> violence or tending to provoke or excite others to break the peace, or, as is some times said, it includes any violation of any law enacted to preserve peace and good order. It may consist of an act of violence or an act likely to produce violence.

Morris v. First Natl. Bank & Trust Co., 254 N.E.2d 683 (Ohio 1970). A breach of peace includes "'all violations of public peace, order or decorum'" and "'breaking or disturbing the public peace by any riotous, forceful or unlawful proceedings.'" *Makepeace v. Chrysler Motors Corp.*, 403 N.E.2d 348 (Ohio Ct. App. 1981).

In the case at bar, ARS repossessed three vehicles copurchased by James and R & R, as well as Carolyn's vehicle. Three of the repossessions proceeded uneventfully. On February 7, 2006, ARS towed the Mountaineer from the parking lot of R & R's office building. Although James "saw it go away," he "didn't have any time to respond." ARS took the Monterey that James copurchased from his son's driveway sometime during the night of February 7 and 8, 2006. That same night, ARS took Carolyn's vehicle from the carport of the Ryans' home. Neither James, his wife, nor his son knew that the repossessions had occurred until they awoke the next morning.

Appellants acknowledge that the ARS agents did not threaten, incite, or commit any act of violence when they repossessed the three vehicles on February 7 and 8, 2006. Appellants, however, argue that the ARS agents breached the peace when they entered onto private property to repossess the vehicles.

Generally, no breach of peace occurs merely because the repossessor enters on a person's driveway or carport to retrieve

a vehicle. *Geeslin v. Nissan Motor Acceptance Corp.*, 1998 WL 433932 (N.D. Miss. June 3, 1998), *affirmed* (C.A.5, 2000), 228 F.3d 408. *See also Butler v. Ford Motor Credit Co.* (C.A.5, 1987), 829 F.2d 568, 570 (holding that the removal of a vehicle from a private driveway in the early morning hours while the debtor was asleep did not constitute a breach of peace).“‘[I]n general, a mere trespass, standing alone, does not automatically constitute a breach of the peace.’” *Pantoja–Cahue v. Ford Motor Credit Co.* (2007), 872 N.E.2d 1039. *See also Ivy*, 612 So.2d at 1111 (“[E]ntering a private driveway to repossess collateral without use of force does not constitute a breach of peace”); 2 Anderson, Uniform Commercial Code (3d Ed.) 924, Section 9–609:6 (“[T]aking property from a driveway or other open area, even though technically trespassing, will not generally, by itself, make the repossession involve a breach of the peace”).

Indeed, R.C. 1309.609 gives a repossessor a privilege to enter another's land to effectuate a repossession, so long as the repossessor does not breach the peace. *See also Callaway v. Whittenton*, 892 So.2d 852, 858(Ala.2003) (the Alabama repossession statute based on U.C.C. 9–609 “gives a secured creditor the right to enter a debtor's land for the purpose of repossession”); *Thompson v. First State Bank of Fertile*, 709 N.W.2d 307, 312 (Minn. Ct. App. 2006) (“a secured party's authority to take possession of collateral after default carries with it the privilege to enter another's land for the purpose of taking possession of the collateral if the entry is reasonably necessary in order to take possession”); Restatement of the Law 2d, Torts (1965), Entry Pursuant to Legislative Duty or Authority, Section 211 (“A duty or authority imposed or created by legislative enactment carries with it the privilege to enter land in the possession of another for the purpose of

performing or exercising such duty or authority in so far as the entry is reasonably necessary to such performance or exercise, if, but only if, all the requirements of the enactment are fulfilled"); Carter, Repossessions (6th Ed.2005) 205, Section 6.4.4.2 ("When there is a limited entry onto the debtor's property, such as the debtor's driveway, carport, or open garage, the creditor is said to have an implied limited privilege peacefully to trespass and take possession of the collateral, as long as the debtor does not object and no breach of the peace is committed while on the land").

Here, ARS exercised its right under R.C. 1309.609 to enter onto private property to repossess the three vehicles on February 7 and 8, 2006. This trespass, without more, does not constitute a breach of peace. Accordingly, no liability for conversion arose out of the repossessions of the three vehicles.

Appellants, however, argue that ARS did not have the right to enter onto their property because R.C. 1309.609 extends that authority only to the "secured party." Because ARS is not the "secured party," appellants contend that it cannot rely on R.C. 1309.609. We find this argument unavailing. Just because R.C. 1309.609 confers the right of repossession on the "secured party" does not mean that the secured party must personally repossess the collateral. 10 Anderson, Uniform Commercial Code (3d Ed.) 381, Section 9–503:137. The secured party may hire another to make the repossession, and the right of repossession accrues to the hired entity. *Id.* Here Ford, the "secured party," hired ARS to repossess the vehicles, and thus, ARS operated under the auspices of R.C. 1309.609.

…

Unlike the February 7 and 8, 2006 repossessions, the

January 12, 2006 repossession of the Premier occurred over James's objection. On January 12, 2006, at approximately 8:15 a.m., James was dressing when his wife told him that someone with a tow truck was in their carport. James went out to the carport and found an ARS agent hooking the Premier to his tow truck. James told the ARS agent to stop, unhook the Premier, and leave the premises because he was trespassing. James then reached down to unhook the Premier, and the ARS agent grabbed his hands, pushed him, and began screaming at him. According to James, the ARS agent screamed, "I'm going to make your neighbors know about what you're doing[;] you rich bastard, I got you." At that point, James began pushing back and yelling. James eventually backed away, and the ARS agent towed the Premier away.

Based upon this evidence, a reasonable finder of fact could conclude that a breach of the peace occurred. If the finder of fact reached such a conclusion, then it could also find ARS liable for conversion. Accordingly, we conclude that the trial court erred in granting ARS summary judgment on James's claim for conversion of the Premier.

…

Although R.C. 1309.609 permits a repossessor to lawfully take possession of another's vehicle that permission does not extend to the personal items inside the vehicle. Consequently, even though a lawful repossession leaves the debtor with no claim for conversion of his vehicle, he may assert a conversion claim against the repossessor for any personal property taken with the vehicle and not returned. *Perkins v. City Natl. Bank & Trust Co.*, 1977 WL 200020(Ohio Ct. App. Mar. 22, 1977). *See also McGrady v. Nissan Motor Acceptance Corp.*, 40 F.Supp.2d 1323,

1330(M.D.Ala.1998) ("Conversion may occur when, during a repossession, personal property located in the repossessed vehicle is taken. * * * [A]lthough the taking of the vehicle was lawful, the taking of Plaintiff's personal property * * * was not lawful).

Here, ARS does not dispute that when it repossessed the Premier in May 2005, the Premier contained personal items that it did not return to James. Accordingly, we conclude that the trial court erred in granting ARS summary judgment on James's claim for conversion of his personal property.

…

By their third assignments of error, appellants argue that the trial court erred in granting ARS summary judgment on their claims for intentional infliction of emotional distress…. A defendant is liable for intentional infliction of emotional distress if his "extreme and outrageous conduct intentionally or recklessly causes serious emotional distress to another." *Yeager v. Loc. Union 20, Teamsters, Chauffeurs, Warehousemen & Helpers of Am.*, 453 N.E.2d 666 (Ohio 1983);*Welling v. Weinfeld*, 113 Ohio St.3d 464, 2007-Ohio-2451, 866 N.E.2d 1051. "Serious emotional distress" goes beyond merely trifling disturbance, mere upset, or hurt feelings. *Paugh v. Hanks* (1983), 6 Ohio St.3d 72, 78, 6 OBR 114, 451 N.E.2d 759. The emotional injury must be so severe and debilitating that "a reasonable person, normally constituted, would be unable to cope adequately with the mental distress engendered by the circumstances of the case." *Id.* Serious emotional distress includes traumatically induced neurosis, psychosis, chronic depression, and phobia. *Id.*

A plaintiff claiming serious emotional distress must present some "'guarantee of genuineness'" in support of his

claim to prevent summary judgment in favor of the defendant. *Powell v. Grant Med. Ctr.* (2002), 771 N.E.2d 874. In most instances, a plaintiff can supply that genuineness with expert medical testimony. Such testimony, however, is not always necessary. In lieu of expert testimony, a plaintiff may submit testimony of lay witnesses who "testify as to any marked changes in the emotional or habitual makeup that they discern in the plaintiff." *Paugh* at 80, 451 N.E.2d 759. A court may decide whether the emotional injury alleged constitutes "serious emotional distress" as a matter of law. *Id.*

In the case at bar, James testified that his interactions with the ARS agents have "shaken [him] up mentally" and that he "wake[s] up probably at least two times a night * * * to see if they've come to tow any cars." Carolyn stated that she was "truly frightened" by the ARS agents' behavior. Neither James nor Carolyn sought the treatment of a psychologist, psychiatrist, or any other mental-health provider as a result of their experiences with ARS. No expert medical witness testified regarding the Ryans' mental states, and no lay witness acquainted with the Ryans testified as to a marked change in their mental states.

Given the state of the evidence, we conclude that no reasonable finder of fact could find that the Ryans have incurred the type of severe and debilitating emotional injury necessary for them to prevail on their claims for intentional infliction of emotional distress. Although the Ryans have felt emotional discomfort, as a matter of law their suffering did not rise to the level of serious emotional distress….

Because the evidence in the record does not establish severe emotional distress, the trial court properly granted ARS

summary judgment on appellants' claims for intentional infliction of emotional distress. Accordingly, we overrule appellants' third assignments of error.

3. Strict Foreclosure

The secured party can sell the collateral and then seeks a deficiency. If the secured party wants to keep the collateral, the secured party must observe the rules for strict foreclosure. See § 9-620. The debtor is entitled to notice of strict foreclosure and decides whether to accept or reject the secured party's proposal to keep the collateral. If the security agreement contains a provision of automatic-transfer of the collateral prior to default, such provision is invalid and unenforceable. The case below is instructive on strict foreclosure.

Fagen, Inc. v. Exergy Development Group of Idaho. LLC

2016 WL 5660418 (Banrk. D. Minn. Sept. 29, 2016)

John R. Tunheim, Chief Judge United States District Court

The Big Blue Project wind farm is located in Blue Earth, Minnesota, near the Iowa border. The farm has 18 wind turbines, generates power for approximately 20,000 homes, and sells its electricity to North States Power. Exergy began developing the Big Blue Project in 2006 and owned the project through several subsidiary companies—Exergy was the sole member of Exergy Minnesota Holdings, LLC ("Exergy Minnesota"), which was the sole member of Minnesota Wind Partners I, LLC, which was the sole member of Big Blue Wind Farm, LLC, which actually owned the Big Blue Project.

In 2011, Exergy needed funding to officially begin construction on the project, but was unable to obtain financing.

Exergy ultimately turned to Fagen because the parties had a prior business relationship….On September 14, 2011, the parties executed a Master Loan Agreement, Security Agreement, and Pledge Agreement. Between that date and February 21, 2012, Fagen made five additional loans to Exergy, as documented in the First, Second, Third, Fourth and Fifth Amended and Restated Loan Agreements. Altogether, the cumulative loan amount was approximately $12 million. As collateral for these loans, Fagen obtained a security interest in most of Exergy's assets, including all 100 member units of Exergy Minnesota….

Despite Fagen's loans, the Big Blue Project began to experience financial difficulties. Exergy lacked capital to finance the project on its own and could not find other investors, which caused Fagen to worry that Exergy would not be able to repay its loans. Fagen also began to worry that the Big Blue Project would not be completed and operational before December 31, 2012, the deadline for receiving a $22 million grant from the federal government that was crucial to the project's profitability.

Matters came to a head on January 31, 2012, when Exergy needed to post a $16.8 million letter of credit to a wind turbine manufacturer. Exergy did not have the financial resources to post the letter and accordingly missed the posting deadline. On February 2, 2012, the manufacturer gave notice to Exergy that it had 30 days, until March 3, 2012, to post the letter of credit; otherwise the manufacturer would delay delivery of the wind turbines or terminate the agreement altogether. Having no "alternative commercial means to secure" the necessary financing, Exergy again turned to Fagen. Fagen agreed to post the letter of credit, but only subject to a specific condition—that the deal would be structured as a sale. Ron Fagen testified in

his deposition that he wanted to structure the deal as a sale—and not as another loan coupled with a security interest in Exergy's assets—so that Fagen could take immediate "control" and "ownership" of the Big Blue Project in order to ensure that it would be operational before the December 31 federal grant deadline….

The parties thus entered into the Big Blue Transaction, executing three instruments, effective February 29, 2012: (1) a Sixth Amended and Restated Master Loan Agreement; (2) a Limited Liability Company Interest Purchase Agreement ("Purchase Agreement"); and (3) a First Amended and Restated Member Control Agreement of Exergy Minnesota ("MCA").

The Sixth Amended Loan Agreement obligated Fagen to post a $16.8 million letter of credit to the wind turbine manufacturer. The Purchase Agreement effectuated a conveyance from Exergy to Fagen of 99 of the 100 membership units of Exergy Minnesota, with Exergy retaining the remaining unit. In exchange, Fagen agreed to (1) forgive approximately 95% of Exergy's outstanding debt on Fagen's Big Blue Project loans, totaling $11,447,503.02; and (2) post the $16.8 million letter of credit. The Purchase Agreement also included a section acknowledging that Fagen would continue to hold a perfected security interest in the single unit of Exergy Minnesota retained by Exergy as collateral for all of Exergy's outstanding debt obligations, "in accordance with the terms of the [2011] Pledge Agreement."

Lastly, the MCA, which was incorporated by reference into the Purchase Agreement, confirmed that Fagen now owned 99 of the 100 membership units in Exergy Minnesota. The MCA also included a "Purchase Option," which allowed

Exergy to repurchase the 99 units from Fagen if it could obtain "Repayment Capital" on or before June 29, 2012…. To exercise the repurchase option, the MCA provided that "Exergy must deliver the Option Purchase Price to Fagen within two (2) business days of receipt by Exergy of Repayment Capital ..., but in no event later than June 29, 2012." The MCA further provided that if Exergy failed to timely exercise the repurchase option, (1) the single membership unit "owned by Exergy shall automatically transfer to Fagen, such that Fagen is the owner of one hundred percent (100%) of the Units."

Exergy was represented during the Big Blue Transaction by the law firm Hawley Troxell….

Following the closing of the Big Blue Transaction, Exergy attempted to find financing for the Big Blue Project so that it could exercise the repurchase option…. When the June 29, 2012, repurchase option deadline came and went, Fagen extended the deadline because Exergy represented that it was close to a deal with EME. However, when Fagen insisted on a phone call with EME to confirm that a deal was imminent, it learned that EME was no longer interested in financing the project. Accordingly, on August 29, 2012, Fagen notified Exergy by letter that it was invoking the automatic transfer of the Exergy's single membership unit in Exergy Minnesota; removing Exergy's principals from their officer roles at Exergy Minnesota; terminating Exergy's membership rights in Exergy Minnesota; and taking control of the Big Blue Project by virtue of its 100% ownership of Exergy Minnesota. Over the next four months, Fagen invested approximately $60 million into the Big Blue Project and completed the wind farm in time to qualify for the federal grant deadline.

[*Legal Analysis*]

Fagen commenced this action against Exergy, seeking a declaratory judgment affirming its ownership of the Big Blue Project. Exergy counterclaimed, alleging that Fagen seized control of the windfarm in violation of Article 9 of the Minnesota Uniform Commercial Code ("UCC"); committed conversion, breach of contract, breach of fiduciary duties, and tortious interference with a prospective business advantage; and was unjustly enriched….

Exergy alleges that Fagen violated Article 9 of the UCC by unilaterally assuming control of Exergy's one membership unit in Exergy Minnesota on August 29, 2012. Exergy contends that Fagen held only a security interest in the unit, and Fagen therefore was required to comply with Article 9's post-default dispositional requirements, which it did not….

The Court also finds that when Exergy failed to exercise the repurchase option, Fagen was required to comply with Article 9's post-dispositional requirements and could not rely on the automatic-transfer provision within the repurchase option as grounds to unilaterally assume control of the unit. Minnesota law prohibits a secured party from retaining collateral "in full or partial satisfaction of the obligation it secures" unless the debtor consents to the acceptance after the default. Here, the parties agreed to the automatic-transfer provision before Exergy defaulted on its remaining loan obligations. The automatic transfer provision was accordingly invalid and unenforceable, and Fagen did not dispose of the collateral in a "commercially reasonable" manner.

…

Fagen argues that Exergy agreed to a strict foreclosure.

Under Minn. Stat. § 336.9–620(c), a secured party may accept the collateral in partial or full "satisfaction of the obligation it secures" if the debtor "consents" to such an acceptance and "agrees to the terms of the acceptance in a record authenticated after default." Here, Fagen argues that the MCA and Repurchase Option constituted a strict foreclosure because (1) Exergy allegedly defaulted on the Fifth Amended Loan Agreement by failing to disclose to Fagen that it had encumbered the Big Blue Project with a $7.6 million promissory note; (2) this alleged default occurred before the parties executed the MCA and repurchase option; (3) Exergy consented to transferring the one unit to Fagen in satisfaction of the debt secured under the Fifth Amended Loan Agreement; and (4) the MCA constitutes an authenticated record of Exergy's consent, which was executed after the default. But this argument cannot succeed. Minnesota Stat. § 336.9–620(c) requires the debtor to "consent" to a strict foreclosure, and here, there is absolutely no evidence that Exergy ever gave such consent. When the parties executed the MCA, they did so as a part of the larger Big Blue Transaction. The driving force behind the Big Blue Transaction was Exergy's need to post a $16.8 million letter of credit, not to effectuate a strict foreclosure. Indeed, Fagen has not offered any evidence showing that the parties contemplated or even discussed Exergy's purported default under the Fifth Amended Loan Agreement prior to executing the MCA. Accordingly, it can hardly be said that Exergy consented to Fagen accepting the member unit in satisfaction under § 336.9–620(c). The Court therefore finds that strict foreclosure does not apply here.

4. Disposition of Collateral

After repossession of the collateral, a secured party will typically dispose of the collateral at either public or private

proceedings. The secured party must send a notice of disposition to the debtor, secondary obligators, other secured parties, and other third parties required under § 9-611(c). The significance of the notice of disposition requirement as articulated by the court in *Regions Bank v. Thomas*, 2016 WL 1719325 (Tenn. Ct. App. April 27, 2016):

> The significance of the notice requirements is two-fold. In addition to allowing debtors and secondary obligors the opportunity to avoid a sale altogether by discharging the debt and redeeming the collateral, the notice requirements afford such parties a reasonable opportunity to see that the collateral brings a fair price.
>
> Understanding the function of the notice requirements helps to underscore why secured creditors cannot narrowly focus on the fair market value of collateral when their noncompliance with the applicable notice of sale requirements has been established. … A debtor or guarantor may be motivated to redeem the collateral prior to sale, and a debtor or guarantor can always try to "bid up" the price of collateral at a sale held by the creditor. Under the latter scenario, the debtor or guarantor may arrange to have a close friend or associate purchase the collateral at a specified price. Absent proper notice, however, these actions are frustrated. Notice can make a difference, irrespective of what the market may otherwise dictate that the collateral is worth. If secured parties have failed to provide proper notice, it is their burden to show that the amount they would have realized through

compliance is less than the "sum of the secured obligation, expenses, and attorney's fees."

Upon receipt of the notice of disposition, a debtor, secondary obligor, or any other secured party or lienholder may redeem collateral. To redeem collateral, a person must tender all obligations secured by the collateral and reasonable expenses and attorney's fees before the secured party has disposed of the collateral or has accepted collateral in full or partial satisfaction of the obligation. UCC § 9-623. Debtor's right to receive the notice of disposition, to redeem the collateral, and to have mandatory disposition of consumer goods under § 9-620(e) cannot be waived prior to default. The debtor may waive these rights only by agreement entered and authenticated after default. UCC § 9-624. The case below on waiver is instructive.

Ross v. Rothstein

92 F.Supp.3d 1041(D. Kan. 2015)

One of the provisions related to disposition of collateral is K.S.A. 84–9–611, which requires a secured party who disposes of collateral to send a "reasonable authenticated notification of disposition" to the debtor. However, the notice requirement does not apply "if the collateral is perishable or threatens to decline speedily in value or is of a type customarily sold on a recognized market." K.S.A. 84–9–612 further provides that whether a notification is sent within a reasonable time is a question of fact, but a notification of disposition sent after default and 10 days or more before the earliest time of disposition set forth in the notification is a reasonable time before the disposition.

In this case, the parties agree that Ross received no prior notice of Rothstein's September 16, 2013 disposition of the Infinity shares. Rothstein argues that no notice was required because Ross waived any right to notice of the disposition of the collateral in the August 27, 2012 Pledge Agreement. Section 12.1 of the Pledge Agreement allowed Rothstein "without notice except as specified below, [to] sell the Pledged Collateral or any part thereof at a commercially reasonable price or prices and upon such other terms as Pledgee [Rothstein] deems reasonable."

Whether Waiver Was Post Default

Ross argues that any waiver of notice that may appear in the Pledge Agreement cannot be deemed to be a waiver entered into and authenticated by Ross "after default" within the meaning of K.S.A. 84–9–624(a). According to Ross, any waiver appearing in a document which Ross executed on August 27, 2012 cannot be deemed to be a "post-default waiver" when in fact the default did not occur until January 1, 2013.

Rothstein counters that Ross ignores the controlling provisions in the Forbearance Agreement by which he not only acknowledged, but reiterated the May 31, 2012 default date, and specifically agreed there was no waiver by Rothstein of his rights with respect to that existing default date. Rothstein points out that there is no language in the Forbearance Agreement stating that the "term" of the loan was extended to January 1, 2013, but rather the Forbearance Agreement only states that Rothstein would forbear from exercising his rights until January 1, 2013.

K.S.A. 84–9–624(a) governs the waiver by a debtor of his right to notice of the disposition of collateral. It provides that

"[a] debtor or secondary obligor may waive the right to notification of disposition of collateral under K.S.A.2009 Supp. 84–9–611 and amendments thereto only by an agreement to that effect entered into and authenticated after default."

Here, the Court finds that Ross defaulted on the Promissory Note on May 31, 2012. His subsequent execution of the (Superseding) Pledge Agreement on August 27, 2013, which contained the waiver of notice provision in Section 12.1, constitutes a post-default waiver of his right to notification of disposition of the collateral under K.S.A. 84–9–624(a). The Forbearance Agreement, executed the same day as the Pledge Agreement, recited that May 31, 2012 was the date that Ross failed to pay Rothstein the outstanding principal balance resulting in an "Event of Default." It did not, as Ross argues, extend the maturity date to January 1, 2013, but only provided that Rothstein would forbear taking any remedial action on the note in connection with the non-payment default until January 1, 2013. Ross's waiver of his right to notice of disposition of the collateral, contained in Section 12.1 of the (Superseding) Pledge Agreement, was therefore a post-default waiver.

****

Disposition means "sell, lease, license, or otherwise dispose of any or all of the collateral." § 9-610(a). The disposition, in every aspect, must be commercially reasonable, including the method, manner, time, place, and other terms. That means the secured party may need to clean up and prep the repossessed collateral, advertise the upcoming sale of the collateral, conduct the sale at the courthouse steps or at a law office during business hours, etc.

Morgantown Excavators and Shirley E. Godfrey v. The Huntington National Bank

557 B.R. 469 (N.D. W. Va. 2016)

On June 14, 2016 Shirley E. Godfrey, Morgantown Excavators, Inc. ("MEI"), and their respective Chapter 7 bankruptcy estates (collectively, the "Plaintiffs"), filed their complaint against The Huntington National Bank ("HNB") and Myron Bowling Auctioneers, Inc. ("Myron Bowling"), alleging multiple violations of the West Virginia Uniform Commercial Code (U.C.C.) and other applicable state law based on HNB's sale of MEI's equipment, which served as collateral securing certain loans HNB made to the Plaintiffs, to Myron Bowling….

MEI executed multiple promissory notes to HNB on April 9, 2010. Shirley Godfrey personally guaranteed repayment of these notes. As collateral for the notes, MEI granted HNB a security interest in multiple categories of collateral, including its equipment. MEI failed to make required payments on its promissory notes, entered into multiple forbearance agreements, and then again defaulted by failing to make payments. As a result, HNB made plans to sell MEI's equipment.

On February 27, 2012, HNB and Myron Bowling entered into an Asset Purchase Agreement (the "Agreement"). The parties executed this agreement in anticipation of a future sale of MEI's equipment. By its terms, the Agreement provided that Myron Bowling would pay $535,000 to HNB for MEI's collateral. The Agreement obligated Myron Bowling to pay a 25% deposit upon execution of the contract and to pay the remaining 75% upon "Purchaser's removal of the equipment from its location and HNB providing title (including title

certificates for any titled Equipment).” Furthermore, under the Agreement, Myron Bowling was to take possession of the property no later than March 15, 2012. The Agreement required HNB to deliver good title for all equipment and permitted the parties to accept partial performance of the contract should complications arise outside of their control. Finally, the Agreement contains a merger clause which indicates that it constitutes the entire agreement between the parties; supersedes any prior agreements, representations, or understandings; and may only be modified by signed written agreement of the parties.

On March 5, 2012, Myron Bowling took possession of MEI's equipment. Then, on March 22, 2012, HNB sent a notice of private disposition to the Plaintiffs. This notice stated that HNB would sell MEI's equipment by private disposition “sometime after April 9, 2012.” The next day, March 23, 2012, Myron Bowling paid HNB the full purchase price of MEI's equipment. Sometime before April 6, 2012, Myron Bowling began to advertise for a public auction of MEI's equipment to be held on April 20, 2012. On April 18, 2012, HNB delivered a Bill of Sale and executed titles for the equipment in favor of Myron Bowling. Myron Bowling then sold the equipment at a public auction on April 20, 2012.

DISCUSSION

The Plaintiffs assert that the facts before the court demonstrate that Myron Bowling acquired equitable title to MEI's equipment no later than March 23, 2012. The Plaintiffs further allege that transfer of equitable title amounts to a disposition of collateral under the Uniform Commercial Code (“U.C.C.”). Thus, the Plaintiffs argue that HNB failed to

provide commercially reasonable notice to the Plaintiffs that HNB was disposing of MEI's collateral….

West Virginia law, by way of Article 9 of the U.C.C., requires a secured creditor to undertake certain actions before disposing of debtor's collateral. W. Va. Code § 46–9–610 and 611. Specifically, “every aspect of a disposition of collateral ... must be commercially reasonable” and “a secured party that disposes of collateral ... shall send to the [debtor] a reasonable authenticated notification of disposition. W. Va. Code § 46–9–610 and 611. The notification date is the date on which “a secured party sends to the debtor ... an authenticated notification of disposition.” W. Va. Code § 46–9–611(a)(1). However, notification of disposition must also be reasonable. W. Va. Code § 46–9–611(a)(2). Whether a notice is reasonably timely is a question of fact. W. Va. Code § 46–9–612. The purpose of giving the debtor notice before disposing of its property is to allow the debtor an opportunity to take action in order to potentially redeem the property or bring a better offer to the table. “A notification that is sent so near to the disposition date that a notified person could not be expected to act on or take account of the notification would be unreasonable.” W. Va. Code § 46–9–612 cmt. 1.

In order to trigger the requirements of §§ 46–9–611 and 612, a secured creditor must dispose of a debtor's collateral. However, the U.C.C. does not define disposition. *General Elec. Capital Corp. v. Vashi*, 480 N.W.2d 880, 881 (Iowa 1992)….

Many courts have considered the definition of ‘disposition’ under Article 9, and concluded that it encompasses various types of permanent transfers of possession. *See e.g.Williams v. Regency Financial Corp.*, 309 F.3d

1045, 1049 (8th Cir.2002) (finding that "sale and disposition are not intended to be synonymous, and that a disposition of collateral need not be in the form of a sale."); *Charles E. Brauer Co., Inc. v. NationsBank of Va. N.A.*, 251 Va. 28, 466 S.E.2d 382, 386 (1996) ("The term 'disposition' ... means an actual transfer of an interest in the collateral by sale, lease, or contract."); *In re the Estate of Rothko*, 84 Misc.2d 830, 379 N.Y.S.2d 923, 958 (Sur.Ct.N.Y.1975) (finding that a "shipment to [an] alleged purchasers for their permanent possession or permanent control" is a disposition under the U.C.C.). The U.C.C. defines sale to mean "the passing of title from the seller to the buyer for a price." W. Va. Code § 46–2–106(1). As is made clear above, courts have repeatedly found that a disposition is a broader form of a transfer than a sale. Thus, the requirements for a disposition are more lenient than those for a sale.

In *Williams*, the Eighth Circuit indicated that transfer of legal title is not necessary for a U.C.C. disposition. 309 F.3d at 1049. In that case, the appellee-defendant was a car dealership that acted as a "repossession churning mill." *Id.* at 1046. The defendant engaged in a system of quickly selling cars to individuals with bad credit, repossessing said cars, and then quickly reselling them. *Id.* at 1046-47. Frequently, the dealership resold cars before acquiring repossession title. *Id.* at 1047. Despite lacking legal title, and thus failing to transfer legal title, the court held that "'disposition' encompasses the transactions by which [the defendant] permanently transferred the [plaintiff's car]." *Id.* at 1049.

As the court finds the reasoning in *Williams* persuasive, it now finds that a transfer of equitable title amounts to a disposition under the U.C.C. Therefore, HNB disposed of MEI's equipment no later than March 23, 2012, the date upon which

Myron Bowling paid the full purchase price for the equipment. As HNB sent this notice only one day before it disposed of MEI's equipment, the disposition was not reasonably noticed, and was therefore in violation of W. Va. Code § 46–9–611. Furthermore, the notice sent to the Plaintiffs indicated that HNB would sell the equipment no earlier than April 9, 2012. As the disposition occurred on or before March 23, 2012, this notice was inadequate. Moreover, because W. Va Code § 46–9–610 requires all aspects of a disposition to be reasonable, and HNB's notice was unreasonable, the disposition also violated that provision.

CONCLUSION

Based upon the court's analysis herein, the court will enter a separate order granting summary judgment in favor of the Plaintiffs regarding the HNB's liability under W. Va. Code §§ 46–9–610 and 611.

****

The secured party may not purchase the collateral at a private sale if the collateral is not "of a kind that is customarily sold on a recognized market or the subject of widely distributed standard price quotations." UCC § 9-610(c)(2).

The case below addresses the disposition of the repossessed collateral, shares in a limited partnership. Obviously, potential buyers for such a collateral would be extremely rare. Should the disposition be a public or private sale?Should the secured party be permitted to purchase the collateral in the private sale of the "shares in a limited partnership" collateral?

Bruce v. Cauthen

2017 WL 455578 (Tex. Ct. App. 2017)

In 2002, David Bruce founded Alliance Recruiting Resources, Inc. (Alliance), a medical staffing company. That same year, Bruce hired Misty Cauthen as a recruiter. In 2006, Cauthen was promoted to Vice–President and awarded 20% of the shares of stock in Alliance…. By 2010, Cauthen had been given an additional 20% of the stock, increasing her ownership to 40% of the company.

In 2007, Bruce and Cauthen also formed Kingwood Place Investments # 1, LP (the Partnership). The limited partners in the Partnership were Bruce and Cauthen, and the general partner was Kingwood Place GP, LLC, a company solely owned by Bruce. Bruce and Cauthen's ownership interests in the Partnership mirrored their ownership interests in Alliance, except that Kingwood Place GP, LLC, owned 1% of the Partnership. Consequently, in 2012, Bruce owned 60.4% and Cauthen owned 39.6% of the Partnership.

The initial purpose of the Partnership was to hold title to an approximately 4.57-acre tract of undeveloped land it had purchased next to the Kingwood Medical Center in Montgomery County, where Bruce and Cauthen intended to construct a new office building for Alliance. Based on an "oral lease" agreement, Alliance leased the land from the Partnership, and Alliance's lease payments were used to pay the Partnership's mortgage loan. The Partnership had no assets other than the land and no liabilities other than the mortgage.

By the fall of 2012, business disagreements arose between Bruce and Cauthen, and ultimately Cauthen resigned from

Alliance in February 2013….

Although Cauthen had resigned from Alliance, she was still a limited partner in the Partnership. In 2013, the Partnership's land was valued by one estimate at $1,695,000.00. Cauthen asked Bruce to dissolve the Partnership and sell the land, but he refused. Bruce also refused Cauthen's offer to sell her interest in the Partnership to Bruce for $478,000.00. Cauthen then tried to find a third party to purchase her Partnership interest, but was unsuccessful.

In the meantime, Alliance continued to make lease payments to the Partnership, and Bruce began invoicing Cauthen for her share of the Partnership's monthly mortgage payments and other operating expenses. Cauthen made no payments, however, and the Partnership eventually declared her to be in default. In February 2014, Bruce notified Cauthen that her interest in the Partnership would be sold at a foreclosure sale. Neither Cauthen nor her ex-husband, who was also notified of the foreclosure sale, participated in the sale.

On March 6, 2014, a private foreclosure sale was held at which Bruce was the only bidder. Bruce acquired Cauthen's interest in the Partnership for the amount of her alleged indebtedness, then totaling $51,234.02. About a week later, Cauthen and her ex-husband were sent a "Notification of Transfer of Limited Partnership Interest" informing them of the details of the sale and the general partner's transfer of Cauthen's interest in the Partnership to Bruce.

…

In March 2014, Cauthen asserted claims for wrongful foreclosure on Cauthen's partnership interest in violation of Texas's codification of the Uniform Commercial Code (UCC) ….

The jury unanimously answered all questions favorably to Cauthen, awarding her $469,044.73 on her wrongful foreclosure claim….Because the jury found that Bruce had acted with malice, the second phase of the trial focused on the amount of exemplary damages…. The jury returned a verdict assessing exemplary damages of $1,200,00.00 against Bruce.

…

On May 15, 2015, the trial court signed a final judgment. After applying the statutory cap to the amount of exemplary damages found by the jury, the trial court ordered, in relevant part, that Cauthen recover from Bruce actual damages of $520,278.75, exemplary damages of $1,040.567.50, and attorney's fees of $454,682.53…. This appeal followed.

In his first issue, Bruce contends that the trial court erred by granting Cauthen a partial summary judgment on her claim that Bruce wrongfully foreclosed on Cauthen's 39.6% interest in the Partnership in violation of section 9.625 of the UCC. *See* Tex. Bus. & Com. Code § 9.625(b) (providing that a debtor may recover damages for losses caused by a secured party's failure to comply with Chapter 9)….

Section 9.610 of the UCC, titled "Disposition of Collateral After Default," provides that after a default, a secured party "may sell, lease, license, or otherwise dispose of any or all of the collateral." Tex. Bus. & Com. Code § 9.610(a). If the secured party undertakes to dispose of the collateral, "[e]very aspect" of the disposition "must be commercially reasonable," including "the method, manner, time, place, and other terms." *Id.* § 9.610(b). If commercially reasonable, "a secured party may dispose of collateral by public or private proceedings ... and at any time and place and on any terms." *Id.* (emphasis added).

However, the secured party may not *purchase* the collateral at a private sale if the collateral is not "of a kind that is customarily sold on a recognized market or the subject of widely distributed standard price quotations." *Id.* § 9.610(c)(2) (emphasis added).

Cauthen argues, as she did in the trial court, that section 9.610 cannot apply because her minority interest in a limited partnership it is not the kind of property "that is customarily sold on a recognized market or the subject of widely distributed standard price quotations" as section 9.610(c) requires, and therefore the private sale was governed by section 9.620. *See id.* § 9.610 cmt. 7 (explaining that a secured party's purchase of collateral at its own private disposition is equivalent to a "strict foreclosure" and is governed by sections 9.620, 9.621, and 9.622). Section 9.620(a) governs a secured party's acceptance of collateral in full or partial satisfaction of a debt, and requires that either (1) the debtor consents to the secured party's acceptance in the manner specified in the statute, or (2) the secured party does not timely receive notice of an objection to the secured party's proposal by the debtor or other interested persons. *See id.* § 9.620(a). Cauthen argues that there is no evidence that Bruce complied with the requirements of section 9.620(a). Accordingly, Cauthen maintains, she was entitled to summary judgment on her wrongful foreclosure claim. *See id.* § 9.625.

On appeal, Bruce does not dispute that section 9.610(c) precludes him from purchasing Cauthen's minority interest in the Partnership at a private sale. Instead, Bruce argues that the UCC permits section 9.610(c) to be modified by agreement of the parties, noting that section 9.610(c) is not included in the list of mandatory provisions that may not be waived or varied. *See id.* § 9.602 (prohibiting a debtor or obligor from waiving or varying certain provisions of the Code). According to Bruce, the

limited partnership agreement reflects the parties' agreement that the foreclosure sale of any limited partnership interest as collateral would be in a private sale to a restricted class of purchasers who would buy the partnership interest as an investment and not for resale, and that Bruce meets the contractual definition of such a purchaser. Bruce also argues that by signing the limited partnership agreement, Cauthen agreed that the private sale was commercially reasonable.

As support for his position, Bruce points to the entirety of Paragraph 7.2 of the limited partnership agreement:

> (b) Foreclosure. Each Partner, by signing this Agreement, shall be deemed to have granted a lien to the Partnership and the non-Defaulter, in the event that such Partner becomes a Defaulter, securing the payment of all sums required to be paid and performance of all covenants required to be performed by the Defaulter, and securing the Partnership and the non-Defaulter against any loss, cost or expense resulting from the default of the Defaulter, and the Partnership or the non-Defaulter as secured parties may foreclose the lien in the manner provided under the Texas Business and Commerce Code (the "UCC"). If, upon an Event of Default the Defaulter's interest in the Partnership is disposed of, 10 days' notice by the Partnership or by any Partner is reasonable notice under any provision of the UCC requiring notice. The Partners acknowledge that the Partnership or the non-Defaulter may be unable to effect a public sale of any or all of the Defaulter's interest in the Partnership by reason of certain prohibitions contained in the

> Securities Act of 1933, as amended, and applicable state securities laws, and may be compelled to resort to one or more private sales to a restricted group of purchasers who will be obligated to agree, among other things, to acquire the Defaulter's interest in the Partnership for their own respective accounts for investment and not with a view to distribution or resale. The Partners acknowledge that any private sale may result in prices or other terms less favorable to the seller than if the sale were a public sale. Notwithstanding those circumstances, each Partner agrees that a private sale is commercially reasonable, and neither the Partnership nor the non-Defaulter is under any obligation to take any steps in order to permit the Defaulter's interest in the Partnership to be sold at a public sale. ...

Bruce also points to the testimony of his expert, Allyn Needham, who averred that "the transactions and activities that led to the sale of Misty Cauthen's interest in Kingwood Place are consistent with the wording of the limited partnership and my experience in reviewing other limited partnerships' transactions." Needham further opined that the limited partnership agreement "anticipates and agrees to the potential purchase of a defaulting limited partner's interests in a private sale" and that "[t]he limited partnership agreement also anticipates and agrees that a creditor limited partner may purchase the defaulter's interest in a private sale."

In construing a contract, we must ascertain the true intentions of the parties as expressed in the writing itself. *Italian Cowboy Partners, Ltd. v. Prudential Ins. Co. of Am.*, 341 S.W.3d 323, 333 (Tex. 2011). Initially, we note that Paragraph 7.2(b) of

the limited partnership agreement grants a lien to both the Partnership and the non-defaulting partner to secure another partner's debt. The agreement also authorizes foreclosure on the lien in accordance with the provisions of the UCC: “the Partnership or the non-Defaulter as secured parties may foreclose the lien in the manner provided under the Texas Business and Commerce Code (the ‘UCC’).” As mentioned above, the UCC contemplates that a secured party may dispose of collateral by commercially reasonable proceedings that may be either public or private. *See* Tex. Bus. & Com. Code § 9.610(b). Consistent with this provision, Paragraph 7.2(b) reflects the parties' agreement that the sale of an interest in the Partnership via a public sale may be problematic, requiring a private sale “to a restricted group of purchasers” who would be obligated to agree to acquire the partnership interest as an investment and “not with a view to distribution or resale.” Further, the parties agreed that even though a private sale may result in “prices or other terms less favorable to the seller,” such a sale “is commercially reasonable.”

Notably, however, Paragraph 7.2(b) does not include any express language reflecting that the parties have agreed to modify section 9.610(c) of the UCC. Nor is there any language indicating an agreement permitting the secured party to acquire the defaulting party's partnership interest at a private sale. Further, the agreement does not modify section 9.610(c) to say that the potential purchaser may be the limited partner who is also the secured party. Indeed, the lack of any express language providing that the secured party may purchase the defaulting partner's partnership interest at a private sale in direct contravention of the UCC militates against Bruce's argument that the parties intended and agreed to modify section 9.610(c)

to permit such a transaction.

We conclude that nothing in Paragraph 7.2(b) of the limited partnership agreement modifies section 9.610(c) to permit Bruce to acquire Cauthen's interest at a private sale. Nor does Needham's testimony raise a fact issue precluding a partial summary judgment in Cauthen's favor. Needham's bare assertion that the limited partnership agreement "anticipates and agrees that a creditor limited partner may purchase the defaulter's interest in a private sale" is unsupported by any evidence or substantive analysis, and is therefore conclusory and no evidence. *See Elizondo v. Krist*, 415 S.W.3d 259, 264 (Tex. 2013) ("A conclusory statement of an expert witness is insufficient to create a question of fact to defeat summary judgment"). Moreover, his testimony is no evidence to the extent it addresses pure questions of law. *See Greenberg Traurig of N.Y., P.C. v. Moody*, 161 S.W.3d 56, 94 (Tex. App.–Houston [14th Dist.] 2004, no pet.). Consequently, we reject Bruce's argument that a fact issue exists as to whether the limited partnership agreement modified section 9.610(c) to permit Bruce, as the secured party, to acquire Cauthen's partnership interest at a private sale.

Bruce additionally argues that the partnership agreement's language and Needham's testimony establishes that the private sale was commercially reasonable. Therefore, Bruce maintains, the sale fits within the Code's safe harbor provision that "a disposition of collateral is made in a commercially reasonable manner" if the disposition is made "in conformity with reasonable commercial practices among dealers in the type of property that was the subject of the disposition." *See* Tex. Bus. & Com. Code § 9.627(b)(3). But this argument is irrelevant because the dispute is not whether some

aspect of the disposition of Cauthen's minority interest in the Partnership was commercially unreasonable; the issue is whether Bruce, as the secured party, acquired Cauthen's minority interest in violation of the UCC.

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In many business financing cases, there are multiple secured parties in the same collateral. A debtor may be in default in one secured transaction but is still in good standing in a different secured transaction. Disputes arise when one secured party tries to foreclose on the property that is subject to other secured transactions. The case below shows how complex it could be to sort out secured parties and their interests in the proceeds after the disposition of the collateral.

Chadron Energy Corp. v. First Nat. Bank of Omaha

459 N.W.2d 718 (Neb. 1990)

This litigation is based on a series of involved and somewhat complicated transactions.

In March 1979, the First National Bank of Chadron [FNB-Chadron] was a national banking corporation which had issued and outstanding 2,000 shares of capital stock. On March 6, 1979, six individuals represented by George Wulf (Wulf Group) entered into a stock purchase agreement for 1,990 shares of FNB-Chadron stock. The sale price was $5 million, part of which was to be paid in cash at the time of the closing and the balance of which was to be represented by notes from the individual members of the Wulf Group. Of the 1,990 shares of stock to be purchased, 1,815 would be purchased from the Shaffers and Kleman. In order to obtain the necessary cash to make the downpayment to the Shaffers and Kleman, the Wulf

Group borrowed $2.1 million from FNBO. The Shaffers received $860,000 in cash plus notes totaling $2,102,500, and Kleman received $1,180,000 in cash plus notes totaling $395,000.

Both the loan from FNBO and the notes to the Shaffers and Kleman were secured by 1,850 shares of FNB-Chadron stock. (The discrepancy between the number of shares purchased from the Shaffers and Kleman and the number of shares securing the debts to FNBO, the Shaffers, and Kleman is unexplained in the record.) By agreement among all parties, FNBO was designated as the senior lienholder at that time and the Shaffers and Kleman as junior lienholders.

FNBO took physical control of six individual stock certificates, each issued in the name of one of the six members of the Wulf Group. FNBO assured the Shaffers and Kleman in writing that "[w]e will not release such collateral from our possession until you have notified us that your security interest has been released or discharged."

Later in 1979, the Wulf Group formed a corporation under the name of First of Chadron Bank Corporation, and received approval of the Federal Reserve Bank of Kansas City to become a one-bank holding company and to acquire the capital stock of FNB-Chadron. The holding company's name was later changed to Chadron Energy Corporation (CEC).

… As the result of pay downs and additional borrowing, the amount owed by CEC to FNBO varied over time. On March 29, 1982, CEC's note was renewed in the amount of $666,000. *178 Because of various difficulties experienced throughout 1982, CEC was unable to make the September 27, 1982, payment due on the March 29 note held by FNBO.

FNBO notified CEC that it was in default on the note for

nonpayment in the total amount of $720,767.10 principal and accrued interest and that the collateral (stock) would be sold on October 28, 1982. In a notice dated October 18, 1982, FNBO notified CEC that the sale would occur on October 29, 1982. FNBO then sent notice of the sale to approximately 110 people.

Prior to the sale, FNB-Chadron, CEC, and the Shaffers filed a petition to restrain the sale. Although a temporary restraining order was granted on October 28, 1982, the required bond was never posted and FNBO proceeded with the sale.

Only three people participated in the bidding during the October 29, 1982, auction/sale of the 1,850 shares of FNB-Chadron stock. The highest bid obtained during the public bidding was $1,450,000. However, a representative of FNBO held private discussions with each of the three bidders as to the amount each was willing to pay down as a nonrefundable deposit on his bid. As a result of those discussions, the second highest bidder agreed to put down $500,000, as compared to $10,000 by the highest bidder. Therefore, FNBO declared the bid of the second highest bidder to be the highest and best bid and accepted $1,410,000 for the stock.

On October 29, 1982, the $500,000 downpayment was applied to CEC's debt to FNBO, and when the balance of $910,000 was paid on December 10, 1982, FNBO took out its claimed expenses of the sale and the remaining principal and interest owed by CEC.

After the sale, FNB-Chadron dismissed itself from the pending lawsuit, and CEC and the Shaffers proceeded against FNBO for damages. …

SECURITY INTERESTS OF SHAFFERS AND KLEMAN

The district court reasoned that FNBO's conversion of the stock in which the Shaffers and Kleman had security interests cut off the security interests, leaving the Shaffers and Kleman with tort claims for conversion against FNBO and no claims to the collateral or the proceeds of the sale….

Disputing the correctness of the district court's analysis, FNBO claims that the court should have dismissed the interpleader and released the money to it rather than releasing the money to CEC, FNBO argues that it is entitled to all of the sale proceeds, including the interpleaded funds, for the following reasons: (1) The senior security interests of the Shaffers and Kleman continued in the sale proceeds, and because of the nature of conversion, those security interests became the property of FNBO; (2) the Shaffers and Kleman assigned their interests to FNBO; and (3) FNBO was subrogated to the rights of the Shaffers and Kleman.

… FNBO sold the stock over the protest of the Shaffers and without notice to Kleman. …

While it is true that this court did determine that after November 1980 the security interests of the Shaffers and Kleman were senior to the security interest of FNBO, this court did not say that FNBO was guilty of conversion because it failed to turn over proceeds of the sale to the senior secured parties. Such a holding would be unsupported by the Uniform Commercial Code.

Despite the senior secured status of the Shaffers and Kleman, when CEC defaulted, under the code FNBO was entitled to sell the 1,850 shares of FNB-Chadron securing CEC's debt. Neb. U.C.C. § 9-503 (Reissue 1980) provides in part that

"[u]nless otherwise agreed a secured party has on default the right to take possession of the collateral." Section 9-504(1) provides that "[a] secured party after default may sell, lease or otherwise dispose of any or all of the collateral...." These sections make no distinction between secured parties of graduated priorities; they authorize "a secured party" to repossess the collateral upon default via self-help, if repossession is necessary, and to dispose of the collateral. There is no requirement that the secured party hold first priority status.

When CEC defaulted, FNBO, as a secured party, albeit a junior secured party, was authorized under the code to sell the collateral. FNBO was not guilty of conversion because it retained proceeds of the sale in satisfaction of CEC's indebtedness without first applying proceeds to the satisfaction of the security interests of the Shaffers and Kleman. Section 9-504(1) provides that proceeds of a foreclosure sale are to be applied in the following order: (1) to the reasonable expenses of the sale, (2) to the satisfaction of the indebtedness secured by the security interest under which the disposition is made, and (3) to the satisfaction of indebtedness secured by any subordinate security interest in the collateral if written notification of demand therefor is received before distribution of the proceeds is completed. If there are any proceeds remaining, they go to the debtor. § 9-504(2). The code does not require distribution of proceeds to the satisfaction of senior security interests when a junior secured party conducts a foreclosure sale.

However, despite the right FNBO had under the code to sell the collateral, it had created a bailor/bailee relationship between itself and the Shaffers and Kleman and had agreed not to release the collateral from its possession until notified by the

Shaffers and Kleman that their security interests had been released or discharged. This court has previously held that a special contract of bailment prevails in determining the liabilities of the parties, as against general principles of law applicable in the absence of express agreement. *Bozell & Jacobs, Inc. v. Blackstone Terminal Garage, Inc.*, 162 Neb. 47, 75 N.W.2d 366 (1956). When FNBO sold the stock in breach of the bailment agreement, it was guilty of conversion whether the security interests of the Shaffers and Kleman were junior or senior to the security interest of FNBO.

In settling the conversion claims of the Shaffers and Kleman, FNBO in effect purchased their interests in the stock. As a general rule, one converting the property of another who pays to the owner the value of the property converted becomes, by operation of law, the owner of the property. *See, Foley v. Dick*, 436 So.2d 139 (Fla.App.1983); *Mason v. Schumacher*, 231 Neb. 929, 439 N.W.2d 61 (1989). To determine what interests FNBO thereby acquired, it is necessary to determine the interests of the Shaffers and Kleman after the sale.

The Interests of the Shaffers and Kleman in the Collateral After the Sale.

28 Neb.U.C.C. § 9-306 (Reissue 1980) deals with a secured party's rights upon disposition of the collateral other than by the secured party. Section 9-306(2) provides:

> Except where this article otherwise provides, a security interest continues in collateral not with standing sale, exchange or other disposition thereof unless the disposition was authorized by the secured party in the security agreement or otherwise, and also continues in any identifiable proceeds including

collections received by the debtor.

In 1980, the Nebraska Legislature amended § 9-306(2) by deleting the phrase "by the debtor" following "sale, exchange or other disposition thereof." Therefore, even if the disposition is not by the debtor, a secured party's security interest continues in the collateral unless one of the conditions specified in § 9-306(2) for cutting off the security interest is satisfied. *See El Paso County Bank v. Charles R. Milisen & Co.*, 622 P.2d 594 (Colo.App.1980).

Section 9-306(2) provides that a security interest continues in the collateral after a sale, exchange, or other disposition unless (1) otherwise provided in article 9 of the code or (2) the secured party authorized the disposition.

Article 9 does not "otherwise" provide that a senior secured party's security interest in the collateral is cut off by a disposition by a junior secured party. Section 9-504(4) provides:

> When collateral is disposed of by a secured party after default, the disposition transfers to a purchaser for value all of the debtor's rights therein, discharges the security interest under which it is made and any security interest or lien subordinate thereto. The purchaser takes free of all such rights and interests....

(Emphasis supplied.) Under § 9-504(4) only subordinate security interests and liens are cut off. A senior secured party's interest in the collateral is not discharged by a junior secured party's foreclosure sale, and the collateral in the hands of the purchaser is subject to the senior secured interest. *See*, 2 J. White & R. Summers, Uniform Commercial Code § 27-9 (3d ed. 1988); R. Duncan & W. Lyons, The Law and Practice of Secured Transactions: Working with Article 9 § 5.04[4] (1990).

FNBO's sale of the stock was not authorized by the Shaffers and Kleman, either in the security agreements or "otherwise."

Neither of the conditions specified in § 9-306(2) for cutting off a security interest in collateral having been satisfied, the security interests of the Shaffers and Kleman continued in the stock after the sale. By settling the conversion claims of the Shaffers and Kleman, FNBO acquired their continuing security interests in the stock. This, however, does not support FNBO's claim of entitlement to the proceeds of the sale, including the interpleaded funds.

The Interests of the Shaffers and Kleman in the Proceeds After the Sale.

Section 9-306(2) provides that after sale, exchange, or other disposition, a security interest continues "in any identifiable proceeds including collections received by the debtor." Unlike the continuing security interest in the collateral, whether the sale was authorized does not affect the secured party's continuing interest in the proceeds. *See, Norfolk Prod. Credit Assn. v. Bank of Norfolk*, 220 Neb. 593, 371 N.W.2d 276 (1985); 9 R. Anderson, Uniform Commercial Code §§ 9-306:11 and 9-306:23 (3d ed. 1985).

When the disposition of the collateral is by a junior secured party, what is the interest of a senior secured party in the proceeds of the disposition? The security interest of the senior secured party continues only in those proceeds of the disposition that are received by the debtor.

As previously stated, the distribution scheme specified in § 9-504(1) does not provide for distribution of any of the proceeds to the satisfaction of indebtedness secured by a senior

security interest. Therefore, a continuing security interest of the senior secured party in proceeds of the sale properly distributed to other secured parties pursuant to § 9-504(1) would be inconsistent with the distribution scheme of § 9-504(1). However, if the disposition of the collateral by a junior secured party produces a surplus which the debtor is entitled to receive pursuant to § 9-504(2), such proceeds are subject to the continuing security interest of the senior secured party.

Despite FNBO's contention to the contrary, the security interests of the Shaffers and Kleman did not continue in the proceeds of the sale retained by FNBO as reimbursement for the expenses of the sale and in satisfaction of CEC's debt. However, the Shaffers and Kleman did have continuing security interests in those proceeds of the sale to which CEC was entitled, i.e., the surplus proceeds represented by the interpleaded funds.

By settling the conversion claims of the Shaffers and Kleman, FNBO acquired their continuing security interests in the surplus proceeds/interpleaded funds.

Furthermore, in their settlements with FNBO, the Shaffers and Kleman assigned to FNBO the promissory notes from the members of the Wulf Group and their rights to and interests in the proceeds of the sale of the FNB-Chadron stock. Since the security interests of the Shaffers and Kleman continued in the surplus proceeds/interpleaded funds, FNBO also has an interest in the interpleaded funds by virtue of the assignments.

FNBO also argues that it is entitled to the proceeds, including the interpleaded funds, because the theory of subrogation would clearly give it the right to the sale proceeds because it was compelled to pay a debt that was owed to the

Shaffers and Kleman and which was to be paid from the proceeds of the sale of the stock.

As discussed above, FNBO is incorrect in asserting that proceeds of the sale had to be paid to the Shaffers and Kleman to pay the debt of the Wulf Group….

From the foregoing discussion it is clear that the district court erred in ordering the interpleaded funds released to CEC. Despite FNBO's conversion, the security interests of the Shaffers and Kleman continued in the collateral and the surplus proceeds of the sale. FNBO acquired the security interests of the Shaffers and Kleman in the surplus proceeds/interpleaded funds when it settled their conversion claims and by virtue of the assignments.

It must, however, be remembered that the security interests of the Shaffers and Kleman in the FNB-Chadron stock gave them a secured position in the event of nonpayment by the Wulf Group. There having been no default by the Wulf Group when the stock was sold, the Shaffers and Kleman could have claimed the surplus proceeds/interpleaded funds only by virtue of their continuing security interests which, given that the proceeds were money, could be perfected only by possession. They could not have applied the proceeds to the debts of the Wulf Group; they could only have held the proceeds as security against nonpayment by the Wulf Group. In the event the members of the Wulf Group paid off their debts to the Shaffers and Kleman, CEC would then be entitled to the surplus proceeds/interpleaded funds.

FNBO having acquired, by settlement of the conversion claims and by virtue of the assignments, the security interests of the Shaffers and Kleman and the promissory notes representing

the debts those security interests secured, FNBO is entitled to hold the interpleaded funds in order to perfect its security interests but can only hold the money as security against nonpayment by the Wulf Group. Therefore, whether FNBO or CEC is ultimately entitled to the interpleaded funds depends on whether the members of the Wulf Group default on their debts and the extent of any defaults, and the entitlement to the funds cannot be decided by this court in this appeal.

****

A secured party, after a commercially reasonable disposition of the repossessed collateral, applies the proceeds to satisfy the obligation. If the proceeds are insufficient to satisfy the obligation, the secured party may wish to obtain a deficiency judgment for the amount still owing on the obligation. If the commercially reasonableness of the disposition of the repossessed collateral is at issue, the secured party has the burden ofproving its compliance. When the secured party fails to meet its burden, the liability of a debtor for the deficiency is limited to an amount by which the sum of the secured obligation, expenses, and attorney's fees exceeds the greater of (1) the proceeds of the disposition or (2) the amount of proceeds that would have been realized had the noncomplying secured party disposed of the collateral in a commercially reasonable manner. See UCC § 9-626(a)(4) ("[T]he amount of proceeds that would have been realized is equal to the sum of the secured obligation, expenses, and attorney's fees, unless the secured party proves that the amount is less than that sum."). As the case below illustrates, whether the disposition of a repossessed collateral is commercially reasonable is a question of fact, so is the determination of the amount of the deficiency.

Comerica Bank v. Mann

13 F.Supp.3d 1262 (N.D. Ga. 2013)

This is a deficiency action by Plaintiff, Comerica Bank ("Comerica") against Defendant Charles H. Mann, III ("Mann")….Comerica filed its Complaint in this case on February 16, 2011, seeking a deficiency judgment against Mann following liquidation of collateral. Comerica sued Mann on a guaranty, claiming that Mann had guaranteed Yacht Ventures, Ltd.'s ("Yacht Ventures") obligations under a promissory note.

…

This case arises out of a $3,750,000.00 loan Comerica made to Yacht Ventures in June 2008 to refinance the purchase of an 82–foot luxury sport yacht named the Louise. Yacht Ventures was a Cayman Islands company, of which Defendant Mann was the sole principal. Mann personally guaranteed the loan.

The Louise experienced a number of technical problems throughout its short life as a charter vessel for Yacht Ventures. Ultimately, unable to secure enough charter business, Yacht Ventures notified Comerica of its intention to stop making its mortgage payments. In November 2008, Yacht Ventures missed its first payment, and Comerica notified Yacht Ventures that it was accelerating the payments due on the promissory note….In May 2009, Comerica notified Mann's attorney that it was electing to exercise its remedies under the mortgage and deed of covenants and that it was taking possession of the Louise….In December 2010, Comerica sold the Louise for $1,400,000.00.

The parties' dispute is over whether Comerica sold the Louise in a commercially reasonable manner as required under

Florida law.

Commercial reasonableness of sale

The existence of commercial reasonableness is a question of fact. If notice or other aspects of the sale are found to have been deficient under the statute, a rebuttable presumption arises that the sale of the collateral at issue was commercially unreasonable, and that the fair market value of the collateral at the time of the repossession was equal to the total secured debt. *Gangelhoff v. Transamerica Comm. Fin. Corp.*, 611 So.2d 1333, 1334 (Fla.Dist.Ct.App.1993). The secured party may overcome this presumption by showing that the amount actually received at the sale was equal to the fair market value of the collateral at the time of repossession and that the proceeds of the sale were less than the debt. *Gangelhoff v. Transamerica Comm. Fin. Corp.*, 611 So.2d at 1334.

…

Comerica's marketing and sale of the Louise was … commercially unreasonable. First, Comerica sold the Louise to XSMG for $1,400,000.00, a price $300,000.00 lower than the next lowest offer Comerica received, and $2,500,000.00 below its listing price. The facts elicited during trial suggest that Roscioli was pressured to sell the Louise at a below-market price by an aggressive and perhaps threatening buyer. Coch, who had been at the forefront of marketing the Louise and getting it up to speed for sea trial, advised against selling the yacht at that price to XSMG, because it was not anywhere close to what Comerica was asking for the Louise. Second, Waterside did not direct a marketing campaign at European buyers. Mann's expert testified that the Louise was geared toward a European market both because it was built in a European style and because the

European yacht market was stronger when the Louise was for sale. Glass concurred that the Louise was designed with this distinctly European style. Third, Waterside did not engage in a full "direct marketing" campaign for this highly specialized boat. Mann's expert, James Mattingly, testified that direct marketing would entail a variety of reasonable measures under the circumstances: communicating both by internet and personal phone calls with all relevant brokerage houses in Florida and internationally (including ones in the European market); aggressively using the independent marine surveys of the Louise in communications with brokers and customers, particularly if the yacht were still manifesting performance issues in sea trials; and holding open houses and boarding the boat in a facility where the boat could easily be shown to prospective purchasers. Waterside's marketing of the Louise need not have been perfectly crafted or implemented. However, the Court finds that Waterside and Comerica's minimalist approach to marketing a yacht which had been independently assessed multiple times to have a value in excess of $3 million dollars and their failure to reach out to the most likely European customer base cannot be said to have been in conformity with reasonable commercial practices in the luxury yacht trade under the totality of these circumstances.

E. Amount of Mann's Remaining Debt Owed

As of the date of the bench trial, Mann's remaining debt owed to Comerica, inclusive of principal, accrued interest, and late charges resulting from Mann's default on the loan was as follows:

Loan Principal:$2,755,163.7926

Loan Interest: $319,083.67

Late Charges: $12,079.36

Total Amount of Debt:$3,086,326.82

If the dockage fees, repair costs, and insurance and taxes paid by Comerica following Mann's default are included, the amount of the remaining debt on the loan would total: $3,624,526.03.

F. Value of the Louise on Date of Repossession

The amount of a deficiency judgment to which the secured party is entitled is a question of fact. Florida law provides that:

> [W]hen it has been determined that a secured party has disposed of collateral in a commercially unreasonable manner, there will arise a presumption that the fair market value of the collateral at the time of repossession was equal to the amount of the total debt that it secured. The burden to prove that the fair market value of the collateral was less than the debt will be upon the secured party. If the secured party meets this burden, he will be allowed to recover a deficiency judgment in an amount equal to the total debt minus the fair market value of the collateral as ultimately determined.The Court thus cannot confine its analysis of value to the price for which the yacht ultimately sold.

The Court has determined as a matter of fact that Comerica's sales and marketing efforts with respect to the Louise were commercially unreasonable. Thus, the Court cannot look to offers produced by such unreasonable efforts as capturing the complete picture of the Louise's value in the international high-end yacht market or rely on Comerica's

likely low-balling of the anticipated sales price through its "repo" advertising of the yacht. In order to rebut the presumption that the fair market value of the collateral was equal to the amount of the debt, Comerica bore the burden of "present[ing] competent proof that the fair market value of the collateral was less than the outstanding balance [of the debt]." *In re Darling*, 207 B.R. 253, 255 (Bankr.M.D.Fla.1997).

In addition to the evidence supplied by Comerica, the Court also has at its disposal the three independent … surveys valued the Louise as follows:

- Pliske Marine, Inc. Survey (May 2008): $5,000,000.00 (May 2008 Survey);
- Patton Marine, Inc. Survey (December 2008): 4,500,000.00 (Dec. 2008 Survey);
- Kelly Marine Surveyors, Inc. Survey (June 2009): $3,275,000.00 (June 2009 Survey).

In the instant case, Comerica bore the burden to prove the value of the collateral both because Mann placed the commercial reasonableness of the sale at issue and because the Court found that sale to be commercially unreasonable. However, the Court looks to the totality of the evidence available in this case to assess the likely fair market value of the Louise at the time of its repossession by Comerica, assessing the evidence in the record to determine the proper fair market value for the Louise, without respect to which party carried the burden of proof. Although this evidence does not conclusively establish the Louise's fair market value, or carry Comerica's burden of proof, the Court has assessed Plaintiff's evidence in tandem with evidence produced by Defendant in order to gain a more complete understanding of the Louise's fair market

value at the time of its repossession….

As stated above, because the $1.4 million bid price Comerica accepted (and that Coch recommended against) was not a commercially reasonable fair market price, it cannot serve as the basis for determining the fair market value for purposes of a deficiency. The July 2009 list price for the Louise was $3,500,000.00. The June 2009 Marine Survey, prepared at Comerica's request immediately after repossession, valued the boat at $3,275,000.00, including the costs of needed repairs. The average valuation provided by the three separately prepared independent marine surveys of the Louise, which took into account the Louise's condition and necessary repairs, as calculated and relied on by Mattingly was $4,258,333.33. The average sale price for all 12 comparable yachts as calculated by Mattingly, including the 2006 yacht sales, was $4,021,059.81 If the 2006 sales are excluded, the average sale price for the comparables, again using Mattingly's averaging methodology, would be $4,443,400. The average sale price for the three yachts that Mattingly identified as most similar to the Louise that were sold after 2006 is $5,645,445.00. Based on this evidence, the fair market value of the Louise at the time of Comerica's repossession was anywhere from $3,275,000.00 to $5,645,445.00.

As the Court has determined that Comerica failed to dispose of the Louise in a commercially reasonable manner in accordance with Florida's statutory requirements, Comerica bore the burden of proving that the fair market value of the Louise at the time of repossession, not at the time of sale, was less than the debt owed by Mann. Comerica failed to carry its burden of conclusively establishing that the bid price it accepted of $1.4 million in fact was close to the fair market value of the Louise at the time of repossession or that the fair

market value of the Louise was less than the total debt owed of $3,624,526.03, including interest, insurance, dockage fees, and repair costs. Comerica produced evidence of the offers it received for the Louise as a result of its marketing efforts. However, those efforts defined the market so narrowly as to create a self-fulfilling, distorted rendering of the Louise's value. The bank's advertisement of the yacht as a "repo" deal further reasonably could have been anticipated to attract low-ball offers. Finally, Captain Coch, Defendant's agent who had been most intimately involved in the sale and maintenance of the Louise, urged Comerica to reject the $1.4 million offer because it was too low and did not fairly reflect the value of the Louise.

Comerica failed to offer any evidence as to the value of the Louise as of the date of its repossession on May 21, 2009. Thus, Comerica has failed to satisfy its burden of rebutting the presumption that the value of the Louise was, at a minimum, equal to the amount of the outstanding debt. Accordingly, the Court finds that Comerica has failed to provide sufficient evidence to support a factual finding by the Court that it is entitled to a deficiency judgment in its favor. Although the Court cannot determine from the record the Louise's exact dollar value, the Court's factual finding precludes Comerica from collecting a deficiency judgment against Mann under the Guaranty for the collateral of the Louise in light of the foregoing authority and factual findings.

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Debtors can look to UCC § 9-625 which provides remedies for secured party's failure to comply with UCC Article 9. The secured party may be liable for damages in the amount of any loss caused by a failure to comply as well as loss resulting from

the debtor's inability to obtain, or increase costs of, alternative financing. UCC § 9-625(c) provides a minimum statutory damage if the collateral is consumer goods. The statutory damageis not "less than the credit service charge plus 10 percent of the principal amount of the obligation or the time-price differential plus 10 percent of the cash price." Supplemental damages of $500 under UCC § 9-625(e) are available to the debtor when the secured party fails to comply with certain subprovisions, or a person files a financing statement that the person is not entitled to file, or causes the secured party to file or send a termination statement, among others.

Problems

6.1 Using as many provisions in Part VI of UCC-9 as possible, construct a flow chart of the secured party's and debtor's rights and remedies.

6.2 Why are there not that many disputes between secured parties and debtors nationwide?

CHAPTER SEVEN

SECURED TRANSACTIONS AND INTELLECTUAL PROPERTY AS COLLATERAL

It has become common for the debtor to use its intellectual property as collateral in secured transactions. UCC § 9-102 does not have a separate definition for patents, copyrights, trademarks, trade secrets, database, intellectual property and the like. Instead, Article 9 provides a residue, catchall definition of *General Intangibles* which means "any personal property, including things in action, other than accounts, chattel paper, commercial tort claims, deposit accounts, documents, goods, instruments, investment property, letter-of-credit rights, letters of credit, money, and oil, gas, or other minerals before extraction. The term includes payment intangibles and software." The Official Comment explaining "general intangibles" indicates that the term covers categories of intellectual property, licenses of intellectual property, and the right to exploit intellectual property without liability for infringement.

Parties to a security agreement may wish to define "Collateral" to include patents, copyrights, trademarks, and other assets. The secured party must perfect its security interest in the intellectual property. Without proper perfection of the security interest, the secured party may lose out to the bankruptcy trustee, as seen below. Perfection of security interests in patents requires filing of the financing statement with the Secretary of State's Office not with the USPTO. The same is required for trademarks and unregistered copyrights. Security interests in registered copyrights are perfected when the secured party files with the Copyright Office.

In re Coldwave Systems, LLC

368 B.R. 91 (Bankr. D. Mass. 2007)

Debtor was a Massachusetts limited liability company engaged in the design, development, manufacture, licensing, and sale of shipping, freezing, and storage systems. It owned the Patent, which deals with Debtor's proprietary freezing technology, used in apparatuses such as shipping containers, for the shipping of frozen foods.

Gateway was in the business of leasing insulated shipping containers into which Debtor's patented technology was incorporated. Debtor was indebted to Gateway under the terms of a finance lease and related documents. To facilitate the relationship between Debtor and Gateway, they entered into a Repayment and Security Agreement dated January 31, 2003 (the "Agreement"). The Agreement provides that Debtor "hereby grants and conveys to [Gateway] a continuing lien and security interest in the Collateral" to secure payment of its indebtedness to Gateway. "Collateral" is defined in the Agreement to include the Patent. The Agreement provides that it is governed by the laws of California other than conflicts of laws principles.

To perfect Gateway's interest in the "Collateral," including the Patent, Debtor filed a Recordation Form Cover Sheet with the United States Patent and Trademark Office ("USPTO") on June 28, 2003, recording the conveyance of a security agreement dated January 31, 2003. Gateway filed UCC–1 Financing Statements describing the Patent with the Massachusetts Secretary of State on December 2, 2004, and with the Washington, D.C., Recorder of Deeds on December 1, 2004.

Debtor was continuously indebted to Gateway at all times

after January 31, 2003. On November 24, 2004, Gateway's counsel notified Debtor by facsimile that Debtor was in default of its obligations to Gateway and that Gateway elected to "exercise all of its rights under the lease and related documents, including exercise of its security interests and all rights otherwise addressed in Lease paragraph 11 ('Remedies')." It further provided that "Gateway elects to accelerate all amounts due under its lease and all other obligations with [Debtor] and to demand payment now of all amounts accelerated under the leases and those other obligations." The lease was not offered as evidence but Gateway's remedies upon default are encompassed within the Agreement which includes Gateway's right upon default, to "(iv) dispose of the Collateral, (v) sell the Collateral at public or private sales, in whole or in part, and have the right to bid and purchase at said sale, and/or (vi) take control over, lease or otherwise dispose of all or part of the Collateral, applying proceeds therefrom to the Indebtedness."

On November 30, 2004, Gateway filed a Transfer Statement with the USPTO indicating the transfer of ownership of the Patent from the Debtor to Gateway. Gateway notified Debtor of this action on December 8, 2004 (the "December 8 Letter"). The December 8 Letter also provided that "further pursuant to applicable law, Gateway without prejudice, offers to place a value of $300,000 (Three Hundred Thousand Dollars) on the patent in partial satisfaction of the debt overdue to Gateway from [Debtor]. Please let us, for Gateway, have [Debtor's] timely response to this offer."

Debtor filed its petition under Chapter 11 on March 1, 2005. The case was converted to Chapter 7 on April 14, 2005, and the Trustee was duly appointed and qualified.

The parties have stipulated that Debtor was insolvent as of December 1, 2004, and that Gateway received more value from the transfer of the Patent pursuant to its foreclosure than it would have received in distribution from Debtor's estate pursuant to Chapter 7 had the transfer not been made.

Not included in the stipulated facts, but a matter of record in the principal case, is the fact that Gateway filed a proof of claim on August 11, 2005, asserting an unsecured claim of $462,388.07 and a priority claim of $44,204.77, for an aggregate claim of $506,592.84. It may be useful to summarize the time line of relevant events:

Date	Event
January 31, 2003	Agreement executed
June 28, 2003	Cover Sheet filed with USPTO
November 24, 2004	Notice of default given; asserted date of foreclosure
November 30, 2004	Transfer Statement filed with USPTO
December 1, 2004	UCC–1 filed in District of Columbia
December 2, 2004	UCC–1 filed in Massachusetts
December 8, 2004	Strict foreclosure offer
March 1, 2005	Chapter 11 petition filed
April 14, 2005	Case converted, Trustee appointed and qualified.

I. POSITIONS OF THE PARTIES

The Trustee asserts that, as a matter of law, the filing with the USPTO was ineffective to perfect a security interest in the Patent; that perfection of a security interest in a patent is governed by state law; and that Gateway's security interest was not perfected until December 2, 2004, 89 days before the Debtor

filed its petition, and hence its perfection was preferential and the foreclosure under that security interest was an avoidable preferential transfer.

Gateway contends that its security interest in the Patent was perfected when Debtor filed the Recordation Form Cover Sheet with the USPTO on June 28, 2003, well before the preference period. It further asserts that the November 24, 2004 letter constituted foreclosure of its security interest and that it took possession of the Patent by the filing of the Transfer Statement outside of the preference period, and hence became its owner, a fact which it contends Debtor acknowledged by not listing the Patent as an asset in its bankruptcy schedules, creating an estoppel against Debtor.

II. DISCUSSION

A. Applicable Law

The relationship between the parties is, by agreement, governed by the laws of California. The applicable California law is its version of the Uniform Commercial Code as a patent falls within the Uniform Commercial Code definition of a "general intangible."

…

B. Strict foreclosure

The language quoted from the December 8 Letter indicates Gateway's attempt to accept the Patent in partial satisfaction of its claim. It proposed a value to be placed on the Patent "in partial satisfaction of the debt overdue" and asked for Debtor's timely response to the offer. There is no evidence that an acceptance of the offer was forthcoming.

The applicable portion of the Commercial Code provides that a secured party may accept collateral in full or partial satisfaction of the obligation it secures only if the conditions of the statute are satisfied. The triggering condition is that "the debtor consents to the acceptance under subdivision (c)." Subdivision (c)(1) provides that "a debtor consents to an acceptance of collateral in partial satisfaction of the obligation it secures only if the debtor agrees to the terms of the acceptance in a record authenticated after default."

It appears that the Debtor did not respond. Silence is not consent in the case of a[n] acceptance in partial satisfaction of a debt. As a result, the attempted strict foreclosure fails. Debtor retains its rights in the Patent, subject [to] Gateway's security interest, but it does retain rights, and it had those rights at the time of the filing. The encumbered Patent is property of Debtor's estate.

As agreed by the parties in the PTS, "If the Patent is determined to be property of the estate, however, the Trustee would at that point be free to seek to recover monetary damages from Gateway for its use of the Patent following its alleged foreclosure." But this understanding does not go quite far enough. It will be necessary to determine if the estate's interest in the Patent is subject to a security interest in favor of Gateway not subject to attack as a preferential transfer.

C. Perfection

The Commercial Code provides that the general rule for perfection of a security interest in a general intangible is by filing. There is an exception for "property subject to a statute, regulation, or treaty described in section 9311." The referenced section provides that no filing is necessary to perfect a security

interest in property subject to "a statute, regulation, or treaty of the United States whose requirements for a security interest's obtaining priority over the rights of a lien creditor with respect to the property preempt section 9310." I must determine if Federal legislation governing patents is such a superceding law.

…

The Ninth Circuit [in *Cybernetic Services*] looked to the phrase in the statute "assignment, grant or conveyance," which has been in the act since 1870, to determine its scope. It concluded that the Patent Act requires parties to record with the USPTO only ownership interests in patents and does not preempt the Commercial Code as to the perfection of security interests.

…

D. The U.C.C. Filings

As noted, Gateway did file two financing statements under the Uniform Commercial Code, one in the District of Columbia on December 1, 2004, and the second in Massachusetts on December 2, 2004. The District of Columbia filing was 90 days before the bankruptcy petition was filed, and the Massachusetts filing just 89 days prior. Both fall within the preference period as the outer limit is "on or within 90 days before the date of the filing." As a result, it does not matter which filing was made in the correct location.

E. Perfection by Possession

Gateway further asserts that it obtained perfection by possession of the Patent, evidenced by the filing of the Transfer Statement on November 30, 2004. As the Supreme Court pointed out more than a century ago, "a patent-right is

incorporeal property, not susceptible of actual delivery or possession." There is nothing in the Commercial Code that excepts general intangibles from the general rule requiring filing for perfection. The Code provisions involving "transfer statements," cited by Gateway, apply to collateral covered by a certificate of title. Gateway's position is ill taken.

III. CONCLUSION

The granting of the security interest to Gateway was a transfer under the terms of the Bankruptcy Code. With exceptions not relevant here, the trustee may avoid any transfer to or for the benefit of a creditor on account of an antecedent debt made while the debtor is insolvent and on or within 90 days before the date of filing of a bankruptcy petition that enables the creditor to receive more than it would receive in a chapter 7 case if the transfer had not been made.

The agreed facts demonstrate that the grant of the security interest in the Patent (and other assets) was preferential and voidable by the Trustee. Since there are no factual disputes, judgment to that effect is appropriate at this time. The Trustee holds title to the Patent free of the claims of Gateway.

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In financing for software and movies, a secured party takes a security interest in copyrights and other assets. Whether a copyright is registered at the time the secured party takes the security interest dictates where the secured party will file its security interest. The secured party's filing or lack therefore affects its priority, as seen in the next case.

Prodigy Distribution, Inc. v. Seven Arts Entertainment, Inc.

2015 WL 12672739 (C.D. Cal. May 21, 2015)

I. INTRODUCTION

On June 25, 2014, Prodigy Distribution, Inc. filed a Complaint against defendants Seven Arts Entertainment, Inc. ("SAE"), Schism LLC ("Schism"), Peter Hoffman, Wireless Connect, Inc., Seven Arts Filmed Entertainment Louisiana, Inc. ("SAFELA"), Seven Arts Pictures, Inc., Seven Arts Future Flows I, LLC, Bright Idea Productions, LLC, and New Moon Pictures, LLC (collectively, "Defendants"). The Complaint seeks a declaratory judgment that Plaintiff is the sole owner of a film entitled "Schism," and all rights therein, as well as related relief.

On March 19, 2015, Defendants filed the present Motion for Partial Summary Judgment (the "Motion"). For the following reasons, the Court DENIES the Motion.

II. STATEMENT OF FACTS

Plaintiff alleges the following facts. Schism is a company created for the sole purpose of producing a film titled Schism (the "Picture"), and it owned the copyright in the Picture. On November 18, 2011, Schism granted distribution rights in the Picture to SAE pursuant to a Distribution Agreement. In return, among other things, SAE advanced Schism $3.75 million secured by the Picture. One year later, on November 18, 2012, Schism executed a mortgage of copyright in favor of SAE (the "SAE Mortgage") as security for its obligation.

In 2013, Mr. Hoffman, who managed Schism as well as affiliated entities, approached Plaintiff's CEO about obtaining financing to complete post-production on the Picture. On June 14, 2013, Plaintiff and Schism entered into a Loan and Security

Agreement, an Assignment of Copyright, a Guarantee, a Power of Sale, and other documents, which collectively comprised the "Loan Agreement." In the Loan and Security Agreement, Plaintiff agreed to lend Schism approximately $216,000 for the purpose of paying post production expenses. Plaintiff asserts that at some point the parties agreed to a loan of $314,463.75, though it does not cite to a document containing that figure. The Loan and Security Agreement provided that Schism would repay the loan three-and-a-half months later, by October 31, 2013. SAE and Mr. Hoffman jointly and severally guaranteed the loan.

Schism "grant[ed], convey[ed] and assign[ed] all of the worldwide distribution rights in and to the Picture" to Plaintiff "to hold as security for the repayment of the Loan." (Dhaliwal Decl., Ex. 3.) Upon repayment in full of the loan, Plaintiff would re-assign and grant its distribution rights to Schism. Schism also granted Plaintiff

> a first ranking and superior charge and security interest in the amount of the outstanding balance of the Loan ... over all of [Schism's] properties, assets and rights, title and interest (whether now owned or hereafter acquired), including without limitation, all of [Schism's] rights in and to the Picture ....
>
> *(Id.)*

The Loan and Security Agreement further provided that if the full amount of the loan and applicable interest and charges was not repaid by October 31, 2013, (1) Plaintiff would have no obligation to re-assign its worldwide distribution rights in the Picture, and (2) Plaintiff would be "entitled to keep and exploit all rights in and to the Picture as contemplated under the Power of Sale" attached to the document. (*Id.*) In turn, the Power of Sale stated that if the full amount of indebtedness was not

repaid by the repayment date, the Power of Sale would "serve as a conveyance of all of [Schism's] and [the guarantors'] right, title and interest in and to the Picture to [Plaintiff]." (*Id.*)

An Assignment and Notice of Ownership of Copyright and Other Rights also accompanied the Loan and Security Agreement, and provided that Schism

> hereby assigns, transfers and otherwise to Prodigy ... for security purposes all rights of every kind and nature whatsoever that are possessed by or that have been or that may in the future be assigned, granted, or transferred to, or otherwise obtained by law by [Schism] in and to ... [the Picture], including without limitation all underlying rights, distribution, ancillary and exploitation rights and all copyright in and to the Production ... pursuant to the terms of the Loan and Security Agreement ....

The Loan and Security Agreement's grant of worldwide distribution rights was made subject only to existing sub-distribution agreements between SAE and three other entities. Schism, SAE, and Mr. Hoffman agreed to, and did, provide notices of assignment and direction which "direct all payments to [Plaintiff] in respect of the sales of the Picture"; these notices were to be a primary source of repayment of the loan. (*Id.*) Additionally, the loan was expressly condition upon "delivery to [Plaintiff] of a written confirmation from [SAE] that they will defer any and all fees and costs" under its November 2011 agreement with Schism "until full repayment of the Indebtedness to [Plaintiff]." (*Id.*)

On June 18, 2013, Plaintiff recorded the Loan Agreement by filing a UCC-1 financing statement in Louisiana, where

Schism is located and where the Picture was filmed. At that time, no copyright registration for the Picture had been filed.

Once all conditions precedent were satisfied, Plaintiff remitted the agreed-upon loan amount to Schism. Schism did not repay Plaintiff by the deadline set forth in the Loan and Security Agreement, and still has not done so. Plaintiff provided Defendants written notice of default multiple times from November 2013 through March 2014.

On October 1, 2013, SAE entered into a multi-picture distribution agreement with SAFELA, which purported to grant SAE's distribution rights in the Picture to SAFELA. That same day, SAE executed a mortgage of copyright in favor of SAFELA (the "SAFELA Mortgage").

On December 9, 2013, Schism as author registered its copyright in the Schism film with the United States Copyright Office ("Copyright Office"). Over six months later, on June 30, 2014, Defendants recorded the SAE Mortgage and SAFELA Mortgage with the Copyright Office.

…

III. DISCUSSION

…

B. Priority of Security Interests

Defendants also argue that because both the SAE and SAFELA Mortgages were recorded with the Copyright Office, whereas the Loan Agreement was not, the distribution rights contained in those mortgages are senior in priority to the distribution rights set forth in the Loan Agreement.

The Copyright Act contains a provision for recording

"transfers of copyright ownership." *See* 17 U.S.C. § 205. However, recordation is permissive rather than mandatory, as Section 205 provides that "[a]ny transfer of copyright ownership or other document pertaining to a copyright *may* be recorded in the Copyright Office...." *Id.* at § 205(a) (emphasis added); *see World Auxiliary Power*, 303 F.3d at 1125-26. The purpose of recordation is to "give [ ] all persons constructive notice" of the facts stated in documents recorded with the Copyright Office. 17 U.S.C. § 205(c).

Section 205 addresses priority between conflicting transfers, as follows:

> As between two conflicting transfers, the one executed first prevails if it is recorded, in the manner required to give constructive notice under subsection (c), within one month after its execution in the United States or within two months of its execution outside the United States, or at any time before recordation in such manner of the later transfer. Otherwise the later transfer prevails if recorded first in such manner, and if taken in good faith, for valuable consideration or on the basis of a binding promise to pay royalties, and without notice of the earlier transfer.

The "constructive notice" under subsection (c) is provided by a recording only if, among other requirements, "registration has been made for the work." *Id.* at § 205(c)(2). Thus, "when a copyright has been registered, a security interest can be perfected"—and thus afforded priority over unperfected interests—"only by recording the transfer in the Copyright Office." *World Auxiliary Power*, 303 F.3d at 1128. Where a

copyright is unregistered, however, Article 9 of the UCC, as adopted by the states, governs perfection and priority of security interests. *Id.* at 1127-28.

Here, at the time the Loan Agreement was executed, Schism had not registered its copyright in the *Schism* film with the Copyright Office. Therefore, Plaintiff properly perfected its security interest in that film by filing a UCC-1 financing statement on June 18, 2013, over one year before Defendants recorded the SAE and SAFELA mortgages.

Defendants point out that Schism later registered its copyright with the Copyright Office effective December 9, 2013. Defendants then recorded the SAE and SAFELA Mortgages with the Copyright Office on June 30, 2014.

With regard to SAE, Defendants do not cite any authority holding that recording a security interest with the Copyright Office affects its priority vis-à -vis another security interest where the parties holding those interests previously signed agreements delineating their respective rights. Here, the Loan and Security Agreement expressly acknowledged the existence of SAE's distribution agreement, and along with the Power of Sale it addressed Plaintiff's rights in relation to those of SAE. SAE signed the Loan and Security Agreement as a guarantor, and was a party to the Power of Sale. Thus, there is no apparent "conflict" between the two transfers, and it appears that Section 205(d) does not apply. Instead, the language of the Loan Agreements governs. Defendants do not address that language, and consequently fail to carry their burden of showing that SAE's interest takes priority.

In contrast, SAFELA's distribution agreement with SAE, executed after the Loan Agreement, did not address the

respective rights owned by SAFELA and Plaintiff. Instead, the two transfers conflict. The Ninth Circuit in *World Auxiliary Power* envisioned a scenario similar to what unfolded with respect to Plaintiff and SAFELA. One party in that case "conjure[d] up the image of a double-crossing debtor who, having gotten financing based on unregistered copyrights, registers them, thus triggering federal law, and gets financing from a second creditor, who then records its interest with the Copyright Office and takes priority." *Id.* at 1131. The court noted that "[p]rudent creditors will ... protect themselves against subsequent creditors gaining priority by means of covenants and policing mechanisms." *Id.* at 1132. The court concluded that "[a]s we read the law, unregistered copyrights have value as collateral," since security interests in such copyrights may be recorded pursuant to state law, but the value of that collateral is "discounted by the remote potential for priming" by subsequent creditors. *Id.*

In other words, because the Picture was unregistered at the time Plaintiff acquired its security interest, and as a result Plaintiff could not record that interest with the Copyright Office, Plaintiff ran the risk of being "primed" by a subsequent creditor such as SAFELA, as described in the above scenario. It appears from the Ninth Circuit's discussion of the issue that if SAFELA's recordation with the Copyright Office satisfied the requirements of Section 205, its interest takes priority under federal law.

Plaintiff first argues that Section 205's requirements were not met because Defendants did not record within one month after the mortgages' execution. *See* 17 U.S.C. § 205(d). However, the one-month time period only applies to the transfer executed first in time. *See id.* ("[T]he [transfer] executed first prevails if it

is recorded ... within one month after its execution in the United States....”). No similar language applies to the later transfer. Thus, the SAFELA Mortgage is not affected by this provision.

Plaintiff's next argument fares better. Plaintiff presents evidence showing that SAFELA had notice of the transfer to Prodigy via the Loan Agreement at the time it entered into the agreement with SAE. SAE owns 60% of SAFELA (*see* Adler Decl., Ex. A at 83:5-7, Ex. D), and as explained above, SAE clearly had notice of the Loan Agreement. Additionally, Mr. Hoffman signed the Loan Agreement as a guarantor (Dhaliwal Decl., Ex. 3), and also appears to be the individual who signed the SAE-SAFELA agreement on behalf of SAFELA. (See Adler Decl., Ex. J.) Thus, there is at the very least a genuine dispute of material fact as to whether SAFELA entered into the distribution agreement “without notice of the earlier transfer” to Prodigy, as required for its transfer to prevail under Section 205(d).

For the foregoing reasons, Defendants have not met their burden of showing that the SAE and SAFELA Mortgages are senior in priority to Plaintiff's security interest in the copyright.

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The following case focuses on the foreclosure and disposition of the patent collateral. The purchaser of the repossessed patent subsequently brought a patent infringement suit against others. The purchaser faced a challenge on whether it had standing to bring the suit. To decide on the standing issue, the court had to resolve whether the purchaser of the repossessed patent became the owner of the patent by operation of law.

Sky Technologies LLC v. SAP AG

576 F.3d 1374 (Fed. Cir. 2009).

I. BACKGROUND

Jeffrey Conklin ("Conklin") founded TradeAccess, Inc. ("TradeAccess") in 1996. Conklin, along with other inventors, obtained a portfolio of patents, which are the subject of this suit. Conklin and the other inventors assigned all of their "right[s], title[s], and interest together with the benefits and privileges in and to said inventions and discoveries" to TradeAccess. These assignments were recorded with the United States Patent and Trademark Office ("PTO"). TradeAccess later changed its name to Ozro, Inc. ("Ozro").

On April 2, 2001, Ozro, the Grantor, executed an Intellectual Property Security Agreement with Silicon Valley Bank ("SVB") ("SVB Agreement"), granting SVB a "security interest in all of Grantor's right, title, and interest, whether presently existing or hereafter acquired in, to and under all of the Collateral." The Collateral included the patents-in-suit. The SVB Agreement was filed with the PTO on April 2, 2001. On April 3, 2001, Ozro executed a similar security agreement with Cross Atlantic Capital Partners, Inc. ("XACP") ("XACP Agreement"), for the benefit of the XACP Entities. The XACP Agreement contained virtually identical language as the SVB Agreement. Ozro used both Agreements to secure loans, and, in the event of default by Ozro, both parties had "the right to exercise all the remedies of a secured party upon such default under the Massachusetts UCC," including the right

> (i) to take possession of all or any portion of the Intellectual Property Collateral, (ii) to sell, lease, or

> otherwise dispose of any or all of the Intellectual Property Collateral ... and (iii) to exercise all or any of the rights, remedies, powers, privileges and discretions under all or any of the documents relating to the Secured Obligations.
>
> Moreover, in the event of default, Ozro would be required to "assemble the Intellectual Property Collateral and any tangible property in which [SVB or XACP] has a security interest and to make it available to [SVB or XACP]." The XACP Agreement also contained a specific provision providing for disposition of the Intellectual Property Collateral at a public or private sale, should default occur, and permitted XACP to purchase the Collateral at the public sale, should it wish to do so.

In December 2002, SVB assigned its security interest to XACP through a Non–Recourse Assignment, giving XACP all of the "right, title, and interest" formerly held by SVB. This Assignment was recorded with the PTO; at that point, XACP held the security interest in all of the patents-in-suit.

Ozro defaulted on its loan obligations and XACP foreclosed on the patents. On February 18, 2003, XACP issued a foreclosure notice ("Notice") to all of Ozro's creditors, inventors, and counsel. The Notice identified the patents-in-suit as those to be sold at public auction.

In the meantime, Conklin started a new company, Whitelight Technology, later known as Sky Technologies LLC ("Sky"). Conklin entered into negotiations with XACP to transfer ownership of the patents-in-suit to Sky. On June 4, 2003, XACP and Conklin signed a Settlement Agreement

stating that XACP:

> shall use [its] best efforts to obtain title to the Intellectual Property [including the patents-in-suit] for purposes of a transfer from [XACP] to [Sky] by selling all of [XACP]'s rights in and to the Secured Intellectual Property by Public Auction within sixty (60) days after the Effective Date.... At the Public Auction, [XACP] will credit bid up to $4,031,844 as may be required to purchase the Intellectual Property, including but not limited to the right to sue for past infringement or misappropriation of the Patents, covered by security interest held by [XACP].
>
> To the extent that portions of the Intellectual Property are not subject to the security interests held by [XACP] ... [XACP] and Conklin agree to use their best efforts to acquire such assets from Ozro to be held by [Sky] without further consideration payable by Conklin or XACP.

Both XACP and Jeffrey Conklin, as an individual, signed the Settlement Agreement. Conklin also signed the document as Manager of Whitelight Technology.

On July 14, 2003, XACP foreclosed on its security interests at public auction. The security interest formerly held by SVB and subsequently assigned to XACP was sold first, and then XACP foreclosed on its own security interest. XACP was the only bidder for both sales and purchased all of the assets. On July 22, 2003, pursuant to the Settlement Agreement, XACP assigned all of its "right[s], title, and interest in" the patents-in-suit to Sky by a written assignment ("Sky Assignment"). At no point after foreclosure did Ozro execute a written agreement

assigning all of its rights, title, or interests in the patents to XACP.

On October 17, 2006, Sky filed a patent infringement suit against SAP in the United States District Court for the Eastern District of Texas. On January 4, 2008, SAP moved to dismiss Sky's Complaint for lack of standing. On March 20, 2008, the district court requested supplemental briefings from the parties to discuss whether the SVB and XACP Agreements alone granted substantial rights, or whether the security agreements transferred title upon default of the debtor.

On June 4, 2008, the district court, relying on this court's opinion in *Akazawa*, held the patents-in-suit were transferred from Ozro to XACP through the July 14, 2003 foreclosure proceedings. Because XACP properly complied with the Massachusetts Uniform Commercial Code ("UCC") foreclosure requirements by placing the patent collateral up for sale at a public auction and notifying Ozro of the sale, the district court held title was transferred on July 14, 2003, the date of the foreclosure. For this reason, when XACP assigned the patents-in-suit to Sky on July 22, 2003, Sky became vested with all rights, title, and interest in the patents. Thus, the chain-of-title had not been broken from Ozro to Sky, and Sky was declared the proper title-holder of the patents-in-suit, giving Sky standing to bring the patent infringement suit. [SAP then filed this appeal].

II. DISCUSSION

…

B. Valid Transfer of Patent Title through Operation of Law

In the present case, the central question is whether XACP

had legal right, title, and interest in the patents-in-suit to transfer all of those rights to Sky, thereby providing Sky with standing to bring the underlying infringement claim. Appellants contend that because no writing exists transferring the patents-in-suit to XACP, Sky did not obtain legal title from XACP, and therefore does not have standing in this matter. Appellee disagrees, and argues that *Akazawa* permits transfers of patent ownership by operation of law without a writing, and because the patents-in-suit were foreclosed upon in accordance with Massachusetts law, XACP became the owner of the patents on July 14, 2003, after the foreclosure proceedings. Accordingly, Appellee contends that XACP's assignment to Sky vested Sky with full legal title and standing in the underlying case. We agree.

1. *Akazawa* Controls

We have previously held that patent ownership is determined by state, not federal law. *Akazawa*, 520 F.3d at 1357.

…

We find that *Akazawa* controls in the instant case, and that the district court's reliance on its reasoning was appropriate because transfer of patent ownership by operation of law is permissible without a writing. *Akazawa* says nothing about permitting assignments without a writing; rather, this court made it clear that if assignment is the method of transfer of patent ownership, it must be done in writing, pursuant to § 261. *SeeAkazawa*, 520 F.3d at 1356. However, assignment is not the only method by which to transfer patent ownership. As noted below, foreclosure under state law may transfer patent ownership. Here, XACP's foreclosure on its security interest was in accordance with Massachusetts law; therefore, Sky

received full title and ownership of the patents from XACP providing it with standing in the underlying case.

2. Transfer of Title under Massachusetts Law

In the instant case the controlling state law is the Massachusetts UCC. Massachusetts UCC § 9–610 permits a secured party to sell the collateral after default, in a commercially reasonable manner, and that same party may purchase the collateral at a public disposition. Section 9–617 of the UCC states that once a secured party disposes of collateral after default, the transferee for value takes all of the debtor's rights in the collateral. Mass. Gen. Laws ch. 106, § 9–617(a)(1) (2009). Because XACP foreclosed on the patents-in-suit in conformity with these provisions, XACP obtained title to the patents on July 14, 2003.

In the XACP Security Agreement, Ozro gave XACP a security interest in the patents-in-suit as collateral security. Upon default, XACP could exercise all rights pursuant to the Massachusetts UCC and "sell, lease, or otherwise dispose" of the Collateral. The XACP Agreement also contained a provision dictating the sale of the Collateral, including a clause permitting XACP to purchase the Collateral at a public sale. In accordance with the Security Agreement and the Massachusetts UCC, XACP gave Ozro at least seven days' notice of the sale, disposed of the Collateral through a public auction, and purchased the Collateral at the same auction. Therefore, consistent with sections 9–610 and 9–617, XACP received all of Ozro's rights in the Collateral, making XACP the title-holder of the patents-in-suit after foreclosure.

…

D. Public Policy Justifications

The policy justifications for permitting transfers of patent ownership through operation of law without a writing also support our holding. First, if foreclosure on security interests secured by patent collateral could not transfer ownership to the secured creditor, a large number of patent titles presently subject to security interests may be invalidated. Any secured creditor who maintained an interest in patent collateral would be in danger of losing its rights in such collateral. Second, by restricting transfer of patent ownership only to assignments, the value of patents could significantly diminish because patent owners would be limited in their ability to use patents as collateral or pledged security. Lastly, it would be impractical to require secured parties to seek out written assignments following foreclosure from businesses that may have ceased to exist.

We need not address the pre or post-default documents submitted by Appellee to determine if a writing exists which transferred title to XACP. By following proper foreclosure procedures, XACP became the owner of the patents-in-suit. Therefore, XACP's assignment to Sky of all of its rights, title, and interest in the patents-in-suit made Sky the owner of the same, and the proper party to bring the underlying infringement action.

APPENDIX: LOAN AND SECURITY AGREEMENT

LOAN AND SECURITY AGREEMENT

THIS LOAN AND SECURITY AGREEMENT (this "**Agreement**") dated as of April 19, 2012 (the "Effective Date") between **SILICON VALLEY BANK** ("**Bank**"), as collateral agent and Administrative Agent (in such capacity referred to herein as "Agent" or "Collateral Agent"), and the Lenders listed on Schedule 1.1 hereof and party hereto (each, a **"Lender"** and collectively, the **"Lenders"**), including without limitation, Bank and LEADER LENDING, LLC – SERIES B ("Leader") and **HYPERION THERAPEUTICS, INC.** , a Delaware corporation ("Borrower"), provides the terms on which Lenders shall lend to Borrower and Borrower shall repay Lenders. The parties agree as follows:

1. ACCOUNTING AND OTHER TERMS

Accounting terms not defined in this Agreement shall be construed following GAAP. Calculations and determinations must be made following GAAP. Capitalized terms not otherwise defined in this Agreement shall have the meanings set forth in Section 13. All other terms contained in this Agreement, unless otherwise indicated, shall have the meaning provided by the Code to the extent such terms are defined therein.

2. LOAN AND TERMS OF PAYMENT

2.1 Promise to Pay. Borrower hereby unconditionally promises to pay Lenders the outstanding principal amount of all Credit Extensions and accrued and unpaid interest thereon and any other amounts due hereunder as and when due in accordance with this Agreement.

2.1.1 Term Loans.

(a) Availability. Subject to the terms and conditions of this Agreement, Lenders agree, severally and not jointly, to lend to Borrower, on the Effective Date, a loan (each, a "**Term Loan**" and collectively, the "**Term Loans**"), according to each Lender's pro rata share of the Term Loan Commitment (based upon the respective

Term Loan Commitment Percentage of each Lender). All Term Loans made hereunder shall not in the aggregate exceed the Term Loan Commitment. When repaid, the Term Loans may not be re-borrowed.

(b) Repayment. For each Term Loan, Borrower shall make monthly payments of interest only commencing on May 1, 2012 and continuing thereafter on the first day of each successive calendar month during the Term Loan Interest Only Period. Commencing on the Term Loan Amortization Date, Borrower shall make twenty seven (27) equal monthly payments of principal and interest which would fully amortize the outstanding Term Loan as of the Term Loan Amortization Date over the Term Loan Repayment Period and continuing thereafter during the Term Loan Repayment Period on the first day of each successive calendar month. All unpaid principal and accrued and unpaid interest is due and payable in full on the Term Loan Maturity Date with respect to such Term Loan. The Term Loan may only be prepaid in accordance with Sections 2.1.1(c) or 2.1.1(d).

(c) Prepayment. Borrower shall have the option to prepay all, but not less than all, of the Term Loans advanced by Lenders under this Agreement, provided Borrower, (a) provides written notice to Lenders of its election to prepay the Term Loans at least five (5) Business Days prior to such prepayment, and (b) pays, on the date of the prepayment (i) all outstanding principal and accrued interest on the Term Loans; (ii) the Term Loan Prepayment Fee; (iii) the Term Loan Final Payment and (iv) all other sums, including Lenders Expenses, if any, that have become due and payable hereunder with respect to the Term Loans.

(d) Mandatory Prepayment Upon an Acceleration. If the Term Loans are accelerated following the occurrence of an Event of Default, Borrower shall immediately pay to Lenders an amount equal to the sum of: (i) all outstanding principal plus accrued and unpaid interest on the Term Loans, (ii) the Term Loan Prepayment Fee, (iii) the Term Loan Final Payment plus (iv) all other sums, if any, that shall have become due and payable, including interest at the Default Rate with respect to any past due amounts.

2.1.2 Bank Term Loan.

(a) Availability. Subject to the terms and conditions of this Agreement, Bank agrees to lend to Borrower from time to time from the Bank Term Loan Availability Start Date through the Bank Term Loan Commitment Termination Date, a single loan (the "**Bank Term Loan**") in an amount equal to the Bank Term Loan Commitment. When repaid, the Bank Term Loan may not be re-borrowed. Bank's obligation to lend hereunder shall terminate on the earlier of (i) the occurrence and continuance of an Event of Default, or (ii) the Bank Term Loan Commitment Termination Date.

(b) Repayment. Borrower shall make monthly payments of interest only on the Bank Term Loan commencing on the first day of the month following the month in which the Bank Term Loan Funding Date occurs and continuing thereafter on the first day of each successive calendar month (each a "**Bank Term Loan Interest Only Payment Date**") during the Bank Term Loan Interest Only Period. Commencing on the Bank Term Loan Amortization Date, Borrower shall make twenty seven (27) equal monthly payments of principal and interest which would fully amortize the outstanding Bank Term Loan as of the Bank Term Loan Amortization Date over the Bank Term Loan Repayment Period and continuing thereafter during the Bank Term Loan Repayment Period on the first day of each successive calendar month. All unpaid principal and accrued and unpaid interest is due and payable in full on the Bank Term Loan Maturity Date with respect to the Bank Term Loan. The Bank Term Loan may only be prepaid in accordance with Sections 2.1.2(c) or 2.1.2(d).

(c) Prepayment. Borrower shall have the option to prepay all, but not less than all, of the Bank Term Loan advanced by Bank under this Agreement, provided Borrower, (a) provides written notice to Bank of its election to prepay the Bank Term Loan at least five (5) Business Days prior to such prepayment, and (b) pays, on the date of the prepayment (i) all outstanding principal and accrued interest on the Bank Term Loan; (ii) the Bank Term Loan Prepayment Fee; (iii) the Bank Term Loan Final Payment and (iv) all other sums,

including Lenders Expenses of Bank, if any, that have become due and payable hereunder with respect to the Bank Term Loan.

(d) Mandatory Prepayment Upon an Acceleration. If the Bank Term Loan is accelerated following the occurrence of an Event of Default, Borrower shall immediately pay to Bank an amount equal to the sum of: (i) all outstanding principal plus accrued and unpaid interest on the Bank Term Loan, (ii) the Bank Term Loan Prepayment Fee, (iii) the Bank Term Loan Final Payment plus (iv) all other sums, if any, that shall have become due and payable, including interest at the Default Rate with respect to any past due amounts.

2.2 Payment of Interest on the Credit Extensions.

(a) Interest Rates.

i) Term Loans. Subject to Section 2.2(b), the principal amount outstanding for each Term Loan shall accrue interest, which interest shall be payable monthly as provided in Section 2.1.1(b), at a per annum rate equal to the greater of (i) eight and eighty eight one hundredths of one percent (8.88%) and (ii) the Treasury Rate on the Term Loan Funding Date plus eight and fifty one hundredths of one percent (8.50%).

ii) Bank Term Loan. Subject to Section 2.2(b), the principal amount outstanding for the Bank Term Loan shall accrue interest, which interest shall be payable monthly as provided in Section 2.1.2(b), at a per annum rate equal to the greater of (i) eight and eighty eight one hundredths of one percent (8.88%) and (ii) the Treasury Rate on the Bank Term Loan Funding Date plus eight and fifty one hundredths of one percent (8.50%).

(b) Default Rate. Immediately upon the occurrence and during the continuance of an Event of Default, Obligations shall bear interest at a rate per annum which is five percentage points above the rate that is otherwise applicable thereto (the "**Default Rate**"). Payment or acceptance of the increased interest rate provided in this

Section 2.2(b) is not a permitted alternative to timely payment and shall not constitute a waiver of any Event of Default or otherwise prejudice or limit any rights or remedies of Lenders.

(c) 360-Day Year. Interest shall be computed on the basis of a 360-day year of twelve 30-day months.

(d) Debit of Accounts. Collateral Agent, or Bank, for the benefit of the Lenders, may debit any of Borrower's deposit accounts, including the Designated Deposit Account, for principal and interest payments or any other amounts Borrower owes Lenders when due. These debits shall not constitute a set-off. Notwithstanding the foregoing, all regularly scheduled interest only payments and all regularly scheduled payments due to either Lender shall be effected by automatic debit of the appropriate funds from the Designated Deposit Account. Borrower shall make all other payments due to any Lender in lawful money of the United States, in immediately available funds, according to the instructions for other payments specified in Schedule 1.

(e) Payments. Unless otherwise provided, interest is payable monthly on the first calendar day of each month. Payments of principal and/or interest received after 12:00 p.m. Pacific time are considered received at the opening of business on the next Business Day (unless such payments are received after 12:00 p.m. Pacific time as a result of Collateral Agent, or Bank, for the benefit of the Lenders, debiting any of Borrower's accounts after 12:00 p.m. Pacific time in which case such payments are considered received on such day). When a payment is due on a day that is not a Business Day, the payment is due the next Business Day and additional fees or interest, as applicable, shall continue to accrue.

2.3 Fees. Borrower shall pay to Collateral Agent or Bank (as applicable):

(a) Term Loan Prepayment Fee. The Term Loan Prepayment Fee, if applicable, when due hereunder;

(b) Bank Term Loan Prepayment Fee. The Bank Term

Loan Prepayment Fee, if applicable, when due hereunder;

(c) Good Faith Deposit. Borrower has paid Lenders a good faith deposit of One Hundred Fifty Thousand Dollars ($150,000). The good faith deposit will be applied towards Lenders Expenses for the documentation and negotiation of this Agreement and the remainder, if any, shall

i) be refunded to Borrower after the determination of such expenses if at least one Term Loan is made, or (ii) retained by Lenders if no Term Loans are made;

(d) Term Loan Final Payment. The Term Loan Final Payment, when due hereunder;

(e) Bank Term Loan Final Payment. The Bank Term Loan Final Payment, when due hereunder; and

(f) Lenders Expenses. All Lenders Expenses (including reasonable and documented out-of-pocket attorneys' fees and expenses in connection with the documentation and negotiation of this Agreement in excess of the good faith deposit referred to in Section 2.3(c)) incurred through and after the Effective Date, when due and such amounts shall be debited from the Designated Deposit Account.

3. CONDITIONS OF LOANS

3.1 **Conditions Precedent to Initial Credit Extension.** Lenders' obligation to make the initial Credit Extension is subject to the condition precedent that Lenders shall have received, in form and substance satisfactory to Lenders, such documents, and completion of such other matters, as Lenders may reasonably deem necessary or appropriate, including, without limitation:

(a) duly executed original signatures to this Agreement;

(b) a duly executed original signature to the Effective Date Bank Warrant;

(c) a duly executed original signature to the Leader

Warrant;

(d) a Warrant Purchase Agreement in the form provided by Leader or its designated affiliate and agreed to by Borrower, duly executed by Borrower;

(e) its certificate of incorporation certified by the Secretary of State of the State of Delaware and a good standing certificate of Borrower from the Secretary of State of the States of Delaware and California as of a date no earlier than thirty (30) days prior to the Effective Date;

(f) duly executed original signatures to the completed Borrowing Resolutions for Borrower (one set for each Lender);

(g) a legal opinion of Borrower's counsel dated as of the Effective Date together with the duly executed original signatures thereto;

(h) two copies of the Perfection Certificate executed by Borrower (one for each Lender);

(i) a copy of its executed Investors' Rights Agreement and any amendments thereto; and

(j) payment of any Lenders Expenses in excess of the good faith deposit referenced in Section 2.3(c);

(k) duly executed original signatures to a note for each of Bank and Leader with respect to each Lender's Term Loan;

(l) duly executed original signatures to the Control Agreements, if any;

(m) certified copies, dated as of a recent date, of financing statement searches, as Lenders shall request, accompanied by written evidence (including any UCC termination statements) that the Liens indicated in any such financing statements either constitute Permitted Liens or have been or, in connection with the initial Credit Extension, will be terminated or released;

(n) a Subordination Agreement from each holder of

Subordinated Debt; and

(o) evidence satisfactory to Lenders that the insurance policies required by Section 6.5 hereof are in full force and effect, together with appropriate evidence showing loss payable and/or additional insured clauses or endorsements in favor of the Collateral Agent.

3.2 Conditions Precedent to Bank Term Loan. Bank's obligation to make the Bank Term Loan, is further subject to the following:

(a) a duly executed original signature to the Bank Term Loan Funding Date Warrant; and

(b) a duly executed original signature to a Note for Bank with respect to the Bank Term Loan.

3.3 Conditions Precedent to all Credit Extensions. Each Lenders obligations to make each Credit Extension, including the initial Credit Extension, are subject to the following:

(a) Except as otherwise provided in Section 3.6, Borrower shall have duly executed and delivered to Agent a Payment/Advance Form;

(b) the representations and warranties in Section 5 shall be true in all material respects on the date of the Payment/Advance Form and on the Funding Date of each Credit Extension; provided, however, that such materiality qualifier shall not be applicable to any representations and warranties that already are qualified or modified by materiality in the text thereof; and provided, further that those representations and warranties expressly referring to a specific date shall be true, accurate and complete in all material respects as of such date, and no

Default or Event of Default shall have occurred and be continuing or result from the Credit Extension. Each Credit Extension is Borrower's representation and warranty on that date that the representations and warranties in Section 5 remain true in all material

respects; provided, however, that such materiality qualifier shall not be applicable to any representations and warranties that already are qualified or modified by materiality in the text thereof; and provided, further that those representations and warranties expressly referring to a specific date shall be true, accurate and complete in all material respects as of such date; and

(c) in Lenders' sole discretion, there has not been a Material Adverse Change.

3.4 Postclosing Deliverables.

(a) No later than thirty (30) days after the Closing Date, Borrower shall deliver to Bank a landlord's consent executed in favor of Collateral Agent, for the ratable benefit of the Lenders for each of Borrower's leased locations and

(b) no later than forty-five (45) days after the Closing Date, Borrower shall deliver to Bank a lender's loss payable endorsement to its property insurance policy.

3.5 Covenant to Deliver. Borrower agrees to deliver to Lenders each item required to be delivered to any Lender under this Agreement as a condition to any Credit Extension. Borrower expressly agrees that the extension of a Credit Extension prior to the receipt by Lenders of any such item shall not constitute a waiver by Lenders of Borrower's obligation to deliver such item, and any such extension in the absence of a required item shall be in Lenders' sole discretion.

3.6 Procedures for Borrowing.

(a) Term Loans. To obtain a Term Loan, Borrower must notify Collateral Agent by facsimile, electronic mail or telephone by 12:00 p.m. Pacific Time ten (10) Business Days prior to the date the Term Loan is to be made. If such notification is by telephone, Borrower must promptly confirm the notification by delivering to Collateral Agent a completed Payment/Advance Form in the form attached as Exhibit B. Upon receipt of a Payment/Advance Form,

Collateral Agent shall promptly provide a copy of the same to each Lender. On the Term Loan Funding Date, each Lender shall credit and/or transfer (as applicable) to Borrower's deposit account, an amount equal to its Term Loan Commitment Percentage multiplied by the amount of the Term Loan Commitment. Each Lender may rely on any telephone notice given by a person whom such Lender reasonably believes is a Responsible Officer. Borrower shall indemnify each Lender for any loss Lender suffers due to such reliance.

(b) Bank Term Loan. To obtain the Bank Term Loan, Borrower must notify Bank by facsimile, electronic mail or telephone by 12:00 p.m. Pacific Time three (3) Business Days prior to the date the Bank Term Loan is to be made. If such notification is by telephone, Borrower must promptly confirm the notification by delivering to Bank a completed Payment/Advance Form in the form attached as Exhibit B. On the Bank Term Loan Funding Date, Bank shall credit and/or transfer (as applicable) to Borrower's deposit account, an amount equal to the Bank Term Loan Commitment Amount. Bank may rely on any telephone notice given by a person whom such Lender reasonably believes is a Responsible Officer. Borrower shall indemnify Bank for any loss Bank suffers due to such reliance.

4. CREATION OF SECURITY INTEREST

4.1 Grant of Security Interest. Borrower hereby grants Collateral Agent, for the ratable benefit of the Lenders, and to each Lender, to secure the payment and performance in full of all of the Obligations, a continuing security interest in, and pledges to Collateral Agent, for the ratable benefit of the Lenders, and to each Lender, the Collateral, wherever located, whether now owned or hereafter acquired or arising, and all proceeds and products thereof. Borrower represents, warrants, and covenants that the security interest granted herein is and shall at all times continue to be a valid and enforceable security interest in the Collateral and upon the filing of a financing statement in appropriate form with the Secretary of

State of the State of Delaware, the security interest created hereby shall constitute a first priority perfected security interest to the extent perfection can be obtained by filing financing statements (subject only to Permitted Liens that may have superior priority under this Agreement). If Borrower shall acquire a commercial tort claim (as defined in the Code), Borrower shall promptly, and in any event within thirty (30) days, notify Collateral Agent in a writing signed by Borrower of the general details thereof (and further details as may reasonably be required by Collateral Agent) and grant to Collateral Agent, for the ratable benefit of the Lenders, and to each Lender, in such writing a security interest therein and in the proceeds thereof, all upon the terms of this Agreement, with such writing to be in form and substance reasonably satisfactory to Collateral Agent.

Borrower acknowledges that it previously has entered, and/or may in the future enter, into Bank Services Agreements with Bank. Regardless of the terms of any Bank Services Agreement, Borrower agrees that any amounts Borrower owes Bank thereunder shall be deemed to be Obligations hereunder and that it is the intent of Borrower and Bank to have all such Obligations secured by the first priority perfected security interest in the Collateral granted herein (subject only to Permitted Liens that may have superior priority to Bank's Lien in this Agreement).

If this Agreement is terminated, Collateral Agent's Lien in the Collateral shall continue until the Obligations (other than inchoate indemnity obligations) are satisfied in full, and at such time, Collateral Agent shall, at Borrower's sole cost and expense, terminate its security interest in the Collateral and execute and deliver to Borrower all documents that the Borrower reasonably requests to evidence the release of the security interest in the Collateral. In the event (x) all Obligations (other than inchoate indemnity obligations), except for Bank Services, are satisfied in full, and this Agreement is terminated, upon Borrower providing cash collateral acceptable to Bank in its good faith business judgment for any such Bank Services, Collateral Agent shall execute and deliver to Borrower all documents

that the Borrower reasonably requests to evidence the release of the security interest in the Collateral. In the event such Bank Services consist of outstanding Letters of Credit, Borrower shall provide to Bank cash collateral in an amount equal to one hundred ten percent (110%) of the face amount of all such Letters of Credit plus all interest, fees, and costs due or to become due in connection therewith (as estimated by Bank in its good faith business judgment), to secure all of the Obligations relating to such Letters of Credit.

4.2 Authorization to File Financing Statements. Borrower hereby authorizes Collateral Agent to file financing statements, without notice to Borrower, with all appropriate jurisdictions to perfect or protect Collateral Agent's, for the benefit of each Lender, and each Lender's, interest or rights hereunder, including a notice that any disposition of the Collateral, by either Borrower or any other Person, shall be deemed to violate the rights of the Collateral Agent and the Lenders under the Code.

5. REPRESENTATIONS AND WARRANTIES

Borrower represents and warrants as follows:

5.1 Due Organization and Authorization. Borrower and each of its Subsidiaries, if any, are duly existing and in good standing, as Registered Organizations in their respective jurisdictions of formation and are qualified and licensed to do business and are in good standing in any jurisdiction in which the conduct of their business or their ownership of property requires that they be qualified except where the failure to do so could not reasonably be expected to result in a Material Adverse Change. In connection with this Agreement, Borrower has delivered to Collateral Agent a completed perfection certificate signed by Borrower (the "**Perfection Certificate**"). Borrower represents and warrants that (a) Borrower's exact legal name is that indicated on the Perfection Certificate and on the signature page hereof; (b) Borrower is an organization of the type and is organized in the jurisdiction set forth in the Perfection Certificate; (c) the Perfection Certificate accurately sets forth Borrower's organizational identification number or accurately

states that Borrower has none; (d) the Perfection Certificate accurately sets forth Borrower's place of business, or, if more than one, its chief executive office as well as Borrower's mailing address (if different than its chief executive office); (e) Borrower (and each of its predecessors) has not, in the past five (5) years, changed its jurisdiction of formation, organizational structure or type, or any organizational number assigned by its jurisdiction; and (f) all other information set forth on the Perfection Certificate pertaining to Borrower and each of its Subsidiaries is accurate and complete in all material respects (it being understood and agreed that Borrower may from time to time update certain information in the Perfection Certificate after the Effective Date).

The execution, delivery and performance by Borrower of the Loan Documents to which it is a party have been duly authorized, and do not conflict with any of Borrower's organizational documents, (ii) contravene, conflict with, constitute a default under or violate any material Requirement of Law, (iii) contravene, conflict or violate any applicable order, writ, judgment, injunction, decree, determination or award of any Governmental Authority by which Borrower or any of its Subsidiaries or any of their property or assets may be bound or affected, (iv) require any action by, filing, registration, or qualification with, or Governmental Approval from, any Governmental Authority (except such Governmental Approvals which have already been obtained and are in full force and effect or filings required to perfect the security interest granted herein) or are being obtained pursuant to Section 6.1(b), or (v) constitute an event of default under any material agreement by which Borrower is bound. Borrower is not in default under any agreement to which it is a party or by which it is bound in which the default could reasonably be expected to result in a Material Adverse Change.

5.2 Collateral. Borrower has good title to, has rights in, and the power to transfer each item of the Collateral upon which it purports to grant a Lien hereunder, free and clear of any and all Liens except Permitted Liens. Borrower has no deposit accounts other than the deposit accounts with Bank, the deposit accounts, if any, described in

the Perfection Certificate delivered to Lenders in connection herewith, or of which Borrower has given Lenders notice and taken such actions as are necessary to give Collateral Agent a perfected security interest therein. The Collateral is not in the possession of any third party bailee (such as a warehouse) except as otherwise provided in the Perfection Certificate (as may be updated from time to time). All Inventory is in all material respects of good and marketable quality, free from material defects.

Borrower is the sole owner of its material Intellectual Property, except for non-exclusive licenses granted to its customers in the ordinary course of business. Each patent is valid and enforceable, and no part of the Intellectual Property has been judged invalid or unenforceable, in whole or in part, and to the best of Borrower's knowledge, no claim has been made that any part of the Intellectual Property violates the rights of any third party except to the extent such claim could not reasonably be expected to have a Material Adverse Change. Except as noted on the Perfection Certificate (it being understood and agreed that Borrower may from time to time update certain information in the Perfection Certificate after the Effective Date), Borrower is not a party to, nor is bound by, any material license or other material agreement with respect to which Borrower is the licensee (a) that prohibits or otherwise restricts Borrower from granting a security interest in Borrower's interest in such license or agreement or any other property, or (b) for which a default under or termination of could reasonably be expected to result in a Material Adverse Change. Borrower shall provide written notice to Collateral Agent (to update the Perfection Certificate) within ten (10) days of entering or becoming bound by any such license or agreement (other than over-the-counter software that is commercially available to the public).

5.3 Litigation. There are no actions or proceedings pending or, to the knowledge of the Responsible Officers, threatened in writing by or against Borrower or any of its Subsidiaries involving more than Five Hundred Thousand Dollars ($500,000).

5.4 No Material Deviation in Financial Statements. All consolidated financial statements for Borrower and any of its Subsidiaries delivered to Lenders fairly present in all material respects Borrower's consolidated financial condition and Borrower's consolidated results of operations. There has not been any material deterioration in Borrower's consolidated financial condition since the date of the most recent financial statements submitted to Lenders. The use of proceeds of the Credit Extensions for the purposes permitted in Section 5.9 shall not be deemed to be a material deterioration in Borrower's consolidated financial condition.

5.5 Solvency. The fair salable value of Borrower's assets (including goodwill minus disposition costs) exceeds the fair value of its liabilities; Borrower is not left with unreasonably small capital after the transactions in this Agreement; and Borrower is able to pay its debts (including trade debts) as they mature.

5.6 Regulatory Compliance. Borrower is not an "investment company" or a company "controlled" by an "investment company" under the Investment Company Act of 1940, as amended. Borrower is not engaged as one of its important activities in extending credit for margin stock (under Regulations T and U of the Federal Reserve Board of Governors). Borrower has complied in all material respects with the Federal Fair Labor Standards Act. Neither Borrower nor any of its Subsidiaries is a "holding company" or an "affiliate" of a "holding company" or a "subsidiary company" of a "holding company" as each term is defined and used in the Public Utility Holding Company Act of 2005. Borrower has not violated any laws, ordinances or rules, the violation of which could reasonably be expected to result in a Material Adverse Change. None of Borrower's or any of its Subsidiaries' properties or assets has been used by Borrower or any Subsidiary or, to the best of Borrower's knowledge, by previous Persons, in disposing, producing, storing, treating, or transporting any hazardous substance other than legally. Borrower and each of its Subsidiaries have obtained all consents, approvals and authorizations of, made all declarations or filings with, and given all

notices to, all Government Authorities that are necessary to continue their respective businesses as currently conducted.

5.7 Subsidiaries; Investments. Borrower does not own any stock, partnership interest or other equity securities except for Permitted Investments.

5.8 Tax Returns and Payments; Pension Contributions. Borrower has timely filed all federal and other material tax returns and reports required to have been filed by it, and Borrower and its Subsidiaries have timely paid all foreign, federal, state and local taxes, assessments, deposits and contributions owed by Borrower, except those which are being contested, provided that Borrower (a) in good faith contests its obligation to pay the taxes by appropriate proceedings promptly and diligently instituted and conducted, and (b) has set aside on its books adequate reserves in accordance with GAAP. Borrower is unaware of any claims or adjustments proposed for any of Borrower's prior tax years which could result in additional taxes becoming due and payable by Borrower. Borrower has paid all amounts necessary to fund all present pension, profit sharing and deferred compensation plans in accordance with their terms, and Borrower has not withdrawn from participation in, and has not permitted partial or complete termination of, or permitted the occurrence of any other event with respect to, any such plan which could reasonably be expected to result in any liability of Borrower, including any liability to the Pension Benefit Guaranty Corporation or its successors or any other Governmental Authority.

5.9 Use of Proceeds. Borrower shall use the proceeds of the Credit Extensions solely as working capital and to fund its general business requirements and not for personal, family, household or agricultural purposes.

5.10 Full Disclosure. No written representation, warranty or other statement of Borrower in any certificate or written statement given to Collateral Agent or any Lender, as of the date such representation, warranty, or other statement was made, taken

together with all such written certificates and written statements given to Collateral Agent or any Lender, contains any untrue statement of a material fact or omits to state a material fact necessary to make the statements contained in the certificates or statements not misleading (it being recognized that the projections and forecasts provided by Borrower in good faith and based upon reasonable assumptions are not viewed as facts and that actual results during the period or periods covered by such projections and forecasts may differ from the projected or forecasted results).

6. AFFIRMATIVE COVENANTS

Borrower shall do all of the following for so long as this Agreement remains in effect:

6.1 Government Compliance.

(a) Maintain its and all its Subsidiaries' legal existence and good standing in their respective jurisdictions of formation and maintain qualification in each jurisdiction in which the failure to so qualify would reasonably be expected to have a Material Adverse Change. Borrower shall comply, and have each Subsidiary comply, with all laws, ordinances and regulations to which it is subject, noncompliance with which could reasonably be expected to have a Material Adverse Change.

(b) Obtain all of the Governmental Approvals necessary for the performance by Borrower of its obligations under the Loan Documents to which it is a party and the grant of a security interest to Collateral Agent for the ratable benefit of the Lenders, in all of the Collateral. Borrower shall promptly provide copies of any such obtained Governmental Approvals to Collateral Agent.

6.2 Financial Statements, Reports, Certificates.

(a) Deliver to each Lender: (i) as soon as available, but no later than thirty (30) days after the last day of each month, a company prepared consolidated balance sheet, cash flow statement and income statement covering Borrower's consolidated operations for such month certified by a Responsible Officer and in a form reasonably acceptable

to Lenders; (ii) as soon as available, but no later than one hundred eighty Days after the last day of Borrower's fiscal year, audited consolidated financial statements prepared under GAAP, consistently applied, together with an opinion (which may include a "going concern" qualification and any other qualifications reasonably acceptable to Lenders) on the financial statements from an independent certified public accounting firm acceptable to Bank in its reasonable discretion; (iii) within five (5) days of delivery, copies of all statements, reports and notices delivered to Borrower's security holders or to any holders of Subordinated Debt, (iv) in the event that Borrower becomes subject to the reporting requirements under the Securities Exchange Act of 1934, as amended, within five (5) days of filing, all reports on Form 10-K, 10-Q and 8-K filed with the Securities and Exchange Commission or a link thereto on Borrower's or another website on the Internet; (iv) a prompt report of any legal actions pending or threatened against Borrower or any of its Subsidiaries that could result in damages or costs to Borrower or any of its Subsidiaries of One Hundred Thousand Dollars ($100,000) or more; and (v) budgets, sales projections, operating plans and other financial information reasonably requested by Lenders, including but not limited to Borrower's financial projections for current fiscal year as approved by Borrower's Board of Directors as soon as available, but no later than thirty (30) days after the last day of Borrower's fiscal year.

(b) Within thirty (30) days after the last day of each month, deliver to Lenders with the monthly financial statements, a duly completed Compliance Certificate signed by a Responsible Officer.

(c) Allow Lenders to audit or inspect Borrower's Collateral at Borrower's expense. Such audits or inspections shall be conducted no more often than once every twelve (12) months unless an Event of Default has occurred and is continuing.

6.3 Inventory; Returns; Collateral. Keep all Inventory in good and marketable condition, free from material defects. Returns and allowances between Borrower and its Account Debtors shall follow

Borrower's customary practices as they exist at the Effective Date. Borrower must promptly notify Lenders of all returns, recoveries, disputes and claims that involve more than Two Hundred Fifty Thousand Dollars ($250,000). None of the components of the Collateral shall be maintained at locations other than as provided in the Perfection Certificate or as Borrower has given Lenders notice pursuant to Section 7.2. In the event that Borrower, after the date hereof, intends to store or otherwise deliver any portion of the Collateral to a bailee, then Borrower will first receive the written consent of Lenders and such bailee must execute and deliver a bailee agreement in form and substance reasonably satisfactory to Collateral Agent.

6.4 Taxes; Pensions. Timely file, and require each of its Subsidiaries to timely file, all required federal and material tax returns and reports and timely pay, and require each of its Subsidiaries to timely file, all foreign, federal, state and local taxes, assessments, deposits and contributions owed by Borrower and each of its Subsidiaries, except for taxes contested pursuant to the terms of Section 5.8 hereof, and shall deliver to Lenders, on demand, appropriate certificates attesting to such payments, and pay all amounts necessary to fund all present pension, profit sharing and deferred compensation plans in accordance with their terms.

6.5 Insurance. Keep its business and the Collateral insured for risks and in amounts standard for companies in Borrower's industry and location and as Lenders may reasonably request. Insurance policies shall be in a form, with companies, and in amounts that are reasonably satisfactory to Lenders. All property policies shall have a lender's loss payable endorsement showing Collateral Agent as an additional lender loss payee and waive subrogation against Lenders, and all liability policies shall show, or have endorsements showing, Collateral Agent as an additional insured. All policies (or their respective endorsements) shall provide that the insurer must endeavor to give Collateral Agent at least thirty (30) days notice before canceling, amending, or declining to renew its policy. At

Collateral Agent's and any Lenders' request, Borrower shall deliver certified copies of policies and evidence of all premium payments. So long as no Event of Default has occurred and is continuing, the proceeds payable under any casualty policy shall, at Borrower's option, be payable to Borrower to replace or repair destroyed or damaged property; provided that any such replaced or repaired property (i) shall be of equal or like value as the replaced or repaired Collateral and (ii) shall be deemed Collateral in which Collateral Agent, for the benefit of the Lenders, has been granted a first priority security interest. After the occurrence and during the continuance of an Event of Default, all proceeds payable under such casualty policy shall, at the option of Collateral Agent, be payable to Collateral Agent, for the ratable benefit of the Lenders, on account of the Obligations. If Borrower fails to obtain insurance as required under this Section 6.5 or to pay any amount or furnish any required proof of payment to third persons and Collateral Agent, Collateral Agent may make all or part of such payment or obtain such insurance policies required in this Section 6.5, and take any action under the policies Collateral Agent deems prudent.

6.6 Operating Accounts.

(a) Maintain substantially all its depository and operating accounts and securities accounts and all foreign exchange transactions with Bank and Bank's Affiliates.

(b) Provide Collateral Agent five (5) days prior written notice before establishing any Collateral Account at or with any bank or financial institution other than Collateral Agent or its Affiliates. In addition, for each Collateral Account that Borrower at any time maintains, Borrower shall cause the applicable bank or financial institution (other than Collateral Agent) at or with which any Collateral Account is maintained to execute and deliver a Control Agreement or other appropriate instrument with respect to such Collateral Account to perfect Collateral Agent's Lien in such Collateral Account in accordance with the terms hereunder, which Control Agreement may not be terminated without prior written

consent of Collateral Agent. The provisions of the previous sentence shall not apply to (i) deposit accounts exclusively used for payroll, payroll taxes and other employee wage and benefit payments to or for the benefit of Borrower's employees and identified to Collateral Agent by Borrower as such and (ii) the Cash Collateral Account.

6.7 Protection of Intellectual Property Rights. Borrower shall: (a) protect, defend and maintain the validity and enforceability of its Intellectual Property; (b) promptly advise Lenders in writing of material infringements of its Intellectual Property; and (c) not allow any Intellectual Property material to Borrower's business to be abandoned, forfeited or dedicated to the public without Lenders' written consent.

6.8 Litigation Cooperation. Make available to Collateral Agent, without expense to Collateral Agent, Borrower and its officers, employees and agents and Borrower's books and records, to the extent that Collateral Agent may deem them reasonably necessary to prosecute or defend any third-party suit or proceeding instituted by or against Collateral Agent with respect to any Collateral or relating to Borrower.

6.9 Notices of Litigation and Default. Borrower will give prompt written notice to Collateral Agent of any litigation or governmental proceedings pending or threatened (in writing) against Borrower which would reasonably be expected to result in a Material Adverse Change. Without limiting or contradicting any other more specific provision of this Agreement, promptly (and in any event within three (3) Business Days) upon Borrower becoming aware of the existence of any Event of Default or event which, with the giving of notice or passage of time, or both, would constitute an Event of Default, Borrower shall give written notice to Collateral Agent of such occurrence, which such notice shall include a reasonably detailed description of such Event of Default or event which, with the giving of notice or passage of time, or both, would constitute an Event of Default.

6.10 Creation/Acquisition of Subsidiaries. In the event Borrower or any Subsidiary creates or acquires any Subsidiary, Borrower and such Subsidiary shall promptly notify Lenders of the creation or acquisition of such new Subsidiary and take all such action as may be reasonably required by Lenders to cause each such domestic Subsidiary to guarantee the Obligations of Borrower under the Loan Documents and grant a continuing pledge and security interest in and to the assets of such Subsidiary (substantially as described on Exhibit A hereto); and Borrower shall grant and pledge to Bank a perfected security interest in the stock, units or other evidence of ownership of each Subsidiary (not to exceed sixty five percent (65%) of such stock units or other evidence of ownership in the case of a foreign Subsidiary).

6.11 Further Assurances. Execute any further instruments and take further action as Collateral Agent reasonably requests to perfect or continue Collateral Agent's and Lenders' Lien in the Collateral or to effect the purposes of this Agreement. Deliver to Collateral Agent, within ten days after the same are sent or received, copies of all material correspondence, reports, documents and other filings with any Governmental Authority regarding compliance with or maintenance of Governmental Approvals or Requirements of Law or that could reasonably be expected to result in a Material Adverse Change.

7. NEGATIVE COVENANTS

Borrower shall not, for so long as this Agreement is in effect, do any of the following without Collateral Agent's prior written consent:

7.1 Dispositions. Convey, sell, lease, transfer or otherwise dispose of (collectively, "**Transfer**"), or permit any of its Subsidiaries to Transfer, all or any part of its business or property, except for Transfers (a) of Inventory in the ordinary course of business; (b) of used, worn-out, damaged, obsolete or surplus Equipment; (c) in connection with Permitted Liens and Permitted Investments; and (d) of non-exclusive licenses or similar arrangements for the use of the property of Borrower or its Subsidiaries in the ordinary course of

business, (e) licenses of Borrower's Intellectual Property in the ordinary course of business, including without limitation, licenses of product to partnerships in bona fide collaborations, (f) of Accounts in connection with the compromise, settlement or collection thereof in the ordinary course of business (and not as part of a bulk sale or receivables financing), (g) resulting from any casualty or other damage to, or any taking under power of eminent domain or by condemnation or similar proceeding, (h) to a Borrower or a Subsidiary of a Borrower that has guaranteed the Obligations and granted a security interest in its assets in accordance with Section 6.10, (i) Transfers not permitted by clauses (a) through (h) provided that the aggregate fair value of all assets Transferred in reliance upon this Section 7.1(i) shall not exceed One Hundred Thousand Dollars ($100,000) in the aggregate in any fiscal year.

7.2 Changes in Business, Management, Ownership, or Business Locations. (a) Engage in or permit any of its Subsidiaries to engage in any business other than the businesses currently engaged in by Borrower and such Subsidiary, as applicable, or reasonably related thereto; (b) liquidate or dissolve; or (c) (i) have a change in Key Person (provided that Collateral Agent shall not unreasonably withhold, condition or delay consent to such a change) or (ii) enter into any transaction or series of related transactions in which the stockholders of Borrower immediately prior to the first such transaction own less than forty nine percent (49%) of the voting stock of Borrower immediately after giving effect to such transaction or related series of such transactions (other than by the sale of Borrower's equity securities in a public offering or to venture capital investors, private equity investors or similar institutional investors so long as Borrower identifies to Lenders such investors prior to the closing of the transaction). Borrower shall not, without at least ten (10) Business Days prior written notice to Lenders: (1) add any new offices or business locations, including warehouses (unless such new offices or business locations contain less than One Hundred Thousand Dollars ($100,000) in Borrower's assets or property), (2)

change its jurisdiction of organization, (3) change its organizational structure or type, (4) change its legal name, or (5) change any organizational number (if any) assigned by its jurisdiction of organization.

7.3 Mergers or Acquisitions. Merge or consolidate, or permit any of its Subsidiaries to merge or consolidate, with any other Person, or acquire, or permit any of its Subsidiaries to acquire, all or substantially all of the capital stock or property of another Person. Notwithstanding the foregoing (i) Borrower may consummate the Ucyclyd Asset Sale and (ii) a Subsidiary may merge or consolidate into another Subsidiary or into Borrower.

7.4 Indebtedness. Create, incur, assume, or be liable for any Indebtedness, or permit any Subsidiary to do so, other than Permitted Indebtedness.

7.5 Encumbrance. Create, incur, or allow any Lien on any of its property, or assign or convey any right to receive income, including the sale of any Accounts, or permit any of its Subsidiaries to do so, except for Permitted Liens, or permit any Collateral not to be subject to the first priority security interest granted herein. Borrower shall not sell, transfer, assign, mortgage, pledge, lease, grant a security interest in, or encumber, or enter into any agreement, document, instrument or other arrangement (except pursuant to the Loan Documents or in any other agreement with or in favor of Collateral Agent) with any Person which directly or indirectly prohibits or has the effect of prohibiting Borrower or any Subsidiary from selling, transferring, assigning, mortgaging, pledging, leasing, granting a security interest in or upon, or encumbering any of Borrower's or any Subsidiary's Intellectual Property, except as is otherwise permitted in Section 7.1 hereof and the definition of "Permitted Liens" herein or in connection with Subordinated Debt.

7.6 Maintenance of Collateral Accounts. Maintain any Collateral Account except pursuant to the terms of Section 6.6(b) hereof.

7.7 Distributions; Investments. (a) Directly or indirectly make any Investment other than Permitted Investments, or permit any of its Subsidiaries to do so; or (b) pay any dividends or make any distribution or payment or redeem, retire or purchase any capital stock provided that

i) Borrower may pay dividends solely in common stock; and (ii) Borrower may repurchase the stock of former employees or consultants pursuant to stock repurchase agreements so long as an Event of Default does not exist at the time of such repurchase and would not exist after giving effect to such repurchase, provided such repurchase does not exceed in the aggregate of Two Hundred Thousand Dollars ($200,000) per fiscal year.

7.8 Transactions with Affiliates. Directly or indirectly enter into or permit to exist any material transaction with any Affiliate of Borrower, except for (i) equity or Subordinated Debt investments by Borrower's investors or (ii) transactions that are in the ordinary course of Borrower's business, upon fair and reasonable terms that are no less favorable to Borrower than would be obtained in an arm's length transaction with a non-affiliated Person.

7.9 Subordinated Debt. (a) Make or permit any payment on any Subordinated Debt, except under the terms of the subordination, intercreditor, or other similar agreement to which such Subordinated Debt is subject, or (b) amend any provision in any document relating to the Subordinated Debt which would increase the amount thereof or adversely affect the subordination thereof to Obligations owed to the Lenders.

7.10 Compliance. Become an "investment company" or a company controlled by an "investment company", under the Investment Company Act of 1940, as amended, or undertake as one of its important activities extending credit to purchase or carry margin stock (as defined in Regulation U of the Board of Governors of the Federal Reserve System), or use the proceeds of any Credit

Extension for that purpose; fail to meet the minimum funding requirements of ERISA, permit a Reportable Event or Prohibited Transaction, as defined in ERISA, to occur to the extent such occurrence would reasonably be expected to result in a Material Adverse Change; fail to comply with the Federal Fair Labor Standards Act or violate any other law or regulation, if the violation could reasonably be expected to result in a Material Adverse Change; withdraw or permit any Subsidiary to withdraw from participation in, permit partial or complete termination of, or permit the occurrence of any other event with respect to, any present pension, profit sharing and deferred compensation plan which could reasonably be expected to result in any liability of Borrower, including any liability to the Pension Benefit Guaranty Corporation or its successors or any other Governmental Authority.

7.11 Indebtedness Payments. (i) Prepay, redeem, purchase, defease or otherwise satisfy in any manner prior to the scheduled repayment thereof any Indebtedness for borrowed money (other than amounts due under this Agreement or due any Lender) or lease obligations, (ii) amend, modify or otherwise change the terms of any Indebtedness for borrowed money or lease obligations so as to accelerate the scheduled repayment thereof or (iii) repay any notes to officers, directors or shareholders.

8. EVENTS OF DEFAULT

Any one of the following shall constitute an event of default (an "**Event of Default**") under this Agreement:

8.1 Payment Default. Borrower fails to (a) make any payment of principal or interest on any Credit Extension on its due date, or (b) pay any other Obligations within three (3) Business Days after such Obligations are due and payable (which three (3) day grace period shall not apply to payments due on the Term Loan Maturity Date or Bank Term Loan Maturity Date (as applicable)). During the cure period, the failure to cure the payment default is not an Event of Default (but no Credit Extension will be made during the cure

period);

8.2 Covenant Default.

(a) Borrower fails or neglects to perform any obligation in Sections 6.1, 6.2, 6.4, 6.5, 6.6 or 6.9 or violates any covenant in Section 7; or

(b) Borrower fails or neglects to perform, keep, or observe any other term, provision, condition, covenant or agreement contained in this Agreement or any Loan Documents, and as to any default (other than those specified in this Section 8) under such other term, provision, condition, covenant or agreement that can be cured, has failed to cure the default within ten (10) days after the occurrence thereof; provided, however, that if the default cannot by its nature be cured within the ten (10) day period or cannot after diligent attempts by Borrower be cured within such ten day period, and such default is likely to be cured within a reasonable time, then Borrower shall have an additional period (which shall not in any case exceed thirty (30) days without Lenders' written consent) to attempt to cure such default, and within such reasonable time period the failure to cure the default shall not be deemed an Event of Default (but no Credit Extensions shall be made during such cure period). Grace periods provided under this Section shall not apply, among other things, to covenants set forth in subsection (a) above;

8.3 Material Adverse Change. A Material Adverse Change occurs;

8.4 Attachment.

(a) (i) The service of process seeking to attach, by trustee or similar process, any funds of Borrower or of any Subsidiary on deposit or otherwise maintained with Bank or any Bank Affiliate, or (ii) a notice of lien, levy, or assessment is filed against any of Borrower's assets by any Governmental Authority, and the same under subclauses (i) and (ii) hereof are not, within ten (10) Business Days after the occurrence thereof, discharged or stayed (whether through the posting of a bond or otherwise; provided, however, no

Credit Extensions shall be made during any ten day cure period; and

(b) (i) any material portion of Borrower's assets is attached, seized, levied on, or comes into possession of a trustee or receiver, or (ii) any court order enjoins, restrains, or prevents Borrower from conducting any material part of its business;

8.5 Insolvency. (a) Borrower is unable to pay its debts (including trade debts) as they become due or otherwise becomes insolvent; (b) Borrower begins an Insolvency Proceeding; or (c) an Insolvency Proceeding is begun against Borrower and not dismissed or stayed within thirty (30) days (but no Credit Extensions shall be made while of any of the conditions described in clause (a) exist and/or until any Insolvency Proceeding is dismissed);

8.6 Other Agreements. There is a default in any agreement to which Borrower or any Guarantor is a party with a third party or parties resulting in a right by such third party or parties, whether or not exercised, to accelerate the maturity of any Indebtedness in an amount in excess of Two Hundred Thousand Dollars ($200,000) or that could reasonably be expected to have a Material Adverse Change;

8.7 Judgments. One or more final judgments, orders, or decrees for the payment of money in an amount, individually or in the aggregate, of at least Five Hundred Thousand Dollars ($500,000) (not covered by independent third-party insurance as to which liability has been accepted by the insurance carrier) shall be rendered against Borrower and the same are not, within ten (10) Business Days after the entry thereof, discharged or execution thereof stayed or bonded pending appeal, or such judgments are not discharged prior to the expiration of any such stay (provided that no Credit Extensions will be made prior to the discharge, stay, or bonding of such judgment, order, or decree);

8.8 Misrepresentations. Borrower or any Person acting for Borrower makes any representation, warranty, or other statement

now or later in this Agreement, any Loan Document or in any writing delivered to Collateral Agent and/or any Lender or to induce Collateral Agent and/or Lenders to enter this Agreement or any Loan Document, and such representation, warranty, or other statement is incorrect in any material respect when made;

8.9 Subordinated Debt. A default or breach occurs under any agreement between Borrower and any creditor of Borrower that signed a subordination, intercreditor, or other similar agreement with Lenders, or any creditor that has signed such an agreement with Lenders breaches any terms of such agreement (to the extent not cured or waived);

8.10 Governmental Approvals. Any Governmental Approval shall have been (a) revoked, rescinded, suspended, modified in an adverse manner or not renewed in the ordinary course for a full term or (b) subject to any decision by a Governmental Authority that designates a hearing with respect to any applications for renewal of any of such Governmental Approval or that could result in the Governmental Authority taking any of the actions described in clause (a) above, and such decision or such revocation, rescission, suspension, modification or non-renewal has, or could reasonably be expected to have, a Material Adverse Change.

9. RIGHTS AND REMEDIES

9.1 Rights and Remedies. While an Event of Default occurs and continues Collateral Agent may, without notice or demand, do any or all of the following:

(a) declare all Obligations immediately due and payable (but if an Event of Default described in Section 8.5 occurs all Obligations are immediately due and payable without any action by Collateral Agent or Lenders);

(b) stop advancing money or extending credit for Borrower's benefit under this Agreement or under any other agreement between Borrower and Collateral Agent and/or Lenders;

(c) demand that Borrower (i) deposits cash with Bank in an amount equal to the aggregate amount of any Letters of Credit remaining undrawn, as collateral security for the repayment of any future drawings under such Letters of Credit, and Borrower shall forthwith deposit and pay such amounts, and (ii) pay in advance all Letter of Credit fees scheduled to be paid or payable over the remaining term of any Letters of Credit;

(d) terminate any FX Forward Contracts;

(e) settle or adjust disputes and claims directly with Account Debtors for amounts on terms and in any order that Collateral Agent considers advisable, notify any Person owing Borrower money of Collateral Agent's and Lenders' security interest in such funds, and verify the amount of such account;

(f) make any payments and do any acts it considers necessary or reasonable to protect the Collateral and/or its security interest in the Collateral. Borrower shall assemble the Collateral if Collateral Agent requests and make it available as Collateral Agent designates. Collateral Agent may enter premises where the Collateral is located, take and maintain possession of any part of the Collateral, and pay, purchase, contest, or compromise any Lien which appears to be prior or superior to its security interest and pay all expenses incurred. Borrower grants Collateral Agent a license to enter and occupy any of its premises, without charge, to exercise any of Collateral Agent's rights or remedies;

(g) apply to the Obligations any (i) balances and deposits of Borrower it holds, or (ii) any amount held by Collateral Agent or Lenders owing to or for the credit or the account of Borrower;

(h) ship, reclaim, recover, store, finish, maintain, repair, prepare for sale, advertise for sale, and sell the Collateral. Collateral Agent is hereby granted, effective solely upon an Event of Default and solely during the continuation of such Event of Default, a non-exclusive, non-transferable, non-sublicenseable, royalty-free license or other right to use, without charge, Borrower's labels, patents, copyrights, mask works, rights of use of any name, trade secrets,

trade names, trademarks, service marks, and advertising matter, or any similar intellectual property as it pertains to the Collateral, solely to the extent necessary for (x) completing production of any in-process inventory in the Collateral in connection with the enforcement of its security interest and (y) advertising for sale and selling any Collateral in connection with the enforcement of its security interest. In connection with Collateral Agent's exercise of its rights under this Section, Borrower's rights under all licenses and all franchise agreements inure to Collateral Agent for the benefit of the Lenders, solely to the extent necessary for (x) completing production of any in-process inventory in the Collateral in connection with the enforcement of its security interest and (y) advertising for sale and selling any Collateral in connection with the enforcement of its security interest;

(i) place a "hold" on any account maintained with Collateral Agent or Lenders and/or deliver a notice of exclusive control, any entitlement order, or other directions or instructions pursuant to any Control Agreement or similar agreements providing control of any Collateral;

(j) demand and receive possession of Borrower's Books; and

(k) exercise all rights and remedies available to Collateral Agent under the Loan Documents or at law or equity, including all remedies provided under the Code (including disposal of the Collateral pursuant to the terms thereof).

9.2 Power of Attorney. Borrower hereby irrevocably appoints Collateral Agent as its lawful attorney-in-fact, exercisable only upon the occurrence and during the continuance of an Event of Default, to: (a) endorse Borrower's name on any checks or other forms of payment or security; (b) sign Borrower's name on any invoice or bill of lading for any Account or drafts against Account Debtors; (c) settle and adjust disputes and claims about the Accounts directly with Account Debtors, for amounts and on terms Collateral Agent determines reasonable; (d) make, settle, and adjust all claims under

Borrower's insurance policies; (e) pay, contest or settle any Lien, charge, encumbrance, security interest, and adverse claim in or to the Collateral, or any judgment based thereon, or otherwise take any action to terminate or discharge the same; and (f) transfer the Collateral into the name of Collateral Agent or a third party as the Code permits. Borrower hereby appoints Collateral Agent as its lawful attorney-in-fact to sign Borrower's name on any documents necessary to perfect or continue the perfection of Collateral Agent's and Lenders' security interest in the Collateral regardless of whether an Event of Default has occurred until all Obligations have been satisfied in full and Collateral Agent and Lenders are under no further obligation to make Credit Extensions hereunder. Collateral Agent's foregoing appointment as Borrower's attorney in fact, and all of Collateral Agent's rights and powers, coupled with an interest, are irrevocable until all Obligations have been fully repaid and performed and Collateral Agent's and Lenders' obligation to provide Credit Extensions terminates.

9.3 Accounts Verification; Collection. Upon the occurrence and during the continuance of an Event of Default, Lenders may notify any Person owing Borrower money of Lenders' security interest in such funds and verify the amount of such account. After the occurrence of an Event of Default, any amounts received by Borrower shall be held in trust by Borrower for Lenders, and, if requested by Lenders, Borrower shall immediately deliver such receipts to Lenders in the form received from the Account Debtor, with proper endorsements for deposit.

9.4 Protective Payments. If Borrower fails to obtain the insurance called for by Section 6.5 or fails to pay any premium thereon or fails to pay any other amount which Borrower is obligated to pay under this Agreement or any other Loan Document, Collateral Agent may obtain such insurance or make such payment, and all amounts so paid by Collateral Agent are Lenders' Expenses and immediately due and payable, bearing interest at the then highest applicable rate, and secured by the Collateral. Collateral Agent will

make reasonable efforts to provide Borrower with notice of Collateral Agent obtaining such insurance at the time it is obtained or within a reasonable time thereafter. No payments by Collateral Agent are deemed an agreement to make similar payments in the future or Collateral Agent's waiver of any Event of Default.

9.5 Application of Payments and Proceeds. Unless an Event of Default has occurred and is continuing, Lenders shall apply any funds in their possession, whether from Borrower account balances, payments, or proceeds realized as the result of any collection of Accounts or other disposition of the Collateral, first, to Lenders Expenses, including without limitation, the reasonable costs, expenses, liabilities, obligations and attorneys' fees incurred by Lenders in the exercise of their rights under this Agreement; second, to the interest due upon any of the Obligations; and third, to the principal of the Obligations and any applicable fees and other charges, in such order as Lenders shall determine in their sole discretion. Any surplus shall be paid to Borrower or other Persons legally entitled thereto; Borrower shall remain liable to Lenders for any deficiency. If an Event of Default has occurred and is continuing, Lenders may apply any funds in their possession, whether from Borrower account balances, payments, proceeds realized as the result of any collection of Accounts or other disposition of the Collateral, or otherwise, to the Obligations in such order as Collateral Agent and Lenders shall determine in their sole discretion. Any surplus shall be paid to Borrower or other Persons legally entitled thereto; Borrower shall remain liable to Lenders for any deficiency. If Collateral Agent, in its good faith business judgment, directly or indirectly enters into a deferred payment or other credit transaction with any purchaser at any sale of Collateral, Collateral Agent shall have the option, exercisable at any time, of either reducing the Obligations by the principal amount of the purchase price or deferring the reduction of the Obligations until the actual receipt by Collateral Agent of cash therefor.

9.6 Liability for Collateral. So long as the Collateral Agent and Lenders comply with reasonable banking practices regarding the safekeeping of the Collateral in the possession or under the control of the Collateral Agent and Lenders, the Collateral Agent and Lenders shall not be liable or responsible for: (a) the safekeeping of the Collateral; (b) any loss or damage to the Collateral; (c) any diminution in the value of the Collateral; or (d) any act or default of any carrier, warehouseman, bailee, or other Person. Borrower bears all risk of loss, damage or destruction of the Collateral.

9.7 No Waiver; Remedies Cumulative. Collateral Agent's failure, at any time or times, to require strict performance by Borrower of any provision of this Agreement or any other Loan Document shall not waive, affect, or diminish any right of Collateral Agent thereafter to demand strict performance and compliance herewith or therewith. No waiver hereunder shall be effective unless signed by Collateral Agent and then is only effective for the specific instance and purpose for which it is given. Collateral Agent's rights and remedies under this Agreement and the other Loan Documents are cumulative. Collateral Agent has all rights and remedies provided under the Code, by law, or in equity. Collateral Agent's exercise of one right or remedy is not an election, and Collateral Agent's waiver of any Event of Default is not a continuing waiver. Collateral Agent's delay in exercising any remedy is not a waiver, election, or acquiescence.

9.8 Demand Waiver. Borrower waives demand, notice of default or dishonor, notice of payment and nonpayment, notice of any default, nonpayment at maturity, release, compromise, settlement, extension, or renewal of accounts, documents, instruments, chattel paper, and guarantees held by Collateral Agent on which Borrower is liable.

10. NOTICES

All notices, consents, requests, approvals, demands, or other communication (collectively, "**Communication**") by any party to this

Agreement or any other Loan Document must be in writing and shall be deemed to have been validly served, given, or delivered: (a) upon the earlier of actual receipt and three (3) Business Days after deposit in the U.S. mail, first class, registered or certified mail return receipt requested, with proper postage prepaid; (b) upon transmission, when sent by electronic mail or facsimile transmission; (c) one (1) Business Day after deposit with a reputable overnight courier with all charges prepaid; or (d) when delivered, if hand-delivered by messenger, all of which shall be addressed to the party to be notified and sent to the address, email address or facsimile number indicated below. Each party may change its address or facsimile number by giving the other parties written notice thereof in accordance with the terms of this Section 10.

If to Borrower:	HYPERION THERAPEUTICS, INC. 601 Gateway Blvd., Suite 200 South San Francisco, CA 94080 Attn: Jeff Farrow Tel.: (650) 745-7816 Fax: (650) 887-1827 Email: Jeff.Farrow@hyperiontx.com
If to Collateral Agent:	Silicon Valley Bank 555 Mission Street, Suite 900 San Francisco, CA 94105 Attn: Lindsay Schwallie Fax: (415) 512-4243 Email: lschwallie@svb.com
If to Leader:	Leader Ventures, LLC 311 California Street, Suite 420 San Francisco, CA 94104 Telephone: 415-956-8230 Fax: 415-956-8233 Email: finance@leaderventures.com Attention: Chief Financial Officer

11. CHOICE OF LAW, VENUE, JURY TRIAL WAIVER AND JUDICIAL REFERENCE

California law governs the Loan Documents without regard to principles of conflicts of law. Borrower, Collateral Agent and Lenders each submit to the exclusive jurisdiction of the State and Federal courts in Santa Clara County, California; provided, however, that nothing in this Agreement shall be deemed to operate to preclude Collateral Agent from bringing suit or taking other legal action in any other jurisdiction to realize on the Collateral or any other security for the Obligations, or to enforce a judgment or other court order in favor of Collateral Agent and Lenders. Borrower expressly submits and consents in advance to such jurisdiction in any action or suit commenced in any such court, and Borrower hereby waives any objection that it may have based upon lack of personal jurisdiction, improper venue, or forum non conveniens and hereby consents to the granting of such legal or equitable relief as is deemed appropriate by such court. Borrower hereby waives personal service of the summons, complaints, and other process issued in such action or suit and agrees that service of such summons, complaints, and other process may be made by registered or certified mail addressed to Borrower at the address set forth in Section 10 of this Agreement and that service so made shall be deemed completed upon the earlier to occur of Borrower's actual receipt thereof or three (3) days after deposit in the U.S. mails, proper postage prepaid.

TO THE FULLEST EXTENT PERMITTED BY APPLICABLE LAW, BORROWER, COLLATERAL AGENT AND LENDERS EACH WAIVE THEIR RIGHT TO A JURY TRIAL OF ANY CLAIM OR CAUSE OF ACTION ARISING OUT OF OR BASED UPON THIS AGREEMENT, THE LOAN DOCUMENTS OR ANY CONTEMPLATED TRANSACTION, INCLUDING CONTRACT, TORT, BREACH OF DUTY AND ALL OTHER CLAIMS. THIS WAIVER IS A MATERIAL INDUCEMENT FOR THE PARTIES TO ENTER INTO THIS AGREEMENT. EACH PARTY HAS REVIEWED THIS WAIVER WITH ITS COUNSEL.

WITHOUT INTENDING IN ANY WAY TO LIMIT THE PARTIES' AGREEMENT TO WAIVE THEIR RESPECTIVE RIGHT TO A TRIAL BY JURY, if the above waiver of the right to a trial by jury is not enforceable, the parties hereto agree that any and all disputes or controversies of any nature between them arising at any time shall be decided by a reference to a private judge, mutually selected by the parties (or, if they cannot agree, by the Presiding Judge of the Santa Clara County, California Superior Court) appointed in accordance with California Code of Civil Procedure Section 638 (or pursuant to comparable provisions of federal law if the dispute falls within the exclusive jurisdiction of the federal courts), sitting without a jury, in Santa Clara County, California; and the parties hereby submit to the jurisdiction of such court. The reference proceedings shall be conducted pursuant to and in accordance with the provisions of California Code of Civil Procedure §§ 638 through 645.1, inclusive. The private judge shall have the power, among others, to grant provisional relief, including without limitation, entering temporary restraining orders, issuing preliminary and permanent injunctions and appointing receivers. All such proceedings shall be closed to the public and confidential and all records relating thereto shall be permanently sealed. If during the course of any dispute, a party desires to seek provisional relief, but a judge has not been appointed at that point pursuant to the judicial reference procedures, then such party may apply to the Santa Clara County, California Superior Court for such relief. The proceeding before the private judge shall be conducted in the same manner as it would be before a court under the rules of evidence applicable to judicial proceedings. The parties shall be entitled to discovery which shall be conducted in the same manner as it would be before a court under the rules of discovery applicable to judicial proceedings. The private judge shall oversee discovery and may enforce all discovery rules and order applicable to judicial proceedings in the same manner as a trial court judge. The parties agree that the selected or appointed private judge shall have the power to decide all issues in the action or

proceeding, whether of fact or of law, and shall report a statement of decision thereon pursuant to the California Code of Civil Procedure § 644(a). Nothing in this paragraph shall limit the right of any party at any time to exercise self-help remedies, foreclose against collateral, or obtain provisional remedies. The private judge shall also determine all issues relating to the applicability, interpretation, and enforceability of this paragraph.

12. GENERAL PROVISIONS

12.1 Successors and Assigns. This Agreement binds and is for the benefit of the successors and permitted assigns of each party. Borrower may not assign this Agreement or any rights or obligations under it without Collateral Agent's prior written consent (which may be granted or withheld in Collateral Agent's discretion). Lenders have the right, without the consent of or notice to Borrower, to sell, transfer, assign, negotiate, or grant participation in all or any part of, or any interest in, Lenders' obligations, rights, and benefits under this Agreement and the other Loan Documents (other than the Warrants, as to which assignment, transfer and other such actions are governed by the terms of the Warrants).

12.2 Indemnification; Expenses. Borrower agrees to indemnify, defend and hold Collateral Agent and the Lenders and their respective directors, officers, employees, agents, attorneys, or any other Person affiliated with or representing Collateral Agent or the Lenders (each, an "Indemnified Person") harmless against: (a) all obligations, demands, claims, and liabilities (collectively, "Claims") asserted by any other party in connection with the transactions contemplated by the Loan Documents; and (b) all losses or expenses (including Lenders' Expenses) in any way suffered, incurred, or paid by such Indemnified Person from, following from, consequential to, or arising from transactions between Collateral Agent, and/or Lenders and Borrower (including reasonable attorneys' fees and expenses), except for Claims and/or losses directly caused by such Indemnified Person's gross negligence or willful misconduct.

12.3 Time of Essence. Time is of the essence for the performance of all Obligations in this Agreement.

12.4 Severability of Provisions. Each provision of this Agreement is severable from every other provision in determining the enforceability of any provision.

12.5 Correction of Loan Documents. Lenders may correct patent errors and fill in any blanks in this Agreement and the other Loan Documents consistent with the agreement of the parties.

12.6 Amendments in Writing; Integration. All amendments to this Agreement must be in writing signed by Collateral Agent, Lenders and Borrower. This Agreement and the Loan Documents represent the entire agreement about this subject matter and supersede prior negotiations or agreements. All prior agreements, understandings, representations, warranties, and negotiations between the parties about the subject matter of this Agreement and the Loan Documents merge into this Agreement and the Loan Documents.

12.7 Counterparts; Facsimile Copies. This Agreement may be executed in any number of counterparts and by different parties on separate counterparts, each of which, when executed and delivered, are an original, and all taken together, constitute one Agreement. Delivery of an executed signature page to this Agreement by facsimile or electronic transmission shall be effective as delivery of a manually signed counterpart of this Agreement so long as the original signatures follow within seven (7) Business Days.

12.8 Survival. All covenants, representations and warranties made in this Agreement continue in full force until this Agreement has terminated pursuant to its terms and all Obligations (other than inchoate indemnity obligations and any other obligations which, by their terms, are to survive the termination of this Agreement) have been paid in full and satisfied. Without limiting the foregoing, except as otherwise provided in Section 4.1, the grant of security interest by

Borrower in Section 4.1 shall survive until the termination of all Bank Services Agreements. The obligation of Borrower in Section 12.2 to indemnify Collateral Agent and each Lender shall survive until the statute of limitations with respect to such claim or cause of action shall have run.

12.9 Confidentiality. In handling any confidential information, Collateral Agent and each Lender shall exercise the same degree of care that it exercises for its own proprietary information, but disclosure of information may be made: (a) to Lenders' and Collateral Agent's Subsidiaries or Affiliates; (b) to prospective transferees or purchasers of any interest in the Credit Extensions (provided, however, Lenders and Collateral Agent shall obtain such prospective transferee's or purchaser's agreement to the terms of this provision); (c) as required by law, regulation, subpoena, or other order; (d) to regulators or as otherwise required in connection with an examination or audit; and (e) as Collateral Agent considers appropriate in exercising remedies under the Loan Documents. Confidential information does not include information that either: (i) is in the public domain or in Lenders' and/or Collateral Agent's possession when disclosed to Lenders and/or Collateral Agent, or becomes part of the public domain after disclosure to Lenders and/or Collateral Agent; or (ii) is disclosed to Lenders and/or Collateral Agent by a third party, if Lenders and/or Collateral Agent does not know that the third party is prohibited from disclosing the information.

Lenders and Collateral Agent may use confidential information for any purpose, including, without limitation, for the development of client databases, reporting purposes, and market analysis, so long as Lenders and the Collateral Agent do not, directly or indirectly, disclose Borrower's identity or the identity of any person associated with Borrower unless otherwise expressly permitted by this Agreement. The provisions of the immediately preceding sentence shall survive the termination of this Agreement.

12.10 Attorneys' Fees, Costs and Expenses. In any action or proceeding between Borrower, Collateral Agent and/or Lenders arising out of or relating to the Loan Documents, the prevailing party shall be entitled to recover its reasonable attorneys' fees and other reasonable costs and expenses incurred, in addition to any other relief to which it may be entitled.

12.11 Right of Set Off. Borrower hereby grants to Collateral Agent and to each Lender, a lien, security interest and right of set off as security for all Obligations to Collateral Agent and each Lender hereunder, whether now existing or hereafter arising upon and against all deposits, credits, Collateral and property, now or hereafter in the possession, custody, safekeeping or control of Collateral Agent or Lenders or any entity under the control of Collateral Agent or Lenders (including an Collateral Agent affiliate) or in transit to any of them. At any time after the occurrence and during the continuance of an Event of Default, without demand or notice, Collateral Agent or Lenders may set off the same or any part thereof and apply the same to any liability or obligation of Borrower even though unmatured and regardless of the adequacy of any other Collateral securing the Obligations. ANY AND ALL RIGHTS TO REQUIRE COLLATERAL AGENT TO EXERCISE ITS RIGHTS OR REMEDIES WITH RESPECT TO ANY OTHER COLLATERAL WHICH SECURES THE OBLIGATIONS, PRIOR TO EXERCISING ITS RIGHT OF SETOFF WITH RESPECT TO SUCH DEPOSITS, CREDITS OR OTHER PROPERTY OF BORROWER ARE HEREBY KNOWINGLY, VOLUNTARILY AND IRREVOCABLY WAIVED.

12.12 Captions. The headings used in this Agreement are for convenience only and shall not affect the interpretation of this Agreement.

12.13 Construction of Agreement. The parties mutually acknowledge that they and their attorneys have participated in the preparation and negotiation of this Agreement. In cases of uncertainty this Agreement shall be construed without regard to

which of the parties caused the uncertainty to exist.

12.14 Relationship. The relationship of the parties to this Agreement is determined solely by the provisions of this Agreement. The parties do not intend to create any agency, partnership, joint venture, trust, fiduciary or other relationship with duties or incidents different from those of parties to an arm's-length contract.

12.15 Third Parties. Nothing in this Agreement, whether express or implied, is intended to: (a) confer any benefits, rights or remedies under or by reason of this Agreement on any persons other than the express parties to it and their respective permitted successors and assigns; (b) relieve or discharge the obligation or liability of any person not an express party to this Agreement; or (c) give any person not an express party to this Agreement any right of subrogation or action against any party to this Agreement.

13. DEFINITIONS

13.1 Definitions. As used in this Agreement, the following terms have the following meanings:

"**Account**" is any "account" as defined in the Code with such additions to such term as may hereafter be made, and includes, without limitation, all accounts receivable and other sums owing to Borrower.

"**Affiliate**" of any Person is a Person that owns or controls directly or indirectly the Person, any Person that controls or is controlled by or is under common control with the Person, and each of that Person's senior executive officers, directors, partners and, for any Person that is a limited liability company, that Person's managers and members.

"**Agent**" is defined in the preamble hereof.

"**Agreement**" is defined in the preamble hereof.

"**Bank**" is defined in the preamble hereof.

"**Bank Services**" are any products, credit services, and/or

financial accommodations previously, now, or hereafter provided to Borrower or any of its Subsidiaries by Bank or any Bank Affiliate, including, without limitation, any letters of credit, cash management services (including, without limitation, merchant services, direct deposit of payroll, business credit cards, and check cashing services), interest rate swap arrangements, and foreign exchange services as any such products or services may be identified in Bank's various agreements related thereto (each, a "**Bank Services Agreement**").

"**Bank Term Loan**" is defined in Section 2.1.2(a).

"**Bank Term Loan Amortization Date**" means the date nine (9) months after the first Bank Term Loan Interest Only Payment Date.

"**Bank Term Loan Availability Start Date**" is the date Borrower provides evidence reasonably satisfactory to Bank that is has received at least Thirty Million Dollars ($30,000,000) in proceeds from the sale of Borrower's equity securities or the incurrence of Subordinated Debt.

"**Bank Term Loan Commitment**" is Two Million Five Hundred Thousand Dollars ($2,500,000).

"**Bank Term Loan Commitment Termination Date**" is September 30, 2012.

"Bank Term Loan Final Payment" is a payment (in addition to and not a substitution for the regular monthly payments of principal plus accrued interest) due on the earlier to occur of (a) the Bank Term Loan Maturity Date, (b) the acceleration of the Bank Term Loan, or (c) the prepayment of the Bank Term Loan, equal to the Loan Amount of the Bank Term Loan multiplied by the Final Payment Percentage.

"**Bank Term Loan Funding Date**" is the date on which the Bank Term Loan is made to or on account of Borrower.

"**Bank Term Loan Funding Date Warrant**" means that certain Warrant to Purchase Stock dated as of the Bank Term Loan Funding Date in the form of Exhibit E executed by Borrower in favor of Bank.

"**Bank Term Loan Interest Only Payment Date**" is defined in Section 2.1.2(b).

"**Bank Term Loan Interest Only Period**" means, for the Bank Term Loan, the period of time commencing on the Bank Term Loan Funding Date through the day before the Bank Term Loan Amortization Date.

"**Bank Term Loan Maturity Date**" is the date twenty six (26) months after the Bank Term Loan Amortization Date.

"**Bank Term Loan Prepayment Fee**" shall be an additional fee payable to Bank in amount equal to:

(a) for a prepayment made on or prior to the first anniversary of the Bank Term Loan Funding Date, four percent (4.0%) of the principal amount of the Bank Term Loan prepaid; or

(b) for a prepayment made after the first anniversary of the Bank Term Loan Funding Date but on or prior to the second anniversary of the Bank Term Loan Funding Date, three percent (3.0%) of the principal amount of the Bank Term Loan prepaid; and

(c) for a prepayment made after the second anniversary of the Bank Term Loan Funding Date but prior to the Bank Term Loan Maturity Date, two percent (2.0%) of the principal amount of the Bank Term Loan prepaid.

"**Bank Term Loan Repayment Period**" is a period of time equal to twenty seven (27) consecutive months commencing on the Bank Term Loan Amortization Date.

"**Borrower**" is defined in the preamble hereof

"**Borrower's Books**" are all Borrower's books and records including ledgers, federal and state tax returns, records regarding Borrower's assets or liabilities, the Collateral, business operations or financial condition, and all computer programs or storage or any equipment containing such information.

"**Borrowing Resolutions**" are, with respect to any Person, those resolutions adopted by such Person's Board of Directors and delivered by such Person to Lenders approving the Loan Documents

to which such Person is a party and the transactions contemplated thereby, together with a certificate executed by its secretary on behalf of such Person certifying that (a) such Person has the authority to execute, deliver, and perform its obligations under each of the Loan Documents to which it is a party, (b) that attached as an exhibit to such certificate is a true, correct, and complete copy of the resolutions then in full force and effect authorizing and ratifying the execution, delivery, and performance by such Person of the Loan Documents to which it is a party, (c) the name(s) of the Person(s) authorized to execute the Loan Documents on behalf of such Person, together with a sample of the true signature(s) of such Person(s), and (d) that Lenders may conclusively rely on such certificate unless and until such Person shall have delivered to Lenders a further certificate canceling or amending such prior certificate.

"**Business Day**" is any day that is not a Saturday, Sunday or a day on which Bank is closed.

"**Cash Collateral Account**" means that certain account (no. 1893069763) maintained at Comerica Bank as collateral for corporate credit cards issued by Comerica Bank to Borrower; provided (i) the aggregate amount in such account does not exceed Twenty Five Thousand Dollars ($25,000) at any time and (ii) the Cash Collateral Account is closed, and any amounts therein are transferred to an account maintained with Bank, within sixty (60) days of the Effective Date.

"**Cash Equivalents**" means any of the following:

(a) direct obligations of, or obligations the principal of and interest on which are unconditionally guaranteed by, the United States of America (or by any agency thereof to the extent such obligations are backed by the full faith and credit of the United States of America), in each case maturing within one (1) year from the date of acquisition thereof;

(b) investments in commercial paper maturing within three hundred sixty five (365) days from the date of acquisition thereof and having, at such date of acquisition, a credit rating from

S&P or Moody's of at least A2 or P2, respectively;

(c) investments in certificates of deposit, banker's acceptances and time deposits maturing within three hundred sixty five (365) days from the date of acquisition thereof issued or guaranteed by or placed with, and money market deposit accounts issued or offered by, any domestic office of any commercial bank organized under the laws of the United States of America or any State thereof that has a combined capital and surplus and undivided profits of not less than Five Hundred Million Dollars ($500,000,000);

(d) fully collateralized repurchase agreements with a term of not more than 30 days for securities described in clause (a) above and entered into with a financial institution satisfying the criteria described in clause (c) above; and

(e) investments in money market funds that comply with the criteria set forth in SEC Rule 2a-7 under the Investment Company Act of 1940, as amended, substantially all of whose assets are invested in investments of the type described in clauses (a) through (d) above.

"**Code**" is the Uniform Commercial Code, as the same may, from time to time, be enacted and in effect in the State of California; provided, that, to the extent that the Code is used to define any term herein or in any Loan Document and such term is defined differently in different Articles or Divisions of the Code, the definition of such term contained in Article or Division 9 shall govern; provided further, that in the event that, by reason of mandatory provisions of law, any or all of the attachment, perfection, or priority of, or remedies with respect to, Collateral Agent's and Lenders' Lien on any Collateral is governed by the Uniform Commercial Code in effect in a jurisdiction other than the State of California, the term "Code" shall mean the Uniform Commercial Code as enacted and in effect in such other jurisdiction solely for purposes on the provisions thereof relating to such attachment, perfection, priority, or remedies and for purposes of definitions relating to such provisions.

"**Collateral**" is any and all properties, rights and assets of Borrower described on Exhibit A.

"**Collateral Account**" is any Deposit Account, Securities Account, or Commodity Account.

"**Collateral Agent**" means Silicon Valley Bank, not in its individual capacity, but solely in its capacity as agent on behalf of and for the benefit of the Lenders.

"**Commitment Percentage**" is set forth in Schedule 1.1, as amended from time to time.

"**Commodity Account**" is any "commodity account" as defined in the Code with such additions to such term as may hereafter be made.

"**Communication**" is defined in Section 10.

"**Compliance Certificate**" is that certain certificate in the form attached hereto as Exhibit C.

"**Contingent Obligation**" is, for any Person, any direct or indirect liability, contingent or not, of that Person for (a) any indebtedness, lease, dividend, letter of credit or other obligation of another Person, including without limitation, an obligation directly or indirectly guaranteed, endorsed, co-made, discounted or sold with recourse by that Person, or for which that Person is directly or indirectly liable; (b) any obligations for undrawn letters of credit for the account of that Person; and (c) all obligations from any interest rate, currency or commodity swap agreement, interest rate cap or collar agreement, or other agreement or arrangement designated to protect a Person against fluctuation in interest rates, currency exchange rates or commodity prices; but "Contingent Obligation" does not include endorsements in the ordinary course of business. The amount of a Contingent Obligation is the stated or determined amount of the primary obligation for which the Contingent Obligation is made or, if not determinable, the maximum reasonably anticipated liability for it determined by the Person in good faith; but the amount may not exceed the maximum of the obligations under

any guarantee or other support arrangement.

"**Control Agreement**" is any control agreement entered into among the depository institution at which Borrower maintains a Deposit Account or the securities intermediary or commodity intermediary at which Borrower maintains a Securities Account or a Commodity Account, Borrower, and Collateral Agent pursuant to which Collateral Agent obtains control (within the meaning of the Code) for the benefit of the Lenders over such Deposit Account, Securities Account, or Commodity Account.

"**Credit Extension**" is any Term Loan, the Bank Term Loan or any other extension of credit by Lenders for Borrower's benefit.

"**Default**" means any event which with notice or passage of time or both, would constitute an Event of Default.

"**Default Rate**" is defined in Section 2.2(b).

"**Deposit Account**" is any "deposit account" as defined in the Code with such additions to such term as may hereafter be made.

"**Designated Deposit Account**" is Borrower's deposit account, account number 3300521673, maintained with Bank.

"**Dollars**," "**dollars**" and "**$**" each mean lawful money of the United States.

"**Effective Date**" is defined in the preamble of this Agreement.

"**Effective Date Bank Warrant**" means that certain Warrant to Purchase Stock dated on or about the Effective Date executed by Borrower in favor of Bank.

"**Equipment**" is all "equipment" as defined in the Code with such additions to such term as may hereafter be made, and includes without limitation all machinery, fixtures, goods, vehicles (including motor vehicles and trailers), and any interest in any of the foregoing.

"**ERISA**" is the Employee Retirement Income Security Act of 1974, and its regulations.

"**Event of Default**" is defined in Section 8.

"**Excluded Licenses**" means the licenses granted pursuant to the following agreements: (i) the Ucyclyd Collaboration Agreement; (ii) License Agreement dated April 16, 1999, among Dr. Saul Brusilow, Brusilow Enterprises LLC, and Borrower (as successor in interest to Ucyclyd, which was successor in interest to Medicis Pharmaceutical Corporation), including the Settlement Agreement and First Amendment dated August 21, 2007 among Dr. Saul Brusilow, Brusilow Enterprises LLC, Borrower (as successor in interest to Ucyclyd) and Medicis Pharmaceutical Corporation; and (iii) Asset Purchase Agreement between Borrower and Ucyclyd dated March 22, 2012.

"Final Payment Percentage" is six and one half percent (6.50%).

"Foreign Currency" means lawful money of a country other than the United States.

"**Funding Date**" is any date on which a Credit Extension is made to or on account of Borrower which shall be a Business Day.

"**FX Forward Contract**" is any foreign exchange contract by and between Borrower and Bank under which Borrower commits to purchase from or sell to Bank a specific amount of Foreign Currency on a specified date or other hedging contract between Borrower and Bank.

"**GAAP**" is generally accepted accounting principles set forth in the opinions and pronouncements of the Accounting Principles Board of the American Institute of Certified Public Accountants and statements and pronouncements of the Financial Accounting Standards Board or in such other statements by such other Person as may be approved by a significant segment of the accounting profession, which are applicable to the circumstances as of the date of determination.

"**General Intangibles**" is all "general intangibles" as defined in the Code in effect on the date hereof with such additions to such term as may hereafter be made, and includes without limitation, all

copyright rights, copyright applications, copyright registrations and like protections in each work of authorship and derivative work, whether published or unpublished, any patents, trademarks, service marks and, to the extent permitted under applicable law, any applications therefor, whether registered or not, any trade secret rights, including any rights to unpatented inventions, payment intangibles, royalties, contract rights, goodwill, franchise agreements, purchase orders, customer lists, route lists, telephone numbers, domain names, claims, income and other tax refunds, security and other deposits, options to purchase or sell real or personal property, rights in all litigation presently or hereafter pending (whether in contract, tort or otherwise), insurance policies (including without limitation key man, property damage, and business interruption insurance), payments of insurance and rights to payment of any kind.

"**Governmental Approval**" is any consent, authorization, approval, order, license, franchise, permit, certificate, accreditation, registration, filing or notice, of, issued by, from or to, or other act by or in respect of, any Governmental Authority.

"**Governmental Authority**" is any nation or government, any state or other political subdivision thereof, any agency, authority, instrumentality, regulatory body, court, central bank or other entity exercising executive, legislative, judicial, taxing, regulatory or administrative functions of or pertaining to government, any securities exchange and any self-regulatory organization.

"**Guarantor**" is any present or future guarantor of the Obligations.

"**Indebtedness**" is (a) indebtedness for borrowed money or the deferred price of property or services, such as reimbursement and other obligations for surety bonds and letters of credit, (b) obligations evidenced by notes, bonds, debentures or similar instruments, (c) capital lease obligations, and (d) Contingent Obligations.

"**Indemnified Person**" is defined in Section 12.2.

"**Insolvency Proceeding**" is any proceeding by or against any Person under the United States Bankruptcy Code, or any other bankruptcy or insolvency law, including assignments for the benefit of creditors, compositions, extensions generally with its creditors, or proceedings seeking reorganization, arrangement, or other relief.

"**Intellectual Property**" means, to the extent owned by Borrower, any copyright rights, copyright applications, copyright registrations and like protections in each work of authorship and derivative work, whether published or unpublished, any patents, patent applications and like protections, including improvements, divisions, continuations, renewals, reissues, extensions, and continuations-in-part of the same, trademarks, service marks and, to the extent permitted under applicable law, any applications therefor, whether registered or not, and the goodwill of the business of Borrower connected with and symbolized thereby, know-how, operating manuals, trade secret rights, rights to unpatented inventions, and any claims for damage by way of any past, present, or future infringement of any of the foregoing.

"**Inventory**" is all "inventory" as defined in the Code in effect on the date hereof with such additions to such term as may hereafter be made, and includes without limitation all merchandise, raw materials, parts, supplies, packing and shipping materials, work in process and finished products, including without limitation such inventory as is temporarily out of Borrower's custody or possession or in transit and including any returned goods and any documents of title representing any of the above.

"**Investment**" is any beneficial ownership interest in any Person (including stock, partnership interest or other securities), and any loan, advance or capital contribution to any Person.

"**Key Person**" is each of Borrower's CEO and CFO.

"**Leader**" is defined in the preamble hereof.

"**Leader Warrant**" means that certain Warrant to Purchase

Stock dated on or about the Effective Date executed by Borrower in favor of the designee of Leader.

"**Lender**" is any one of the Lenders.

"**Lenders**" shall mean the Persons identified on Schedule 1.1 hereto and each assignee that becomes a party to this Agreement pursuant to Section 12.1.

"**Lenders' Expenses**" are all reasonable and documented out-of-pocket audit fees and expenses, costs, and expenses (including reasonable attorneys' fees and expenses) for preparing, amending, negotiating, administering, defending and enforcing the Loan Documents (including, without limitation, those incurred in connection with appeals or Insolvency Proceedings) or otherwise incurred with respect to Borrower.

"**Letter of Credit"** is a standby or commercial letter of credit issued by Bank upon request of Borrower based upon an application, guarantee, indemnity, or similar agreement.

"**Lien**" is a claim, mortgage, deed of trust, levy, charge, pledge, security interest or other encumbrance of any kind, whether voluntarily incurred or arising by operation of law or otherwise against any property.

"**Loan Amount**" in respect of each Term Loan or the Bank Term Loan is the original principal amount of such Term Loan or Bank Term Loan.

"**Loan Documents**" are, collectively, this Agreement, the Warrants, the Perfection Certificate, any Note, or Notes or guaranties executed by Borrower or any Guarantor, any Bank Services Agreement and any other present or future agreement between Borrower any Guarantor and/or for the benefit of Collateral Agent and/or any Lender in connection with this Agreement, all as amended, restated, or otherwise modified.

"**Material Adverse Change**" is (a) a material impairment in the

perfection or priority of Lenders' Lien in the Collateral or in the value of such Collateral; (b) a material adverse change in the business, operations, or condition (financial or otherwise) of Borrower; or (c) a material impairment of the prospect of repayment of any portion of the Obligations.

"**Moody's**" means Moody's Investors Service, Inc.

"**Note**" means for each Term Loan and/or for the Bank Term Loan, one of the secured promissory notes of Borrower substantially in the form of Exhibit D.

"**Obligations**" are Borrower's obligation to pay when due any debts, principal, interest, Lenders' Expenses, Term Loan Prepayment Fee, Bank Term Loan Prepayment Fee, Term Loan Final Payment, Bank Term Loan Final Payment and other amounts Borrower owes Lenders now or later, whether under this Agreement, the Loan Documents, or otherwise, including, without limitation, all obligations relating to letters of credit (including reimbursement obligations for drawn and undrawn letters of credit), cash management services, and foreign exchange contracts, if any, and including interest accruing after Insolvency Proceedings begin (whether or not allowed) and debts, liabilities, or obligations of Borrower assigned to Lenders and/or Collateral Agent, and the performance of Borrower's duties under the Loan Documents.

"**Payment/Advance Form**" is that certain form attached hereto as Exhibit B.

"**Perfection Certificate**" is defined in Section 5.1.

"**Permitted Indebtedness**" is:

(a) Borrower's Indebtedness to Lenders and Collateral Agent under this Agreement and the other Loan Documents;

(b) Indebtedness existing on the Effective Date and shown on the Perfection Certificate;

(c) Subordinated Debt;

(d) The Ucyclyd Indebtedness;

(e) unsecured Indebtedness to trade creditors and with respect to surety bonds and similar obligations incurred in the ordinary course of business;

(f) Indebtedness in an aggregate principal amount not to exceed Two Hundred Fifty Thousand Dollars ($250,000) secured by Permitted Liens;

(g) Other unsecured Indebtedness in an aggregate principal amount not to exceed Two Hundred Fifty Thousand Dollars ($250,000);

(h) Indebtedness representing deferred compensation to employees incurred in the ordinary course of business;

(i) Indebtedness pursuant to the FX Forward Contract;

(j) Indebtedness in respect of corporate credit cards issued by Comerica Bank to Borrower secured only by the Cash Collateral Account; provided that (i) the aggregate amount of any such Indebtedness shall not exceed Twenty Five Thousand Dollars ($25,000) at any time and (ii) any such Indebtedness is indefeasibly paid in full in cash, or otherwise discharged, within sixty (60) days of the Effective Date.

(k) Indebtedness owed to any person with respect to premiums payable for property, casualty, or other insurance, so long as such Indebtedness shall not be in excess of the amount of the unpaid cost of, and shall be incurred only to defer the cost of, such insurance for the year in which such Indebtedness is incurred and such Indebtedness shall be outstanding only during such year; and

(l) extensions, refinancings, modifications, amendments and restatements of any items of Permitted Indebtedness (a) through (e) above, provided that the then-outstanding principal amount thereof is not increased or the terms thereof are not modified to impose more burdensome terms upon Borrower or its Subsidiary, as the case may be.

“**Permitted Investments**” are:

(a) Investments shown on the Perfection Certificate and existing on the Effective Date;

(b) Cash Equivalents;

(c) any Investments permitted by Borrower’s investment policy, as amended from time to time, provided that such investment policy (and any such amendment thereto) has been approved by Lenders;

(d) Investments consisting of the endorsement of negotiable instruments for deposit or collection or similar transactions in the ordinary course of Borrower;

(e) Investments accepted in connection with Transfers permitted by <u>Section 7.1</u>;

(f) Investments of Subsidiaries in or to other Subsidiaries or Borrower and Investments by Borrower in Subsidiaries not to exceed One Hundred Thousand Dollars ($100,000) in the aggregate in any fiscal year;

(g) Investments consisting of (i) travel advances and employee relocation loans and other employee loans and advances in the ordinary course of business, and (ii) loans to employees, officers or directors relating to the purchase of equity securities of Borrower or its Subsidiaries pursuant to employee stock purchase plans or agreements approved by Borrower’s Board of Directors which do not exceed One Hundred Thousand Dollars ($100,000) in the aggregate in any year, provided that no cash loans under this clause (ii) may be made if an Event of Default is then occurring or would otherwise upon the making thereof;

(h) Investments (including debt obligations) received in connection with the bankruptcy or reorganization of customers or suppliers and in settlement of delinquent obligations of, and other disputes with, customers or suppliers arising in the ordinary course of business; and

(i) Investments consisting of notes receivable of, or prepaid royalties and other credit extensions, to customers and suppliers who are not Affiliates, in the ordinary course of business; provided that this paragraph (i) shall not apply to Investments of Borrower in any Subsidiary.

Notwithstanding the foregoing, Permitted Investments shall not include, and Borrower and each Subsidiary is prohibited from purchasing, purchasing participations in, entering into any type of swap or other equivalent derivative transaction, or otherwise holding or engaging in any ownership interest in any type of debt instrument, with a long-term nominal maturity for which the interest rate is reset through a dutch auction and more commonly referred to as an "auction rate security."

"**Permitted Liens**" are:

(a) Liens existing on the Effective Date and shown on the Perfection Certificate or arising under this Agreement and the other Loan Documents;

(b) Liens for taxes, fees, assessments or other government charges or levies, either not delinquent or being contested in good faith and for which Borrower maintains adequate reserves on its Books, <u>if</u> they have no priority over any of Collateral Agent's and/or Lenders' Liens;

(c) statutory Liens securing claims or demands of materialmen, mechanics, carriers, warehousemen, landlords and other Persons imposed without action of such parties, provided, they have no priority over any of Collateral Agent's and/or Lenders' Liens and the aggregate amount of such Liens does not at any time exceed One Hundred Thousand Dollars ($100,000);

(d) Liens to secure payment of workers' compensation, employment insurance, old-age pensions, social security and other like obligations incurred in the ordinary course of business, provided, they have no priority over any of Collateral Agent's and/or Lenders' Liens and the aggregate amount of the Indebtedness secured by such

Liens does not at any time exceed One Hundred Thousand Dollars ($100,000);

(e) Liens incurred in the extension, renewal or refinancing of the indebtedness secured by Liens described in (a) through (d), but any extension, renewal or replacement Lien must be limited to the property encumbered by the existing Lien and the principal amount of the indebtedness may not increase;

(f) Liens in favor of Ucyclyd in the Ucyclyd Collateral;

(g) deposits to secure the performance of bids, trade contracts, government contracts, leases, statutory obligations, surety, stay, custom and appeal bonds, performance bonds and other obligations of like nature;

(h) good faith deposits in connection with any acquisition permitted hereunder or any Permitted Investment and to the extent constituting a Lien, escrow arrangements securing indemnification obligations associated with any acquisition permitted hereunder or any Permitted Investment;

(i) leases or subleases of real property granted in the ordinary course of business, and leases, subleases, non-exclusive licenses or sublicenses of property (other than real property or Intellectual Property) granted in the ordinary course of Borrower's business, if the leases, subleases, licenses and sublicenses do not prohibit granting Collateral Agent and/or Lenders a security interest;

(j) licenses of Intellectual Property permitted pursuant to Section 7.1(e);

(k) pledges or deposits made in the ordinary course of business to secure liability to insurance carriers;

(l) the filing of financing statements solely as a precautionary measure in connection with operating leases, consignment of goods or similar transactions;

(m) easements, zoning restrictions, rights-of-way, minor defects or irregularities of title and other similar encumbrances on

real property imposed by law or arising in the ordinary course of business that do not sure any monetary obligations and do not interfere with the ordinary course of business of Borrower in any material respect;

(n) Liens on fixed or capital assets acquired, constructed or improved, including Liens securing capital lease obligations, provided that such Lien secures Indebtedness permitted by clause (f) of the definition of Permitted Indebtedness;

(o) Liens granted in the ordinary course of business securing the financing of insurance premiums;

(p) Liens in favor of Comerica Bank in respect of the Cash Collateral Account, provided that any such Liens are terminated within sixty days of the Effjective Date.

(q) Liens arising from judgments, decrees or attachments in circumstances not constituting an Event of Default under Section 8.4 or 8.7; and

(r) Liens in favor of other financial institutions arising in connection with Borrower's deposit and/or securities accounts held at such institutions, provided that Borrower has complied with Section 6.6 hereof.

"**Person**" is any individual, sole proprietorship, partnership, limited liability company, joint venture, company, trust, unincorporated organization, association, corporation, institution, public benefit corporation, firm, joint stock company, estate, entity or government agency.

"**Registered Organization**" is any "registered organization" as defined in the Code with such additions to such term as may hereafter be made

"Requirement of Law" is as to any Person, the organizational or governing documents of such Person, and any law (statutory or common), treaty, rule or regulation or determination of an arbitrator or a court or other Governmental Authority, in each case applicable

to or binding upon such Person or any of its property or to which such Person or any of its property is subject.

"**Responsible Officer**" is any of the Chief Executive Officer, Chief Financial Officer or Controller of Borrower.

"**S&P**" means Standard & Poor's Ratings Group, Inc.

"**Securities Account**" is any "securities account" as defined in the Code with such additions to such term as may hereafter be made.

"**Subordinated Debt**" is indebtedness incurred by Borrower subordinated to all of Borrower's now or hereafter indebtedness to Lenders in connection with the Loan Documents other than the Warrants pursuant to a subordination, intercreditor, or other similar agreement in form and substance satisfactory to Collateral Agent and Lenders entered into between Collateral Agent, the Borrower and the other creditor), on terms acceptable to Collateral Agent and Lenders.'

"**Subsidiary**" means, with respect to any Person, any Person of which more than 50% of the voting stock or other equity interests is owned or controlled, directly or indirectly, by such Person or one or more Affiliates of such Person.

"**Term Loan**" or "**Term Loans**" is defined in Section 2.1.1(a).

"**Term Loan Amortization Date**" is February 1, 2013.

"**Term Loan Commitment**" is Ten Million Dollars ($10,000,000).

"**Term Loan Commitment Percentage**" means fifty percent (50%) with respect to Bank, and fifty percent (50%) with respect to Leader.

"Term Loan Final Payment" is a payment (in addition to and not a substitution for the regular monthly payments of principal plus accrued interest) due on the earlier to occur of (a) the Term Loan Maturity Date, (b) the acceleration of the Term Loan, or (c) the prepayment of the Term Loan, equal to the Loan Amount of the Term Loan multiplied by the Final Payment Percentage.

"**Term Loan Funding Date**" is any date on which a Term Loan is made to or on account of Borrower.

"**Term Loan Interest Only Period**" means, for each Term Loan, the period of time commencing on its Term Loan Funding Date through the day before the Term Loan Amortization Date.

"**Term Loan Maturity Date**" is the date twenty six (26) months after the Term Loan Amortization Date.

"**Term Loan Prepayment Fee**" shall be an additional fee payable to the Collateral Agent, for the benefit of each Lender according to each Lender's pro rata share of the Term Loan Commitment (based upon the respective Term Loan Commitment Percentage of each Lender) in amount equal to:

(a) for a prepayment made on or prior to the first anniversary of the Term Loan Funding Date, four percent (4.0%) of the principal amount of the Term Loan prepaid; or

(b) for a prepayment made after the first anniversary of the Term Loan Funding Date but on or prior to the second anniversary of the Term Loan Funding Date, three percent (3.0%) of the principal amount of the Term Loan prepaid; and

(c) for a prepayment made after the second anniversary of the Term Loan Funding Date but prior to the Term Loan Maturity Date, two percent (2.0%) of the principal amount of the Term Loan prepaid.

"**Term Loan Repayment Period**" is a period of time equal to twenty seven (27) consecutive months commencing on the Term Loan Amortization Date.

"**Transfer**" is defined in Section 7.1.

"**Treasury Rate**" is the average weekly yield (of the week-ending figures) in the most recent Federal Reserve Statistical Release on actively traded U.S. Treasury obligations for a three (3) year maturity or if a Statistical Release is not published, the arithmetic average (to the

nearest .01%) of the per annum yields to maturity for each Business Day during the week (ending at least two Business Days before the determination is made) of all actively traded marketable United States Treasury fixed interest rate securities with a constant maturity of, or not more than 30 days longer or shorter than, the average life of the principal and interest payments that are being paid (excluding securities that can be surrendered at face value to pay federal estate tax, or which provide for tax benefits to the holder). The Treasury Rate shall initial be set as of February 1, 2012 and will be adjusted upward in the event of any subsequent increase in the index rate.

"**Ucyclyd**" means UCYCLYD PHARMA, INC.

"**Ucyclyd Asset Sale**" means sale by Ucyclyd to Borrower of its BUPHENYL and AMMOUL products as contemplated by the Ucyclyd Collaboration Agreement.

"**Ucyclyd Collaboration Agreement**" means that certain Amended and Restated Collaboration Agreement by and between Borrower and Ucyclyd dated as of March 22, 2012.

"**Ucyclyd Collateral**" means the "Collateral", as such term is defined in the Ucyclyd Security Agreement.

"**Ucyclyd Indebtedness**" means Indebtedness to Ucyclyd in connection with the Ucyclyd Asset Sale in a principal amount not to exceed Twenty Two Million Dollars ($22,000,000).

"**Ucyclyd Security Agreement**" means a Security Agreement by and between Borrower and Ucyclyd in the form attached as Exhibit 2 to the Collaboration Agreement (and in the same form as in effect on the Effective Date).

"**Warrants**" are the Effective Date Bank Warrant, the Leader Warrant and the Bank Term Loan Funding Date Warrant.

IN WITNESS WHEREOF, the parties hereto have caused this Agreement to be executed as of the Effective Date.

BORROWER:

HYPERION THERAPEUTICS, INC.

By: /s/ Donald Santel

Name: Donald Santel

Title: CEO

COLLATERAL AGENT:

SILICON VALLEY BANK

By: /s/ Pete Scott

Name: Pete Scott

Title: Region Manager

LENDERS:

SILICON VALLEY BANK

By: /s/ Pete Scott

Name: Pete Scott

Title: Region Manager

LEADER LENDING, LLC—SERIES B

By: Leader Ventures, LLC

Its Manager

By: /s/ Robert W. Molke

Name: Robert W. Molke

Title: Managing Director

[Signature page to Loan and Security Agreement]

SCHEDULE 1.1

LENDERS AND COMMITMENTS

TERM LOANS

Lender	Commitment	Commitment Percentage
LEADER LENDING, LLC - SERIES B	$5,000,000	50.00%
Silicon Valley Bank	$5,000,000	50.00%
TOTAL	$10,000,000	100.00%

EXHIBIT A

The Collateral consists of all of Borrower's right, title and interest in and to the following personal property:

All goods, Accounts (including health-care receivables), Equipment, Inventory, contract rights or rights to payment of money, leases, license agreements, franchise agreements, General Intangibles (except as provided below), commercial tort claims, documents, instruments (including any promissory notes), chattel paper (whether tangible or electronic), cash, deposit accounts, certificates of deposit, fixtures, letters of credit rights (whether or not the letter of credit is evidenced by a writing), securities, and all other investment property, supporting obligations, and financial assets, whether now owned or hereafter acquired, wherever located; and all Borrower's Books relating to the foregoing, and any and all claims, rights and interests in any of the above and all substitutions for, additions, attachments, accessories, accessions and improvements to and replacements, products, proceeds and insurance proceeds of any or all of the foregoing.

Notwithstanding the foregoing, the Collateral does not include any of the following, whether now owned or hereafter acquired, (i) any copyright rights, copyright applications, copyright registrations and like protections in each work of authorship and derivative work, whether published or unpublished, any patents, patent applications and like protections, including improvements, divisions, continuations, renewals, reissues, extensions, and continuations-in-part of the same, trademarks, service marks and, to the extent permitted under applicable law, any applications therefor, whether registered or not, and the goodwill of the business of Borrower connected with and symbolized thereby, know-how, operating manuals, trade secret rights, rights to unpatented inventions, and any claims for damage by way of any past, present, or future infringement of any of the foregoing; (ii) any assets that are subject to a purchase money lien or capital lease permitted by this Agreement

to the extent the documents relating to such purchase money lien or capital lease would not permit such assets to be subject to the security interest created hereby or the grant or perfection of an additional lien would result in a breach or termination of, or constitutes a default under, the documentation governing such liens or the obligations secured by such liens, provided upon the release of such restriction any such assets shall automatically constitute Collateral; (iii) any lease or other contract if the grant of a security interest therein in the manner contemplated by this Agreement, under the terms thereof or under applicable law, is prohibited or would give any other party thereto (other than Borrower) the right to terminate such lease or other contract (but only to the extent that, and for so long as, any such prohibitions or termination right would not be rendered ineffective pursuant to the Code or any other applicable law); (iv) the Excluded Licenses and (v) for so long as the Ucyclyd Security Agreement is in effect, the Ucyclyd Collateral; provided, further, the Collateral shall include all Accounts, license and royalty fees and other revenues, proceeds, or income arising out of or relating to any of the items described in clauses (i) through (iv) above.

Agent and Lenders further acknowledge that the Collateral shall not include more than 66% of the voting securities of any Subsidiary that is not organized under the Laws of the United States or any of its states if such pledge would cause a material increase in the Borrower's federal income tax liability.

Pursuant to the terms of a certain negative pledge arrangement with Collateral Agent and Lenders, Borrower has agreed not to encumber any of its copyright rights, copyright applications, copyright registrations and like protections in each work of authorship and derivative work, whether published or unpublished, any patents, patent applications and like protections, including improvements, divisions, continuations, renewals, reissues, extensions, and continuations-in-part of the same, trademarks, service marks and, to the extent permitted under applicable law, any applications therefor, whether registered or not, and the goodwill of

the business of Borrower connected with and symbolized thereby, know-how, operating manuals, trade secret rights, rights to unpatented inventions, and any claims for damage by way of any past, present, or future infringement of any of the foregoing, without Collateral Agent's prior written consent.

Defined terms used above but not defined shall have the meaning assigned such terms in that certain Loan and Security Agreement by and between Borrower, Silicon Valley Bank, as collateral agent and Administrative Agent and the Lenders listed on Schedule 1.1 thereof dated as of April 19, 2012.

EXHIBIT B

Loan Payment/Advance Request Form

DEADLINE FOR SAME DAY PROCESSING IS NOON P.S.T.

Fax To: Date:___________

LOAN PAYMENT:

HYPERION THERAPEUTICS, INC.

From Account #________________ To Account # __________________
(Deposit Account #) (Loan Account #)

Principal $______________________ and/or Interest $________________

Authorized Signature: __________ Phone Number: ________________

Print Name/Title: _______________

LOAN ADVANCE:

Complete *Outgoing Wire Request* section below if all or a portion of the funds from this loan advance are for an outgoing wire.

From Account #________________ To Account # __________________
(Deposit Account #) (Loan Account #)

Amount of Advance $____________

All Borrower's representations and warranties in the Loan and Security Agreement are true, correct and complete in all material respects on the date of the request for an advance; provided, however, that such materiality qualifier shall not be applicable to any representations and warranties that already are qualified or modified by materiality in the text thereof; and provided, further that those representations and warranties expressly referring to a specific date shall be true, accurate and complete in all material respects as of such date:

Authorized Signature: __________ Phone Number: ________________

Print Name/Title: _______________

OUTGOING WIRE REQUEST:

Complete only if all or a portion of funds from the loan advance above is to be wired.

Deadline for same day processing is noon, P.S.T.

Beneficiary Name: ______________ Amount of Wire: $ ______________
Beneficiary Lender: ______________ Account Number: ______________
City and State: __________________
Beneficiary Lender Transit (ABA) #: ______________________________ Beneficiary Lender Code (Swift, Sort, Chip, etc.): _____________________
(For International Wire Only)
Intermediary Lender: Transit (ABA) #:

For Further Credit to: ____

Special Instruction: ____

By signing below, I (we) acknowledge and agree that my (our) funds transfer request shall be processed in accordance with and subject to the terms and conditions set forth in the agreements(s) covering funds transfer service(s), which agreements(s) were previously received and executed by me (us).

Authorized Signature: __________ 2nd Signature (if required): _______
Print Name/Title: _______________ Print Name/Title: _______________
Telephone#: ___________________ Telephone#: ___________________

EXHIBIT C

COMPLIANCE CERTIFICATE

TO: [SILICON VALLEY BANK][LEADER LENDING, LLC—SERIES B]
Date: ______________________________
FROM: HYPERION THERAPEUTICS, INC.

The undersigned authorized officer of HYPERION THERAPEUTICS, INC. ("Borrower") certifies that under the terms and conditions of the Loan and Security Agreement between Borrower, Collateral Agent and the Lenders (the "Agreement"), (1) Borrower is in complete compliance for the period ending________ with all required covenants except as noted below, (2) there are no Events of Default, (3) all representations and warranties in the Agreement are true and correct in all material respects on this date except as noted below; provided, however, that such materiality qualifier shall not be applicable to any representations and warranties that already are qualified or modified by materiality in the text thereof; and provided, further that those representations and warranties expressly referring to a specific date shall be true, accurate and complete in all material respects as of such date, (4) Borrower has timely filed all required federal and other material tax returns and reports, and Borrower and its Subsidiaries have timely paid all foreign, federal, state and local taxes, assessments, deposits and contributions owed by Borrower except as otherwise permitted pursuant to the terms of Section 5.8 of the Agreement, and (5) no Liens have been levied or claims made against Borrower or any of its Subsidiaries relating to unpaid employee payroll or benefits of which Borrower has not previously provided written notification to Collateral Agent. Attached are the required documents supporting the certification. The undersigned certifies that the financial statements delivered in connection with this certificate are prepared in accordance with generally GAAP consistently applied from one period to the next except as explained in an accompanying letter or

footnotes. The undersigned acknowledges that no borrowings may be requested at any time or date of determination that an Event of Default has occurred and is continuing. Capitalized terms used but not otherwise defined herein shall have the meanings given them in the Agreement.

Please indicate compliance status by circling Yes/No under "Complies" column for any applicable item.

Reporting Covenant	Required	Complies
Monthly financial statements with Compliance Certificate	Monthly within 30 days	Yes No
Annual financial statement (CPA Audited) + CC	FYE within 180 days	Yes No
Annual projections	30 days after FYE	Yes No
10-Q, 10-K and 8-K	Within 5 days after filing with SEC	Yes No

The following are the exceptions with respect to the certification above: (If no exceptions exist, state "No exceptions to note.")

HYPERION THERAPEUTICS, INC.	**LENDERS' USE ONLY**
	Received by: ___________________ AUTHORIZED SIGNER
By: ______________________________	Date: _________________________
Name: ___________________________	
Title: ____________________________	Verified: ______________________
	Compliance Status: Yes No

EXHIBIT D

SECURED PROMISSORY NOTE

$____________________ Date: _____________,2012

FOR VALUE RECEIVED, the undersigned, HYPERION THERAPEUTICS, INC., a [Delaware] corporation ("Borrower"), HEREBY PROMISES TO PAY to [SILICON VALLEY BANK][LEADER LENDING, LLC—SERIES B] ("Lender") the principal amount of

[Dollars ($)] or such lesser amount as shall equal the outstanding principal balance of the [Term Loan][Bank Term Loan] made to Borrower by Lender, plus interest on the aggregate unpaid principal amount of the [Term Loan][Bank Term Loan], at the rates and in accordance with the terms of the Loan and Security Agreement by and between Borrower and Silicon Valley Bank, as Collateral Agent, and the Lenders (as amended, restated, supplemented or otherwise modified from time to time, the "Loan Ag~~reemen~~t"). If ~~not soo~~ner paid, the entire principal amount and all accrued interest hereunder and under the Loan Agreement shall be due and payable on [Term Loan Maturity Date][Bank Term Loan Maturity Date] as set forth in the Loan Agreement

Principal, interest and all other amounts due with respect to the [Term Loan][Bank Term Loan], are payable in lawful money of the United States of America to Lender as set forth in the Loan Agreement. The principal amount of this Note and the interest rate applicable thereto, and all payments made with respect thereto, shall be recorded by Lender and, prior to any transfer hereof, endorsed on the grid attached hereto which is part of this Note.

This Note is one of the Notes referred to in, and is entitled to the benefits of, the Loan and Security Agreement, dated as of April __, 2012, to which Borrower and Lender are parties (the "Loan Agreement"). The Loan Agreement, among other things, (a) provides

for the making of this secured [Term Loan][Bank Term Loan] to Borrower, and (b) contains provisions for acceleration of the maturity hereof upon the happening of certain stated events.

This Note may not be prepaid except as provided in the Loan Agreement. This Note and the obligation of Borrower to repay the unpaid principal amount of the [Term Loan][Bank Term Loan], interest on the [Term Loan][Bank Term Loan] and all other amounts due Lenders under the Loan Agreement is secured under the Loan Agreement.

Presentment for payment, demand, notice of protest and all other demands and notices of any kind in connection with the execution, delivery, performance and enforcement of this Note are hereby waived.

Borrower shall pay all reasonable and documented out-of-pocket fees and expenses, including, without limitation, reasonable and documented out-of-pocket attorneys' fees and costs, incurred by Lenders in the enforcement or attempt to enforce any of Borrower's obligations hereunder not performed when due. This Note shall be governed by, and construed and interpreted in accordance with, the laws of the State of California.

[Remainder of page left intentionally blank; signature page follows]

IN WITNESS WHEREOF, Borrower has caused this Note to be duly executed by one of its officers thereunto duly authorized on the date hereof.

HYPERION THERAPEUTICS, INC.

By: ______________________________

Name: ____________________________

Title: _____________________________

[Signature Page to Secured Promissory Note]

LOAN INTEREST RATE AND PAYMENTS OF PRINCIPAL

Date	Principal Amount	Interest Rate	Scheduled Payment Amount	Notation By

EXHIBIT E

FORM OF BANK TERM LOAN FUNDING DATE WARRANT

SECURITY AGREEMENT

On this _______ day of ______________________, 20___, __________________ ("Debtor"), for valuable consideration, receipt of which is acknowledged, grants to ______________________________ ("Secured Party") a security interest in the following property of Debtor (the "Collateral")[*insertdescription of collateral*]

____

____

____

to secure payment of the following obligations of Debtor to Secured Party (the "Obligations"):[*choose one*]

❑ The following indebtedness: ________________________ ____[*description*]

❑ All obligations and liabilities of Debtor to Secured Party.

1. **Warranties and Covenants of Debtor**. Debtor warrants and covenants that:

(a) No other creditor has a security interest in the Collateral except the following: ____.

(b) Debtor is the owner of the Collateral free from any adverse lien or encumbrance except this lien and the others described in this Security Agreement.

(c) Debtor will defend the Collateral against all claims ofother persons.

(d) Debtor will immediately notify the Secured Party in

writing of any change in name or address.

(e) Debtor will do all such things as Secured Party at any time or from time to time may reasonably request to establish and maintain a perfected security interest in the Collateral.

(f) Debtor will pay the cost of filing this agreement in all public offices whererecording is deemed by Secured Party to be necessary or desirable. A photographic or other reproduction of this agreement is sufficient as a financing statement.

(g) Debtor will not transfer or encumber the Collateral without the prior written consent of Secured Party.

(h) Debtor will keep the Collateral insured against risk of loss or damage upon such terms as Secured Party may reasonably require.

(i) Debtor will keep the Collateral free from any adverse lien and in good repair, will not waste or destroy the Collateral, and will not use the Collateral in violation of any law or policy of insurance. Secured Party may examine and inspect the Collateral at any reasonable time.

(j) Debtor will pay promptly when due all taxes and assessments upon the Collateral or for its use or operation or upon this Agreement or upon any note evidencing the Obligations.

2. **Additional Rights**. Secured Party may dischargeliens placed on the Collateral, may place and pay for insurance on the Collateral upon failure by the Debtorto do so, and may pay for the maintenance, repair, and preservation of the Collateral.

To the extent permitted by applicable law, Debtor agrees to reimburse Secured Party on demand for any payment under this authorization.

3. **Events of Default**. Debtor shall be in default under this Agreement upon the occurrence of any of the following events or conditions: (a) the failure to perform any of the Obligations or this Agreement; (b) the loss, theft, substantial damage, destruction, transfer or encumbrance of the Collateral; (c) the making of any levy, seizure or attachment upon the Collateral; or (d) the filing by Debtor or by any third party against Debtor of any petition under any Federal bankruptcy statute, the appointment of a receiver of any part of the property of Debtor, or any assignment by Debtor for the benefit of creditors.

4. **Remedies**. UPON DEFAULT AND AT ANY TIME THEREAFTER, SECURED PARTY MAY DECLARE ALL OBLIGATIONS IMMEDIATELY DUE AND PAYABLE AND SHALL HAVE THE REMEDIES OF A SECURED PARTY UNDER THE UNIFORM COMMERCIAL CODE OF TENNESSEE.

SECURED PARTY: **DEBTOR:**

__________________________ __________________________

__________________________ __________________________

SECURED TRANSACTIONS
Law, Materials and Best Practices
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