AGENDA
2:30 p.m. - 3:30 p.m.  Emerging Issues in Secured Transactions
   - Presented by Barkley Clark and Mark Hargrave
3:00 p.m. - 3:30 p.m.  Break
3:30 p.m. - 4:35 p.m.  Emerging Issues in Financial Services Regulation
   - Presented by Adam Maier and Tim McTaggart
4:35 p.m. - 6 p.m.  Reception

SEMINAR PRESENTERS
BARKLEY CLARK, DENVER
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A well-known national authority on secured lending issues under the UCC, Barkley has written a number of books and 30 law review articles including “The Law of Secured Transactions under the UCC” and “Clarks’ Secured Transactions Monthly.” Throughout his 50-year career as a scholar and practitioner, he has been active in commercial law reform, serving on the national committee that led to the drafting of Revised Article 9 of the UCC and serving as special advisor to the Federal Reserve Board, the American Bankers Association and various state legislatures in their enactment of commercial and consumer credit legislation. Barkley has taught banking and the UCC for many years in several different law schools.

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Mark focuses his practice on financial and commercial law matters. He places special emphasis on issues involving payment systems, secured lending and regulatory compliance. Mark frequently speaks on these topics at regional and national programs, and he has authored several topic related books.

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As co-chair of Stinson’s Banking and Financial Services division, Adam focuses his practice on the business interests and growth strategies of financial institutions and their owners. Adam regularly represents national financial institutions serving as corporate trustee in connection with high yield and investment grade debt offerings. This includes Rule 144A and Regulation S offerings. The transactions are often multinational and include U.S. and United Kingdom issuances. In 2016, Adam’s clients engaged him as trustee’s counsel on more than $10 billion in corporate debt offerings.

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Tim is a nationally recognized banking lawyer with more than 30 years of private law practice and public sector experience, including at the Fed, U.S. Senate Banking Committee and as the Delaware State Bank Commissioner. Tim has testified before Congress on banking matters, including the constitutionality of the CFPB. Additionally, he has spoken on fintech issues, data privacy, and financial and regulatory compliance matters including CFPB issues. Tim has written on anti-money laundering matters, escheat law issues and other regulatory developments affecting financial services firms and their investors and vendors. Tim has deep experience in corporate governance issues affecting banks, and has counseled boards, board committees, independent directors, lead directors, special committees and senior management on M&A transactions and other regulatory issues.
Emerging Issues in Secured Transactions and Financial Services Regulation

Presented by:
Stinson Leonard Street LLP

Ten Hot Topics on Secured Lending under UCC Article 9

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Mark Hargrave
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#1 Driver’s License Standard for Debtor Names

- New filing rules - 2010 amendments to Article 9
- Terry or Terrance: *In re Kinderknecht* (10th Cir.BAP)
- *Peoples Bank v. Bryan Brothers Cattle Co.* (5th Cir. 2007)
- Alternative A vs. Alternative B
- Ronald Markt Nay or Ronald Mark Nay: *In re Nay, Bankr.* (S.D. Ind. 1/23/17)
- *Clarks' Secured Transactions Monthly* - Jan. 2017

#2 Production Money Security Interests

- Agricultural input financers generally lose to prior blanket liens
- Optional "production money security interest" (limited adoption)
- *Guaranty Bank & Trust Co. v. Agrex, Inc.* (5th Cir. 2016)
- Battle between agricultural input financer and buyer's right of setoff Impact of the Food Security Act
#3 Super-Generic Collateral Descriptions

- *In re Sterling United* (7th Cir. 12/22/16)
  - "all assets of the debtor" irrespective of their location
- *Pro Growth Bank, Inc. v. Wells Fargo Bank* (8th Cir. 2009)
  - subsequent creditors to inquire if collateral is the subject of a prior security agreement

#4 Buying Securities at a Private Sale

- Secured party generally may not purchase at a private foreclosure sale
- Exceptions for recognized markets and widely distributed price quotations
- No agreement to modify the UCC’s limitations on private sales
- Impact of Comment 7 to UCC § 9-610?
#5 Personal Property & Real Estate as Collateral

- *In re Troy and Heather Blanchard* (7th Cir. 2016)
  - Bank’s real estate mortgage created a lien. No UCC filing required
  - Payment is personal property. Article 9 - filing required.
- Other Examples: mortgage or deed, commercial lease assignments, fixtures, general or limited partner in real estate venture, real estate mortgage notes
- *Clarks’ Secured Transactions Monthly* – April 2016

#6 Blanket Liens and IP Licenses

- Coverage of intellectual property under the UCC
- Perfection of security interests in intellectual property
- *Cyber Solutions International, LLC. v. Pro Marketing Sales, Inc.* (6th Cir. 2016)
  - Blanket lien had priority over right of licensee
- Impact of UCC § 9-321(b)?
#7 Strict Foreclosure on Ag Equipment

- Strict foreclosure under Article 9
  - extinguishes junior security interests even though senior secured lender failed to notify the juniors
- Oregon windfall *McDonald v. Yarchenko* (D. Ore. 2013)
  - Valuation disputes or excess collateral value over the amount of obligations does not demonstrate absence of good faith

#8 Floating Leases of Livestock

- True lease versus a disguised security interest
- Messy issues when the debtor also has non-leased livestock
- *Sunshine Heifers, LLC v. Purdy* (W.D. Ky. 2016)
- Impact of state branding laws
- Steps lessors can take to protect themselves
#9 Security Interest in Deposit Account vs. Garnishing Creditor

- Does the lender have priority over the claims of a judgment creditor?
- *Stierwalt v. Associated Third Party Administration* (N.D. Calif. 2016)
  - Priority to garnishing creditor, as a "transferee" of funds
- The power of the take-free rule

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#10 Credit Bids & Delayed Foreclosure Sales

- Overarching requirement of a commercially reasonable foreclosure sale
- Flexibility in pursuing UCC and other remedies
- Secured parties generally prevail in these cases
Emerging Issues in Financial Services Regulation

Overview

• Emerging Issues
  – CFPB Constitutionality, Regulatory Freeze, 2-for-1 Executive Order, Dodd-Frank and Fiduciary Rule Review
• CFPB Overview
  – Background, Regulation by Enforcement, Trends
• Agency Enforcement Actions
  – CFPB, OCC, FDIC, Federal Reserve
• Current and Future Rulemaking
  – Focus on debt collection, overdraft, new financial products, data security, etc.
CFPB Structure Unconstitutional?

- PHH case – October 11, 2016
  - D.C. Circuit Court of Appeals found CFPB structure unconstitutional because of president’s inability to remove single head of agency
  - Found CFPB Director Cordray, as sole head of the agency, by comparison, possesses more authority than any multi-member agency commissioner/member
  - PHH sought a shut-down of agency, but Court opted to strike “for cause” provision concerning grounds for removal of Director to permit Executive control of agency
  - Court ruled that Director can be removed at will
  - Another important finding: CFPB actions are subject to statutes of limitations
  - On February 16, 2017, D.C. Circuit agreed to rehear case en banc

Regulatory Freeze

- Inauguration day (Jan. 20) – Trump Administration issued a “regulatory freeze”
  - Directs “executive departments and agencies” not to send any regulation to Office of Federal Register (OFR) until department or agency head appointed by President Trump reviews and approves
  - Also directs agencies to withdraw regulations previously sent to OFR but not yet published
  - Postpones effective date for published regulations that have not yet taken effect, for 60 days from Jan. 20 order; for those regulations that “raise substantial questions or law or policy,” appropriate further action will be taken

- Application
  - Does not apply to OCC, FDIC or Federal Reserve (independent agencies)
  - Application to CFPB unclear after PHH case (CFPB possibly no longer an independent agency after PHH)
Executive Order: 2-for-1 Regulations

- President Trump Executive Order (Jan. 30)
  - Requires that for every one new federal regulation, two must be revoked
  - Focused on zero net incremental cost, meaning cost of new regulations should be offset by existing rules that will be rescinded
  - Groups have filed suit in U.S. District Court in Washington
    - Claiming the executive order (i) exceeds the president’s constitutional authority, and (ii) violates the Administrative Procedure Act by instructing agencies to act arbitrarily in cancelling regulations
    - Argument that order directs agencies to consider costs but not benefits of new rules
    - Groups include Public Citizen, the Natural Resources Defense Council, and the Communications Workers of America

Executive Orders: Dodd-Frank and Fiduciary Rule Review

- President Trump Executive Orders (Feb. 3)
  - Dodd-Frank review
    - Order requires certain regulators to review Dodd-Frank
    - 120 day review period
    - First step in attempt to scale back Dodd-Frank statutory provisions and regulations
  - “Fiduciary rule” review
    - Rule was slated for implementation during spring of 2017
    - Would impose fiduciary responsibility on financial advisors
    - Order asks Department of Labor to repeal rule
The CFPB: Background

• Who it regulates…

• Authority to regulate a “covered person”
  – Provider of a consumer financial product or service, including non-depository institutions

• Exclusive supervisory authority over large depository institutions, their affiliates (including subsidiaries), and their service providers
  – Large = greater than $10 billion
  – Primary rulemaking and enforcer of consumer protection laws over large entities
  – Prudential regulators (Fed, FDIC, OCC, NCUA) have consumer compliance examination authority over small institutions

The CFPB: Background

• What is its purpose?...

• The CFPB consolidates most Federal consumer protection authority in one place

• Exists to “implement and, where applicable, enforce Federal consumer financial law consistently for the purpose of ensuring that all consumers have access to markets for consumer financial products and services and that markets for consumer financial products and services are fair, transparent, and competitive.”
The CFPB: Background

What it does…

– Conducts financial education programs
– Collects, investigates, and responds to consumer complaints
– Collects, researches, monitors, and publishes information relevant to the functioning of markets for consumer financial products
– Supervises covered persons for compliance with Federal consumer financial law, and takes enforcement action to address violations of Federal consumer financial law
– Issues rules, orders, and guidance implementing Federal consumer financial law

The CFPB: Background

What it oversees (among other Acts and Regs)…

– Consumer Leasing Act
– Electronic Fund Transfer Act
– Equal Credit Opportunity Act
– Fair Credit Billing Act
– Fair Credit Reporting Act
– Home Owners Protection Act
– Fair Debt Collection Practices Act
– Home Mortgage Disclosure Act
– Home Ownership and Equity Protection Act
– Real Estate Settlement Procedures Act
– S.A.F.E. Mortgage Licensing Act
– Truth-in-Lending Act
– Truth-in-Savings Act
The CFPB: Background

UDAAP catch-all
- The agency has broad authority to prohibit unfair, deceptive or abusive acts or practices (UDAAP)
- If the CFPB views a practice as unfair, deceptive or abusive, it can bring an enforcement action and impose penalties

CFPB: 5 Year Overview

According to the CFPB:
1. $11.7 billion in relief for over 27 million consumers
2. Handled nearly a million consumer complaints
3. “Know Before you Owe” initiative—improving consumer disclosures
4. New mortgage protections
5. Other new consumer protections and proposals
CFPB: 5 Year Overview

- Expanding regulation by enforcement
- Increasing coordination across agencies (DOJ, FTC, etc.)
- Escalating penalties
- New areas of enforcement (data security, credit reporting, telephone billing, etc.)

CFPB: Data and Trends

Volume of CFPB UDAAP Enforcement Actions

<table>
<thead>
<tr>
<th>Year</th>
<th>Number of Enforcement Actions</th>
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<tbody>
<tr>
<td>2013</td>
<td>13</td>
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<td>2014</td>
<td>24</td>
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<tr>
<td>2015</td>
<td>42</td>
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</tbody>
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- 2013: 13, 85%
- 2014: 24, 75%
- 2015: 42
CFPB: Data and Trends

UDAAP: Litigated Actions vs. Settled Actions

<table>
<thead>
<tr>
<th>Year</th>
<th>Litigated Actions</th>
<th>2013</th>
<th>2014</th>
<th>2015</th>
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<tbody>
<tr>
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<tr>
<td>2014</td>
<td>9</td>
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<tr>
<td>2015</td>
<td>12</td>
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</tbody>
</table>

- 33% of litigated actions in 2013
- 100% of litigated actions in 2015

Mortgages: $609,286,310 (31%)
- Other: $10,444,075 (1%)
- Auto Lending: $2,750,000 (1%)
- Debit Cards: $1,253,400,000 (63%)
- Debt Collection: $100,000,001 (5%)
- Payday Lending: <1%

2014 Penalties by Area of Enforcement
CFPB: Data and Trends

2015 Penalties by Area of Enforcement

- Student Financial Aid, $544,500,001, 26%
- Telephone Billing, $120,000,000, 6%
- Auto Lending, $42,500,000, 2%
- Credit Cards, $853,901,025, 40%
- Debt Collection, $137,073,000, 6%
- Payday Lending, $10,500,000, <1%
- Other, $80,557,514, 4%
- Mortgages, $340,237,179, 16%

CFPB: Recent Enforcement Actions

- Wells Fargo Bank -- $185 million
  - September 2016
  - Secretly opening unauthorized accounts
  - $100 million penalty (the largest ever CFPB penalty)
  - $85 million in restitution
- First National Bank of Omaha -- $32 million
  - August 2016
  - Deceptive marketing on credit card add-on products
  - Charging for credit card monitoring services consumers did not receive
- Interstate Auto Group (aka CarHop) -- $6.5 million
  - December 2015
  - Providing damaging, inaccurate consumer information to credit reporting companies on a widespread basis
  - “Buy-here, pay-here” auto dealer and affiliated finance company promised consumers it would supply positive credit information
CFPB: Recent Enforcement Actions

• Santander -- $10 million
  – July 2016
  – Using telemarketing vendor to deceptively market their overdraft service and “opt-in” consumers without their consent
• Citibank -- $55 million
  – February 2016
  – Selling credit card debt to collection agencies with misstated interest rates
  – Failing to promptly forward consumer payments to debt buyers
  – Altered affidavits in debt collection litigation

CFPB: Recent Enforcement Actions

• Dwolla -- $100 thousand
  – March 2016
  – Online payment platform made promises about data security that CFPB found to be untrue
  – Action and fine even though no data breach or complaints
• Regions Bank -- $7.5 million
  – April 2015
  – Overdraft fees charged to consumers who had not opted in for overdraft coverage
OCC: Agency Overview

- Charters, regulates, and supervises national banks and federal savings associations
- Current priorities:
  - Business model and strategy changes (e.g., FinTech)
  - Compliance
  - Credit risk and loan underwriting
  - Cybersecurity and resiliency planning
  - Interest rate risk
- Coordination with CFPB and other agencies in enforcement

OCC: Recent Enforcement Actions

- Wells Fargo Bank -- $35 million
  - September 2016
  - OCC coordinated with CFPB in action against Wells Fargo, and ordered a separate civil money penalty
- First National Bank of Omaha -- $3 million
  - August 2016
  - OCC coordinated with CFPB, ordered separate civil money penalty for unfair and deceptive billing practices
- HSBC Bank USA -- $35 million
  - April 2016
  - Bank’s billing practices for credit-monitoring product were unfair and deceptive
OCC: Recent Enforcement Actions

- Citizens Bank -- $10 million
  - August 2015
  - Deposit reconciliation issues and discrepancies between funds deposited and amount encoded from deposit slip
  - OCC coordinated with CFPB and FDIC, which issued separate orders
- Citibank -- $35 million
  - July 2015
  - Unfair or deceptive practices in connection with billing and marketing of identity theft protection products
  - OCC again coordinated with CFPB, which issued separate order

FDIC: Agency Overview

- Insures deposits, and examines and supervises over 4,000 state-chartered banks
- FDIC orders civil money penalties less often than other agencies
  - Focus of recent enforcement orders is on Bank Secrecy Act and Anti-Money Laundering Act compliance; also consumer protection generally
- FDIC has implemented initiatives to address future of community banking
FDIC: Recent Enforcement Actions

• Comenity Bank & Comenity Capital Bank (Delaware; Utah) -- $64 million
  – September 2015
  – $2.5 million penalty and $61.5 million in restitution for UDAP violations in marketing and servicing of credit card add-on products
• Banamex USA (California) -- $140 million
  – July 2015
  – Bank Secrecy Act violations
• Bank of Mingo (West Virginia) -- $3.5 million
  – June 2015
  – Failed to implement an effective BSA/AML compliance program

Federal Reserve: Agency Overview

• Central bank of the United States; supervises and regulates Fed-member state-chartered banks and bank holding companies
• Recent rulemaking has focused on cybersecurity and capital standards
• Enforcement focus on safety and soundness and consumer protection
Federal Reserve: Recent Enforcement Actions

- Banco Bilbao Vizcaya Argentaria -- $27 million
  - December 2016
  - Exceeding securities underwriting limits
- JPMorgan Chase -- $62 million
  - November 2016
  - Unsafe and unsound practices related to improper referral hiring program
  - Practice of hiring officials and other clients in order to obtain improper business advantages
- HSBC North America Holdings -- $131 million
  - February 2016
  - Deficiencies in residential mortgage loan servicing and foreclosure processing

CFPB: Common Industry Complaints

Regulation by enforcement

- Consent orders are “intended as guides to all participants in the marketplace to avoid similar violations and make an immediate effort to correct any such improper practices”
  - Chairman Richard Cordray, Prepared Remarks to the Consumer Bankers Association (March 9, 2016)
- UDAAP used to bring penalties and fines against financial and non-financial companies
- Cordray argues it is impossible to create specific rules that address all the various abusive practices that occur
CFPB: Common Industry Complaints

- Biased appeal process
  - Director/CFPB agency brings the action, but initial (administrative) appeal gets reviewed by director before eligible for judicial review
- Too much regulation
  - Argument that rulemaking and “regulation by enforcement” create unrealistic regulatory burden

CFPB: Common Industry Complaints

Too powerful
- Single director (as opposed to most agencies with board or commissions)
- Director removable only for cause (but now “at will” after PHH case)
OCC, FDIC, Fed: Rulemaking

- **Enhanced Cyber Risk Management Standards** (notice of proposed rulemaking, Oct. 2016)
  - Joint rulemaking effort by OCC, FDIC, and Fed
  - Would apply to large and interconnected financial institutions and their service providers and impose enhanced risk management standards
  - Purpose is to increase operational resilience of large entities and reduce impact on the financial system in the case of a cyber event experienced by one or more of the entities

- **Incentive-Based Compensation Arrangements** (proposed rule, April 2016)
  - Joint rulemaking effort by OCC, FDIC, Fed, FHFA, NCUA and SEC, as required by Dodd-Frank Act
  - Enhances disclosure and reporting of compensation arrangements; prohibits incentive-based payment arrangements that encourage inappropriate risk taking
CFPB: Rulemaking

- Arbitration Agreements (proposed rule, May 2016)
  - Would apply to most consumer financial products and services the CFPB oversees
    - Financial institutions > $10 billion
    - Other entities regulated by the Bureau (Nonbank mortgage originators and servicers; Payday lenders; Consumer debt collection agencies, etc.)
  - Would prohibit providers of such products and services from using an agreement with a consumer that provides for arbitration and waives participation in a class action for any future dispute between the parties
  - Would require a covered provider that is involved in arbitration pursuant to a pre-dispute arbitration agreement to submit specified arbitral records to the Bureau

- Payday, Vehicle Title, and High-Cost Installment Loans (proposed rule, June 2016)
  - Makes it an abusive/unfair practice for lender to make covered loan without reasonably determining ability to repay
  - Imposes restrictions on making covered loans when consumer has or recently had outstanding loans

- Note: unclear whether these proposed rules are affected by regulatory freeze

CFPB: Rulemaking

- Prepaid Accounts (final rule, October 2017)
  - Comprehensive consumer protections for prepaid accounts
  - Modifies Regulation E (which implements Electronic Fund Transfer Act) to create tailored provisions governing disclosures, limited liability and error resolution, and periodic statements, and adds new requirements regarding the posting of account agreements
  - Regulates overdraft credit features that may be offered with prepaid accounts
CFPB: Agenda

What’s to come? Focus on debt collection:

- According to CFPB, debt collection generates more complaints than any other financial product or service
- Agency has outlined proposals to overhaul debt collection market, which would:
  - Cap collector contact attempts
  - Ensure companies collect the correct debt
  - Require debt collectors to have more and better information about the debt before collecting
  - Limit communications, clearly disclose debt details, make it easier for consumers to dispute debt
- Next steps: input from public and industry, proposed regulations, further comments, and final regulations

CFPB: Agenda

What’s to come? CFPB Agenda Items:

- Overdraft
  - Pre-rulemaking activities to consider potential regulation of overdraft services on checking accounts
  - To address issues related to how consumers opt-into overdraft coverage, overdraft coverage limits, transaction posting order practices, overdraft and insufficient funds fee structure, and involuntary account closures
CFPB: Agenda

What’s to come? CFPB Agenda Items:

- Larger participants and non-depository lender registration
  - CFPB seeks to further establish its nonbank supervisory authority by defining larger participants of certain markets for consumer financial products and services
  - Recent proposal on installment and vehicle title loans applies to larger participants in nonbank financial product industry
  - CFPB also considering whether rules to require registration of these or other non-depository lenders would facilitate supervision

CFPB: Agenda

CFPB’s long term agenda (according to agency blog)

• Credit reporting
  - Potential topics for rulemaking might include the accuracy of credit reports, including the process for resolving consumer reports

• Student loan servicing
  - There is a need for market-wide federal standards for student loan servicing
  - Evaluating possible policy responses
CFPB: Looking Forward…

What else to expect in the future of the CFPB?

- Continued use of UDAAP to “regulate by enforcement”
  - Press driven. Seeks headlines, publicity.
- Use of UDAAP and rulemaking to expand jurisdiction over non-depository companies
  - CFPB views jurisdiction broadly
- Focus on new financial products
  - Prepaid cards, virtual currency, mobile wallets, etc.
- Focus on cybersecurity
  - Dwolla signaled an interest; the first example of a cybersecurity enforcement
- Enforcement likely to track with rulemaking subjects and consumer complaints

The Wonderful World of Corporate Trust
The 2016 Corporate Trust Home Run

- More and Better Debt Issued Overall
- 2% Overall Increase in Offerings
- 4% Increase in Investment Grade Offerings
- 10.4% Decrease in High Yield Offerings
- Largest Year on Record Overall
- Healthy Companies Issuing Debt
- 2017 On Pace to be Even Stronger

Marblegate: The Not So Landmark Case


- Trust Indenture Act of 1939
- Prohibits sale of a bond in a public offering unless sold under an indenture qualified under the TIA
- Prohibits impairment of bondholder’s right to payment without consent
Why Marblegate Matters

- Protection of value of issuer in out-of-court restructurings supported by majority of creditors
- Preventing a “hostage crisis” with non-consenting bondholders
- Access to restructuring options for issuers that can’t use the bankruptcy process

EDMC and It’s Debt

- EDMC was a for-profit college
- Bankruptcy filing would destroy the business
- $1.3 billion in secured debt / $216 million unsecured
- Bonds issued by EDMC subsidiary
- EDMC parent guarantied the bonds
- Guaranty could be released by majority of holders or release by secured lenders
EDMC’s Restructuring

- Out-of-court proposal to creditors
- Debt/equity to secured lenders (55%)
- Equity to unsecured holders (33%)
- Secured lenders would release EDMC parent guaranty
- Secured lenders foreclose on assets
- Sell back to EDMC sub, which issues debt and equity to creditors

An Offer He Can’t Refuse…

Consent without a choice
- Non-consenting creditors would retain rights against the original EDMC subsidiary
- No debt or equity in new EDMC issuer
- Guaranty of EDMC parent eliminated because secured debt guaranty termination
Marblegate Fights Back

- Marblegate Asset Management sought declaratory and monetary relief
- Southern District of New York
- Market practice in restructurings
- TIA Section 316(b) was the entire case

Impairment Without Consent

“[A]lthough the Intercompany Sale would not formally alter the dissenting Noteholders’ right to payment on their Notes, it was unequivocally designed to ensure that they would receive no payment if they dissented from the debt restructuring.”

- S.D.N.Y.
A Shock to the Industry

• Significant amendments, including covenant strips
• Exchanges without 100% consent
• Rule 144A for life indentures affected

2nd Circuit Keeps the Party Going

• The bondholders weren’t releasing the parent guaranty – the secured lenders released
• Automatic release provision was the operative fact – bondholders affirmative action would have changed the outcome
What Marblegate Means

• Changes to credit agreements and indentures to limit restructurings by enhancing bondholder rights
• Enhanced disclosures by indenture trustees following events of default
• Increased focus by indenture trustees on retention of state law remedies

Thank You

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INDIANA COURT UPHOLDS “DRIVER’S LICENSE” RULE FOR INDIVIDUAL DEBTOR NAMES

A 2017 Indiana bankruptcy court decision appears to be the first reported case to construe the “driver’s license” rule for identifying individual debtors on UCC financing statements. In doing so, the court correctly construes the rule for identifying individual debtors on UCC 9-503(a)(4), which makes the debtor’s driver’s license the gold standard for UCC filing.

The Indiana case. In In re Nay, Bankr. Case No 16-90762-BHL-11 (S.D. Ind. 1/23/17), the debtors were Ronald Markt Nay and Sherry Nay; the middle name of Nay was “Markd” was not a typo, but the husband’s real name. The Nays were farmers who took Chapter 11 bankruptcy. A secured lender, Mainsource Bank, filed an adversary proceeding to determine the priority of security interests as between itself and a competing lender, LEAF Capital Funding (Leaf). At issue were two pieces of farm equipment. The bank claimed priority based on its blanket security interests in “equipment” and other assets that attached in July 2014 and May 2015; the bank’s loan was in the amount of $1.2 million.

The bank perfected its security interest by prefiling a financing statement with the Indiana secretary of state in February 2014. The debtor’s name on the bank’s financing statement was shown as “Ronald Markt Nay”, which was the name on his Indiana driver’s license. In 2015, Leaf provided purchase-money financing in the amount of $77,950 for two pieces of farm equipment. In order to gain purchase-money priority over the bank’s earlier blanket filing, Leaf filed its financing statements within 20 days of delivery of the equipment to the debtors. The problem was that the debtor’s name used by Leaf on its financing statements was “Ronald Mark Nay” not “Ronald Markt Nay.” The Indiana court stated that Leaf’s failure to use the driver’s license name was “inadvertent.”

Failure to use driver’s license name was not a “minor error.” In the adversary proceeding, the bank contended that it had priority to the two pieces of equipment because Leaf’s security interest was not perfected in accordance with the 2010 amendments to Article 9; these amendments provide that the financing statement against an individual debtor passes muster “only if” the debtor’s name on the financing statement is precisely the same as that on the driver’s license. UCC 9-503(a)(4). Importantly, Indiana is an “Alternative A” state under the 2010 amendments, so that the use of the driver’s license name is mandatory.

Leaf conceded that the debtor’s name on its financing statements was not the same as that found on the debtor’s driver’s license, but contended that the error in the spelling of Nay’s middle name was “minor” and not “seriously misleading.” That led to court to consider UCC 9-506, which provides that a financing statement “substantially satisfying” the requirements of Part 5 of Article 9 is effective “unless the errors or omissions make the financing statement seriously misleading.” Section 9-506 then states that a financing statement which “fails sufficiently to provide the name of the debtor” is “seriously misleading” as a matter of law. However, under the safe-harbor provision of 9-506(c), “[i]f a search of the filing office records under the...
debtor’s correct name, using the filing office’s standard search logic, if any, would disclose a financing statement that fails to sufficiently provide the name of the debtor in accordance with [9-503(a)], the name provided does not make the financing statement seriously misleading.”

**Safe harbor doesn’t save lender.** The Indiana court concluded that Leaf was not saved by the safe-harbor provision because a search under the debtor’s “correct name,” i.e., the driver’s license name, using the Indiana secretary of state’s search logic, did not turn up Leaf’s financing statements. The court noted that Indiana’s “standard search logic” is found in Administrative Rule 503, modeled after filing rules developed by the International Association of Commercial Administrators (IACA). The court rejected Leaf’s contention that Rule 503 in effect changed the statutory driver’s license standard by authorizing broader search parameters regarding the name of the individual debtor: “The standard search logic in Rule 503 establishes how words or things such as punctuation, spaces, initials, case of letters and similar details are interpreted in generating a report. As regards the ‘correct name’ to be searched, however, Rule 503 provides no authority.”

**Driver’s license standard is good public policy.** As a matter of public policy, the Indiana court stressed the need for simplicity and certainty for both filers and searchers against an individual debtor, and the strong presumption against a result that allows an administrative rule to over-ride a clear statutory mandate. The court quoted from Comment 2 to UCC 9-506:

> ...For purposes of [UCC 9-506(c)] any name that satisfies section 503(a) at the time of the search is a “correct name.” This section and Section 9-503 balance the interests of filers and searchers. Searchers are not expected to ascertain nicknames, tradenames, and the like by which the debtor may be known and then search under each of them. Rather, it is the secured party’s responsibility to provide the name of the debtor sufficiently in a filed financing statement. Subsection (c) sets forth the only situation in which a financing statement that fails sufficiently to provide the name of the debtor is not seriously misleading. As stated in subsection (b), if the name of the debtor provided on a financing statement is insufficient and subsection (c) is not satisfied, the financing statement is seriously misleading. Such a financing statement is ineffective even if the debtor is known in some contexts by the name provided on the financing statement and even if searchers know or have reason to know that the name provided on the financing statement refers to the debtor. Any suggestion to the contrary in a judicial opinion is incorrect.

**Key takeaways from the Indiana case:**

*The Indiana decision seems correct on every point. The court properly stressed the plain language of UCC 9-503 and 9-506, as well as the proper relationship between the two provisions.*

*The decision shows the wisdom of the 46 jurisdictions that have chosen Alternative A—the “only if” alternative. In the name of national uniformity, the six Alternative B jurisdictions—Alaska, Colorado, Connecticut, Delaware, New Hampshire, and Wyoming—should get on board. Both filers and searchers need certainty in this important area of secured lending law.*

*The Indiana decision is a case of first impression nationwide. The absence of other litigation over the past four years illustrates that the 2010 amendments are working well around the country.*

*Had Indiana elected to enact Alternative B—allowing perfection using a debtor’s first name and surname on the financing statement—Leaf would have prevailed in the adversary proceeding because a search under that broader standard would have disclosed the Leaf financing statements.*

*The biggest takeaway from the Indiana case is the need for secured lenders to make sure that the name of an individual debtor on the financing statement is taken directly from the driver’s license. It’s hard to feel sorry for a lender who fails to do that obvious due diligence, even though the driver’s license name looks like a typo. Even in Alternative B states, the driver’s license should be the treated as the gold standard.*

*Note that the losing creditor (Leaf) properly complied with its duties under UCC 9-324(a) to make its own PMSI filings within 20 days of delivery of the collateral to the debtor, then threw away that advantage by using the wrong debtor name in those timely filings.*

**THE PERILS OF COMMERCIAL TORT CLAIMS AS COLLATERAL**

A recent Mississippi bankruptcy court ruling underlines the perils of relying on commercial tort claims alone as a description of contract rights in secured lending. *In re Mississippi Phosphates Corp.*, Adv. No. 16-06001-KMS (January 3, 2017). The case does not involve a security interest in commercial tort claims. But it involves contract rights based on commercial tort claims which are relevant to taking a security interest in these claims.

**The Mississippi case.** Mississippi Phosphates filed bankruptcy and sold all of its assets pursuant to a sale contract that excluded from the sale “commercial tort claims.” After completion of the sale, Mississippi Phosphates became eligible for a $1.5 million dollar electricity rebate
arising from a lawsuit that went all the way to the Mississippi Supreme Court. The buyer claimed it was entitled to the refund because it bought all of the assets, including general intangibles. An unsecured creditors’ committee for Mississippi Phosphates (the “Committee”) argued that the refund was a commercial tort claim excluded from the sale transaction.

The bankruptcy court granted summary judgment to the buyer because the Mississippi Supreme Court decision appeared to rely on “non-tort” grounds for requiring the refund which made the amount payable a general intangible acquired by the buyer. Specifically, it stated:

The Court holds that the Mississippi Supreme Court’s findings related to constitutional violations were not necessary to its holding that the overpayments be returned to the ratepayers because it had already ordered repayment before undertaking a constitutional analysis. The Mississippi Supreme Court ordered repayment based on its examination of whether the Commission acted in a statutorily impermissible manner.

The bankruptcy court then went on to hold that the refund was a general intangible acquired by the buyer, disagreeing with a Committee argument that general intangibles do not include claims that require “court action.”

This holding underscores the perils of limiting any contract rights to just “commercial tort claims.” Parties negotiating a contract, including a security agreement, including any litigation claims need to be much more careful in describing what is included and excluded. Here’s why.

What is a commercial tort claim. UCC 9-102 (13) defines a “commercial tort claim” as:

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.

The problem with this definition is that it does not define what is a “tort.” Neither do the Official Comments. Nor is it clear under any other generally applicable law. The Restatement (Second) of Torts § 6 does not define the word “tort” per se, but defines “tortious conduct” as follows:

The word “tortious” is used throughout the Restatement of this Subject to denote the fact that conduct whether of act or omission is of such a character as to subject the actor to liability under the principles of the law of Torts.

The comment to this section explains that it is intended to apply to intentional acts and negligent acts, and also to “conduct which is carried on at the risk that the actor shall be subject to liability for harm caused thereby, although no such harm is intended and the harm cannot be prevented by any precautions or care which it is practicable to require.” A review of the cases citing this provision of the Restatement reveals a wide variety of fact patterns that are and are not considered to be “tortious conduct.”

This problem of defining a “tort” is compounded by the fact that most lawsuits involve multiple claims for liability based on a common set of facts, and these claims often change during the course of a case as the evidence is developed. Even then, the claims can get jumbled in jury verdicts and court rulings. Accordingly, any particular lawsuit likely involves some “tort” claims but also some “non-tort” claims, and it may be difficult if not impossible to determine whether a settlement or judgment is entirely or even partially attributable to either.

The Mississippi Phosphates case is a great example of this. The Committee argued the case was decided on “constitutional tort” grounds, but the bankruptcy court held that was dicta and the actual holding involved “whether the Commission acted in a statutorily impermissible manner.” However, the court did not discuss whether acting in a “statutorily impermissible manner” is a tort because the Committee apparently limited its argument to just the concept of a “constitutional tort.”

Commercial tort claims under Article 9: further complexities. Even if the parties are able to identify a clear commercial tort claim, the provisions of Article 9 make it difficult to sort out who has what rights in it. UCC 9-109 (d)(9) excludes from Article 9 “an assignment of a right represented by a judgment, other than a judgment taken on a right to payment that was collateral.” So, if a commercial tort claim is reduced to a judgment, and then is assigned, Article 9 arguably does not apply. Adding more confusion is § 9-109(d)(12), which excludes from Article 9 “an assignment of a claim arising in tort, other than a commercial tort claim, but Sections 9-315 and 9-322 apply with respect to proceeds and priorities in proceeds.” This appears to make personal injury tort claims of individuals subject to Article 9 to the extent the claim is proceeds of other collateral.

These exclusions from Article 9 reflect a tension with other laws applicable to judgments and tort claims, often involving subrogation claims by insurance companies and other parties. Prior to the 2001 amendments to the UCC, all tort claims were excluded from Article 9. See § 9-109, comment 15. The amendments in 2001 appear to represent a limited “first effort” at having Article 9 apply to commercial tort claims.

Further complicating the treatment of commercial tort claims under Article 9 are the differences among treating commercial tort claims as original collateral, after-acquired property, and proceeds. The only way to take a security interest in a commercial tort claim as original collateral is
through a reasonable description other than a type of collateral defined in the UCC. See § 9-108(a)(1). For example, the Official Comments to § 9-108 of the UCC state that “a description such as ‘all tort claims arising out of the explosion of debtor’s factory’ would suffice, even if the exact amount of the claim, the theory on which it may be based, and the identity of the tortfeasor(s) are not described.” UCC § 9-108, comment 5.

A related provision is UCC § 9-204(b)(2) which prohibits attachment of a security interest to an after-acquired commercial tort claim. The combination of §§ 9-108 and 9-204 of the UCC requires secured parties to take a security interest in commercial tort claims as original collateral one at a time only after the claim arises. It is not possible to take a security interest in something as simple as “all present and future commercial tort claims.”

The proceeds problem. More complications arise when the commercial tort claim in question is proceeds of other original collateral. The UCC makes it clear that “[a] security interest in a tort claim also may exist under this Article if the claim is proceeds of other collateral.” § 9-102, comment 5.g. The only limitation appears to be that the dollar amount of any security interest in a commercial tort claim as proceeds of other collateral is limited “to the extent of the value of [the other] collateral.” UCC § 9-102(a)(64)(D).

This can cause any secured party with any security interest in any kind of collateral to also have a security interest in a commercial tort claim, to the extent a court determines that the commercial tort claim is “proceeds” of the other collateral, but only “to the extent of the value of [the other] collateral.” So, for example, a secured party with a security interest in $500,000 worth of inventory that gets damaged in a fire caused by someone’s intentional or negligent act which results in a judgment for $1 million should have a security interest in the “commercial tort claim” for the intentional or negligent act to the extent of the $500,000 value of the inventory that was damaged. The remainder of the judgment is not “proceeds” of the original collateral, but may be picked up as after-acquired property for a security interest in general intangibles.

The complexity of this proceeds angle on commercial tort claims becomes more clear when you consider the typical life-cycle of a commercial tort claim. Consider the inventory damaged in the fire referenced in the previous paragraph. Immediately after the fire, the debtor has a commercial tort claim against the tortfeasor and a third party can take a security interest in that commercial tort claim as original collateral, subject to any pre-existing security interest in the inventory, to the extent of the value of that inventory. That commercial tort claim then will become the subject of a lawsuit that should result in either a settlement or a judgment. If there is a settlement, there probably is a contract that becomes a general intangible subject to any pre-existing security interest in general intangibles. Alternatively, the commercial tort claim can become a judgment subject to assignment which is excluded from the UCC as noted above.

What strategies should contract parties (including secured parties) use for commercial tort claims?

“Parties who are contemplating attributing any material value to anything that might be considered a commercial tort claim should use words other than “commercial tort claim” to describe what they are trying to do. For example, in the Mississippi Phosphates case, we strongly suspect the Unsecured Creditors Committee intended to keep litigation claims unaffiliated with ongoing business operations, while the buyer was simply trying to acquire litigation claims integrally related to ongoing operations. So, for example, we suspect the Committee intended to keep litigation claims like this electricity refund lawsuit because it did not affect the ongoing operation of the business. On the other hand, if the electricity refund law suit might have resulted in a future rate reduction instead of a lump-sum rebate, the buyer very well may have wanted to acquire the right to the future rate reduction. So the parties could have easily put a provision in the contract describing the lawsuit and stating any cash refund is excluded from the sale, and any rate relief or other ongoing business benefit is included in the sale.

“In addition, parties contemplating taking a commercial tort claim as original collateral need to focus on two things. First, they need to research other security interests or liens that may attach to the very same commercial tort claim as proceeds of other collateral. If any such potential security interests or liens exist, they should be addressed through inter-creditor agreements. Even if no such pre-existing claims exist, a party seeking to acquire a security interest in a commercial tort claim as original collateral would be well advised to include in its security agreement all non-tort claims related to the commercial tort claim. This should eliminate the need for determining whether or not the money at the end of the process was the result of a tort claim or some other claim.

“Finally, any party interested in obtaining a security interest in a commercial tort claim as original collateral would be well advised as to research relevant law on assignment of judgments and tort claims in the jurisdiction in question. The secured party itself may want to record some kind of an assignment of any such judgment, and verify to the extent possible what other assignments exist, if any.
TRIBAL PAYDAY LENDING ENTITIES SUFFER SETBACKS

Two important decisions—one from the California Supreme Court and one from the Ninth Circuit—have put big dents in tribal payday lending programs and could have far-ranging consequences for tribal sovereign immunity.

First, at the end of December, the California Supreme Court ruled that lending entities associated with two tribes were not entitled to sovereign immunity as arms of their affiliated tribes. See People ex rel. Owen v. Miami Nation Enters., 386 P.3d 357 (Cal. 2016). Then, a month later, the Ninth Circuit affirmed the right of the Consumer Financial Protection Bureau to issue civil investigative demands (CIDs) on Native American tribes under the Consumer Financial Protection Act of 2010, a component of Dodd-Frank. See Consumer Fin. Prot. Bureau v. Great Plains Lending, LLC, 2017 U.S. App. LEXIS 1028 (9th Cir. Cal. Jan. 20, 2017).

A brief overview of tribal lending entities. In the past decade, a number of tribes have created entities to provide payday and other short-term lending services to customers. Typically, these lending entities have been formed under tribal law with express statements that they are to share in the tribe’s sovereign immunity. Some or all of the entities’ operations may occur on reservations or other tribal lands, although lending services are offered to the general public, often over the internet.

Frequently, the tribal lending entities partner with non-tribal entities to obtain the capital used in the enterprise. Call center and other operational and management functions may also be outsourced to various partner entities formed under state law. One consequence of these arrangements is that the tribal entities—which are ostensibly formed to generate revenue for the tribes—may only receive a small portion of the lending operation revenue via a royalty-like payment.

If the tribal lending entities successfully partake of tribal sovereign immunity, they are exempt from state usury and consumer protection laws and possibly certain federal laws and regulations that apply to non-tribal entities. (This is the case because states lack jurisdiction in Indian country, and, as “domestic dependent nations,” tribes are subject to plenary control by Congress, which can waive tribal immunity, so long as it expresses the intention to do so clearly.) Indeed, some tribal lending entities formed in response to state legislation, such as the 2003 California Deferred Deposit Transaction Law, which specifically target payday and other small-dollar lending services.

California weighs in on what constitutes an “arm of the tribe.” In the Miami Nation case, the California Supreme Court confronted head-on the issue of what is required for a tribally affiliated entity to be considered an “arm of the tribe” and thus immune from suit. The court’s lengthy opinion provides a detailed synopsis of tribal sovereign immunity. The court concludes its summary by noting the tension in the case law between tribal immunity as a fundamental foundation of tribal self-governance, and concerns that extending tribal immunity to off-reservation commercial activity does little to further self-governance but creates “inequities” as a result of the loss of state-law protections. One way to balance these concerns is to carefully scrutinize which entities are acting as arms of the tribe. Since the California Supreme Court had not previously articulated a test for determining whether tribal-affiliated entities constituted arms of the tribe, it next reviewed the tests applied by various states and federal circuits.

Some states, like New York and California, focus almost exclusively upon the financial relationship between the tribe and the entity: If a suit against the entity can put tribal funds at risk, then immunity applies. Tests like these tilt the scales against a finding of immunity. In contrast, states such as Colorado and Washington apply more formalistic tests that focus more upon how the entities were created and how they are owned and operated. A finding of immunity is more likely under these tests.

California’s new arm-of-the-tribe test. Ultimately, the court adopted a slightly modified version of the test first announced by the Tenth Circuit and recently adopted by the Ninth Circuit. See Breakthrough Mgmt. Group, Inc. v. Chukchansi Gold Casino & Resort, 629 F.3d 1173 (10th Cit. 2010). California’s modified Breakthrough test analyzes five factors:

- **Method of creation:** Formation of the entity under tribal law weighs in favor of immunity; formation under state law weighs against.
- **Tribal intent:** Tribal ordinances or articles of incorporation that don’t express an intent to extend immunity to the entity cut against finding immunity.
- **Purpose:** The stated purpose and the actual purpose served by the entity reveal whether the entity furthers the tribe’s goals of self-governance. The stated and actual purpose need not be purely governmental to support a finding of immunity.
- **Control:** “Evidence that the tribe actively directs or oversees the operation of the entity weighs in favor of immunity; evidence that the tribe is a passive owner, neglects its governance roles, or otherwise exercises little or no control or oversight weighs against immunity.”
- **Financial relationship:** Tribal liability for an entity’s actions and the receipt of a significant portion of the entity’s revenues both support a finding of immunity.

The court emphasized that none of the factors alone is dispositive and that “[e]ach case will call for fact-specific inquiry into all the factors.” The burden of proving that an entity is
an arm of the tribe falls to the entity asserting immunity and must be proven by a preponderance of the evidence.

On the facts in the record before it—which included the tribal entities partnering with an individual who, along with his affiliated entities, recently received a $1.3 billion judgment for violating federal lending laws—the court found that none of the payday lending entities before it qualified for immunity and thus could be subject to suit for making loans without a license, issuing loans in excess of the statutory maximum, charging unlawful fees, and failing to follow desist orders. The court did leave open the possibility that on remand the entities might have the opportunity to develop evidence that could change the analysis.

The CFPB case. When the activities of several tribal lending entities formed by the Chippewa Cree, Tunica Biloxi, and Otoe Missouria Tribes came to the CFPB’s attention, it commenced an investigation “to determine whether small-dollar online lenders or other unnamed persons have engaged or are engaging in unlawful acts or practices relating to the advertising, marketing, provision or collection of small-dollar loan products.” The CFPB believes that the entities may have violated Dodd-Frank, TILA, EFTA, and Gramm-Leach-Bliley Act provisions.

The tribes, which had established their own regulatory frameworks to oversee the tribal lending entities’ operations, instructed the entities not to respond to the CFPB’s CIDs and asserted that the CFPB lacked jurisdiction over the entities. The tribes offered to cooperate with the CFPB as co-regulators of the entities, but the CFPB rejected this invitation and initiated suit.

Tribes not excluded by the statute’s definitions. The tribes’ primary argument was that the Consumer Financial Protection Act authorizes the CFPB to direct CIDs to “persons” and that the tribes are “states” rather than “persons” under the law. The Act defines a “person” as “an individual, partnership, company, corporation, association (incorporated or unincorporated), trust, estate, cooperative, organization, or other entity.” The definition of “State” includes states, territories, other U.S. possessions and “any federally recognized Indian Tribe, as defined by the Secretary of the Interior.”

The tribes argued that the inclusion of tribes in the definition of “State” but not in the definition of “person” demonstrated that the investigative powers of the CFPB were not intended to apply to tribes. They pointed to the Supreme Court’s decision in Vermont Agency of Natural Resources v. United States ex rel. Stevens, 529 U.S. 765 (2000), which holds that the statutory term “person” generally excludes sovereign entities such as states and tribes. While the Ninth Circuit acknowledged that “the Tribal Lending Entities make some appealing arguments,” it relied on its own authority and rejected the definitional argument stating that the tribes “read[,] far too much into a simple definition.” Since the definition of “person” does not expressly exclude tribes, the Ninth Circuit believed that the generally applicable law applies to them.

There’s certainly room to quibble with the Ninth Circuit’s holding. Given the Stevens decision and the fact that none of the terms in the definition of “person” encompasses a tribe (surely an “other entity” is not broad enough to encompass a tribe), perhaps the question should be whether tribes have been included, not excluded, and whether characterizing the law as one of general applicability is correct or sufficient. If Congress is presumed to legislate with knowledge of the Supreme Court’s rulings and the Act’s definition of “person” does not include any term that seems to encompass tribes, what is the basis for finding that tribes are “persons” under the statute?

Finally, the Ninth Circuit relied upon the fact that the tribe’s jurisdictional challenge was reviewed under a “plainly lacked jurisdiction” challenge, repeatedly emphasizing that it was affirming the district court “at this stage of the proceedings.” The court seemed to leave open the possibility that later proceedings could result in a different outcome. While it’s not clear why further litigation might change the court’s analysis under the Act—unless, of course, it were to determine that the entities in question don’t qualify as arms of the tribe, mooting the issue—it will be interesting to see how further proceedings unfold and whether the tribes ultimately seek a writ of certiorari.

Some parting thoughts:

- These two cases are only two of many involving Tribal lending. But the Breakthrough test appears to be gaining momentum, with several circuits and California now applying some version of it. This probably represents a decent outcome for tribes since it avoids the strict approach taken by some jurisdictions and leaves tribes with room to reasonably structure commercial operations that can partake in sovereign immunity. The big drawback to the Breakthrough test for tribes is that the burden rests with the tribal entity and the analysis is fact-intensive. Proving in court that sovereign immunity should apply will be expensive. Such fact-specific tests also provide ample discretion to courts already suspicious of high-interest moneylenders.

- Payday lenders—like Rodney Dangerfield and debt collectors—get no respect. Tribes, which time and again have had to fight hard to protect their sovereign status, invite heightened scrutiny and legal attacks on sovereign immunity through aggressive internet payday lending. Although the California Supreme Court emphasized that its “immunity analysis d[id] not rest on the merits or ethics of deferred lending as a means of tribal economic development” (despite an invitation from California and amici to consider the allegedly pernicious impacts caused by payday lenders), bad facts often lead
to bad law. Exercising legitimate sovereignty through payday lending risks harming tribal autonomy and regulatory authority in other, more important areas.

- Gaming provides a strong analog for tribal regulation of lending. Tribes, as the primary regulators of Indian gaming, have decades of experience overseeing one of the most highly regulated, technical industries in the United States. True cohesive tribal regulation of money lending in Indian country is no far reach for the same governments who have grown gaming to a $30 billion industry. But hands-off regulation of lending by the same governmental components that stand to gain from the business will not stand up to fact-intensive scrutiny by courts.

- The Breakthrough test offers a good baseline roadmap for maintaining immunity. But tribal best practices are not complicated. As Supreme Court nominee Judge Neal Gorsuch wrote in his concurrence in Somerlott v. Cherokee Nation Distributors, Inc., 686 F.3d 1144, 1154 (10th Cir. 2012), “[s]ometimes the solution to a problem comes clear by stating it. [The Cherokee Nation’s LLC] wants sovereign immunity. But [it] is in the business of manipulating spines for profit.” Id. at 1154. In other words, if an entity does not seem like it should have sovereign immunity, it probably doesn’t. In analyzing cases where, for instance, a tribe uses state law to incorporate, Judge Gorsuch wrote, “We can easily tell whether an entity like that is legally separate and distinct from the tribe[.]” Again, Breakthrough provides a minimum. But the more prudent approach is for tribes to not partner with existing non-Indian lenders, actually operate and own their own lending entities, and regulate those entities in a manner that exceeds even state and federal guidelines. Now is the time for tribal lending entities and their partners to re-evaluate their structure, governance, and operation.

- In the Miami Nation case, the California Supreme Court found that the Tribe lacked control over the lending entity because for years the Tribe was embroiled in a governance dispute. If governance disputes, which are increasingly common among California tribes, can flip the “control” prong of the California test, many tribal entities—not merely lending entities—risk losing sovereign immunity.

### FACTOR OF RECEIVABLES FAILED TO GIVE ADEQUATE NOTICE OF ASSIGNMENT TO ACCOUNT DEBTOR

Codifying basic contract assignment principles, UCC 9-406 (a) provides:

An account debtor on an account, chattel paper, or a payment intangible may discharge its obligation by paying the assignor until, but not after, the account debtor receives a notification, authenticated by the assignor or the assignee, that the amount due or to become due has been assigned and that payment is to be made to the assignee. After receipt of the notification, the account debtor may discharge its obligation by paying the assignee and may not discharge the obligation by paying the assignor.

Under these rules, if a factor of receivables (or a secured lender who claims a security interest in the receivables) wants to make sure that it obtains funds owing by the account debtor to the assignor, it must send a “deflection notice” to the account debtor. Failure to send such a notice frees the account debtor to make payment to the assignor; conversely, if the account debtor ignores the deflection notice and pays the assignor, the factor can force the account debtor to pay a second time. This rule has generated a fair amount of litigation. A recent case from Washington nicely illustrates how a factor can lose out by failing to send a sufficiently precise deflection notice to the account debtor.

The Washington case. In Northwest Business Finance, LLC v. Able Contractor, Inc., 383 P.3d 1074, 91 UCC Rep. 2d 1 (Wash. App. 2016), Northwest was a factoring company in the business of buying receivables, at a discount, from various businesses. One of Northwest’s customers was Able, a subcontractor who would be owed progress payments by the general contractor (Western) in connection with a particular construction project. Applying UCC terminology, Northwest was the assignee, Able was the assignor, and Western was the account debtor.

In 2007, Able executed an “assignment of proceeds notification agreement,” naming Northwest as the assignee of all account payments due to Able. The notification indicated that Able had “sold and assigned the proceeds of accounts” to Northwest and instructed its customers to remit future payments due Able directly to Northwest. Able then provided notice of this assignment to its customers on invoices factored by Northwest. A UCC financing statement was filed in 2007; it provided that all receivables were collateral for Northwest loans to Able. In 2010 Able began factoring some of its accounts with Western. Western would pay Able or Northwest, depending on whether the invoice from Able carried a sticker requiring that it be paid to Northwest. The
assignment sticker stated that “this account” had been assigned to Northwest and that the invoice number accompanied payment in order to ensure correct credit.

In 2012, Able agreed to perform work for Western on the “Tumwater” construction project. As part of the project, Able factored an invoice with Northwest, the first of five such invoices for the project. Northwest paid Able a total of $160,000 and sent each invoice to Western with the notice of assignment attached. Independent of these invoices, Able also submitted four other invoices to Western for payment on the Tumwater project. One of the invoices contained the assignment notice and was paid to Northwest. However, the other three invoices, totaling $81,000, lacked the assignment notice and Western paid the money directly to Able. Later, Able fell into default on any part of the Tumwater project need to be paid to Northwestern. Rather, the documents and course of dealing reasonably could lead Western to understand the notices given to it as requiring payment to either Northwest or Able on a case-by-case basis depending on the directions given it. Whether Northwest had reasonably identified the accounts assigned to it presented a question for the trier of fact to resolve at trial.

So the appellate court affirmed the trial court’s verdict against the factor and protected the assignor from double payment.

**Deflection notice was inadequate.** In its lawsuit, Northwest alleged that the earlier invoice assignment notices, coupled with its broad financing statement covering all accounts owing Able, “were notice to Western and the world that no sums could be paid directly to Able,” which satisfied the requirements of UCC 9-406. The Washington court rejected this argument. It concluded that UCC 9-406(b) lists the circumstances in which notification is ineffective. It includes circumstances where the notification “does not reasonably identify the rights assigned.” In the court’s view, a general notification was insufficiently specific to satisfy the statute. The court concluded that UCC 9-406 required notice that each identified account receivable had to be assigned before the account debtor had the obligation to deflect to the assignee the amount owed on the receivable. The court summed up its view of the matter:

In particular, the stickers attached to the factored account invoices expressly told Western that “this account” had been assigned and that payment should reference the invoice number in order to receive proper credit. It thus suggested that only the specific invoice had been assigned. Western was never told that all of the payments owed Able on the Tumwater project need to be paid to Northwestern. Rather, the documents and course of dealing reasonably could lead Western to understand the notices given to it as requiring payment to either Northwest or Able on a case-by-case basis depending on the directions given it. Whether Northwest had reasonably identified the accounts assigned to it presented a question for the trier of fact to resolve at trial.

**Three parting thoughts:**

“The big takeaway from the Washington case is the need for a factor (or a lender with a traditional security interest) to use clear and consistent language in its deflection notices. The factor in the Washington case got just a little sloppy.

“For a detailed analysis of UCC 9-406, the account debtor’s risk of double liability, and the substantial case law in the area, see Clark & Clark, *The Law of Secured Transactions Under the UCC*, § 11.03.

*In a footnote, the court stated: “We are not saying there can never be a blanket claim for all amounts owed by a particular [account debtor] to the assignor, but the assignment will need a more specific statement than claiming all accounts owed by anyone to the debtor.”*
CFPB WILL IMPOSE NEW LIMITS ON DEBT COLLECTION

In recent months, the CFPB has come out with three especially important initiatives. In May it proposed a rule to prohibit mandatory arbitration/class-action waiver provisions in consumer financial services contracts. In June it proposed tighter rules to regulate payday lending, limiting rollovers and imposing new due diligence requirements. Most recently, on July 29, the CFPB outlined proposals to overhaul the rules governing consumer debt collection practices; the last overhaul was 40 years ago.


Perhaps the most important point about the FDCPA is that it does not cover creditors (such as banks) seeking to collect debts that they have originated or taken by assignment, e.g., a car loan assigned by a dealer. Instead, the statute is aimed primarily at collection agencies and other third parties who seek to collect debts in default for the creditors that originated them or took them by assignment. Here are the present statutory rules in a nutshell:

Limits on communications. The FDCPA places strict limits on communications by the debt collector with the consumer and with third parties:

• Without consent of the consumer or a court order, the debt collector may not communicate with the consumer at any “unusual” or “inconvenient” time or place.
• The debt collector can’t communicate directly with the consumer if it knows that the consumer is represented by an attorney.
• No communications may be made at the debtor’s place of employment if the collector knows or has reason to know that the employer prohibits such contact.
• Without consent of the consumer or a court order, the debt collector can’t communicate directly with the consumer if it knows that the consumer is represented by an attorney.
• No communications may be made at the debtor’s place of employment if the collector knows or has reason to know that the employer prohibits such contact.
• Without consent of the consumer or a court order, the debt collector can’t communicate with any person other than the consumer, his attorney, a credit reporting agency, the creditor, or the attorney for the creditor.
• Communication with the debtor must stop if the consumer notifies the collector in writing that he refuses to pay the debt or wishes to cease further communications. Upon such notification, the debt collector can then respond that it may invoke remedies such as bringing suit on the debt.

Acquisition of location information. The federal statute imposes limits on skip-tracing. The purpose of the rule is to keep skip-tracing as “neutral” as possible. To that end, any debt collector seeking location information must state that it is confirming or correcting location information concerning the consumer, but not state that the consumer owes any debt, or that he is in the debt collection business.

Harassment or abuse. The FDCPA sets forth a non-exclusive laundry list of prohibited conduct that tends to harass, oppress or abuse consumer debtors:
• The use or threat of violence
• The use of obscene or abusive language
• Publication of “deadbeat lists” except to a credit bureau
• The advertisement for sale of any debt to coerce payment
• Abusive phone behavior, such as calls without meaningful disclosure of the caller’s identity.

False or misleading representations. The FDCPA prohibits a variety of misrepresentations such as:
• The implication that the debt collector is a government official or attorney
• The false representation that nonpayment will result in arrest or prison, or that sale of the debt will cause the consumer to lose any claim or defense
• The threat to take any action that can’t legally be taken.

Validation of debts. The FDCPA sets forth rules on validating debts. Within five days after the initial communication with a consumer, the debt collector must send the consumer a written notice of the amount of the debt; the name of the creditor; a statement that the debt will be assumed to be valid unless the consumer disputes its validity within 30 days; a statement that if the consumer disputes the debt within the 30-day period, the debt collection will obtain verification of the debt; and a statement that, on the consumer’s written request within the 30-day period, the debt collector will provide the consumer with the name and address of the original creditor, if different from the current creditor.

If the consumer notifies the debt collector in writing that the debt is disputed, the collector must cease collection until it obtains verification of the debt.

Civil liability. The civil liability provisions of the federal statute are modeled on those in the Truth in Lending Act. They include actual damages plus minimum civil penalties and reasonable attorney’s fees. There are ceilings on class-action recoveries. The debt collector is off the hook if it can show “that the violation was not intentional and resulted from a bona fide error notwithstanding the maintenance of procedures reasonably adapted to avoid any such error.”

Administrative enforcement of the FDCPA is generally handled by the Federal Trade Commission. Although the bank regulators enforce compliance for financial institutions, this compliance activity is limited insofar as most banks and other financial institutions are exempt from the FDCPA as original creditors.

CFPB weighs in. In its July 28 press release, the CFPB notes that debt collection is a huge compliance issue; it is a $13.7 billion industry that affects about 70 million consumers. It estimates that there are more than 6,000 debt collection firms in the country. According to a recent CFPB study, about one in three consumers had been contacted by a creditor or collector trying to collect a debt within the past year. Most consumers who had been contacted reported attempts to collect payment on between two and four debts. And one-third of consumers who had been contacted about a debt in the last year reported an attempt to collect in the wrong amount.

The press release reports that “[d]ebt collection generates more complaints to the CFPB than any other financial product or service. [In 2015, the CFPB received 85,200 complaints about debt collection.] The most common complaints are about collectors seeking to collect debt from the wrong consumer, for the wrong amount, or debt that could not be legally enforced [because of a statute of limitations]....The Bureau’s proposals under consideration would overhaul debt collections from when third-party collectors first examine their portfolios of debt to their last attempts to collect.” The Dodd-Frank Act makes the CFPB the first agency with the power to issue substantive rules under the statute.

Six key compliance requirements that the CFPB is highlighting. The CFPB press release identifies six compliance issues that it will target in its rule-making. We are quoting these guidelines in full:

* Collect the correct debt: Collectors would have to scrub their files and substantiate the debt before contacting consumers. For example, collectors would have to confirm that they have sufficient information to start collection, such as the full name, last known address, last known telephone number, account number, date of default, amount owed at default, and the date and amount of any payment or credit applied after default.

* Limit excessive or disruptive communications: Collectors would be limited to six communication attempts per week through any point of contact before they have reached the consumer. In addition, if a consumer wants to stop specific ways collectors are contacting them, for example on a particular phone line, while they are at work, or during certain hours, it would be easier for a consumer to do that. The CFPB is also considering proposing a 30-day waiting period after a consumer has passed away during which collectors would be prohibited from communicating with certain parties, like surviving spouses.

* Make debt details clear and disputes easy: Collectors would be required to include more specific information about the debt in the initial collection notices sent to consumers. This information would include the consumer’s federal rights. They would have to disclose to consumer, when applicable, that the debt is too old for a lawsuit, based on a statute of limitations. The proposal
under consideration would also add a “tear-off” portion to the notice that consumers could send back to the collector to easily dispute the debt, with options for why the consumer thinks the collector’s demand is wrong. The tear-off would allow consumers to pay the debt. The consumer could also verbally question the debt’s validity at any time, and prompt the collector to have to check its files again.

*Document debt on demand for disputes:* If the tear-off sheet or any written notice is sent back within 30 days of the initial collection notice, the collector would have to provide a debt report—written information substantiating the debt—back to the consumer. The collector could not continue to pursue the debt until the report and verification are sent.

*Stop collecting or suing for debt without proper documentation:* If a consumer disputes—in any way—the validity of the debt, collectors would have to stop collections until the necessary documentation is checked. Collecting on debt that lacks sufficient evidence would be prohibited. In addition, collectors that come across any specific warning signs that the information is inaccurate or incomplete would not be able to collect until they resolve the problem. Warning signs could include a portfolio with high rate of disputes or the inability to obtain underlying documents to respond to specific disputes.

Collectors would also be required to check documentation of a debt before pursuing action against a consumer in court. For example, collectors would have to review evidence of the amount of principal, interest, or fees billed, and the date and amount of each payment made after default.

*Stop burying the dispute:* If a debt collector transfers debt without responding to disputes, the next collector could not try to collect until the dispute is resolved. The proposals under consideration also outline information that collectors would have to send when they transfer the debt to another collector so that a consumer does not have to resubmit this information to the new collector.

**Some parting thoughts about the CFPB’s initiative on debt collection:**

- With respect to most consumer protection proposals put forth by the CFPB, including arbitration clauses and payday lending, the response from the affected industry is negative. But debt collection is another story. In recent years, we have witnessed a huge outpouring of litigation involving the 1977 federal statute. A consensus has developed that what the debt collection industry needs is clarity and predictability. Uniform rules enacted by the CFPB can counter the hodge-podge of judicial decisions in different states interpreting the FDCPA.

To the extent that the CFPB has brought enforcement actions involving debt collection and then told the industry to comply by “watching” those enforcement actions, a new set of uniform rules will avoid this “regulation through enforcement” approach. The debt collection industry was pleased with the decision of the CFPB to reject the position of many consumer advocates that non-litigation collection of debt barred by the statute of limitations should be absolutely prohibited. For these reasons, and because the debt collection industry has had substantial input on the proposal, debt collectors seem “cautiously supportive” of the new initiative.

- The banking industry has always taken comfort in the fact that debt collection by the original creditor is outside the scope of the 1977 federal statute. Although the proposal released on July 28 continues that important exemption, The CFPB is working on two tracks. The American Banker reports that, at sometime in the near future, the Bureau will be outlining a second proposal that will affect banks, credit card issuers and other first-party creditors not subject to the FDCPA. The expectation of many in the banking industry is that the CFPB will require that banks certify the accuracy of information on debt given to third parties, which will increase due diligence costs for the banking industry.

- The CFPB rulemaking process for debt collection will take a long time, particularly because of the two tracks taken by the Bureau. Additional background material provided by the CFPB includes a 71-page “Outline of Proposals under Consideration and Alternatives Considered.”

- Debt collectors would do well to review the six compliance guidelines provided in the July 28 press release and implement these as “best practices” going forward.

**FIFTH CIRCUIT RULES THAT PRODUCTION-MONEY SECURITY INTEREST IN CROPS TRUMPS SETOFF RIGHTS OF BUYER**

For a supplier that finances crop inputs, it is tough to get priority over a competing bank that has a blanket security interest in all the debtor’s crops and proceeds. The general rule of Revised Article 9 is that you can’t retain a purchase money security interest in crop inputs like seed and fertilizer, and have that priority carry over to the growing crops. The blanket lienor against the crops will have priority under the first-to-file rule. In the absence of a subordination agreement, the supplier of crop production inputs is forced to extend credit on an unsecured basis.

Super-priority given to production-money security interests. Some states have shown sympathy for the crop input supplier by enacting an optional provision in Revised
Article 9 that recognizes a new type of consensual security interest called a “production money security interest.” This security interest is akin to a purchase money security interest in inventory. If the supplier jumps through the right hoops, by giving “new value” to the debtor, filing a financing statement before the inputs are delivered, and giving pre-notification to prior UCC filers, it will have priority over the blanket lienor who filed first. That’s the good news for crop input financiers. The bad news is that only a handful of states (Maine, Mississippi, North Carolina and West Virginia) have enacted the optional provision in Revised Article 9.

A recent decision from the Fifth Circuit, applying Mississippi law, nicely illustrates the power of the production-money security interest. The interesting twist in the case is that the input financier was not in competition with a prior blanket financer of the crops, but with a buyer of the debtor’s crop who sought to defeat the production-money security interest by exercising setoff of the purchase price he owed to the debtor. The fact that the secured lender complied with the requirements of the federal Food Security Act by filing an “effective” financing statement under federal law along with its financing statement under Revised Article 9, gave victory to the secured lender.

The Fifth Circuit case. In Guaranty Bank & Trust Co. v. Agrex, Inc., 820 F.3d 790, 86 UCC Rep.2d 724 (5th Cir. 4/28/16), Murtaugh-Walker Farms (Walker) entered into a series of commodity futures contracts with a buyer, FGDI. The contracts required Walker to deliver defined amounts of corn and soybeans at agreed-upon prices within a specific range of months. Additional futures contracts were entered into in 2011 and 2012.

Walker needed production financing for his 2012 soybean and corn crops. He met with Guaranty Bank to execute a loan secured by the crops. He signed a loan and security agreement covering not only the upcoming 2012 crops, but also other farm products and equipment. The line of credit was in the amount of $600,000, of which he drew over $400,000 to finance his 2012 crop production. The bank filed a UCC financing statement with the Mississippi secretary of state, gave notice to prior filers, and otherwise complied with the requirements of Revised Article 9 for production-money security interests in the 2012 soybean and corn crops.

At the end of the 2012 growing season, Walker delivered all of his corn and soybeans to two grain elevators in Mississippi. FGDI notified the elevators of its contracts with Walker, and the elevators applied the delivered crops to FGDI’s account, after which FGDI sold the grain to the elevators. Walker fulfilled the corn contracts but was unable to fulfill the soybean contract. As a result, FGDI summed up the amounts due Walker and exercised setoff against the amount it owed Walker as its estimated damages for the unfulfilled soybean contract. In early 2013, the bank demanded the proceeds of all Walker’s 2012 crops from FGDI on the ground that the bank’s production-money security interest, perfected by UCC filings, had priority to the soybean crop and its proceeds, which overrode the setoff. When FGDI refused to deliver the proceeds, the bank sued.

Production-money security interest trumps buyer’s exercise of setoff. FGDI based its priority to the crop proceeds on UCC 9-404, under which a security interest in “accounts” is subject to “all terms of the agreement” between the account debtor (FGDI) and the assignor (Walker). One of those terms was FGDI’s right to exercise setoff against Walker based on his failure to fulfill the soybean contract. The court noted, however, that this argument was based on the premise that the bank’s security interest attached to Walker’s “accounts.” The court concluded that the bank’s “paramount” interest was in Walker’s 2012 crops and crop proceeds:

Guaranty asserts, and FGDI does not dispute, that Guaranty followed the proper procedure and requirements to obtain a production-money security interest in David Walker’s 2012 crops and crop proceeds. Guaranty perfected its interest by filing an effective and appropriately descriptive financing statement with the Mississippi secretary of state, completed all the notification requirements, and provided funds to Walker to be used for the production of crops. These assertions are supported by deposition testimony and are undisputed by the parties. Production-money security interests are granted a higher priority over other secured interests, e.g., secured interests in accounts only, because the obligation incurred by the debtor, for the value given, is restricted to the production of crops.

The court also pointed to Mississippi UCC 9-103A(c), which provides that a production-money security interest does not lose that status even if the production-money crops also secure an obligation that is not production-money in nature, or the collateral that is not production-money crops also secure the production-money obligation.

Secured lender complies with federal Food Security Act, crop buyer doesn’t. The Fifth Circuit concluded that the super-priority in favor of the bank is broadly supported by the UCC rules in Mississippi. Regardless of the bank’s additional security interest in Walker’s “accounts,” its super-priority status as to the soybeans and their proceeds was “paramount to FGDI’s set-off interest which may have been created when Walker delivered his crops to the terminal.” Importantly, while the bank complied with the federal Food Security Act by filing an “effective” financing statement, FGDI failed to comply with the federal statute’s requirement that it register as a buyer. 7 U.S.C. 1631(e)(2). In the court’s view, compliance with both the Food Security Act and UCC filing requirements
insulated the bank from any attack by the buyer based on its right of setoff.

**UCC setoff rule simply doesn’t apply.** In ruling that the secured lender’s compliance with Article 9 and the Food Security Act negated any Article 9 setoff rights asserted by the crop buyer, the Fifth Circuit cited two key cases. In *Farm Credit Services of America, PCA v. Cargill, Inc.*, 750 F.3d 965 (8th Cir. 2014), the Eighth Circuit, applying Nebraska law, was faced with a fact-situation eerily similar to the case in Mississippi. The Nebraska crop buyer argued that the setoff right given to a crop buyer under UCC 9-404 gave it priority. But the court concluded that the secured lender had brought a replevin suit to recover the corn (or its proceeds), not to collect on an account receivable. So 9-404 simply didn’t apply. Instead, the secured lender’s compliance with the filing requirements of Article 9 and the Food Security Act was controlling. The Fifth Circuit also cited a Ninth Circuit decision, *United States v. Handy & Harman*, 750 F.2d 777 (9th Cir. 1984) (noting that UCC 9-404 does not apply when “the secured party’s superior property interest [is] in the inventory itself, not the assignment of the account held by the debtor”). By contrast, the South Dakota Supreme Court has ruled that, if the secured lender fails to comply with the filing requirements of the Food Security Act, the buyer’s setoff rights under UCC 9-404 will give priority to the buyer. *Consolidated Nutrition, L.C. v. IBP, Inc.*, 669 N.W.2d 126 (S.D. 2003).

**Secured lender awarded expanded damages.** Following the Eighth Circuit decision, the Fifth Circuit awarded damages to the secured lender in the full amount of the lender’s security interest in the “proceeds” of the crop sale. That amount was a hefty $417,033.

**Bottom line.** The big takeaway from these cases is the importance of the secured lender’s compliance with both the perfection rules of Article 9 (to protect against blanket secured lenders and the borrower’s trustee in bankruptcy) and the rules of the federal Food Security Act (to protect against the setoff claims of the crop buyer). The case also illustrates the importance of a production-money security interest in the few states that have enacted those nonuniform provisions of Article 9.

**TENNESSEE COURT WRESTLES WITH ARTICLE 9 DEFICIENCY AND SURPLUS CLAIMS FOLLOWING FORECLOSURE**

In a recent case from Tennessee, a secured lender disposed of an airplane in a private UCC sale, and then sued the guarantors for a deficiency. The problem was that the lender had failed to give notice of the sale to the guarantors. The court ruled that the lender had failed to satisfy its statutory burden of establishing that the giving of notice would have yielded a smaller amount than the outstanding secured obligation, together with attorney’s fees and expenses. As a result, the lender could not collect its deficiency claim against the guarantor under the “rebuttable presumption” rule of UCC 9-626.

That was the good news for the guarantors. The bad news was that the guarantors had no standing to recover any surplus from the foreclosure that might have existed had proper notice been given. In reaching its Solomonic decision, the court wrestles with a number of Article 9 foreclosure rules.

**The Tennessee case.** In *Regions Bank v. Thomas*, 2016 Tenn. App. LEXIS 289, 89 UCC Rep. 2d 660 (4/27/16), LGT Aviation, Inc. (LGT) obtained a commercial loan in 2004 from Union Planters Bank (now Regions) in the amount of $2.3 million. The loan documents were executed by Mr. Thomas D. Thomas, the president and sole shareholder of LGT. The proceeds of the loan were used to purchase a 1981 Hawker 700-A airplane. The loan to the corporation was guaranteed by Mr. Thomas, his wife, and a family trust. Although the loan documents required LGT to keep the aircraft fully insured “under a form of policy acceptable to the Bank,” the company inexplicably allowed the policy to lapse in 2006. In 2007, Regions’ counsel sent a letter to Mr. Thomas advising that failure to maintain insurance coverage for the plane constituted a non-payment default under the loan documents. When Mr. Thomas failed to respond to the bank’s demand, Regions accelerated the secured obligation and moved to foreclose.

In October 2007 Regions sued the guarantors on the debt. While the lawsuit was pending, the bank took steps to repossess the aircraft and remarket it for sale. The plane was subsequently located and repossessed. It was then sold at a private foreclosure sale for a purchase price of $875,000. (It was undisputed that LGT made all payments due on the loan until the aircraft was sold.) In 2009, the guarantors filed an answer and counterclaim. The trial court found that Regions had sold the airplane in a commercially reasonable manner and was entitled to a deficiency judgment in the amount of $1.2 million.

**The bank failed to give prior notice of the foreclosure sale.** On appeal, the Tennessee court of appeals reversed. It ruled that the bank had not adequately notified the guarantors of its intent to sell the airplane: “It did not notify the guarantors of a settled intent to dispose of the aircraft, of whether the aircraft would be sold by public or private sale, or on or after what date the sale would occur.” The guarantors did not even know of the repossession until after the sale. The court concluded that they had no opportunity to review marketing materials or to see that the sale brought a fair price. Nor were the guarantors given an opportunity to redeem the collateral prior to the private sale.
The appellate court stressed the importance of pre-sale notice under UCC 9-611 to 9-614:

[Secured] parties cannot ignore the potential effect that notice can have on their ultimate recovery. Indeed, it is entirely possible that secured parties can receive an amount greater than the fair market value of collateral if they adhere to the commercial code’s requirements regarding notice. 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.

The appellate court concluded that, if a secured party has failed to provide notice, it has the burden to show that the amount it would have realized through compliance is less than the unpaid balance of the debt.

Bank loses deficiency claim under “rebuttable presumption” rule. A bank seeking a deficiency judgment in a commercial case must satisfy a burden of establishing notice. The bank 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.

The appellate court concluded that, if a secured party has failed to provide notice, it has the burden to show that the amount it would have realized through compliance is less than the unpaid balance of the debt.

Guarantors get no surplus. Although the guarantors in the Tennessee case escaped liability for the bank’s deficiency following foreclosure, the court rejected their contention that they were entitled to recover a surplus that might have existed had the bank given proper notice of sale. On this point, the court turned to UCC 9-625(d), which provides: “A debtor whose deficiency is eliminated under Section 9-626 may recover damages for any loss of surplus.” The court ruled that the guarantors did not get the benefit of this provision because they did not qualify as “debtors” under Article 9. Under UCC 9-201(a)(28), the term “debtor” means (a) “a person having an interest, other than a security interest or other lien, in the collateral, whether or not the person is an obligor,” (b) “a seller of accounts, chattel paper, payment intangibles, or promissory notes,” or (c) “a consignee.”

The court ruled that the guarantors did not satisfy any of these definitions. Under Article 9, the “debtor” is the grantor of the security interest, i.e., the owner of the collateral.

The court explains: “When LGT obtained the underlying loan in this case, it also granted a security interest in the aircraft. Accordingly, it is the debtor of the secured transaction at issue, as its stake in the enforcement of the security interest is tied to its property interest in the aircraft.” By contrast, the guarantors meet the definition of “secondary obligors” under UCC 9-102(a)(72) because they have a right of recourse with respect to a secured obligation.

**Bottom line.** The Tennessee court gave something to both parties: the guarantors avoided liability for the deficiency, but the bank was not required to pay damages representing a lost surplus. Perhaps the biggest mystery in the case is why the bank totally ignored the pre-sale notice rules in Article 9, while the borrower totally ignored its duty to insure the collateral. The case also makes the important point that a secured lender under Article 9 has a duty to give pre-sale notice not only to the primary borrower, but also to all guarantors.

### UCC FORECLOSURES: COURTS CONTINUE TO ALLOW CREDIT BIDS AND DELAYS IN SALE OF COLLATERAL

In our prior story, we reported on a recent Tennessee decision illustrating some of the defenses that a borrower or guarantor can raise in connection with Article 9 foreclosure sales that lead to deficiency claims. Two additional decisions—one from Washington and the other from Oregon—deal with other defenses that arise in UCC foreclosures. In both Pacific Norwest cases, the secured lender came away victorious.

**The Washington case.** In 395Lampe, LLC v. Kawish, LLC, 2016 U.S. Dis. LEXIS 49878, 89 UCC Rep. 2d 460 (W.D. Wash. 2016), through various transactions between 2008 and 2010, the Prim Entities loaned approximately $30 million to the Blixseth Entities. To collateralize the loans, the lender retained a security interest in the borrowers’ one-third interest in Western Pacific Timber LLC, a company that once belonged to the Blixseth Entities. The secured lender held a public auction sale of the collateral after retaining Realty Marketing Northwest, Inc. (RMN) to market and sell the LLC interest. RMN initiated a public marketing campaign which included newspaper ads and direct marketing to 150 targeted prospects from its database. 48 catalogs were mailed to prospects who requested them. At least 15 prospective bidders signed the nondisclosure and confidentiality agreements allowing them access to the “data room.” On March 19, 2015, the secured lender purchased the collateral with a credit bid of just over $12 million. Prim was the only prospective bidder to submit a bid.
The Blixseth Entities contended that the foreclosure sale was commercially unreasonable under the standards of UCC 9-610. The court noted that a finding of commercial unreasonableness would not necessarily bar the lender from collecting a deficiency judgment in a non-consumer case, but would create a rebuttable presumption that the value of the collateral was at least equal to the amount of the outstanding debt. The burden of proving commercial reasonableness is on the secured party. In the present case, the Blixseth Entities challenged the sale on two grounds: (1) the lender’s use of a credit bid was commercially unreasonable and (2) the auction sale was unreasonably delayed.

**Credit bid was okay.** The Blixseth Entities contended that the disposition was not commercially reasonable because the Prim Entities were able to obtain a “control block” of the company’s equity through their credit bid, i.e., the playing field was uneven because the collateral was worth more to the credit bidder than it could be to unrelated third parties. The court rejected that argument. It found that numerous other courts have allowed credit bids, and that nothing in Article 9 forbids them. On this point, it cited *Sky Techs. LLC v. SAP AG*, 576 F.3d 1378 (Fed. Cir. 2009) (credit bid okay in public bid of patent rights); *In re Adobe Trucking, Inc.*, 2011 Bankr. LEXIS 4929, 76 UCC Rep.2d 365, 2011 Bankr. Lexis 4929 (Bankr. W.D. Tex 2011 (oil and gas equipment; court emphasizes that security agreement expressly contemplated credit bids); *Textron Fin. Corp. v. Vacation Charters, Ltd.*, 2012 U.S. Dist. LEXIS 31412, 77 UCC Rep.2d 6 (M.D. Pa. 3/8/2012). Absent some evidence that credit bidding was prohibited by agreement, or by dealers in a particular type of collateral, there was no reason to consider the practice be commercially unreasonable. In fact, the court found that it was a tool of great commercial utility. Moreover, in the present case, the $12 million bid by the Prim Entities was the same amount as the court had valued the property several years earlier.

The court also found that the credit bid was accompanied by other factors that made the sale commercially reasonable. Most important, the secured lender picked an expert in evaluation of lumber properties to facilitate the foreclosure sale. RMN was the largest Pacific Northwest based auction/marketing firm of its kind and had sold over $1.4 billion in real estate at auction. The expert fully advertised the sale in multiple national and regional outlets, solicited nearly 200 prospective bidders, and signed confidentiality agreements with 15 prospects. In fact, the only evidence presented was that the method chosen was “in conformity with reasonable commercial practices among dealers in timber assets and timber property,” thereby satisfying the requirements of UCC 9-627.

**Sale was not unreasonably delayed.** Comment 3 to UCC 9-610 warns that unreasonable delay can cause problems: “If a secured party does not proceed [with strict foreclosure under UCC 9-620] and holds collateral for a long period of time without disposing of it, and if there is no good reason for not making a prompt disposition, the secured party may be determined not to have acted in a ‘commercially reasonable’ manner.” The leading case finding that delay was unreasonable is *Solfinelli v. Corestates Bank, N.A.*, 203 F.3d 197 (3d Cir. 2000). The court noted, however, that “long periods of time may be commercially reasonable if the secured party had good reasons for delaying the disposition, especially when the delay did not result in any prejudice to the debtor or decline in value in the collateral.”

In the present case, the Blixseth Entities could point to no decline in value during the three-year holding period. In fact, there was evidence that the secured lender benefitted from the three-year delay in disposition; the collateral generated profits of $1.656 million during the holding period. Moreover, much of the delay in the disposition could be attributed to litigation brought by a third party against the secured lender. As the court put it: “In short, the Prim Entities have provided a clear and legitimate reason for their delay: litigation which frustrated their efforts to preserve their right to a deficiency judgment.”

**The Oregon case.** In *VSF Financing, Inc. v. Shilo Management Corp.*, 372. P.3d 582, 89 UCC Rep. 2d 600 (Ore. Ct. App. 2016), Shilo borrowed $4 million from VFS. The purpose of the loan was to purchase a corporate airplane for Shilo’s business affairs, and the plane served as collateral for the loan. Shilo had some payment issues in 2010 and fell into default on the loan. As part of a workout, one of Shilo’s principals provided the lender with a partial guaranty of $1.5 million. But, when payment issues continued to arise in 2011, 2012 and 2013, the plaintiff filed suit on the company’s note and the principal’s guaranty. Early in the litigation, the lender was able to repossess the airplane but did not hold a foreclosure sale prior to entry of the personal judgment.

Shilo sought to block any further action on the note or guaranty on the ground that “plaintiff had acted in a commercially unreasonable manner and in bad faith when it pursued its claim on the note without also seeking to sell the airplane.” The court framed the issue: whether a secured lender acts in bad faith or in a commercially unreasonable manner when it pursues a valid note or guaranty claim, but does not move quickly to sell the collateral that secures the note or guaranty. The defendants argued that they had retained an expert who would testify that their failure to sell the airplane in a timely manner could have reduced or eliminated the debt—creating a material issue of fact that precluded summary judgment.

**The powerful cumulative remedies provision in Article 9.** In rejecting Shilo’s attempt to avoid summary judgment, the Oregon court focused on UCC 9-601,
which provides that, following default, a secured party’s rights are cumulative. The secured lender may “reduce a claim to judgment, foreclose, or otherwise enforce the claim, security interest, or agricultural lien by any available judicial procedure.” The statute further provides that the secured lender’s rights are “cumulative and may be exercised simultaneously.” UCC 9-601(c). Thus, under the plain language of the statute, the secured lender may—among other options—pursue a claim on the debt or seek to foreclose on the collateral. Because the lender’s enforcement rights are “cumulative,” it may seek to enforce one remedy and ignore another, or seek to enforce more than one remedy at the same time. The court also noted that the parties’ security agreement provided that, upon the debtor’s default, the secured lender had “all the rights and remedies of a secured party under the Uniform Commercial Code…and under any other applicable law.” The contract further provided that the lender’s remedies “shall not be exclusive or alternative but shall be cumulative and in addition to all other remedies in favor of [the lender] at law.”

The Oregon loan was governed by New York law. The court cited leading New York cases that strongly support the principle of cumulative remedies. They include First International Bank of Israel, Ltd. v. L. Blankstein & Son, Inc., 452 N.E.2d 1216 (N.Y. 1983) (lender’s decision to sue on the note and delay foreclosing on the diamonds that secured the note was commercially reasonable); Marine Midland Bank v. Hakim, 247 A.D.2d 345 669 N.Y.S.2d 212 (1998) (secured lender was not required to “play the market” by selling nonperishable collateral during the litigation on the unpaid debt).

The plain language of UCC 9-601, plus the parties’ security agreement, plus the New York case law, precluded any testimony from Shilo’s expert: “Because New York law provides that the conduct at issue here was commercially reasonable as a matter of law, any proposed expert testimony otherwise was immaterial and would not inform the factfinder regarding plaintiffs’ subjective good or bad faith.”

**Bottom line.** The courts generally give the secured lender substantial flexibility in using its enforcement tools under Article 9 and outside the statute. In any case, if sophisticated collateral is involved, the best practice is to hire an expert and follow their suggestions.
SUPERGENERIC COLLATERAL DESCRIPTION IN FINANCING STATEMENT CURES ERROR IN MORE PRECISE DESCRIPTION OF COLLATERAL

In a notable New York bankruptcy decision, the Second Circuit has affirmed the bankruptcy court and the federal district court in ruling that an “all assets” collateral description in a financing statement cured an error that the secured lender made elsewhere in the description. As a result, the lender’s blanket security interest in the debtor’s assets could not be set aside as a voidable preference. The decision seems right on target.

The New York bankruptcy court decision. In In re Sterling United, Inc., 519 B.R. 586, 84 UCC Rep. 2d 973 (Bankr. W.D.N.Y. 2014), the debtor had granted a blanket security interest in all its assets, but instead of using simple supergeneric language describing the collateral as “all assets of the debtor, now owned or hereafter acquired,” the secured lender filed a financing statement with a wordy description of “all assets of the debtor, including but not limited to” all the Article 9 categories of collateral. At the end of this description, the financing statement included a reference to the debtor’s address. When the debtor later moved its location to another city prior to filing bankruptcy, the prolix language in the financing statement created an ambiguity as to whether the described collateral was invalid because it was tied to an address that no longer applied. The trustee contended that the collateral description had become “seriously misleading” so that the lender’s security interest was unperfected. A linguistics professor testified that the language was ambiguous.

The New York bankruptcy court upheld the ambiguous collateral description on the ground that a reasonable third-party searcher of the UCC files would note the ambiguity and could inquire further under the “notice filing” regime of Article 9. The court required that searchers be reasonably diligent: “[A] court must presume a certain level of sophistication or a certain level of intelligence and diligence in reading the collateral description in the UCC-1 and in acting upon whatever notice it provides.” This presumption of searcher “diligence” means that filers of financing statements must be given some leeway in describing the collateral.

The court relied heavily on a leading Eighth Circuit decision, Pro Growth Bank, Inc. v. Wells Fargo Bank, 558 F.3d 809 (8th Cir. 2009), where the court ruled that supergeneric language in the financing statement such as “all assets” cured a serial number error in the description of specific annuity contracts in the same financing statement. The court excused the secured lender’s error in numbering the annuity contract in the financing statement: “While Defendants’ specific description of the annuity contracts contain errors, the statements themselves are not seriously misleading because a subsequent creditor should reasonably understand that the financing statements may cover all of [the debtor’s] assets. It was then incumbent upon subsequent creditors to inquire whether specific collateral owned by [the debtor] is the subject of a prior security agreement.”

The Seventh Circuit decision. The federal district court affirmed the bankruptcy court, and the Seventh Circuit agreed with both lower courts, though it shifted its focus to the common-sense grammatical rules that apply to contract construction. In re Sterling United, Inc. v. Wells Fargo Bank, 558 F.3d 809 (8th Cir. 2009), where the court ruled that supergeneric language in the financing statement such as “all assets” cured a serial number error in the description of specific annuity contracts in the same financing statement. The court excused the secured lender’s error in numbering the annuity contract in the financing statement: “While Defendants’ specific description of the annuity contracts contain errors, the statements themselves are not seriously misleading because a subsequent creditor should reasonably understand that the financing statements may cover all of [the debtor’s] assets. It was then incumbent upon subsequent creditors to inquire whether specific collateral owned by [the debtor] is the subject of a prior security agreement.”
was sufficient because it unambiguously referred to “all assets of the Debtor” irrespective of their location. In the Seventh Circuit’s view, the phrase “including, but not limited to” introduces a subset of, but does not function as a limit on “all assets of the Debtor.” The term “including” is not one of all-embracing definition, but connotes simply an illustrative application of the general principle. In short, the supergeneric phrase “all assets of the debtor” cured the problem created by the debtor’s change of address and use of language that tied the covered collateral to that address.

The double standard between collateral descriptions and debtor names. In the first chapter of this litigation, the New York bankruptcy court stated that there is a strong parallel between the leeway given for erroneous collateral descriptions and the leeway courts give to errors in the debtor’s name:

It seems to this Court that the Uniform Commercial Code cases consistently hold a prospective downstream creditor to a standard of “reasonableness” or “prudence” in searching for filings against a prospective debtor’s name. The same standard should be applied in examining the collateral description once the searcher has found a UCC-1 pertaining to that debtor.

On this point, we think the New York bankruptcy court was wrong. As reflected in the 2001 revisions and the 2010 amendments, the drafters of Article 9 have been trying to move away from any standard for UCC searches that requires the searcher to do more than look at the correct name as determined by Article 9. In drawing its parallel, the New York court was relying on pre-2001 case law. Under the 2001 and 2010 amendments, however, the filer is required to use the precise name of an entity debtor based on the organic “birth certificate” public records. UCC 9-503(a)(1). If the debtor is a decedent’s estate, the filing does the job only if it provides the name of the decedent and indicates that the debtor is an estate. UCC 9-503(a)(2). If the debtor is a trust, the financing statement must provide the name of the trust in its organic documents or, if no name is specified, the name of the settlor or testator. UCC 9-503(a)(3). Under the 2010 amendments, if the debtor is an individual, almost all of the states have chosen Alternative A to UCC 9-503(a)(4), which protects the filer only if the name on the financing statement mirrors that found on the debtor’s driver’s license.

Since 2001, the consistent theme of the Article 9 drafters is to require filers to precisely identify their debtor’s name, which eases the burden on the third-party searcher, who needs only search by the organic or driver’s license name. This is a different standard than that employed in the New York case or the Eighth Circuit for collateral descriptions, where a filer has much more leeway and a larger burden falls on the shoulders of the searcher. In that regard, the New York bankruptcy court failed to recognize the double standard currently imposed upon filers, who must use precision in naming the debtor but can be more loosey-goosey in describing the collateral. This double standard seems entirely appropriate since the indexing of the Article 9 filing system is tied to debtor names.

It is true that some measure of “reasonableness” and “prudence” continues to apply insofar as UCC 9-506(c) potentially saves a filing that uses the wrong debtor name: “If the search of the records of the filing office under the debtor’s correct name, using the filing office’s standard search logic, if any, would disclose a financing statement that fails sufficiently to provide the name of the debtor in accordance with Section 9-503(a), the name provided does not make the financing statement seriously misleading.” If a search of the debtor’s precise name discloses a financing statement filed under the wrong name, the searcher would ignore that record at his or her peril due to UCC 9-506(c). A searcher must reasonably evaluate the results of any search. This is not so different than what the Sterling United and ProGrowth courts required of searchers with respect to collateral descriptions.

UCC filers are subject to a double standard: The courts continue to give filers some leeway by okaying financing statements with ambiguous collateral descriptions and requiring more diligence on the part of searchers. By contrast, more precision is required of filers regarding debtor names, and that precision eases the burden on searchers and makes the whole system more efficient. Nonetheless, searchers must carefully review all financing statements disclosed by their searches and act upon whatever notice those filings provide.

Bottom line. The New York bankruptcy litigation dramatically illustrates the power of a supergeneric description in a UCC financing statement. It can cure a descriptive error inserted elsewhere in the financing statement. On this key point, both the Second and Eighth Circuits agree. However, although it ultimately prevailed, we suspect the secured party in the Sterling case could have avoided expensive litigation by using nothing more than simple supergeneric “all assets” language, as clearly authorized by UCC 9-504(2). For further discussion of the bankruptcy court decision in the Sterling case, see the December 2014 issue of this newsletter.
OHIO COURT RULES THAT THE OWNER OF A LOST MORTGAGE NOTE IS PRECLUDED FROM FORECLOSING

In a recent case from Ohio, the court ruled that the assignee of a home mortgage (U.S. Bank) was not entitled to enforce the mortgage through a foreclosure action because there was no evidence that the mortgage assignee was in possession of the mortgage note, or was entitled to enforce it in spite of the lack of possession, as allowed by Ohio’s version of UCC 3-309. Since enforceability of the mortgage was dependent upon enforceability of the note, the bank was not entitled to foreclose. The case would have come out differently had Ohio enacted the 2002 amendments to the UCC, which give greater protection to non-holders who seek to enforce lost promissory notes. In any case, we think the Ohio decision is problematic.

The Ohio case. In U.S. Bank N.A. Tr. v. Jones, 2016 Ohio App. LEXIS 4016 (Ohio Ct. App. 2016), Krista Jones executed a promissory note in February 2003; the note was payable to Wells Fargo Home Mortgage, Inc. in the amount of $75,000. The note was secured by a mortgage in favor of the secured lender, Wells. The note’s repayment terms were later modified through a “loan modification agreement.” In March 2012, Wells Fargo Bank, successor by merger to Wells Fargo Home Mortgage, assigned the note and mortgage to U.S. Bank. Several years later, in 2015, U.S. Bank filed a foreclosure action in the Ohio state court. The complaint alleged that U.S. Bank, as assignee, was entitled to enforce the note even though the original note had been lost somewhere along the way. The complaint stated that Jones had defaulted on her obligation on the note and modification agreement. Copies of a lost-note affidavit, note, mortgage and its assignment and modification agreement were attached to the complaint. The foreclosure complaint stated that U.S. Bank was the “lawful owner” of the note.

In January 2016, U.S. Bank filed a motion for summary judgment. The bank argued that it had established, via affidavit evidence, that it was assignee of the defaulted loan and had provided Jones with proper advance notice before accelerating the loan. The bank’s motion was supported by an affidavit of its record-keeper, who stated that Wells Fargo continued servicing the loan after its assignment to U.S. Bank. The records of U.S. Bank indicated that Jones delivered the original note to Wells Fargo in 2003, but Wells Fargo’s lost note affidavit indicated that the note had been lost, and that only a copy could be presented to the court in the foreclosure proceeding.

Bank can’t escape the plain language of the UCC. The trial court granted the bank’s summary judgment motion, but the appellate court reversed on the ground that U.S. Bank failed to establish that it was in possession of the note when it was lost, as required by the Ohio UCC. The court noted that UCC 3-301 identifies three persons entitled to enforce an instrument: (1) the holder of the instrument; (2) a nonholder in possession of the instrument who has the rights of a holder; and (3) a person not in possession of the instrument who is entitled to enforce it under UCC 3-309. In the present case, because of the loss of the original note, there was no present “holder” of the original instrument, nor could U.S. Bank qualify as a “nonholder in possession of the instrument.”

Under Ohio’s version of UCC 3-309(a), a person not in possession of a lost instrument is entitled to enforce the instrument if all of the following apply: (1) “the person was in possession of the instrument and entitled to enforce it when loss of possession occurred”; (2) the loss of possession was not the result of a transfer by the person or a lawful seizure; and (3) the person can reasonably obtain possession of the instrument because it was destroyed, its whereabouts can’t be determined, or it is in the wrongful possession of an unknown person or a person that can’t be found or isn’t amenable to service. The UCC rule also provides that the court may not enter judgment in favor of the person seeking enforcement unless it finds that the person required to pay the instrument is adequately protected against loss that might occur by reason of a claim by another person to enforce the instrument. Adequate protection for the person required to pay may be provided by any reasonable means.

The Ohio court concluded that the “plain language” of Ohio UCC 3-309(a)(1) “mandates that the plaintiff suing on the note must meet two tests, not just one; it must have been both in possession of the note when it was lost and entitled to enforce the note when it was lost.”

Nonuniform rule in Ohio dooms bank. The court then noted that in 2002, the drafters of the UCC amended Section 3-309 to remove the requirement that the person seeking to enforce the note be in possession of the instrument when it was lost. The court explained: “This section now permits a person not in possession of an instrument to enforce it if the person: (A) was entitled to enforce the instrument when loss of possession occurred; or (B) has directly or indirectly acquired ownership of the instrument from a person who was entitled to enforce the instrument when loss of possession occurred.” Under this amended language, U.S. Bank would have been “entitled to enforce” the note and the mortgage. The problem was that the 2002 amendments to the UCC had not been enacted in Ohio by the time of the present litigation.

In the present case, the lost-note affidavit, executed by Wells Fargo after it had assigned the note and mortgage to
U.S. Bank, stated that Wells Fargo was the lawful owner of the note but did not state when the note was lost or that Wells Fargo was the servicing agent for U.S. Bank when the note was lost. While another affidavit stated that Wells Fargo was the servicing agent for U.S. Bank, it did not state when the note was lost or that Wells Fargo was the servicing agent for U.S. Bank when the note was lost. In short, there was “no evidence in the record establishing that U.S. Bank was in possession of the note and entitled to enforce the note when loss of possession occurred.” At best, the evidence only established that U.S. Bank may have been entitled to enforce the note when loss of possession occurred, and this is insufficient to establish that U.S. Bank was entitled to enforce the lost note [under Ohio’s version of UCC 3-309].” (Emphasis the court’s.) The bottom line was that U.S. Bank could not foreclose on the mortgage.

Legislative history of the 2002 amendment to UCC 9-309. The Ohio court noted that the case would have come out differently under a 2002 amendment to UCC 3-309, which was part of a broader package of “update” amendments to Articles 3 and 4. The amendment at issue in the Ohio case was proposed in reaction to a problematic District of Columbia federal district court decision. In Dennis Joslin Co. v. Robinson Broadcasting Corp., 977 F. Supp. 491, 33 UCC Rep. 2d 1170 (D.D.C. 1997), Robinson Broadcasting signed a $559,000 promissory note payable to Madison National Bank. The FDIC acquired the note when it took over as receiver for Madison in 1991. The FDIC subsequently sold the note as an asset of the failed bank, and the buyer resold it to Joslin, who sued Robinson on the instrument. The original note did not exist because the FDIC had lost it. Robinson raised the defense, based on UCC 3-309, that a person currently not in possession of an instrument is entitled to enforce it only if “the person was in possession of the instrument and entitled to enforce it when the loss of possession occurred.” Since Joslin never had possession of the note, it had no standing to sue on the note under the UCC—an unfortunate conclusion, but one that the court felt was based on the plain language of the statute.

In direct response to the D.C. case, the 2000 UCC revision amends 3-309 so that a transferee of a lost instrument need prove only that its transferor was entitled to enforce it, not that the transferee was in possession at the time the instrument was lost. This change eliminated a problem for the FDIC and—more recently—for assignees in the securitization pipeline.

Critique of the Ohio decision. We think the Ohio decision is wrong because the court never considered the impact of the “shelter rule” found in UCC 3-203(b). Under that rule, which is not dependent upon the 2002 amendment to 3-309, the transferee of an instrument obtains “any right of the transferor to enforce the instrument.” This rule should protect an assignee which acquired its rights after the assignor lost the instrument. As a matter of public policy, the Ohio court’s decision precludes a legitimate assignee from enforcing a note and the mortgage securing that note. Courts in other jurisdictions have taken a broader view of the unamended version of 9-309, recognizing that a statute should be construed in a manner that does not preclude a remedy to support a legitimate claim. See, e.g., Bobby D. Associates v. DiMarcantonio, 751 A.2d 673, 41 UCC Rep. 2d 878 (2000); Southeast Investments, Inc. v. Clade, 40 UCC Rep. 2d 255, 1999 U.S. Dist. LEXIS 10844 (N.D. Tex. 1999), aff’d, 212 F.3d 595 (5th Cir. 2000); Beal Bank, S.S.B. v. Caddo Parish-Villas South, Ltd., 218 B.R. 851, 34 UCC Rep. 2d 1103, 1998 Minn. App. LEXIS 854 (N.D. Tex. 1998); and NAB Asset Venture II v. Lenertz, Inc., 36 UCC Rep. 2d 474 (Minn. Ct. App. 1998).

Some parting thoughts:

“The need for protection of secured lenders when notes are lost by an assignee is of great practical importance, whether the assignee is the FDIC, a one-off assignee, or investors in a securitization trust. Free assignability of negotiable instruments is an important policy concern in secured lending.”

“The recent Ohio case illustrates the need for all the states to enact the 2002 amendments to Articles 3 and 4. At the present time, only 12 jurisdictions have done so. They are Arkansas, District of Columbia, Indiana, Kentucky, Michigan, Minnesota, Missouri, Nevada, New Mexico, Oklahoma, South Carolina and Texas. The amendment to 9-309 is certainly not “technical” in nature. The recent Ohio case should be a warning to banks to see that the various states enact the amendments.”

“The Ohio decision is in some ways parallel to the problematic decision of the Second Circuit in Madden v. Midland, LLC, 786 F.3d 246, 2015 U.S. App. LEXIS 8483 (2d Cir. 2015), which holds that, for usury purposes, nonbank assignees of charged-off credit card debt aren’t protected from the usury ceilings in states where the cardholders reside, even though the assignor/issuer of the credit cards is a national bank protected by federal preemption.”

“The Ohio decision is another application of the principle that “the mortgage follows the note.”

CFPB ISSUES ADVISORY ON BEST PRACTICES TO ENABLE FINANCIAL INSTITUTIONS TO PREVENT AND RESPOND TO EXPLOITATION OF ELDERLY AND DISABLED CUSTOMERS

Many banks and credit unions may not be aware of a notable “Advisory” issued in March 2016 by the CFPB and available on its website. The Advisory identifies
best practices in dealing with exploitation of elderly and disabled customers by con artists. This is a fast-growing area of banking law that has generated numerous statutes across the country in recent years. In the introduction to its Advisory, the CFPB describes elder and disabled financial exploitation as “the crime of the 21st century.” Only a small fraction of the incidents are reported. Older people are attractive targets for con artists because they often have assets and a regular source of income. These consumers may be especially vulnerable due to isolation, cognitive decline, physical disability, health problems, and/or bereavement. Banks and credit unions are uniquely positioned to detect that an elder accountholder has been targeted or victimized, and to take action.

Case scenarios. In its Recommendations and Report, the CFPB provides three examples “to illustrate the ways that a variety of perpetrators exploit older consumers. In all of these cases, funds went from the victims’ deposit accounts to the perpetrators.”

*A Minnesota pastor persuaded a man suffering from Alzheimer’s and Parkinson’s diseases to allow him to manage his finances. The pastor made over 130 withdrawals from the older man’s bank account and was later convicted of stealing about $25,000.

*Prosecutors charged an Indiana home care worker with nine felonies after she took more than $150,000 from a 79-year-old woman with dementia. The caregiver stole the funds through transactions on multiple credit cards, checks drawn on a savings account, and cashed certificates of deposit. A bank fraud analyst was the first to detect unusually large credit card charges, and the analyst called Indiana Adult Protective Services.

*An Oklahoma woman received mail and phone calls telling her that she had won a sweepstakes and would get prizes if she sent money to collect her winnings. She sent as many as 90 checks a month, in response to requests for payments of $50 to $2,000. A bank employee discovered the losses when the victim asked how she could send a large amount of cash through the mail.

The New Jersey case. As further examples of elder customer exploitation, we offer two leading judicial decisions in the area. In Lucca v. Wells Fargo Bank, N.A., 117 A.3d 1267 (N.J. Super. Ct. 2015), an elderly Wells Fargo customer got scammed by a man who called her and purported to be a "lawyer" who could help her participate in an enterprise where she could “win some money.” In response, she sent a series of wire transfers to the fraudster over a six-month period; the transfers totaled $330,000. Alerted by an anomalous wire she sent from another Wells branch, her branch manager told her that she was probably being scammed. Once the reality of the scam sank in, the elderly customer decided to sue Wells Fargo on the ground that the bank owed her a duty to have stopped the scam much earlier, but failed to do so.

The New Jersey court rejected the plaintiff’s claims against the bank. The court noted that New Jersey, like a number of other states, has a statute that permits banks to report instances of suspected abuse against “senior” or “vulnerable” customers. To be “senior,” the customer must be at least 60; to be “vulnerable,” the customer must be at least 18 and “appear to have a physical or mental illness, disability or deficiency, or [to lack] a sufficient understanding of, and the capacity to make, communicate or carry out decisions concerning the management of the customer’s savings or resources.”

The New Jersey court ruled that the statute permits financial institutions to report instances of abuse of senior or vulnerable customers, but does not require the institution to investigate or report suspected scams. In the court’s view, the primary purpose of the statute is to encourage reporting by protecting the bank from liability for violating the customer’s right of privacy. The New Jersey statute imposed no duty on the bank to investigate or report a suspected scam to law enforcement authorities or adult protection services. The court focused on the bank-protection purpose of the New Jersey statute:

Financial institutions, in the course of conducting business with…vulnerable customers, suspect, from time to time, that these customers are targets of illegal schemes but choose not to act because they are unclear about the conditions under which they may release account information, how much information may be released, and the entities to whom they may release such information. Therefore, the legislature finds that it is appropriate to provide statutory guidance to financial institutions in this situation.

The court concluded its opinion by stressing that the primary purpose of the statute at issue is to protect banks from privacy litigation. The statute “provides a safe harbor against lawsuits based upon the institution’s actions. While creating this immunity may serve as an incentive for the financial institution to disclose suspect abuse to the authorities, and in that sense it also benefits elderly and vulnerable customers, the principal benefit [of the legislation] is afforded to financial institutions.”

The California case. A notable California decision, which does not involve any state statute, is also highly protective of the bank. In Shamgochian v. Bank of America, N.A., 2013 Cal. App. Unpub. LEXIS 1948 (Cal. Ct. App. 2013), an elderly woman was hit by a scam artist who bilked her out of $504,101, through unwitting wire transfers and checks drawn on her Bank of America account.
Her complaint alleged that the bank did not investigate those transactions or identify the nature of the beneficiaries, even though she was a vulnerable customer who had no prior history of making wire transfers. As in the New Jersey case, the plaintiff’s outgoing wires were made face-to-face at a branch of the bank.

The plaintiff alleged that the bank had a duty under the circumstances to investigate the reasons for the out-of-pattern use of outgoing wire transfers, and to protect the vulnerable customer from the scam. The plaintiff sought recovery on the ground that the bank maintained its own computer database of suspected fraudulent wire transactions, including information that identified repeat scam artists. The plaintiff sought reimbursement based on common-law theories of negligence, breach of fiduciary duty, and aiding and abetting fraud.

The California court ruled that the bank had no duty to protect the elderly customer. In reaching that conclusion, the court used two separate legal approaches. Under the first approach, the court ruled that common-law claims based on unauthorized wires were displaced by the comprehensive loss-allocation rules of UCC Article 4A. Under the second approach, the plaintiff failed to state a claim because of the nature of the bank/depositor relationship:

As a rule, one has no duty to come to the aid of another. A person who has not created a peril is not liable in tort merely for failure to take affirmative action to assist or protect another unless there is some relationship between them which gives rise to a duty to act.

The California court emphasized that a traditional bank-depositor relationship is one of debtor/creditor, founded on contract, not fiduciary in character. The contractual relationship does not involve any implied duty to supervise account activity or to inquire into the purpose for which the funds are being used. In reaching this decision, the court relied on an earlier California decision involving an elderly man with dementia who was defrauded by a “lottery” scam into making a number of wire transfers to foreign bank accounts in total amount of over $300,000. *Das v. Bank of America, N.A.,* 186 Cal. App. 4th 727, 2010 Cal. App. LEXIS 1126 (Calif. Ct. App. 2010).

Six Best Practices for financial institutions. The heart of the 2016 CFPB Advisory is a series of six recommendations for depository institutions. These recommendations are set forth below:

*1. Develop, implement and maintain internal controls and procedures for protection of account holders from elder financial exploitation.* The protocols for management and staff should include training requirements, procedures for making reports, compliance with the Electronic Funds Transfer Act (EFTA) as implemented by Regulation E, means of consent for information-sharing with trusted third parties, and procedures for collaborating with key stakeholders. Protocols likely will vary depending on the institution’s size and risk.

*2. Train management and staff to prevent, detect, and respond to elder financial exploitation.* Financial institutions should train employees regularly and frequently, and should tailor training to specific staff roles. Key topics for training include:

- Clear and nuanced definition of “elder financial exploitation”
- Warning signs that may signal financial exploitation, including behavioral and transactional indicators of risk (e.g., out-of-pattern outgoing wires)
- Action steps to prevent exploitation and respond to suspicious events, including actionable tips for interacting with account holders, steps for reporting to authorities, and communication with trusted third parties.

*3. Detect elder financial exploitation by harnessing technology.* The CFPB encourages financial institutions to ensure that their fraud detection systems include analysis of the types of products and account activity that may be associated with elder financial exploitation risk. Some indicators of elder fraud risk may not match conventionally accepted patterns of suspicious activity, but nevertheless may be unusual in light of a particular account holder’s regular pattern of behavior. The CFPB encourages financial institutions using predictive analytics to review their filtering criteria against individual account holders’ patterns and explore additional risk factors that may be associated with elder financial exploitation.

*4. Report all cases of suspected exploitation to relevant federal, state and local authorities.*

*Be aware of state reporting mandates.* Financial institutions should be aware of state reporting mandates including to whom and when they must report. Reasonable suspicion rather than certainty or proof can trigger the duty to report to state Adult Protective Services, law enforcement, or both.

*File suspicious activity reports (SARs).* The Financial Crimes Enforcement Network (FinCEN) issued an Advisory in 2011 noting that SARs are a valuable reporting avenue for elder financial exploitation cases. FinCEN now provides a designated category of suspicious activity, “elder financial exploitation,” on the electronic SAR form. Although that form includes a checkbox for elder financial exploitation, the narrative remains critical and FinCEN instructs filers to provide clear, complete, and concise description of the suspicious activity.

*Understand that the Gramm-Leach-Bliley Act (GLBA) is not a barrier to reporting suspected elder financial exploitation.* Financial institutions should
be aware of the 2013 Interagency Guidance from eight federal financial regulators which clarifies that reporting financial abuse of older adults to appropriate local, state and federal authorities does not, in general, violate the privacy provisions of GLBA. The Guidance details the relevant exceptions to the GLBA notice and opt out requirements. Several state regulators have issued similar guidance.

*Understand the roles of first responders. Financial institutions should understand how Adult Protective Services (APS), law enforcement and long-term care ombudsmen work, and the actions that they will and will not take.

*Include core components in reports to state and local authorities. A list of basic components of a complete report can help financial institutions support the allegation and assist responders.

*Expedite documentation requests. When APS, law enforcement and other government entities investigate reports of financial exploitation and request documentation, providing a record in a timely manner is essential. FinCEN Guidance clarifies that financial institutions must provide documentation that supports a SAR to certain law enforcement or supervisory agencies when requested, and that service of legal process on the financial institution is not required in such cases. Financial institutions should provide documents to investigatory agencies at no charge.

*5. Protect older account holders.

*Comply with EFTA and Regulation E. Many older consumers experience financial exploitation involving unauthorized electronic fund transfers (EFTs.) EFTA and Regulation E offer important protections to all consumers, including rules for extending time limits for extenuating circumstances such as extended travel or hospitalization; rules for accepting notices of unauthorized EFTs; and confirmation that all relevant conditions are met before imposing liability on the consumer for an unauthorized EFT. (For example, older consumers with cognitive challenges may write PINs on or near debit cards; under Reg. E, such behavior may not be used as a basis for imposing greater liability on a consumer.)

*Offer account holders the opportunity to consent to disclosure of account information to trusted third parties when the financial institution suspects exploitation. The CFPB recommends that financial institutions establish procedure for enabling consumers to provide advance consent to sharing account information with a designated trusted third party when the bank or credit union believes that elder exploitation is occurring or has occurred. GLBA permits disclosure of nonpublic personal information with the consent of the consumer. The CFPB recommends developing a plain language consent form as well as procedure for offering consumers the opportunity to consent at account opening and periodically thereafter.

*Offer age-friendly services that can enhance protections against financial exploitation. There are certain services that institutions can offer to their general client base that may be particularly useful to older customers. The CFPB recommends that financial institutions:

*Provide information about planning for incapacity. Advanced planning, e.g., by naming a “trusted person” to serve as an agent under a power of attorney, increases the odds that the person managing finances will act in the best interests of the account holder.

*Honor powers of attorney. A financial institution’s refusal to honor a valid power of attorney can create hardships for account holders who need designated surrogates to act on their behalf. Financial institutions should establish procedures to ensure that the institution makes prompt decisions on whether to accept the power of attorney, that qualified staff make decisions based only on state law, and that frontline staff recognize red flags for power of attorney abuse.

*Offer protective opt-in account features. Examples of opt-in features that could reduce the risk of elder exploitation include cash withdrawal limits, alerts for specified account activity, and read-only access to accounts for authorized third parties. A third-party monitoring feature can enable a designated family member or friend to monitor an account for irregularities without having access to funds or transactions.

*Offer “convenience accounts” as an alternative to joint accounts. Traditional joint accounts, often used to enable a helper to pay bills, pose several risks. To avoid risks such as the joint owner withdrawing money for his or her own use, exposing account funds to creditors of the joint owner, and subverting an intended estate plan, financial institutions should provide information to consumers about these risks. When implemented properly, convenience accounts can mitigate these risks. The CFPB recommends routinely offering such accounts as an alternative deposit product.

*6. Collaborate with other stakeholders.

*Work with law enforcement and APS. Financial institutions should work with law enforcement and APS to: share policies and procedures for detecting, assessing and reporting cases; develop relationships with specific personnel to facilitate timely response to reports and have a point of contact when questions arise; and provide expert consultation and document review to assist law enforcement and APS with case investigations.

*Participate in and support coordinate efforts to educate older account holders, caregivers and the public.

*Participate in and support local or regional multidisciplinary network initiatives.
Bottom line. Protection of elderly and disabled customers from the risk of scamming is quickly becoming a major compliance concern of financial institutions. While judicial decisions have generally been protective of banks sued by these customers for reimbursement, the risk of litigation appears to be growing. Moreover, a wide variety of state statutes are being enacted, some with reporting requirements or other compliance issues. (Relevant state statutes should always be reviewed by bank counsel. The bank should also explore opportunities to protect itself through new provisions in the deposit agreement such as the customer’s consent to the bank’s decision to notify the state office of Elderly Affairs and to disclose account records to the agency if the bank reasonably believes or suspects that the customer may be a victim of elder exploitation).

Although the 2016 CFPB “best practice” recommendations are advisory only and don’t constitute a formal rule, financial institutions should carefully review the publication and consider implementation of relevant suggestions, where appropriate. Developing an “anti-financial exploitation” plan by using the CFPB Advisory as a guide would be a positive step in the eyes of bank customers and regulators, and could be helpful in defending against litigation down the road.
On May 5, 2016, the Consumer Financial Protection Bureau finally came out with its proposal to regulate class-action waivers that are included in arbitration agreements found in many consumer financial contracts—by banning them altogether! The proposed rule, which would be codified at 12 CFR Part 1040, is huge because it cuts across all consumer financial products regulated by the CFPB—from credit cards to deposit agreements to secured auto loans. It would overturn Supreme Court decisions in recent years upholding consumer arbitration agreements/class-action waivers based on the preemptive text and policy of the Federal Arbitration Act.

Yet the proposed rule is not something that the CFPB manufactured out of thin air; rather, Section 1028 of the Dodd-Frank Act mandates that the Bureau deal with the issue through rule-making. This it has done, with a vengeance. For consumer creditors such as banks, the only good news is that there is no retroactivity. Consistent with Dodd-Frank, the proposed “compliance date” for any consumer arbitration agreement would be 211 days after publication of the final rule in the Federal Register. We can now settle in for an intense period of public comment prior to publication of a final rule. Comments must be received on or before 90 days after publication of the proposed rule in the Federal Register. The new proposal, promulgated as Docket No. CFPB-2016-0020, comes in a huge package of 376 pages and 703 footnotes. The final product, which contains a wealth of information about consumer financial services, will include Official Comments and Interpretations.

The three prongs of the proposed rule. In a nutshell, the proposed rule contains three elements:

• First and foremost, it would prohibit providers of consumer financial services from using a “pre-dispute arbitration agreement” to block consumer class actions in court. The CFPB explains that this central proposal is based on the Bureau’s preliminary findings—which are consistent with empirical studies it has done—that “pre-dispute arbitration agreements are being widely used to prevent consumers from seeking relief from legal violations on a class basis, and that consumers rarely file individual lawsuits or arbitration proceedings to obtain such relief.”

• Second, the proposal has a strong disclosure component. It would require providers to insert language into their arbitration agreements that reflects the ban on class-action waivers.

• Third, the proposed rule would require providers that use pre-dispute arbitration agreements to submit certain records (the initial arbitration claim; the arbitration agreement as filed with the arbitrator; the award, if any, issued by the arbitrator; any communications from the arbitrator to the CFPB that relate to a refusal to dismiss a claim due to the provider’s failure to pay required fees; and any communications related to a determination that the arbitration agreement does not comply with the administrator’s fairness principles). The Bureau intends to use the information it collects to continue monitoring arbitral proceedings to determine whether there are developments that
raise consumer protection concerns that may warrant further Bureau action. The CFPB intends to publish these materials on its website in some form, in order to provide greater transparency into the arbitration of consumer disputes.

The CFPB’s “contract gotcha” argument in favor of the proposed rule. The CFPB’s press release sets forth in no uncertain terms its conclusion that arbitration clauses with class-action waivers need to be prohibited:

Today the Consumer Financial Protection Bureau (CFPB) is seeking comments on proposed rules that would prohibit mandatory arbitration clauses that deny groups of consumers their day in court. Many consumer financial products like credit cards and bank accounts have contract gotchas that generally prevent consumers from joining together to sue their bank or financial company for wrongdoing. These widely used clauses leave consumers with no choice but to seek relief on their own—usually over small amounts. With this contract gotcha, companies can sidestep the legal system, avoid accountability, and continue to pursue profitable practices that may violate the law and harm countless consumers. The CFPB’s proposal is designed to protect consumers’ right to pursue justice and relief and deter companies from violating the law.

The CFPB contends that mandatory arbitration clauses affect “hundreds of millions of consumer contracts. These clauses typically state that either the company or the consumer can require that disputes between them be resolved by privately appointed individuals (arbitrators) except for cases brought in small claims court. These clauses also typically bar consumers from bringing group claims through the arbitration process. As a result, no matter how many consumers are injured by the same conduct, consumers must proceed to resolve their claims individually against the company.”

The study required by Dodd-Frank. In line with the requirement of Dodd-Frank, the CFPB was required to undertake an empirical study of consumer arbitration clauses as a condition of any rule-making. The Bureau focused on nine topics in its study:

- The prevalence of arbitration agreements in contracts for consumer financial products and their main features.
- Consumers’ understanding of dispute resolution systems, including arbitration, and the extent to which such provisions affect a consumer’s purchasing decision.
- How arbitration procedures differ from procedures in court.
- The volume of individual consumer financial litigation, the types of claims, and how they are resolved.
- The extent to which consumers sue companies in small claims court with respect to disputes involving consumer financial services.
- The size, terms, and beneficiaries of consumer financial class action settlements.
- The relationship between public enforcement and consumer financial class actions.
- The extent to which arbitration agreements lead to lower prices for consumers.

In March 2015 the CFPB released its empirical study of these issues. The study showed that very few consumers ever bring—or think about bringing—individual actions against their financial service providers, either in court or in arbitration. The study found that class actions provide a more effective means for consumers to challenge problematic practices by these companies. The CFPB press release praises the study: “According to the study, class actions succeed in bringing hundreds of millions of dollars in relief to millions of consumers each year and cause companies to alter their legally questionable conduct. The study showed that at least 160 million class members were eligible for relief over the five-year period studies. Those settlements totaled $2.7 billion in cash, in-kind relief, and attorney’s fees and expenses. In addition, these figures do not include the potential value to consumers of class action settlements requiring companies to change their behavior. However, where mandatory arbitration clauses are in place, companies are able to use those clauses to block class actions.” (Unfortunately, the CFPB study does not respond to the biggest concern of providers: that class action awards to individual consumers are usually disappointing, and that it is counsel for the class that always turns out to be the big winner.)

The CFPB concludes, consistent with the study, that (1) the evidence is inconclusive on whether individual arbitration is superior or inferior to individual litigation in terms of remediating consumer harm; (2) individual dispute resolution is insufficient as the sole mechanism available to consumers to enforce contracts and the laws applicable to consumer financial products and services; (3) class actions provide a more effective means of securing relief for large numbers of consumers affected by common legally questionable practices and for changing companies’ potentially harmful behaviors; (4) arbitration agreements block many class action claims that are filed and discourage the filing of others; and (5) public enforcement does not obviate the need for a private class action mechanism.

The huge impact of class action waivers. There is no doubt that the existence of class action waivers can have a big impact on providers. The best example involves bank
posting of debits in high-to-low order, with the result that the bank collects substantially more in overdraft fee revenue. About ten years ago, this posting-order issue generated big-time consumer class action litigation. In the “west coast” version of this litigation, the federal courts ruled that Wells Fargo’s switch to a HTL posting order violated California consumer protection law. The result was a final judgment in favor of the class exceeding $200 million. Wells did not have a class action waiver in its deposit agreement. See Gutierrez v. Wells Fargo Bank, 589 Fed. Appx. 824 (9th Cir. 2014), cert. denied, 2016 U.S. LEXIS 2408 (April 4, 2016).

The “east coast” version of this high-to-low litigation was a Florida multidistrict class action that involved a large number of banks, including many of the biggest ones. When the Florida court finally ruled that HTL debit posting violated deceptive trade practice statutes around the country, many of the banks settled for big bucks. However, after the Supreme Court ruled in favor of arbitration clauses with class-action waivers in AT&T Mobility LLC v. Concepcion, 131 S. Ct. 1740 (2011), those banks that had not yet settled but had arbitration clauses with class action waivers sought to compel one-on-one arbitration. The Eleventh Circuit upheld the clauses, allowing those banks to escape with virtually no damages. See Buffington v. SunTrust Banks, Inc., 459 Fed. Appx. 855, 2012 US App. LEXIS 4180 (11th Cir. 2012) and Hough v. Regions Financial Corp., 672 F3d 1224 (11th Cir. 2012).

The big takeaway from this high-to-low litigation is the huge value of class-action waivers. In the materials supporting the proposed rule, the CFPB cites this litigation for the proposition that class action settlements also benefit consumers not included in a particular class settlement because, as a result of big-buck settlements, providers change their ways. In the case of the HTL litigation, all of the banks that were subject to big settlements turned off their practice of high-to-low debit posting. The banks that escaped big liability because of their class-action waivers have also stopped the practice, particularly since the bank regulators have weighed in against it. On the other hand, we suspect that most banks will keep their class-action waivers in their deposit agreements until they are required to give them up following the CFPB’s final rule.

A concession for prepaid. Although the general “compliance date” will be 211 days after the publication of the final rule in the Federal Register, the proposed rule would also permit providers of general-purpose reloadable prepaid cards to continue selling packages that contain non-compliant arbitration agreements if they give consumers a compliant agreement as soon as consumers register their cards and the providers comply with the rule’s requirement not to use an arbitration agreement to block a class action. The prepaid industry can be thankful for little gifts.

**Bottom line.** Of this we can be certain: the proposed CFPB rule outlawing class-action waivers in consumer arbitration agreements is extremely significant and will generate substantial public comment. Stay tuned.

**SEVENTH CIRCUIT: REAL ESTATE MORTGAGE CAN ATTACH TO A VENDOR’S INTEREST IN A LAND CONTRACT, WITH NO UCC FILING REQUIRED**

When it comes to perfecting security interests, the line between real estate and personal property can be fuzzy. In a recent decision from the Seventh Circuit, applying Wisconsin law, the court ruled that a real estate mortgage can attach to a vendor’s interest in a land contract, including the stream of payments coming from the vendee. The court also ruled that the secured lender properly perfected its lien on the vendor’s interest by recording its mortgage in the county land records rather than by filing a UCC financing statement with the Wisconsin secretary of state. The Seventh Circuit decision clashes with cases in some other jurisdictions holding that a vendor’s interest in a real estate sales contract is personal property rather than real estate; it is an “account” under Article 9 that requires the filing of a financing statement.

The Wisconsin case. In In re Troy and Heather Blanchard, ____F.3d____(7th Cir. 4/14/16), the Blanchards agreed in 2010 to sell a residential property in Wisconsin to Benjamin and Debra Hoffman. The Hoffmans paid the Blanchards $30,000 up front, and the Blanchards agreed to obtain a mortgage loan in their own name (to get a lower rate than if the buyers had obtained the mortgage), with the house as collateral. The rest of the purchase price was due in 2015, but the Hoffmans had the option of completing the land contract sale early by paying off the balance of the Blanchards’ mortgage. Under the land contract, the Blanchards immediately received the $30,000 downpayment and the proceeds of the bank’s mortgage loan. The plan was for the Hoffmans, at some point, to pay off the mortgage by obtaining a loan in their own right.

In line with the financing deal worked out among the parties, the Blanchards obtained a mortgage on the property from Intercity State Bank. In exchange for a loan of $142,000, the Blanchards agreed to “mortgage, convey, assign, grant a security interest in and warrant” the property to the bank. This mortgage included a lien on “all rents, issues, leases and profits.” The bank also obtained an
Assignment of Leases and Rents, but mistakenly neglected to obtain an “Assignment of Land Contract” because it wrongly assumed that the Blanchards were leasing the property rather than selling it to the Hoffmans. The bank recorded its mortgage and Assignment of Leases and Rents in the country land records in 2011.

The bankruptcy trustee’s adversary proceeding. In 2014, the Blanchards took bankruptcy. The trustee filed an adversary proceeding against the bank seeking to avoid the bank’s mortgage under his strongarm powers and to deflect to the unsecured creditors the payment stream under the land contract. The trustee contended that a mortgage could attach only to real property, that the Blanchards had sold their interest in the realty under the land contract, and that their residual interest as vendors in a land contract was personal property to which a real estate mortgage could not attach. The trustee also argued that, even if a security interest attached, it was not perfected because the bank failed to file a UCC financing statement.

The bankruptcy court first found that the bank had notice of the land contract, and that the bank’s interest was subordinate to that of the Hoffmans under the contract. The fighting issue was over priority to the stream of payments coming from the vendee to the vendor. The bankruptcy court ruled in favor of the bank, finding that the Blanchards’ rights as vendors under the contract should be treated as an interest in real property that was lienable under the bank’s mortgage. The bankruptcy court also found that the mortgage was properly recorded in the land records and could not be avoided, and that no UCC filing was required. As a result, the bank prevailed over the trustee/unsecured creditors.

Seventh Circuit: the bank’s real estate mortgage created a lien against the stream of payments due to the vendor. The Seventh Circuit affirmed the bankruptcy court’s decision. It first held that the bank’s mortgage “validly attached a lien to the Blanchards’ interest as vendors under a land contract.” It pointed to an ancient Wisconsin Supreme Court decision holding that a vendor’s interest in the stream of payments from a land contract was lienable. First Nat’l Bank of Stevens Point v. Chafee, 73 N.W.318 (Wis. 1897) (mortgagee of a land contract vendor had priority over an earlier unrecorded assignment of the contract vendor’s interest). The court also quoted from commentators who conclude that, because the vendor retains legal title to the land, it has become a common practice for those who lend money on the security of a vendor’s interest to treat the transaction as a simple mortgage on the real estate. The court also pointed out that the mortgage in these transactions is often accompanied by an assignment of the vendor’s interest in the contract.

The trustee argued that, in other contexts, Wisconsin courts have held that a vendor’s interest in a land contract—primarily the stream of payments coming from the vendee—should be treated as personal property rather than real estate. For example, in City of Milwaukee v. Greenberg, 471 N.W.2d 33 (Wis. 1991), the court invoked the doctrine of “ equitable conversion” in finding that a vendor was not liable for the cost of razing a condemned building; the vendor was not the “owner” of the real estate even though it technically retained title until the vendee completed the required payments. The Seventh Circuit mused: “If the vendor’s interest is treated as personal property, it would be odd to attach a lien to it by a real estate mortgage.” After reviewing all the Wisconsin case law, the Seventh Circuit concluded that the closest case on point was the 1897 decision in Chafee.

The appellate court noted that the language in the mortgage covered “rents, issues and profits,” which was broad enough to grant the bank a lien on the land contract payments. Moreover, the vendors retained key rights in the real property: “the rights to enforce the land contract, collect payments from the Hoffmans and foreclose if the Hoffmans default.” Finally, the court determined that giving the bank a lien on the stream of payments “appears to coincide with the parties intention: in the land contract, the [Blanchards] and the Hoffmans agreed that the [Blanchards] would obtain a mortgage at a favorable interest rate, and the Hoffmans would pay the balance due on the mortgage as the buyout price of the property.”

No UCC filing required. The Seventh Circuit also agreed with the bank’s argument that its local real estate filing was sufficient; no UCC filing was required in order to perfect its security interest in the stream of payments. The court found the Wisconsin land recording statute to be broadly worded: “The scope of the statute is broad enough to include creation of a lien on a vendor’s interest in a land contract, which includes legal title to land.” Moreover, the leading Wisconsin case on point squarely holds that a land contract vendor’s interest was perfected when it was recorded in the county land records, and that a UCC filing with the secretary of state is not required because security interests in real estate are outside the scope of Article 9. In re Hoeppner, 49 B.R. 124 (Bankr. E.D. Wis. 1985) (parties tracing the history of a title in land are not expected to examine the UCC records and should be able to rely on the county land records).

The Seventh Circuit noted that there are other jurisdictions which treat the filing issue differently than Wisconsin. Some states require a UCC filing to perfect the assignment of the contract interest, and a separate recording of the assignment of the vendor’s legal title in the county land records. In re Freeborn, 617 P.2d 424 (Wash. 1980) (“The UCC filing is necessary as to the right to receive contract payments. Recording is required because legal title is conveyed by the same instrument”). Other states go further by holding that only the contract interest has been

In the Seventh Circuit case, the trustee argued that the Hoepner decision was no longer good law in Wisconsin because Revised Article 9, effective in 2001, expressly includes “a right to payment of a monetary obligation, whether or not earned by performance, for property that has been or is to be sold” within the definition of “account,” thereby requiring the filing of a financing statement.

The Seventh Circuit finessed the UCC filing issue by concluding that recording the mortgage or land sales contract in the local land records could be an alternative to UCC filing:

But we do not need to decide in this case whether, under Wisconsin law, UCC filing is now one effective way to perfect a mortgage on a land contract vendor’s interest. What we must decide is only whether recording in the county land records remains one effective way to perfect a mortgage on a land contract vendor’s interest. Our answer is yes. Revised Article 9 might make it unnecessary to record a mortgage on a land contract vendor’s interest in the county records, as it is possible that UCC filing would be sufficient. But that does not mean that recording in the county land records is not also effective. We see nothing in Revised Article 9 that restricts the scope of Wisconsin’s land recording statute, which applies to “every transaction by which any interest in land” is mortgaged.

As a policy matter, the Seventh Circuit concluded that it “makes no sense” to require UCC filing when a mortgage lender might have no notice of a land contract’s existence since land contracts are often not recorded. It would be “manifestly unfair” to require a UCC filing if the mortgagee does not know that a land contract is involved. In sum, the court reasoned that the UCC filing system should “not create a windfall for a bankruptcy estate or a minefield for lenders.” The bottom line was that the trustee could not use his strongarm powers to avoid the bank’s perfected security interest in the stream of payments flowing from vendee to vendor under the land contract.

Examples of real estate-related collateral still covered by Article 9. In the Seventh Circuit case, the court ruled that a bank’s mortgage on the interest of a vendor under a land contract constituted real estate and did not require UCC filing in order to perfect. Consider some other examples of collateral that straddle the line between real estate and personal property:

- A mortgage or deed of trust on land. By its terms, Article 9 does not cover “the creation or transfer of an interest in or lien on real estate.” UCC 9-109(d)(11). This exclusion is simply a reflection of the general rule that Article 9 only applies to security interests in personal property.
- The assignment of a commercial lease or rents thereunder. Significantly, UCC 9-109(d)(11) excludes not only the standard mortgage or deed of trust, but also the assignment of “a lease or rents thereunder.” It could be argued strongly that a security interest in a commercial lease and the stream of rental payments under the lease should be covered by Article 9 because they are simply a form of account receivable, i.e., personal property. Yet the drafters have chosen to exclude this type of receivable from the scope of Article 9. The normal way to perfect is to record the assignment in the real estate records; a UCC filing is a nullity.
- An assignment of a vendor’s stream of payments under a land contract. Of course this is the Seventh Circuit decision. As the court points out, other jurisdictions treat this stream of payments as personal property, i.e., an “account” governed by the filing rules of Article 9. Clearly the best practice is to make both a UCC filing and a real estate recording of the land contract.
- Real estate debt instruments. Some secured creditors forget that a security interest in a real estate mortgage note must be perfected under the rules of Article 9, i.e., by taking possession of the note or filing a financing statement covering it. Even though it’s the underlying real estate that gives the note its value, and it’s important to confirm perfection of the mortgage under real estate law, the note itself is personal property and must be perfected under Article 9. This two-level perfection can be tricky. Importantly, the UCC codifies the ancient rule that “the mortgage follows the note.” See UCC 9-109, Comment 7.
- Fixtures. The vendor of wall-to-wall carpeting or built-in appliances may well find itself covered by the filing rules of Article 9, even though a prior real estate mortgage could also contain language broad enough to pick up the fixtures under real estate law. See UCC 9-334.
- Timber and crops. Timber that is to be cut and removed under a contract of sale is covered as “goods” under Article 9, even though it may constitute realty for tax assessment or other purposes. The same is true of growing crops.
- Other contractual rights related to real estate. Other examples of realty-related transactions that are within the scope of Article 9 include assignments of accounts receivable of a hotel to secure payments under a real estate lease; the interest of a beneficiary in a land trust covering an apartment building; or the interest of a general or limited partner in a real estate venture.
HOW DO YOU PERFECT AND ENFORCE A SECURITY INTEREST IN VIRTUAL CURRENCIES?

With legitimate use of virtual currencies increasing rapidly, creditors may find themselves taking and seeking to perfect security interests in assets that include virtual currencies. There are hundreds of virtual currencies and cryptocurrencies in existence at the present time, with Bitcoin as the largest and most frequently mentioned. Article 9 of the UCC governs security interests in personal property, tangible and intangible. The application of Article 9 to virtual currencies, and issues related to the perfection and control of these animals, are discussed below.

What is a virtual currency? Initially, a distinction must be drawn between virtual currency and real currency. The Financial Crimes Enforcement Network (“FinCEN”), in its Guidance FIN-2013-G-0001 issued March 18, 2013, defines “real” currency as “coin and paper money of the United States or any other country that is designated as legal tender, circulates and is customarily used and accepted as a medium of exchange in the country of issuance.” By contrast, virtual currencies are electronic representations of value that may not have an equivalent value in a real government-backed currency. While virtual currencies can function like real currencies in certain transactions, and certain virtual currencies can be exchanged into real currencies, a virtual currency itself does not have legal tender status.

Users of virtual currency in commerce include owners that use virtual currency for payment; merchants that accept virtual currency; intermediaries that exchange virtual currency on behalf of merchants; exchange agents that exchange virtual currency into real currency; and electronic wallet and other non-deposit account providers who hold virtual currency for any of the above users. A virtual currency may be managed in a centralized fashion by a single administrator or in a decentralized fashion where there is no central administrator and the verification of transactions is performed by participants.

UCC security interests in virtual currency. A creditor taking a security interest in virtual currency must perfect its security interest under applicable state law. Unlike real currency, virtual currency is typically held in electronic wallets or other non-deposit accounts domiciled outside of traditional financial institutions. These electronic wallets and other non-deposit accounts are not “deposit accounts” as that term is defined in Article 9 of the UCC, because the providers thereof are not banks. Therefore, virtual currencies should be treated as general intangibles under Article 9 of the UCC.

General intangibles. Under UCC 9-102(a)(42), a “general intangible” is defined to include “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.”

To perfect a security interest in a general intangible, a creditor must file a UCC-1 financing statement in the proper filing office, and the financing statement must include a sufficient description of the virtual currency being taken as collateral. The collateral can be described supergenerically by a reference to “all assets,” more narrowly described as “general intangibles,” or specifically referenced as “all virtual currency” or “all bitcoins.”

Regardless of the collateral description, controlling an electronic wallet or other non-deposit account in which a security interest has been granted may be difficult, if not impossible. As a “general intangible,” a security interest in virtual currency cannot be perfected by use of a control agreement. As noted above, virtual currency held with a non-bank intermediary is not a “deposit account” – nor is it a securities account. Perfection issues aside, a non-bank intermediary who holds virtual currency may be unwilling to enter into a tri-party agreement whereby the debtor’s ability to transfer the virtual currency is restricted, or the intermediary agrees to remit the virtual currency to the secured party upon receiving a default notice.

Under the current system, a creditor who perfects by filing would remain susceptible to unauthorized transfers of pledged virtual currency. To compound the problem, most virtual currencies are transferred between parties in an anonymous fashion which, in all likelihood, will make it impossible for the creditor to identify the recipient or take possession of the transferred virtual currency. As a result, creditors may want to try to take possession of any virtual currency collateral at the time the security interest is granted.

Money. Under UCC 1-201(b)(24), the term “money” is defined as “a medium of exchange currently authorized or adopted by a domestic or foreign government. The term includes a monetary unit of account established by an intergovernmental organization or by agreement between two or more countries.” On its face, virtual currencies do not meet the UCC definition of money since virtual currencies are not authorized or adopted by a domestic or foreign government. Likewise, virtual currencies do not meet the FinCEN definition of “real” currency, as they are not coin and paper money of a country that is designated as legal tender.

Despite the statutory definitions, one U.S. federal district court has ruled that Bitcoin is, in an investment context, a currency or form of money. If this ruling were applied to UCC perfection issues, it could significantly
impact how creditors perfect a security interest in assets that include virtual currencies.

In SEC v. Shavers, 2014 U.S. Dist. LEXIS 130781 (E.D. Tex. 2014), the SEC accused the defendant and his company of operating a Ponzi scheme where investors used bitcoins to make their investments. In response, defendants argued for dismissal based in part on the fact that defendants’ investors used bitcoins to make their investment, that bitcoins were not currency, and that as a result there could be no investment of money in the transaction.

To provide some background, Bitcoin is an electronic, cryptocurrency which is not regulated by a central bank or governmental administrator. Instead, Bitcoin is based on a decentralized system where the participants work together to validate transactions. Transactions are recorded on a public ledger using blockchain technology. Bitcoin mining is a method of validating transactions that allows participants to obtain bitcoins as a result of their own efforts. Once mined, Bitcoin, like other virtual currencies, can be used for the purchase of goods and services from an ever-increasing number of merchants who accept Bitcoin as payment, and can be exchanged into real currencies.

The Texas federal district court’s analysis focused on the use of bitcoins in an investment context. In holding that bitcoins are currency or a form of money, the court stated that “(i)t is clear that Bitcoin can be used as money. It can be used to purchase goods or services, and as Shavers stated, used to pay for individual living expenses. The only limitation of Bitcoin is that it is limited to those places that accept it as currency. However, it can also be exchanged for conventional currencies, such as the U.S. dollar, Euro, Yen, and Yuan. Therefore, Bitcoin is a currency or form of money…” The court ultimately entered final judgment that, among other things, required the defendants to disgorge over $40 million in profits and interest.

To the extent virtual currencies are “money” under the UCC, to perfect a security interest creditors would not file a UCC-1 financing statement, as they would for a general intangible, but instead must secure “possession” of the virtual currency.

As described above, obtaining a meaningful security interest in an electronic wallet or other non-deposit account may be difficult or impossible due to the inability of a creditor to take control of such accounts. Enforcement and taking actual possession of virtual currency post-default would likely require that the creditor be able to transfer the virtual currency – which requires access to the specific electronic wallet or other non-deposit account, many of which are access-restricted via private keys or other passwords – to an account in the creditor’s name.

Bottom line. The legal and regulatory landscape concerning virtual currencies is evolving and is likely to continue to evolve in the future as the use of virtual currencies becomes more common and expands into new areas. As the use of virtual currency expands, creditors should proceed with caution and understand the risks associated with taking and perfecting a security interest in assets that include virtual currency.

This story was written by Ryan Behrman, a partner in the Banking and Financial Services Division of Stinson Leonard Street LLP.
Clarks’ Oil and Gas Financing Under the UCC
Perfecting and Enforcing Security Interests
Barkley Clark | Barbara Clark | Matthew Clark

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Interests in Unextracted Minerals: Personal Property or Real Estate?
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Article 9 Security Interests in Oil and Gas Equipment and Fixtures
Oil and Gas Pipelines as Transmitting Utilities
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In response to a scourge of bogus UCC financing statement filings primarily intended to harass public officials, most states have enacted legislation that attempts to deal with the problem in different ways. These non-uniform amendments are spurred in part by failure of Revised Article 9 and the 2010 Amendments to deal specifically with the problem of fraudulent filings. The National Association of Secretaries of State (NASS) has issued a report entitled State Strategies to Subvert Fraudulent UCC Filings. This report can be found at the NASS website, www.nass.org. The Report describes the rise in bogus filings, the role of the UCC and the secretary of state’s filing office, and the different legislative approaches to the problem taken by the various states. The Uniform Law Commission is also weighing in on bogus filings by offering the states what the ULC calls its “hip-pocket amendment” to Article 9.

In its 2015 session, the New Jersey legislature took its own approach and enacted non-uniform amendments to Article 9 that deal with the bogus financing statement problem. Unfortunately, these amendments yield unintended consequences including new risks for secured lenders filing legitimate financing statements in New Jersey. In this story, we review the problem of bogus UCC filings, the role of the Article 9 filing offices, the legislative patterns in the various states including the ULC’s hip pocket amendment, and the turmoil that has arisen in New Jersey.

Scope of the bogus filing problem. The NASS Report notes that the “vast majority” of UCC financing statements filed with secretary of state offices are legitimate documents authorized by legitimate debtors for legitimate secured transactions and filed by legitimate secured parties. In recent years, however, we have seen a huge increase in bogus filings, many of which are made by members of the “sovereign citizen movement,” who believe that the U.S. government is illegitimate. The F.B.I. has designated these “sovereigns” as “paper terrorists.”

The NASS Report states that there may be as many as 300,000 “sovereigns” in the U.S. Numerous websites sell “how-to-file” kits, sometimes for a large fee:

Sovereigns regularly file retaliatory, bogus financing statements and real property liens against government officials, corporations, and banks (or their employees) as a response to a perceived injustice. Judges, prosecutors, and public defenders are also frequently targeted. Although [the UCC filings] are not legally effective, victims may spend years battling their false claims, and some may not even realize they have been targeted until they attempt to conduct a property transaction, or open a line of credit.

Prison inmates have gotten into the game, big-time.

The bogus financing statements usually indicate that the “debtor” owes large sums of money to the filer, who is designated as the “secured party.” An interesting twist in the scam is that many bogus filings describe the individual debtor or a “transmitting utility,” which under the rules of Article 9 allows the financing statement to stay on the public records indefinitely, rather than for the normal five years.
Role of the UCC and the secretary of state’s office. Under Revised Article 9, the secretary of state is by far the most important filing office. The filing office has very little discretion in accepting financing statements that contain minimal information and are presented with the proper fee. It does not have statutory authority to verify the authenticity of financing statements. It can’t reject a financing statement even though it appears to be blatantly fraudulent, e.g., describing an individual “debtor” as a “transmitting utility.” The power to reject financing statements is limited to ministerial defects, such as illegible writing, failure to pay the filing fee, or incomplete forms. Of course the financing statement is not even signed by the debtor; anybody can file one. Most important, a financing statement that is not authorized by the debtor is a legal nullity.

Although an unauthorized financing statement is a legal nullity under UCC 9-509 and 9-510, the purported “debtor” can’t easily get rid of a bogus filing. The filing of an “information statement” does allow the debtor to tell the world that the financing statement is bogus, but that doesn’t wipe out the financing statement or eliminate hassles down the line. Although the victim can file a termination statement, that doesn’t delete the bogus financing statement until a full year after it lapses. UCC 9-519(g). The victim can seek injunctive relief and a minimum $500 fine per bogus financing statement (and refusal to file a termination statement) under UCC 9-625, but most debtors are not aware of these limited remedies. In the opinion of most observers, what is needed is pre- and post-filing administrative relief, as well as expedited judicial relief, heavier civil penalties, and criminal penalties.

The drafters of Revised Article 9 acknowledge that such reforms may be necessary. Comment 3 to UCC 9-518 concedes the shortcomings of the UCC in this area:

This Article cannot provide a satisfactory or complete solution to problems caused by misuse of the public records. The problem of “bogus” filing is not limited to the UCC filing system but extends to the real-property records as well. A summary judicial procedure for correcting the public record and criminal penalties for those who misuse the filing and recording systems are likely to be more effective and put less strain on the filing system than provisions authorizing or requiring action by filing and recording offices.

Legislative patterns in the various states. In about 2004, the states began to fight harder against “paper terrorism.” When the 2010 Amendments failed to address the bogus filing problem, NASS and the International Association of Commercial Administrators (IACA) formed a task force to promote more robust legislation. As the NASS Report states: “NASS members decided to examine alternative approaches that would allow state filing offices to play a more active role in subverting these filings, either by expanding the authority of state filing offices so they can refuse to accept bogus UCC financing statements, or by allowing the offices to quickly and inexpensively terminate financing statements and wipe them from the record under certain conditions.” These legislative efforts fall into four broad categories: (1) pre-filing administrative remedies, (2) post-filing administrative remedies; (3) post-filing expedited judicial relief, and (4) post-filing criminal penalties. Many states have authorized a combination of these approaches.

Pre-filing administrative remedies. A pre-filing administrative remedy gives the secretary of state’s office broad discretion to reject a materially false or fraudulent financing statement. A good example is the South Carolina statute that allows the secretary of state to reject a financing statement that contains any of the following elements:

[The financing statement] is not created pursuant to the UCC; is intended for an improper purpose, such as to hinder, harass, or otherwise wrongfully interfere with any person; names the same person as both debtor and secured party; describes collateral not within the scope of the UCC; or is being filed for a purpose other than a transaction within the scope of the UCC.

The big benefit of a pre-filing administrative remedy is that it can prevent a bogus filing before it happens. The victim need not expend time and resources to correct the bogus filing. From the filing officers’ perspective, the pre-filing approach “maintains the integrity of the public record.” The downside of this approach is the additional resources it requires for the filing office to exercise greater discretion than it has under Article 9.

The states that have taken this approach include Alabama, California, Colorado, Idaho, Illinois, Kentucky, Michigan, Montana, Nebraska, North Dakota, North Carolina, Ohio, Oregon, South Carolina, Texas, and Washington.

Post-filing administrative remedies. These remedies authorize the filing office to take corrective action with respect to financing statements that have already been filed. For example, under some of the state laws, the laudable designation of an individual debtor as a “transmitting utility” is grounds for cancelling a financing statement and removing it from the public record. In some states, the filing office must provide due process by giving the interested parties notice and an opportunity to respond before the financing statement is expunged. The big challenge posed by this approach is that the victim may only find out about the bogus filing after encountering trouble securing credit or undertaking some kind of secured transaction.
The states that have embraced post-filing administrative remedies include Illinois, Kentucky, Michigan, Montana, Nebraska, North Carolina, Oregon, Pennsylvania, Washington and West Virginia.

Post-filing expedited judicial relief. This approach authorizes corrective action on an existing financing statement through an expedited judicial review process, with no fee required to initiate the process. Victims are provided with a faster, less costly means for obtaining a declaratory judgment or expungement order. The NASS report states: “The benefit of this approach seems to be that the court system continues to bear responsibility for handling these issues, which means that the secretary of state’s office does not need to have additional resources, training and staffing to provide a faster, less costly solution.” The bad news is that expedited judicial relief “still places significant burdens on the victims. Although there may not be a fee for filing a motion for expedited judicial review, it is still a court action, and a victim will often need to hire an attorney and pay the associated costs. Since this remedy also places burdens on the courts, they may be unwilling to support it.”

States that have embraced post-filing expedited judicial relief include Colorado, California, Kansas, Maine, Minnesota, Oregon and Texas.

Post-filing criminal/civil penalties. These penalties are designed to punish and deter, and they build on the more expedited judicial relief. These penalties are required to initiate the process. Victims are provided with a faster, less costly means for obtaining a declaratory judgment or expungement order. The NASS report states: “The benefit of this approach seems to be that the court system continues to bear responsibility for handling these issues, which means that the secretary of state’s office does not need to have additional resources, training and staffing to provide a faster, less costly solution.” The bad news is that expedited judicial relief “still places significant burdens on the victims. Although there may not be a fee for filing a motion for expedited judicial review, it is still a court action, and a victim will often need to hire an attorney and pay the associated costs. Since this remedy also places burdens on the courts, they may be unwilling to support it.”

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Post-filing criminal/civil penalties. These penalties are designed to punish and deter, and they build on the more limited penalties that are already found in UCC 9-625. At least ten states now have laws that make it a crime to fraudulently submit a bogus filing. Some states, including Texas and Minnesota, even make it a felony to attempt to harass a person by using a bogus financing statement. At least 14 states beef up the civil penalties already allowed by Article 9. These statutes allow victims to seek damages, court costs, attorney’s fees, related expenses, and injunctions. The UCC contains no criminal penalties.

The states with particularly tough criminal and civil penalties include Arkansas, California, Georgia, Illinois, Kansas, Maine, Michigan, Minnesota, Montana, New Hampshire, North Dakota, South Carolina, Texas, Utah and West Virginia.

The Uniform Law Commission weighs in. A few years ago, the Uniform Law Commission developed a “hip-pocket” amendment to Article 9 to deal with the bogus filing problem. The ULC does not recommend that states adopt the amendment, and indeed most of the people involved in developing it believe that states should not adopt it because the cure may be worse than the disease. The rationale for the amendment is that, if states are going to attempt to deal with the problem no matter what, it’s best that they have the benefit of a well-drafted provision. At its October 2013 meeting, the Permanent Editorial Board for the UCC recommended the creation of a working group to help the ULC improve the hip-pocket amendment.

The ULC amendment allows any person identified as a “debtor” on a financing statement to send the filing officer an affidavit stating that the filing is bogus; authorizes the filing officer to file a termination statement in response to the affidavit; provides for notice of the termination statement to the secured party of record; authorizes a judicial action for reinstatement of a financing statement by a secured party; and provides an expedited administrative procedure if an affidavit of bogus filing has been presented to the filing office but the filer is a “trusted filer” who regularly files financing statements with the secretary of state (e.g., an institutional lender or filing company). The amendment also contains special provisions that protect bona fide purchasers, and provides some additional remedies for a victim who prevails in a reinstatement action brought by a secured party.

The ULC amendment focuses primarily on post-filing administrative remedies, but if a state insists on giving the filing office additional pre-filing rejection authority, the amendment gives filing officers some limited discretion. Post-filing judicial relief is limited to “reinstatement” suits brought by a secured party. Wisely, the amendment protects all persons who are victimized by bogus financing statements, not just public officials. In general, the ULC approach seems to be well thought out and deserving of consideration by the various states.

The New Jersey response: unintended consequences. On May 11, 2015, non-uniform amendments to Article 9 dealing with bogus UCC filings (New Jersey Assembly Bill 2481) became effective. The new law applies only to UCC filings on or after that date. These changes were intended to provide the New Jersey central filing office with enhanced tools to fight bogus UCC financing statements. For example, UCC 9-516 was amended to provide the filing office with additional reasons to reject UCC filings based on the unique indications of fraudulent filing. Unfortunately, new amendments to UCC 9-502 impact all UCC filings. A financing statement that fails to meet the requirements of 9-502 will not be effective even if the filing office accepts and indexes the filing. This could be a field day for New Jersey trustees in bankruptcy.

Paul Hodnefield, Associate General Counsel of Corporation Service Company, identifies the unintended consequences:

The new law made two amendments of concern in §12A:9-502. The first changes the requirements for the name of the secured party or representative of the secured party. The new version of §12A:9-502(a)(2) requires that the financing statement provide a name which “discloses the identity of the secured party or representative.” In the majority of cases, §12A:9-502(a)(2) poses little risk for the secured party. Most secured parties file under their actual name or a variation of the name close enough to allow an interested
party to identify the actual secured party or representative. However, it is not clear if a trade name of the secured party would be sufficient in all cases. Many secured parties use a trade name as the name of the secured party. If that trade name is not registered in New Jersey, an interested party arguably would not be able to know where to look for the actual name of the secured party. As a result, use of a trade name that is not registered in New Jersey arguably does not identify the secured party or representative and could render the financing statement ineffective.

In other words, although requiring more precise “identity of the secured party” on the financing statement was intended to help identify fraudulent filers, it also could render unperfected the security interest of legitimate parties.

Mr. Hodnefield explains another big problem for secured lenders in New Jersey:

The other amendment of special concern to secured parties changed the requirements for the indication of collateral in §12A: 9-502(a)(3). Under the new law the financing statement must indicate not only the collateral covered by the security interest—it must also indicate that the collateral falls within the scope of Article 9. Thus, a financing statement that omits the indication of scope would not comply with the requirements for sufficiency under the plain text of this provision. As a result, the financing statement may not be effective.

As one example of the “scope” problem created by this provision, assume that the collateral description in the financing statement was supergeneric, such as “All Assets of the Debtor, Now owned or hereafter acquired.” Although such a description is encouraged by UCC 9-504, the New Jersey amendment to UCC 9-502(a)(3) now requires that the financing statement indicate “that the collateral is within the scope of [Article 9, UCC 9-102 and 9-109].” An “all assets” collateral description necessarily includes assets outside the scope of Article 9. Though the drafters included this language because many fraudulent UCC filings make reference to non-Article 9 assets, the language invites a challenge by a trustee in bankruptcy to supergeneric filings made by legitimate secured parties. As another example, Article 9 allows “precautionary filings” for transactions that may be on the margin of Article 9, such as equipment leases vs. installment sales. See UCC 9-505(b). Under the New Jersey amendments, such filings arguably render the financing statement ineffective and subject to avoidance by a bankruptcy trustee.

As best practices, Mr. Hodnefield urges New Jersey secured lenders (1) to avoid using a trade name for the secured party or representative unless the trade name is registered in New Jersey and (2) to include a statement in the financing statement that all the collateral falls within the scope of Article 9.

New Jersey should adopt the ULC’s hip-pocket amendment. Because of growing concerns about the unintended consequences of New Jersey’s 2015 amendments to Article 9, we understand that the banking industry is joining forces with the Uniform Law Commission to promote repeal of those amendments and to replace them with the ULC’s hip-pocket amendment. In that way, the legislation will be more finely focused on the bogus filing issue without changes that adversely affect legitimate secured lenders. We think that result makes a lot of sense.

Three final thoughts:
• Bogus UCC filings are likely to continue apace, and perhaps even be expanded to include bogus termination statements.
• In responding to this problem, state legislators need to be careful to eliminate unintended consequences.
• The ULC should consider taking its amendments out of its hip-pocket and pushing for their enactment as uniform amendments to Article 9.

SIXTH CIRCUIT: BLANKET SECURED LENDER TRUMPS IP LICENSEE

The Sixth Circuit issued a notable opinion on January 11 that addresses important issues involving intellectual property security agreements and licenses. Cyber Solutions International, LLC v. Pro Marketing Sales, Inc., 2016 U.S. App. LEXIS 533 (6th Cir.) (not recommended for publication). In short, the Sixth Circuit held that a license agreement providing that any updates to existing intellectual property rights developed by the licensor and paid for by the licensee “shall be the property of [licensee]” and that “[Licensor] agrees to assign” such updates to the Licensee was subject to a prior perfected security interest in all intellectual property assets of the Licensor. We think the Sixth Circuit may have misread one provision in the security agreement and the licensee could have avoided this outcome with different language in the license agreement.

What happened? In 2009, a secured party made a loan to a debtor secured by all assets of the debtor, including all intellectual property such as “the Copyrights, the Copyright Licenses …, and all Goodwill associated with or arising in connection with any of the foregoing.” The security agreement included a provision stating the debtor could not “sell, transfer, assign, convey or otherwise dispose” of any intellectual property outside the ordinary course of business without the secured party’s prior written consent.

Although such a provision is generally unenforceable, the Sixth Circuit interpreted the provision to mean the creditor could not sell updates to the intellectual property rights without the debtor’s consent. The Sixth Circuit issued a notable opinion on January 11 that addresses important issues involving intellectual property security agreements and licenses. Cyber Solutions International, LLC v. Pro Marketing Sales, Inc., 2016 U.S. App. LEXIS 533 (6th Cir.) (not recommended for publication). In short, the Sixth Circuit held that a license agreement providing that any updates to existing intellectual property rights developed by the licensor and paid for by the licensee “shall be the property of [licensee]” and that “[Licensor] agrees to assign” such updates to the Licensee was subject to a prior perfected security interest in all intellectual property assets of the Licensor. We think the Sixth Circuit may have misread one provision in the security agreement and the licensee could have avoided this outcome with different language in the license agreement.
In 2011, the debtor filed a Chapter 11 bankruptcy case and entered a License Agreement with a new licensee who paid the debtor $400,000 in return for the License Agreement. That agreement provided:

[ ]ny updates, modifications or improvements to the Licensed Technology developed by [debtor] and paid for by [licensee] shall be the property of [licensee]. Debtor agrees to assign and agrees to assign in the future (when any such updates, modifications, or improvements to the Licensed Technology are first produced to practice or first fixed in a tangible medium, as applicable to [licensee] all right, title, and interest in and to any and all updates, modifications or improvements to the Licensed Technology …

In addition, the License Agreement acknowledged that it was subject to certain liens and security interests which would “continue notwithstanding [debtor’s] entry” into the License Agreement.

In 2012, the bankruptcy court confirmed a plan of reorganization based in part on the License Agreement. Thereafter, the debtor developed an “update, modification, or improvement” of the licensed technology that was not disputed by the parties. However, the debtor continued to struggle financially, and ultimately surrendered all of its assets, including its intellectual property, to the secured party, purportedly as part of a UCC strict foreclosure.

The licensee then sued the secured party for a declaratory judgment that it owned the improvements it paid for, and the secured party counterclaimed for declaratory judgment that it had a superior security interest. The district court granted summary judgment to the secured party, and the Sixth Circuit affirmed.

The Sixth Circuit’s reasoning. The Sixth Circuit gave two reasons for its holding. The impact of the first reason could have been avoided, and the second may be a mistake. The first reason is that the debtor in the License Agreement:

“agrees to assign and agrees to assign in the future” its rights and any modifications to the [licensed] technology. This provision does not instantly grant any rights to [the licensee]; rather, it implicitly recognizes that [the debtor] itself will acquire rights that it must then assign.

Although not explicitly stated in the Sixth Circuit’s opinion, the court is clearly acknowledging that the language in the License Agreement allowed the security interest to attach to such improvements prior to their conveyance to the licensee. Of course, this could have been avoided if the license agreement included a simultaneous transfer of such rights [assuming that is possible with such technology].

The second reason given by the Sixth Circuit for favoring the secured lender is that “[the debtor] did not have the unfettered authority to grant the rights that it purported to grant in the License Agreement.” Further explaining, the Sixth Circuit stated that “any waiver, release, or transfer of the collateral required ‘the prior written consent of [the secured party].’” Nothing in the record indicates that [the secured party] provided such consent …

What can we learn from the case? The first lesson from the case is that licensees must clearly understand whether any intellectual property they are seeking to license is subject to a prior perfected security interest. The licensee in this case learned a $400,000 lesson (not to mention legal fees) in this regard. In addition to representations and warranties about no security interests, licensees should do appropriate UCC searches against their licensor.

Second, if a prior perfected security interest exists against a licensor, licensees must clearly address it in their license agreement and with the secured party. For example, the licensee can have the secured party release its security interest in the licensed intellectual property under UCC 9-512 (a). Alternatively, the licensee can arrange for the secured party to authorize any present or future conveyances in the license under UCC 9-315(a)(1). However, since the intellectual property in this case involved “updates, modifications or improvements” to existing intellectual property subject to the security interest, it is difficult to imagine a way for the licensee to develop a high level of confidence in being able to do any other kind of license without the secured party’s release or consent.

Third, the Sixth Circuit may have gone too far in saying the debtor had no authority to grant the license in question. Although not entirely clear in the Sixth Circuit’s opinion, the language cited by the court from the security agreement probably came from a portion of the security agreement creating a covenant by the debtor to not sell the intellectual property without the secured party’s consent. A breach of that covenant simply creates an event of default entitling the secured party to foreclose. Importantly, such a covenant is not a limitation on the power of a debtor to commit a breach of the covenant. Such a limitation on the power of a debtor would potentially require modifications to the organizational documents for the debtor, with appropriate organizational authorization. That rarely happens for these kinds of provisions.

A final thought: perfection of security interests in IP. Although the issue of how to perfect a security interest in intellectual property never came up in the Sixth Circuit case, the case is a good reminder of the need for secured lenders to be careful. In the Sixth Circuit case, the intellectual property at issue was copyrights. Where to file depends on whether the copyrights are registered or unregistered. If they are registered, the courts have concluded that a filing

Under the secure lender-friendly rules of the UCC, a supergeneric financing statement covering “All Assets Now Owned or Hereafter Acquired” would perfect a security interest in patents, trademarks and unregistered copyrights. A reference to “All General Intangibles Now Owned or Hereafter Acquired” would also do the job.

The preceding story was written by Paul Hoffmann, a bankruptcy attorney at Stinson Leonard Street LLC. Mr. Hoffmann is a frequent contributor to this newsletter.

UNIFORM LAW COMMISSION POISED TO PROPOSE MODEL STATUTE ON PROTECTION OF EXEMPTION FOR WAGES DEPOSITED INTO A BANK ACCOUNT

Both federal and state law provide a number of exemptions from wage garnishment. Most notably, the federal Consumer Credit Protection Act exempts 25 percent of an individual’s earnings from garnishment. 15 USC §1673. But does this exemption go away when the debtor deposits his or her wages into a bank account? The federal statute is unclear on this point. In something of a surprise, the courts have uniformly held that the exemption does not continue into the deposit account; therefore, the bank is not required to protect the depositor’s exemption when answering a garnishment notice. The leading case is Usery v. First Nat’l Bank of Arizona, 586 F.2d 107 (9th Cir. 1978), where the court concluded that the federal statute does not impose a duty on the bank to calculate the amount of the exemption and the applicable number of pay periods. Moreover, the bank is not required to trace the earnings into the account to determine which portion of the deposit is exempt from garnishment.

Treasury rule regulates garnishment of directly deposited government benefits. In the name of consumer protection, the federal agencies that disburse benefits, led by the Treasury Department, published an interim final rule in 2011 that requires banks to flag and protect federal benefits, including social security and VA payments, that are exempt from wage garnishment under federal law. The agencies adopted a final rule in 2013. The rule is codified at 12 CFR Part 212. The Federal Register materials accompanying the interim final rule (76 Fed. Reg. 9939-9962) provide a good summary of the compliance requirements imposed on banks:

• A bank that receives a garnishment order must first determine if the United States or a State child support enforcement agency is the plaintiff that obtained the garnishment order. If so, the bank follows its customary procedures for handling the order. If not, the bank must review the account history for the prior two months to determine whether, during this “look-back” period, one or more exempt benefit payments were directly deposited to the account. The bank may rely on the presence of certain ACH identifiers to determine whether a payment is an exempt benefit payment.

• The bank must allow the account holder to have access to an amount equal to the lesser of the sum of exempt payments directly deposited to the account during the lookback period, or the balance of the account on the date of the account review. This is the “protected amount.”

• In addition, the bank must notify the account holder that the bank has received a writ of garnishment. The notice must briefly explain what a garnishment is and must include other information regarding the account holder’s rights. There is no requirement to send a notice if the balance in the account is zero or negative on the date of account review. Banks may choose to use a model notice contained in the rule in order to be deemed to be in compliance with the notice requirement.

• For a deposit account containing a protected amount, the bank may not collect a garnishment fee from the protected amount. The bank may only charge a garnishment fee against funds in the account in excess of the protected amount and may not charge or collect a garnishment fee after the date of account review.

• Banks that comply with the rule’s requirements are protected from liability.

Banks have now lived with these compliance requirements for five years, while consumers have enjoyed protection of the exemption where federal benefits are involved.
ULC proposes uniform wage garnishment legislation that builds upon the Treasury rule model. In July of 2016, the Uniform Law Commission will take a final vote on promulgation of a uniform Wage Garnishment Act. Article I of that proposed legislation deals with garnishment of earnings generally, with emphasis on the relationship between the garnishing creditor (garnisher) and the employer (garnishee). Article I establishes a legal framework for (1) the commencement of a garnishment action; (2) the initial response of the garnishee to the garnishment action; (3) the pendency of a garnishment; (4) termination of a garnishment action; (5) notice forms; (6) limits on wage garnishment; (7) multiple ordered deductions; (8) compliance process; and (9) garnishee penalties for noncompliance. The goal of the drafters is to bring some uniformity to this area of state law.

Article II of the proposed legislation deals with garnishment of bank accounts titled in the name of an individual that contain exempt earnings. These provisions build upon the Treasury rule dealing with the garnishment of bank accounts containing federal benefits. This should simplify bank compliance. The final decision to include Article II in the proposed legislation will not be made until after the next meeting of the Drafting Committee in late February. Set forth below is a summary of Article II by William Henning, Professor of Law at Texas A&M School of law. Professor Henning chairs the Drafting Committee for the proposed legislation. Here is his nutshell:

• Article II includes the requirement that a bank conduct an account review with a 60-day lookback period within two days after being served with a garnishment order—the same as under the Treasury rule. In conducting the review, the first step is for the bank to determine whether there were two or more direct deposits from the same source during the lookback period. The bank doesn’t have to determine whether the deposits were from an employer; if there are not two direct deposits from the same source, the act doesn’t permit the account holder an exemption and the bank’s responsibilities under the act are at an end.

• If there are two direct deposits from the same source during the lookback period, the bank must send a notice to the account holder not later than three business days after the account review, just as under the Treasury rule. If federal benefits were deposited during the lookback period, the bank can use the federally mandated form, amended to include a very limited amount of additional information—a statement that the account holder can claim an exemption, the beginning date of the lookback period, and an explanation of the process for claiming the exemption.

If there are no federal benefits in the account, the bank must send a form that mirrors the federal form, except for the addition of the same limited amount of information described above. The act contains a standard form for providing the additional information that will make compliance easy.

• Once the bank sends the notice, it waits to see if the account holder claims an exemption. If it does not receive a form claiming an exemption within 15 days after the date on the notice to the account holder, its duties under the act are at an end. The form the account holder is to use is provided in the notice sent by the bank. Even if the account holder claims an exemption, the bank’s duties under the act are at an end if it does not receive one or more pay stubs from the account holder within 15 days after it received the account holder’s claim form.

• If the bank receives pay stubs, it reviews them to see if the earnings were direct-deposited to the account at issue and if the date of payment is within the lookback period. If the answer to those questions is yes, the bank looks to see whether the pay stubs indicate an amount that was garnished. The total amount of garnished funds shown on qualifying pay stubs is the amount of the exemption. The bank’s good-faith determination of the exempt amount is conclusive and not subject to challenge by the creditor or the account holder.

Some final thoughts:

• The drafters of the proposed legislation summarize their efforts dealing with garnishment of bank accounts: “We have structured [Article 2] to be closely aligned with our primary mission, which is regulation of garnishment by employers. As a result, the exemption only applies if the account contains earnings that have already been subjected to some type of prior garnishment within the lookback period, including garnishments governed by Article 1 [which is limited to garnishments by typical creditors and does not govern, e.g., child-support garnishments]. Similarly, the amount protected in [Article 2] is closely tied to those earnings.”

• The drafters also point out that, at the present time, 35 states provide some type of protection for bank depositors against garnishment, but the nature and scope of the protection varies considerably between states. The proposed legislation would bring uniformity and predictability to this area of the law.

• If the proposed garnishment legislation is to be widely adopted by the states, it will require the support of the two key constituencies: consumers and banks. We think that the proposed legislation does a good job of
protecting the exemption of consumers from garnishment after the wages are deposited into a bank, while at the same time seeking to ease the compliance burden of the banks. For example, banks like the fact that they are allowed two days after the date of service to process the garnishment, and that they can’t hold funds until the processing is complete. The legislation deserves careful attention by the states.

- It is possible that the ULC will end up proposing only Article I, dealing with situations where the employer is the garnishee, rather than including Article II, where the bank is garnishee. We think the best approach is to combine the two Articles in the proposed legislation and let the individual states decide whether to delete Article II.
CALIFORNIA COURT CONFIRMS RULE GIVING PRIORITY TO JUDGMENT CREDITOR AS A “TRANSFEREE” FROM THE DEBTOR’S DEPOSIT ACCOUNT

If a debtor has granted a consensual security interest in the funds in its deposit account to a secured lender, does the lender have priority over the claims of a judgment creditor who later levies against the deposit account? In a recent decision from California, the court gives priority to the judgment creditor under the rules of Article 9. The decision is both thoughtful and exhaustive in resolving the priority issue based on the language and policies behind UCC 9-332(b). Yet there’s a good argument on the other side.

The California case. In Stierwalt v. Associated Third Party Administrators, 2016 U.S. Dist. LEXIS 68744, 89 UCC Rep. 2d 921 (N.D. Calif. 2016), CAM loaned more than $12 million to the debtor (ATPA) in 2012 and retained a blanket security interest in all the debtor’s assets, including all contract rights, general intangibles and “all deposit accounts.” The secured notes were designated as “senior in right of payment” with respect to “all other indebtedness of the company.” Later, Richard Stierwalt obtained a $626,000 judgment against ATPA for wrongful termination of his employment with the company. Stierwalt followed up with a writ of execution that included garnishment of ATPA’s deposit accounts with U.S. Bank. However, before any funds were released by the bank, CAM filed a statement claiming a perfected security interest in the funds in the debtor’s deposit account. This claim was made under the California adverse claim statute.

So which creditor had priority? CAM contended that it had priority over the garnishing creditor under the plain language of Article 9: “In general, after perfection the secured party is protected against creditors and transferees of the debtor.” UCC 9-308, Official Comment 2. In the present case, the judgment creditor did not dispute that CAM’s security interest in the funds in the deposit account had attached through the grant of a security interest.

Was CAM’s security interest perfected? On the issue of perfection, the court drew a distinction between a security interest in a deposit account as original collateral and a derivative security interest in the funds in the account generated when receivables owing to the debtor are deposited in the account as “proceeds.” The court concluded that, although CAM’s loan documentation expressly covered “all deposit accounts,” it had not perfected its security interest in the debtor’s accounts as original collateral because it had no “control” over the account under UCC 9-104, for three reasons: (1) the secured lender was not the debtor’s depository bank, (2) there was no third-party control agreement, and (3) the deposit accounts were not placed into CAM’s name as “customer.”

Then the court turned to CAM’s alternative argument that it had a security interest in all the debtor’s receivables, which were collected and then deposited into the debtor’s bank account as “derivative proceeds.” CAM contended that it had filed proper financing statements covering the receivables, and that the collections of those receivables constituted “identifiable” proceeds that were deposited into the debtor’s U.S. Bank accounts. The judgment creditor countered that the monies in the deposit account were not “proceeds” because there was insufficient evidence that any contract rights gave rise to those payments of money to ATPA. The California court rejected that argument, primarily based on a declaration signed by the CEO of the

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debtor that “ATPA performs its services on behalf of its trust clients pursuant to written service agreements” and that “[t]he revenue that ATPA generates is governed exclusively by the service agreements.” The court concluded that, based on this contract documentation, ATPA had “contract rights” which gave rise to payments from its clients that constituted proceeds deposited into the U.S. Bank accounts. The judgment creditor also argued that the service contract proceeds were commingled with other company funds in the deposit accounts, and that CAM’s security interest was lost because the proceeds were no longer “identifiable.” The court didn’t buy that argument; it concluded that “any commingling is negligible at best.” Nor was the security interest cut off after 21 days in the deposit account because that rule does not apply where the proceeds are “identifiable cash proceeds.” UCC 9-315(d) (2). In short, the lender’s security interest in the funds in the deposit account was properly perfected under Article 9.

**Article 9 take-free rule allows judgment creditor to trump lender’s perfected security interest.** In spite of the secured lender’s perfected status, the court gave priority to the judgment creditor. Stierwalt argued that he, and not CAM, should have first crack at the funds in the deposit account, based upon “equitable subrogation.” The California court concluded that it did not need to explore the fuzzy concept of “equitable subrogation” because Article 9 itself has a special rule that gives “transferees” from a debtor’s deposit account priority over competing interests of third parties. In particular, UCC 9-332(b) provides:

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.

The court also pointed to Official Comment 2 to 9-332, which explains that the take-free rule “affords broad protection to transferees who take funds from a deposit account….” Comment 3 then goes on to explain the policy rationale for the take-free rule:

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 is a prerequisite for receiving the ability to take free from third-party claims, where payments are concerned the law is even more protective. [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.

**Does a judgment creditor qualify as a “transferee”?** The California court noted that an argument could be raised that a judgment creditor who gets funds from a deposit account via a writ of garnishment should not be considered a protected “transferee” for purposes of the Article 9 take-free rule, particularly when a court has not yet released the funds pursuant to the writ of garnishment. On this critical point, the judgment creditor in the present case cited an earlier California decision which allowed the judgment creditor to take free of an adverse security interest in the deposit account. In *Orix Financial Services, Inc. v. Kovacs*, 167 Cal. App. 4th 242, 66 UCC Rep. 2d 1063 (Cal. App. 2008), the plaintiff, Orix, had a perfected security interest in the assets of the debtor, ADA. The defendant, Kovacs, obtained a writ of garnishment against ADA’s deposit accounts, which contained funds from the collection of receivables and thus qualified as “identifiable cash proceeds.” The judgment creditor was allowed to take free of the security interest in the deposited funds. Sometime after the physical transfer of the funds, Orix sued the judgment creditor for recovery of the garnished funds, based on theories of unjust enrichment and constructive trust.

The court ruled that Orix could not recover the funds from the judgment creditor, even though the garnishment was not a transfer in the ordinary course of business, as would be a payment to an unsecured creditor. That court concluded that the take-free rule of UCC 9-332(b) should be construed to include a broad range of “transferees”:

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 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 the debtor in exchange for the payment.

In short, a garnishing creditor should be allowed to take free of a prior perfected security interest in the debtor’s deposit account, even though the “transfer” was involuntary.

In the present case, CAM contended that allowing a garnishing creditor to gain priority over a secured party would violate the language and purpose of California’s adverse claim statute: “If any party who levies upon a deposit account is
considered a transferee under section 9-332(b), the entire body of statutory law allowing third-party claims under California law would be rendered meaningless. There would be no purpose for a third-party claim procedure if every time a party levies upon property under a writ of execution, that party automatically prevails on any third-party claim, simply because he is a ‘transferee.’” The court rejected that argument on the ground that the take-free rule is limited to transfers from a deposit account: “The California legislature placed deposit accounts on special footing in order to safeguard against the potential disruption to commerce that would occur if payments from such accounts were subjected to the uncertainty of third-party claims.” The court concluded that there was a “transfer” pursuant to § 9-332(b) when the U.S. Marshal levied upon the bank account, such that Mr. Stierwalt “takes the funds free of a security interest in the deposit account.”

No “collusion” between debtor and transferee. Finally, the California court turned to the question of whether the judgment creditor was not allowed to take free because it had “colluded” with the debtor to gain priority. The court had little difficulty in rejecting this last-gasp argument by the secured lender. The court concluded that the “collusion” exception to the take-free rule is limited to cases that smell like fraudulent transfers. Although CAM cited various “bad acts” on the part of the judgment debtor, these acts arose out of the wrongful termination of employment that gave rise to the lawsuit; they predated the writ of garnishment and did not involve any acts between Mr. Stierwalt and the debtor that were intended to violate CAM’s security interest.

Some parting thoughts.

• Although we think the recent California decision is probably correct, we also think that there is a good argument on the other side. The Orix decision on which it relied involved a situation where the garnishing creditor had already received the funds out of the debtor’s deposit account and had gained physical control over them. To impose damages on such a creditor would require a complete disgorgement—return of the toothpaste to the tube. By contrast, in the recent case the litigation was in a posture where there was no physical delivery to the judgment creditor. Control of the funds was still in the hands of the court. In a very practical sense, there had yet been no “transfer” of the funds to the levying creditor. The California adverse claims statute invited the secured lender, as “adverse claimant,” to challenge the competing levy before it was finalized by physical transfer of the funds to the judgment creditor. In short, it is one thing to claw-back funds that have been physically transferred to the levying creditor or other transferee; it is another to give priority to the judgment creditor under the take-free rule where the funds have been frozen based on the adverse claim of the secured lender. In that sense, the new California case goes one big step further than the court in the prior Orix case.

• Although the courts are uniform in protecting a judgment creditor or other third-party transferee from claw-back if they have already obtained control over the funds, they are split down the middle if an adverse party (including the depository bank itself), through a court order or otherwise, has obtained control. See Myers v. Christensen, 776 NW2d 201, 70 UCC Rep.2d 577 (Neb. 2009) (depository bank may use its consensual security interest in a customer’s deposit account as a shield against liability to a garnishing creditor, even though the bank allows the customer to continue to draw on the account after the bank receives the writ of garnishment) and Frierson v. United Farm Agency, Inc., 868 F.2d 302, 8 UCC Rep.2d 260 (8th Cir. 1989) (bank with consensual security interest in deposit account must “use it or lose it” rather than allow the funds to be garnished by a competing judgment creditor after the debtor’s default).

• The UCC take-free rule has been applied to allow a second-lien secured lender who receives payment from the debtor to trump a first-lien lender. See, e.g., ITT Commercial Fin. Corp. v. Bank of the West, 166 F.3d 295, 37 UCC Rep. 2d 855 (5th Cir. 1999).

• In the recent California case, the UCC take-free rule was held to override the language of the state’s adverse claim statute. In other jurisdictions, the language of the adverse claim statute may be broad enough to override Article 9. In these priority cases, due diligence includes a careful review of the adverse claim statute.

• The leading case on “collusion” under UCC 9-332(b) is Keybank, N.A. v. Ruiz Food Products, Inc., 59 UCC Rep. 2d 870, 2005 U.S. Dist. LEXIS 48262 (D. Ida. 2005) (unsafe vendors of the depositor received payment out of the depositor’s new bank account even though the depositor set up the new account with an intent to launder the funds through the new account and thus divert money away from his secured lender to his unsecured creditors; vendors prevailed over the secured lender under UCC 9-332(b) on the ground that they knew nothing about the “laundering” scheme and thus were not in collusion with the depositor).

LOUISIANA COURT RULES THAT SECURED LENDER COULD ENFORCE BUYER’S RIGHTS UNDER PURCHASE AGREEMENT

When a borrower defaults, the secured lender has a right to foreclose on the collateral by public or private sale. With respect to receivables owing to the debtor—accounts receivable, executory contract rights, general
intangibles, chattel paper, or negotiable instruments—the secured lender can avoid the pitfalls of a foreclosure sale and collect directly from the account debtors. That’s the beauty of being able to step into the shoes of the borrower. For example, if the debtor is a retail dealer, proceeds from the inventory might include accounts receivable (from customers who buy on 30-day open account), chattel paper (from customers who buy on secured installment credit) and promissory notes (from customers who buy on long-term unsecured credit). With respect to direct collection against the third-party obligors, the rights and duties of the secured party are set forth in UCC 9-607. A recent bankruptcy court decision from Louisiana nicely illustrates the power of direct collection in the context of a Chapter 11 bankruptcy.

The Louisiana bankruptcy case. In In re Gremillion, 550 B.R. 307, 89 UCC Rep. 2d 584 (E.D. La. 2016), HealthEdge Investment Fund entered into an agreement with Founders in August 2008 under which HealthEdge would purchase 51% of Founders’ ownership interest in an LLC whose business was providing monitoring services to the healthcare industry. The purchase price was $16,250,000. In September 2008, Gemino and the LLC (together with some affiliated entities) entered into a credit agreement under which Gemino agreed to loan the LLC a substantial sum payable in August 2013. HealthEdge guaranteed repayment of the loan through a “collateral assignment” that pledged HealthCare’s rights under the purchase agreement in favor of Gemino.

Prior to the maturity date of the secured loan, a dispute arose between HealthEdge as buyer of the LLC and Founders as seller, with each alleging breach of the purchase agreement. Upon learning of HealthEdge’s claims against Founders, Gemino notified both parties that all payments due to HealthEdge in connection with the purchase agreement were to be made to Gemino until the secured loan was paid in full. Gemino, however, did not join in HealthEdge’s claims against Founders. The dispute was finally settled with an arbitration award to HealthEdge in the amount of $8,098,176. The arbitration award was reduced to a judgment.

While arbitration was proceeding, the maturity date on the secured loan expired but Gemino was not repaid. Gemino asserted that it had the right to collect the judgment from Founders. In connection with its direct collection efforts, Gemino finally settled with Founders in the amount of $5.8 million in full satisfaction of the judgment. As a fallout of the disputes, one of the Founders principals, Paul Gremillion, filed Chapter 11 bankruptcy. HealthEdge objected to any negotiated settlement by Gemino, asserting that while Gemino was entitled to receipt of the proceeds derived from the judgment, it lacked the right to negotiate or force HealthEdge to accept a settlement. The key issue before the bankruptcy court was whether Gemino or HealthEdge had the authority to file and pursue claims against Gremillion, as well as negotiate and vote on any plan of reorganization submitted by Gremillion. The bankruptcy court noted that, because the $5.8 million judgment represented the majority of debt owed by Gremillion, the party who controlled both the claim and its disposition would have a major impact on the administration and reorganization of the debtor’s estate.

Secured lender could pursue direct collection against the account debtor. The bankruptcy court first turned to the language of the collateral assignment, which allowed the secured lender, upon an event of default, to enforce all of the rights of HealthEdge as purchaser of the LLC interest. As secured lender/assignee, Gemino had the right to step into HealthEdge’s shoes under the purchase agreement. Gemino’s rights included the right to receive any payments due to HealthEdge and to “compromise or settle any disputed claims HealthEdge had under the Purchase Agreement.” When it learned of HealthEdge’s claims under the purchase agreement, Gemino notified both the borrower/assignor and the account debtor that all payments due to HealthEdge were to be redirected to Gemino. Gemino allowed HealthEdge to pursue its claims which resulted in the judgment.

The court concluded that the judgment confirmed HealthEdge’s rights and quantified its damages for breach of the purchase agreement. The big issue was “whether the transformation of HealthEdge’s rights under the Purchase Agreement into the Judgment somehow diminished Gemino’s right under its Assignment.” HealthEdge first argued that Gemino waived its right to pursue direct collection because it did not initially exercise that right when HealthEdge brought claims against Founders. Second, HealthEdge argued that the $5.8 million judgment was not a “disputed claim” and only disputed claims could be enforced by Gemino.

Regarding Gemino’s right to direct collection from the account debtor, the court ruled that contract rights under the purchase agreement qualified as an “account” under UCC 9-102(a)(2) (the term “account” includes “a right to payment of a monetary obligation, whether or not earned by performance...for property [the LLC interest] which has been or is to be sold”). HealthEdge contended that, under the terms of the collateral assignment, Gemino was only entitled to enforce “disputed claims” arising out of the contract. Having “liquidated” the disputes arising out of the purchase contract, HealthEdge argued that Gemino had lost its ability to enforce those rights. The court rejected this argument, based on the broad “direct collection” language of UCC 9-607(a):
(3) [A secured party] may enforce the obligations of an account debtor or other person obligated on collateral and exercise the rights of the debtor with respect to the obligation of the account debtor or other person obligated on collateral to make payment or otherwise render performance to the debtor and with respect to property which secures the obligations of the account debtor or other person obligated on the collateral.

The court ruled that, even if the collateral assignment did not allow the deflection of an “undisputed” stream of payments, Article 9 of the UCC did allow such a remedy. The court explained: “Gemino’s right to enforce the terms of the Purchase Agreement are not dependent on any grant of authority under the Collateral Assignment. As such, they are not limited by the Collateral Assignment’s reference to ‘disputed claims’.”

The secured lender’s rights in the judgment. Neither party disputed that Gemino retained a security interest in the judgment. HealthEdge argued, however, that once the judgment was obtained, Gemino’s rights changed from those specified in the collateral assignment to those in “proceeds” from the account. As such, Gemino was only entitled to receive the cash or property collected in payment, but was not entitled to exercise control over the collection process through the defection notice. In response, Gemino argued that its initial reluctance to enter into the litigation did not waive its right to control the enforcement of the dispute at a later date. The secured lender also argued that the judgment was “merely a confirmation of the claims flowing from the purchase agreement” and therefore was not “proceeds” under Article 9.

The Louisiana court agreed with the reasoning of the secured lender:

A judgment does not change the contract, nor does it eliminate or expand the prevailing party’s rights under the contract. A judgment is not a sale or disposition of collateral. At most it interprets its terms and quantifies the obligations owed, leaving to the parties the same rights now reduced to judgment. Further, the rendering of any judgment does not automatically result in the satisfaction of the obligations owed to the judgment creditor. … Because a judgment does not create new rights but merely quantifies the rights that already exist, it cannot be considered a proceed of the contract. As a judgment, it confirms the rights held by HealthEdge. By the collateral assignment, Gemino retains the right to enforce those interests. For the foregoing reasons and by virtue of its Collateral Assignment, Gemino has the power and authority to enforce the judgment. As such, it has authority to file a claim on behalf of HealthEdge; negotiate treatment of the claim whether by payment, settlement or treatment under a plan of reorganization; and oppose or support by vote or objection any proposed plan of reorganization.

Some parting thoughts:

- The Louisiana decision illustrates the power of direct collection as a secured lender’s remedy after default, though in a somewhat unusual bankruptcy setting. The decision seems correct.
- Although direct collection of receivables is the rule, there is nothing in Article 9 that precludes outright disposition of a debtor’s receivables as a “bundle” in a foreclosure, by public or private sale. Such a disposition of receivables is governed by UCC 9-610.
- If a secured lender uses direct collection of receivables as a remedy, it must handle the collections in a commercially reasonable manner. UCC 9-607(c). See Western Décor & Furnishing Indus., Inc. v. Bank of America, NA, 91 Calif. App. 293, 26 UCC Rep. 567 (Cal. App. 1979) (it was not commercially unreasonable to collect receivables directly from the account debtors at less than face value, as part of a reasonable accord and satisfaction).
- A secured party undertaking direct collection must consider the impact of UCC 9-404, which make the rights of a secured lender/assignee subject to (1) all claims and defenses arising out of the assigned obligation and (2) all rights of setoff arising out of unrelated transactions between assignor and account debtor, to the extent that the right of setoff accrues before the account debtor receives notification of the assignment.
- An interesting decision from the Fifth Circuit imposes a form of “borrower liability” against a debtor for improper interference with the lender’s direct collection on receivables following the borrower’s default. Texas Nat’l Bank v. Sandia Mortgage Corp., 872 F.2d 692, 8 UCC Rep. 2d 881 (5th Cir. 1989).

**Strategic Foreclosure on Agricultural Equipment Extinguishes Junior Lien Even in Absence of Notice**

A handy option to holding a foreclosure sale is to retain the collateral in satisfaction of the debt, as authorized by UCC 9-620 through 9-622. This “strict foreclosure” approach has historical antecedents in the law of real property, particularly the deed in lieu of foreclosure. From the secured lender’s viewpoint, there are many advantages to strict foreclosure: (1) it avoids the extra costs of a foreclosure sale in situations where no deficiency claim is likely to be collected; (2) it insulates the creditor from later attack.
upon the disposition as “commercially unreasonable”; (3) it can quickly remove property from the debtor’s estate, as when bankruptcy is imminent. (4) it can be used for a variety of personal property assets, including intangible collateral such as receivables. It is sometimes used by blanket secured lenders as a way of maintaining the debtor’s business as a going concern; and (5) collateral may be retained in full satisfaction of the debt or, as part of a workout, in partial satisfaction. If a consumer transaction is involved, retention in partial satisfaction is not allowed. UCC 9-620(g).

A recent case from Michigan underscores the utility of strict foreclosure, and makes the important point that the procedure extinguishes junior security interests even though the senior secured lender failed to notify the juniors, as required by 9-622(a)(3). In *Agri-Science Technologies, L.L.C. v. Greiner’s Green Acres, Inc.*, 89 UCC Rep. 2d 199, 2016 Mich. App. LEXIS 561 (Mich. Ct. App. 2016), Greiner’s was a Michigan farm operation that transferred property in 2008 that was part of a 700-acre family farm. The transfer was made by the corporate entity to James Greiner. Greiner’s retained a security interest in the property that included about $1.2 million worth of equipment and machinery. When James defaulted on his obligations in 2010, Greiner’s sued him to recover the property. In May 2011 James and Greiner’s agreed that James would return the farm to Greiner’s if he couldn’t obtain refinancing.

In 2012, Agri-Science loaned James $180,000 and took a security interest in specific equipment and personal property: Agri-Science filed a proper financing statement on February 10, 2012. On July 3, 2012, a settlement agreement was reached under which the farm (including the equipment and machinery) was transferred back to Greiner’s, which agreed to accept the collateral in full satisfaction of James’ debt. At some point James defaulted on the Agri-Science loan and Agri-Science obtained a judgment against James for $204,716 and the right to possess the collateral subject to any prior perfected security interest. Agri-Science had never been notified of Greiner’s prior strict foreclosure.

No harm, no foul. In May 2014 Agri-Science sued Greiner’s on the ground that it had disposed of the cherry-pitting and other equipment without giving notice to Agri-Science, which violated the strict foreclosure requirements found in UCC 9-620. Greiner’s sought summary judgment on the ground that the strict foreclosure extinguished Agri-Science’s subordinate security interest. Greiner’s offered evidence that, even though it had failed to comply with the Article 9 notice requirements, Agri-Science suffered no injury because the collateral was worth less than the $1.2 million obligation that was discharged by the strict foreclosure.

The trial court granted summary judgment to Greiner’s and the appellate court affirmed. It relied on UCC 9-622 (b), which provides that “a subordinate interest is discharged or terminated under subsection (a), even if the secured party fails to comply with this article.” The court noted that a second lienor could always recover actual damages under UCC 9-625, but in the present case it offered no such proof. It was “no harm, no foul.”

The Michigan decision puts the burden of proof on the second lienor to show that it was damaged by the senior secured lender’s noncompliance with Article 9. That ruling seems consistent with the language of UCC 9-625. By contrast, if collateral is sold to a third party at a foreclosure sale and the secured lender fails to notify the debtor or guarantor of the sale, a rebuttable presumption is raised that noncompliance damaged the debtor. UCC 9-626. The burden of proof is shifted.

The mechanics of strict foreclosure. The Michigan case illustrates how Revised Article 9 streamlines the mechanics of strict foreclosure to make it more useful as an enforcement tool for secured lenders. (For a statement of the strong policy encouraging strict foreclosure, see UCC 9-620, Comment 2.) Although the secured party still has the option to make a proposal to the debtor inviting a response, the secured lender may simply accept the collateral in full or partial satisfaction of the debt if the debtor consents or the secured lender does not receive objection within 20 days. Under old Article 9, the secured lender had to make a proposal to retain and the debtor had a fixed period to respond. Allowing the simple acceptance option without a formal proposal/acceptance eliminates an element of awkwardness under the old law. As indicated in the Michigan case, in addition to getting the debtor’s consent to a strict foreclosure, notice must be sent to the same persons who get notice of a foreclosure sale, i.e., all prior UCC filers, though failure to give notice to second lienors does not invalidate the strict foreclosure.

No more “constructive strict foreclosure.” Under old Article 9, there was much litigation as to whether undue retention of collateral amounted to a “constructive strict foreclosure,” eliminating the secured lender’s right to a deficiency. Revised Article 9 does away with that doctrine. Instead, undue delay in dealing with the collateral is a factor relating to whether the secured lender acted in a commercially reasonable manner under UCC 9-607 and 9-610. On a related point, the debtor’s voluntary surrender of collateral to the secured lender and the lender’s acceptance of the return do not, of themselves, raise an implication that the secured party is proposing to accept the collateral in satisfaction of the secured debt. See UCC 9-620, Comment 5.

Strict foreclosure may be okay even if it yields a “windfall” to the secured lender. In a notable federal
court decision from Oregon, one member of an LLC took a security interest in another member’s interest as collateral for a loan. When the debtor defaulted, the lender exercised “strict foreclosure” on the membership interest. The court ruled that the debtor could not invalidate the strict foreclosure on the ground that the value of the collateral greatly exceeded the debt, giving a “windfall” to the secured lender. *McDonald v. Yarchenko*, 81 UCC Rep. 2d 165, 2013 U.S. Dist. LEXIS 102728 (D. Ore. 2013). In that case, both McDonald and Yarchenko were members of David Hill LLC, a member-managed Oregon limited liability company. The LLC’s operating agreement indicated six members, each of which had a 1/6 membership interest. In 2007, McDonald made a term loan to Yarchenko to cover his 2007 capital contribution to the LLC. The court noted that Yarchenko pledged his membership interest to McDonald as collateral for the loan.

When Yarchenko failed to make a final payment on July 1, 2009, McDonald sent a demand letter stating that if payment were not made immediately he would “take possession” of Yarchenko’s LLC interest. Not receiving any response, McDonald sent another letter in 2010 proposing that Yarchenko “sign over” his shares in the LLC “in exchange for cancellation of all of [Yarchenko’s] debt...both secured and unsecured.” Still no response. Finally, in 2011 McDonald sent a third letter making an “unconditional proposal that McDonald would accept Yarchenko’s 16.67 % interest in the LLC “in full satisfaction” of the note.

**Article 9 rules trump anti-assignment provision.** The Oregon court first held that an anti-assignment provision in the LLC operating agreement did not void the lender’s security interest. Yarchenko contended that the strict foreclosure was invalid because the remaining five members of the LLC had not consented to the pledge, as required by the operating agreement. The court ruled that the promissory note could still serve as a valid security agreement and that Yarchenko waived his right to enforce the anti-encumbrance provision. The court also relied on a Kansas case holding that an anti-assignment provision can’t block a security interest because the provision is intended to benefit the non-transferring members’ interests, not the transferor’s. *In re Buerge*, 497 B.R. 101 (Bankr. D. Kan. 2012). In short, the security interest attached in spite of the anti-encumbrance provision.

The Oregon court also ruled that the secured lender followed the UCC procedures for strict foreclosure. Yarchenko contended that McDonald’s foreclosure of his LLC membership interest was improper because he was never notified of the disposition under UCC 9-611. The court rejected that argument on the ground that the procedures for strict foreclosure (governed by UCC 9-620) are different than those governing foreclosure sales to a third party (governed by UCC 9-610 and 9-611). Under UCC 9-620(c)(2), a debtor consents to strict foreclosure if the secured lender:

- sends to the debtor after default a proposal that is unconditional or subject only to the condition that collateral not in the possession of the secured party be preserved or maintained;
- proposes to accept collateral in full satisfaction of the obligation is secured; and
- does not receive a notification of objection authenticated by the debtor within 20 days after receipt of the proposal.

In the present case, McDonald sent Yarchenko an unconditional proposal after Yarchenko had defaulted on his loan, proposing to accept the debtor’s membership interest in the LLC in full satisfaction of the $22,000 note, as well as other previously unsecured loans. Yarchenko never did object to the “proposal” letter that aped the language of UCC 9-620, let alone object within 20 days as required by the statute.

Yarchenko argued that giving McDonald full ownership of the collateral, which the debtor contended was now worth approximately $1.6 million and the parties had previously agreed was worth at least $407,335, would be “a windfall for Plaintiff and an unjust and devastating loss for Mr. Yarchenko, especially considering that Mr. Yarchenko only borrowed $22,000 from Plaintiff and has repaid $10,000.” In response to this “windfall” contention, the court quoted from Comment 11 to UCC 9-620: “In the normal case, proposals and acceptances should not be second-guessed on the basis of “value” of the collateral involved. Disputes about valuation or even a clear excess of collateral value over the amount of obligations satisfied do not necessarily demonstrate the absence of good faith.” A case from Washington that makes the same point is *Eddy v. Glen Devore Pers. Trust*, 131 Wash. App. 1015 (Wash. Ct. App. 2006).

**Two parting thoughts about the Oregon “windfall” case:**

- Regarding the anti-assignment provision in the LLC operating agreement, the Oregon court never made the important point that such clauses are void under the free-assignability principles of Article 9, particularly 9-406(d) and 9-408(a) and (d). The effect of these rules is that an anti-assignment clause can’t stop a security interest from attaching or from being the subject of a secured claim in bankruptcy. The secured party can always reap the economic benefits flowing from the LLC membership interest, even though it has no right to non-economic rights such as voting and governance. For a leading case illustrating this distinction, see
Eureka VIII LLC v. Niagara Falls Holdings LLC, 899 A.2d 95 (Del. Ch. Ct. 2006). Some states, including Delaware and Virginia, have made UCC 9-406 and 9-408 inapplicable to transfer restrictions that relate to LLCs. These non-uniform amendments to Article 9 give full effect to anti-assignment provisions in LLC operating agreements.

- Although the Oregon court gave short shrift to Mr. Yarchenko’s argument that McDonald should not be allowed to keep a “huge windfall,” there could be a different result in a bankruptcy proceeding. The trustee or an unsecured creditors committee could argue that a pre-petition strict foreclosure yielding a huge surplus to the secured lender can be avoided as a fraudulent transfer under Section 548 of the Bankruptcy Code on the ground that the benefit received by the debtor is disproportionate to the consideration received by the secured lender. There is as yet no case law on this issue. However, the United States Supreme Court has ruled that the consideration received in a properly conducted, non-collusive real estate foreclosure sale is deemed to be “reasonably equivalent value” for purposes of Section 548 of the Bankruptcy Code. BFP v. Resolution Trust Corp. Imperial Fed. Sav. Ass’n, 511 U.S. 531 (1994) (Justice Scalia). The key issue is whether the rationale of that decision would allow a windfall in an Article 9 strict foreclosure sale where there is no court involvement.
THE PERILS OF PURDY: FLOATING LEASES OF LIVESTOCK

Some readers may recall an article from the September, 2014, edition of this newsletter about a Sixth Circuit ruling that a cattle lease was a “true lease” instead of a financing arrangement. The ruling is one of many in a long line of rulings on this issue. The only notable aspect of the ruling was that the Sixth Circuit held that it was possible to have a “true lease” of a “floating mass” of cattle (i.e. – a lease for a specific number of cattle to be maintained over the life of the lease and returned to the lessor at the end of the lease, as opposed to the specific cattle identified at the commencement of the lease). This was happy news for the lessor who was competing against a prior perfected secured party for at least a portion of the proceeds from the sale of all the lessee’s cattle (leased and not leased) after the lessee had filed bankruptcy.

The Sixth Circuit remanded the case to the bankruptcy court for further rulings, and that is where the real significance of the case has become more clear. The bankruptcy court ruled against the lessor on remand, and the district court recently affirmed. There are many important lessons from these rulings.

**Background.** Lee Purdy ran a dairy farm where his primary income was milk from dairy cattle. Between 2009 and 2012, Citizens First Bank provided loans for operations secured by a security interest in, among other things, “All … Livestock … currently owned and hereafter acquired including but not limited to all dairy cattle … ” In re Purdy, 490 B.R. 530, 532 (Bankr. W.D. Ken. 2013). Among other loan documents, a security agreement with the above description of collateral was entered into in August, 2010, and a financing statement with the above description of collateral was filed on September 1, 2010.

Also between 2009 and 2012, Lee Purdy entered into five leases with Sunshine Heifers, LLC for a specified number of cows in each lease. In addition, Lee Purdy also entered into at least three security agreements granting a security interest to secure all obligations to Sunshine in “All cows, heifers, offspring, or replacements including but not limited to cattle on Exhibit A attached.” Exhibit A was the list of cattle in specified leases. Sunshine filed the first of two financing statements for this collateral on December 28, 2010, almost three months after the Citizens First financing statement.

While operating under the Citizens First loans and the Sunshine leases, Purdy did many things that varied from the lease terms and, we suspect, the loan terms. Some of those actions are detailed in the prior article in this newsletter. Others are detailed in the reported cases below. Suffice it to say that Purdy’s actions created a mess as to what cattle were owned by Purdy, what cattle were owned by Sunshine, and what cattle were owned by other parties.

On November 23, 2012, Lee Purdy filed Chapter 12 bankruptcy and all 415 cows he had in his possession at that time ended up being sold for about $402,000. In re Purdy (Sunshine Heifers, LLC v. Citizens First Bank), 763 F.3d 513, 518 (6th Cir. 2014). Sunshine argued it owned 289 of these cows under its “true leases” and was entitled to about $309,000 of the sale proceeds.

**The original bankruptcy court ruling: no true leases.** In the first reported case, the bankruptcy court held that the Sunshine leases were not “true leases” under Section...
1-203 of the Arizona UCC (due to a choice of law provision in the leases, but was also identical to the Kentucky UCC). In re Purdy, 490 B.R. 530, 535-536. In so holding, the bankruptcy court relied on both the “bright line” test under UCC § 1-203(b) and the “facts and circumstances” test under UCC § 1-203(a). Under the former, the bankruptcy court found that the remaining economic life of the cattle covered by the leases was about three years, whereas the leases were just over four years. And under the latter, the bankruptcy court found that the conduct of the parties at the commencement and during the term of the leases indicated “[t]his arrangement simply does not have the economic or practical footprint of a lease transaction,” including evidence that many of the cattle were purchased by, and delivered to, Mr. Purdy months before Sunshine provided a check to reimburse Mr. Purdy and thereby activate one of the five leases. Finally, the bankruptcy court noted that Citizens First had properly perfected a security interest in all cattle prior to Sunshine, and therefore was entitled to priority in all of the cattle and their proceeds. The district court affirmed the bankruptcy court ruling, finding in relevant part that “the Court finds no reason to depart from either the factual findings or the conclusions of law of the Bankruptcy Court as to the nature of Sunshine’s agreement. …”

Sixth Circuit ruling: true leases. As noted in the September, 2014 edition of this newsletter, a split panel of the Sixth Circuit reversed, framing the issue as follows:

If the agreements are true leases, then Sunshine has a reversionary interest in 435 head of cattle and is entitled to approximately $309,000 from the cattle auction. … If the agreements represent the sale of the cattle and Sunshine’s retention of a security interest, then Citizens First’s perfected agricultural security interest trumps Sunshine’s interest, and the bank keeps all of the proceeds from the cattle auction.

The Sixth Circuit then held that the Sunshine leases were “true leases”:

According to the terms of the agreements between Purdy and Sunshine, Purdy had a duty to return the same number of cattle to Sunshine that he originally leased, not the same cattle. … Given these provisions and the testimony of the parties, it is clear to us that the relevant “good” is the herd of cattle, which has an economic life far greater than the lease term, and not the individual cows originally placed on Purdy’s farm.

763 F.3d at 519-520. As for the actual conduct of the parties after the leases were entered, the Sixth Circuit said:

[W]hether the parties adhered to the terms of these leases in all facets, in our view, is irrelevant to determining whether the agreements were true leases or disguised security agreements. Neither the bankruptcy court nor the parties have sufficiently explained the legal import of Purdy’s culling practices [whereby leased cows periodically were replaced] or put forward any evidence that the parties altered the terms of the leases making them anything but what they proclaim to be.

The Sixth Circuit remanded the case to the bankruptcy court “for further proceedings consistent with this opinion.”

The bankruptcy court ruling on remand. On remand, the bankruptcy court held that Citizens First was still entitled to all of the cattle and their proceeds. In re Purdy, 2015 Bankr. LEXIS 2938 (Bankr. W.D. Ky. 2015). In so holding the court stated that “[t]he issue before the Court now is whether the 415 head of cattle sold at the auction by the Trustee were cattle subject to the [Sunshine] leases or whether the cattle were owned outright by the Debtor and subject to [Citizens First’s] security interest.” Noting the Sixth Circuit’s statement above about the irrelevance of the parties’ adherence to the terms of the leases, the bankruptcy court stated that “[w]hether the parties followed the terms of the leases, however, is critically important to this Court’s analysis of ownership of the cows auctioned by the Trustee…”

The bankruptcy court held that Sunshine had the burden of proving its ownership of the sold cattle based on a preponderance of the evidence, and it failed to do so. It then went on to hold that Citizens First’s security interest attached to the sold cattle prior to Sunshine acquiring any interest in the cattle under its leases. Id. at *14. Finally, it noted that the debtor testified that all of Sunshine’s cattle were sold prior to the filing of the bankruptcy case.

The bankruptcy court also noted several ways that Sunshine could have protected itself, but did not. Among other things, Sunshine could have (1) required Purdy to follow the lease terms on culling, branding, and sales of its cattle, thereby tracing its cattle under the leases, (2) required Purdy to set up and use a separate bank account for sale and replacement of Sunshine’s cattle, thereby preventing the commingling of its cash with Purdy’s other cash on deposit with Citizens First, (3) registered its brand with the State of Kentucky to allow Sunshine to take advantage of a statute declaring registered brands on cattle to be prima facie proof of ownership (all the cattle sold by the Trustee bore Sunshine’s brand, but the testimony was that all of Purdy’s cattle, owned or leased, bore Sunshine’s brand), and (4) entered an agreement with Citizens First to subordinate its security interest in Sunshine’s cattle.

Sunshine noted the framing of the issue by the Sixth Circuit above, and argued that this prevented any alternative finding by the bankruptcy court. However, the district court disagreed, stating that “[The Sixth Circuit] did not determine that the cattle which were sold at auction were owned by Sunshine and subject to the Dairy Cow leases. The Court believes the [framing of the issue by the Sixth Circuit noted above] was simply the circuit court restating the position of the parties.”

As for the various rulings by the bankruptcy court, the district court found that the relevant fact findings by the bankruptcy court were not clearly erroneous. One fact-finding, that the bank’s security interest attached to all the cattle prior to the relevant lease being activated, was acknowledged by the district court to be erroneous as to certain cattle which in fact were paid for by Sunshine prior to delivery to Purdy, but that was irrelevant because “the bankruptcy court ultimately found that all of Sunshine’s cattle had been sold long before the auction.”

**Will the Sixth Circuit agree?** We will be fascinated to see if this case is appealed to the Sixth Circuit. The conflicting statements by the bankruptcy court and Sixth Circuit about the issue on appeal and the relevance of what happened after the leases were executed could make this case a toss-up on appeal. That said, we think the bankruptcy court is correct about who should get the proceeds of the auction based on the findings of fact, discussed further below.

**Can you have a “true lease” on a “floating mass”?** We note that the case involves a unique issue – can a lessor have a “true lease” on a “floating mass” (i.e. – a specified number of property items, as opposed to specific property items, be it cattle, equipment, vehicles, or other property). We do not recall any other reported case involving such a lease, and the Sixth Circuit did not cite any. Instead, every lease we have ever seen has involved specific property, such as a specific cattle, equipment, or vehicles. And we think there are good reasons for this, noted below.

We question whether Sunshine truly intended to create a lease on a “floating mass” where Sunshine expected to receive 415 head of cattle back at the end of the lease. There certainly was no purchase option expressed in the lease, the lease clearly required the cattle to be returned when the lease term expired, and the lease included a “residual guaranty” whereby Purdy was obligated to pay Sunshine the difference between whatever Sunshine sold the cattle for at the end of the lease and around $300 per cow. However, the original bankruptcy court decision found that Sunshine “often let dairy farmers purchase the cattle at the end of the agreement.” Of course, the frequency of this practice is unclear and such a practice could indicate a true lease if the price was for more than a nominal amount. More clear findings from the bankruptcy court would have been helpful in this regard.

We acknowledge that it might be possible to have a “true lease” on a “floating mass” such as the cattle in this case, but only if the replacement cattle are provided by the lessor. In this regard, we note that Article 2A of the UCC addresses true leases of goods. Section 2A-103 defines a “lease” as “a transfer of the right to possession and use of goods for a term…” and defines a “lessor” as “a person who transfers the right to possession and use of goods under a lease.” How could Sunshine be considered to have transferred possession of any replacement cattle it did not provide? Put another way, how could Sunshine be considered to have transferred possession of any replacement cattle provided by Purdy that Sunshine did not own or purchase?

On this point we note that the bankruptcy court found in its original opinion that:

> Debtor regularly sold culled cows and retained the proceeds from those sales in his [Citizens First] bank account. Debtor repeatedly paid for replacements by giving money to intermediaries who found the cows and purchased them with Debtor’s funds. At some future time Sunshine forwarded the funds for the purchase to the intermediary who then reimbursed the debtor.

These facts support finding those replacement cows to be subject to the lease, just like a truck lessor can replace a truck that is destroyed with another truck selected by a lessee and paid for by the lessor, net of any insurance or damages payable by the lessee. This is the hallmark of a finance lease under UCC § 2A-103(g).

> On the other hand, the lease also required Purdy to replace any cattle that died or otherwise were lost for any reason at the lessee’s sole cost. If Purdy selected and paid for any replacement cattle, how did Sunshine transfer “the right to possession and use” of those replacement cows? This is much more akin to the concept of after-acquired property under Article 9, which is not part of Article 2A of the UCC, and is discussed further below.

**Bankruptcy court got it right on remand.** We note that these Purdy cases address a critical practical issue that can arise in a contest between a prior perfected secured party and a lessor under a “true lease” on a “floating mass.” Theoretically, the answer is simple. Under Section 2A-307 (1) of the UCC a competing secured party “takes subject to the lease contract.” In other words, a prior perfected secured party on the same collateral as described in a true lease can only attach to the debtor’s leasehold interest.

But, as shown in the Purdy cases, the practical answer is not so simple when the debtor has property (such as cattle), some of which is leased and other property which is owned by the debtor subject to a prior perfected security interest with an after-acquired property clause. In this circumstance,
the lessor needs to be able to identify the property subject to its lease because the secured party otherwise will be able to rely on its prior perfected security interest in all such property then owned or thereafter acquired. In this regard, note that UCC § 9-203 allows a security interest to attach to whatever interest a debtor has in property, that UCC § 2-403 allows a debtor to transfer good title to a purchaser (including a secured party) when goods have been delivered under a “transaction of purchase” even though there was some fraud in the transaction or the sale price was not paid by the debtor, and that UCC § 9-202 provides that Article 9 applies “whether title to collateral is in the secured party or the debtor.” Taken together, these provisions allow a security interest to attach to virtually all property in a debtor’s possession, unless it is subject to a “true lease” which requires the lessor to identify the leased property.

That appears to be precisely what the bankruptcy court after remand found to be the problem – Sunshine could not prove which cattle were subject to its lease. Sunshine’s brand appeared on all the cattle that were sold, but Sunshine failed to register the brand until after the bankruptcy case was filed, which deprived Sunshine of the presumption created by state law except as to cattle branded after the registration, which was not proven in the case. Absent an ability to rely on the brand, Sunshine had to trace the funds it provided to the cattle owned by Purdy. Absent an ability to rely on the brand, Sunshine had to prove which cattle were subject to its lease. Sunshine could not do that.

Many lessors can avoid this by using serial numbers, vehicle identification numbers, or other unique identifying information for their leased property. But this becomes a serious problem when the leased property does not have any such unique identifying information, or is easily mislabeled. Compound this with leased property that is regularly replaced (such as the cattle in this case), and the problem is only worse.

Even if the lessor is very careful about identifying its property, the lessor also needs to ensure the debtor has no prior rights in the property. Here, the evidence is that many of the replacement cattle under the lease were purchased by Purdy, and then reimbursed by Sunshine. When Purdy purchased the cattle, the cattle became subject to Citizens First’s prior perfected security interest. When Purdy subsequently conveyed the cows to Sunshine (after Sunshine paid Purdy for the cattle), the conveyance to Sunshine was subject to Citizen First’s prior perfected security interest.

We hope the Sixth Circuit takes this to heart. If the Sixth Circuit adopts some other rule that does not require tracing of clear title by the lessor, then the burden will shift to secured parties (like Citizens Bank) to monitor their borrowers and collateral for subsequent “floating leases” (like Sunshine’s) that may somehow take priority over their security interests. As a policy matter, it makes more sense and is consistent with many UCC provisions, to make the subsequent lessor (Sunshine) check for prior perfected security interests (like Citizens First) and then deal with them.

What other steps can a lessor like Sunshine take? Most lessors, including Sunshine, are well aware that there is a risk that a court may recharacterize their lease as a disguised sale transaction. Accordingly, many lessors (including Sunshine) also include documents or language providing for them to have a security interest in the leased property, just in case. But many lessors then forget to figure out whether there are any competing security interests on the same property, in which case they need to take further action to establish priority over the existing secured party. As noted above, the bankruptcy court identified four things Sunshine could have done to better protect itself.

We think there also is a fifth – properly perfect a purchase-money security interest in the leased property.

Under UCC §9-324(d) and (e), a purchase-money security interest in livestock that are farm products will defeat a prior perfected security interest if the purchase-money lender (Sunshine) (1) is perfected “when the debtor receives possession of the livestock,” and (2) sends a notice that (a) says the purchase-money lender “has or expects to acquire a purchase-money security interest in [described] livestock of the debtor,” and (b) is received by the prior perfected secured party within six months before the debtor receives possession of the livestock. Given the regular replacement of cattle under the Sunshine leases, Sunshine should have made it a practice to send a notice to Citizens First every six months.

If the lease involves inventory, then the same rules apply except the purchase-money lender (Sunshine) (a) has a five-year prior notice requirement instead of a six month requirement, and (b) has a more limited lien on proceeds (notably, the purchase-money lender does not have a lien on proceeds in the form of accounts). UCC § 9-324(b) and (c).

And if the lease involves equipment, then the only trick is for Sunshine to perfect its security interest (generally by filing a financing statement) before or within 20 days after the debtor receives possession of the equipment. UCC § 9-324(a).

Did Sunshine miss an issue? Finally, we wonder if Sunshine missed an issue in the Purdy case – did Citizens First get the proceeds of the alleged Sunshine cattle sold prior to the filing of the bankruptcy case? If so, then Sunshine may have a conversion claim against Citizens First for receipt of those proceeds that belonged to Sunshine. Stay tuned for further developments.
NEW OCC CREDIT CARD LENDING BOOKLET IDENTIFIES RISKS AND PROVIDES COMPLIANCE GUIDELINES FOR CREDIT CARD DEBT

At the end of last year, the Comptroller of the Currency issued a revised “Credit Card Lending” booklet for the Comptroller’s Handbook, replacing a 1996 booklet of the same name. The OCC, part of the U.S. Department of the Treasury, is the prudential regulator for all national banks, federal savings associations, and federal branches of agencies of foreign banks. Part of the OCC’s role involves supervising these institutions to ensure their “safety and soundness.” Thus, as with other booklets, the Credit Card Lending booklet “is prepared for use by OCC examiners in connection with their examination and supervision of national banks and federal savings associations."

Although specifically designed to aid in the examination of national banks and federal savings associations, the OCC’s booklets can serve as helpful compliance tools for all covered financial institutions. The Credit Card Lending booklet also contains a wealth of information of value to partners in affinity and co-branded card programs, credit card debt buyers, and counsel who advise clients on credit card matters.

Why a credit card lending booklet? The new Credit Card Lending booklet begins by acknowledging the ubiquity of credit cards and the continuing growth of the credit card industry. As a result, and “[h]ecause of their profitability, credit cards play a role in the strategic plans of many banks.” Furthermore, the OCC explains that competition for credit card customers is fierce and regulation of the credit card market is extensive.

While credit card lending presents an enormous opportunity for many large financial institutions, risks abound. Specifically, the Credit Card Lending booklet defines risk as “the potential that events will have an adverse effect on a bank’s current or projected financial condition and resilience.” The OCC has identified seven primary risk categories that credit-card-issuing financial institutions are likely to encounter and need to actively manage: credit risk, interest rate risk, liquidity risk, operational risk, compliance risk, strategic, risk and reputational risk. The booklet contains a detailed discussion of the tools at a bank’s disposal for managing the risks posed by credit card lending. These tools include everything from management oversight, to information technology, to credit score modeling, to collection procedures.

A brief overview of credit card lending. The OCC delineates several varieties of credit cards issued by banks. “General purpose” cards typically participate in the VISA or MasterCard networks and allow cardholders to make purchases at a multitude of merchants. Issuing banks may form partnerships with various businesses or groups to offer “co-branded” and “affinity” cards that provide special benefits to the cardholder (e.g., discounts or a way to identify with a brand or cause) and the partnering organization (e.g., a low-cost source of income). “Proprietary” or “private-label” cards are accepted by a single retailer for purchase of that retailer’s goods and services.

Unlike consumer cards, “corporate” or “commercial” cards usually require all balances to be paid at the end of each billing cycle. Annual fees, interchange, and other service fees, rather than finance charges, represent the primary source of income to banks from these typically lower-profit cards.

The OCC’s booklet emphasizes time and again that—from customer solicitation through collection after write-off—the credit-card-lending industry is highly regulated. TILA, the CARD Act, the FTC Act, the Dodd-Frank Act, the BSA, FCRA, and FDCPA, among others, all have some role to play in the process. One of the most useful features of the Credit Card Lending booklet, both for institutions subject to OCC examination and other players in the credit card world, is its frequent citation to applicable laws, regulations, and related OCC bulletins and publications.

Banks can play many different roles in the credit card lending world. As the name suggests, “issuing banks” issue credit cards to their customers and then hold or sell credit card loans. “Merchant” or “acquiring” banks sign up merchants to allow them to accept credit card payments. Acquiring banks then “accept deposits generated by credit card transactions.” Agent banks participate in other banks’ card programs, either by identifying and turning over credit-card applicants or acting as depositories for merchants. The Credit Card Lending booklet focuses primarily on the operations of and risks faced by issuing banks as to consumer credit cards, with a particular emphasis on credit risk.

Secured credit card lending to manage credit risk. As the booklet explains, “[c]redit risk poses the most significant risk to banks involved in credit card lending. Because credit card debt is generally unsecured, repayment depends primarily on a borrower’s willingness and capacity to repay.” While credit cards are often unsecured, two primary methods exist for a bank to secure credit card debt and reduce the inherent credit risk associated with credit card lending: (1) obtain a pledge of funds as security and (2)
obtain a purchase money security interest in the consumer goods purchased with consumer credit cards.

**Using a deposit account as security.** As the OCC’s booklet explains, issuing banks can partially or wholly secure credit card debt by requiring a customer to pledge funds placed into some form of deposit account or instrument as security for the credit card debt. Issuers typically offer such secured credit cards to customers whose risk profiles do not justify extension of credit on an unsecured basis. One issue the OCC booklet does not address is that the law concerning the creation and perfection of such security interests is less than straightforward.

UCC 9—109(d)(13) specifically excludes consumer deposit accounts from the scope of Article 9. Thus, creating and perfecting a security interest in a consumer deposit account used as collateral for credit card debt will be governed by the common law of pledges. See UCC 9—109, cmt. 16 (“By excluding deposit accounts from the Article’s scope as original collateral in consumer transactions, subsection (d) leaves those transactions to law other than this Article.”). As a result, it is possible that variations across jurisdictions may crop up when it comes to perfecting security interests in consumer deposit accounts; however, Article 9’s usual rules for perfection of a deposit account by control should provide a strong analogy and there is good authority for this proposition. See In re Ala. Land & Mineral Corp., 292 F.3d 1319 (11th Cir. 2002).

What happens if a certificate of deposit rather than a demand deposit account is used as collateral for the credit card debt? Does Article 9 supply the rules of the game? It depends. Article 9 classifies a CD in negotiable paper form as an “instrument,” rather than a deposit account, and so Article 9 governs and perfection occurs via filing or possession. See UCC 9—102(47), 9—312(a), and 9—313(a). But if a CD is issued in uncertificated or non-negotiable form, then it will usually be classified as a deposit account and shot out of Article 9 and back to the common law. See 9—102, cmt. 12 (“[A]n uncertificated certificate of deposit would be a deposit account (assuming there is no writing evidencing the bank’s obligation to pay) whereas a nonnegotiable certificate of deposit would be a deposit account only if it is not an ‘instrument’ (a question that turns on whether the nonnegotiable certificate of deposit is ‘of a type that in ordinary course of business is transferred by delivery with any necessary indorsement or assignment.’”).

**Automatically perfected PMSIs in consumer goods.** Although not discussed in the OCC’s booklet, the other way that a bank is likely to secure repayment of credit card debt is through a purchase money security interest. Once a valid security agreement is in place between the bank and the credit card customer, a bank can obtain a purchase money security interest whenever it provides the credit used by the customer to purchase goods. See UCC 9—103 (a) and (b). When the goods purchased are consumer goods (which is likely more often than not the case), the PMSI automatically perfects upon attachment. UCC 9—309(1). The only significant advantage obtained by filing a financing statement is that the filer receives protection in the event a sale of the consumer goods for value, to a buyer without knowledge of the PMSI, for the buyer’s personal, family, or household use. UCC 9—320. But in bankruptcy, automatic perfection suffices.

Thus, while the OCC’s Credit Card Lending booklet perhaps gives secured credit card lending a bit of a short shrift, banks may consider obtaining rights in collateral, whether deposit accounts, certificates of deposit, or in the goods purchased with the credit card as one means to reduce the credit risk associated with their credit card lending program.

**Two more issues raised by the Credit Card Lending booklet:**

- **Successful credit card lending typically involves economies of scale, since ‘[c]redit card operations are highly automated, service large volumes of transactions, and require strong operational controls.” As a result, the OCC booklet repeatedly emphasizes the critical role strong technology and management information systems play in successful credit card lending programs, which by their very nature present attractive targets for fraud and theft.**

While the booklet briefly mentions data breaches, it surprisingly never references the Payment Card Industry Data Security Standard. PCI DSS provides technical and operational requirements designed to protect credit card account data and is a wonderful example of industry self-regulation. PCI compliance is critical for any player in the credit card industry who handles cardholder and authentication data. For banks involved in credit card lending, PCI compliance is an important tool for managing operational risk, even though the Credit Card Lending booklet is silent on this point.

- **Readers of this newsletter know we’re none too fond of the Second Circuit’s recent decision in Madden v. Midland Funding, LLC. 786 F.3d 246 (2d Cir. 2015). The decision (wrongly) held that—notwithstanding federal preemption under the National Banking Act and a very long-standing, Supreme-Court endorsed, common law “valid-when-made” principle—the nonbank assignee of bad credit card debt (i.e., a debt collector) was subject to usury laws prohibiting interest rates above a certain percentage, even though the bank from whom the debt was acquired could and had charged higher interest rates.**

The Second Circuit justified its decision in part based upon the fallacious assumption that imposing state usury law against debt collectors “would not significantly interfere with any national bank’s ability to exercise its
powers under the National Banking Act.” It’s hard to square this with important banking realities recognized by the OCC in the Credit Card Lending booklet: (1) “As providers of consumer credit, banks lend money to be repaid with interest”; (2) “A percentage of the loans that banks make goes unpaid”; (3) credit card lending constitutes a majority of the unpaid bank loans; (4) the OCC “advises that credit card accounts be charged off when they become 180 days delinquent”; and (5) debt sales are an important mechanism through which banks can recover some value from charged-off debt. In other words, sales to debt buyers play an important role as banks seek to maintain liquidity and achieve optimal financial performance.

While the Credit Card Lending booklet demonstrates that the OCC recognizes the importance of debt sales to the overall health of financial institutions and the OCC in fact disagreed with the Midland decision, nonetheless the OCC rather shockingly urged the Supreme Court to deny Midland’s certiorari petition—which the Supreme Court in fact did.

The preceding story was written by Matthew D. Clark, a commercial litigator with Faegre Baker Daniels LLP. Matthew is a frequent contributor to this newsletter.

SUPPLIER OF OIL TO DISTRIBUTOR LEARNS ABOUT UCC CONSIGNMENT RULES THE HARD WAY

Although consignments of inventory are not true secured transactions, the drafters of the UCC have brought them within the scope of Article 9. UCC 9-103(d). A classic consignment arrangement is treated as a form of purchase-money security interest in inventory, with the consignor as the secured lender and the consignee as the debtor. As a result, the consignor will be in deep trouble if it fails to file a financing statement before delivery of the goods and to notify prior filers against the consignee of the consignment arrangement. UCC 9-324(b). Failure to jump through the hoops of Article 9 will be fatal as against the consignee’s trustee in bankruptcy. This was the lesson learned in a recent case from Washington.

The Washington case. In In re Pettit Oil Co., 89 UCC Rep. 2d 872 (Bankr. W.D. Bankr. 2016), a fuel distributor and one of its suppliers entered into a consignment arrangement. When the consignee filed bankruptcy, the trustee claimed priority to fuel in the consignee’s tanks on the date of the bankruptcy petition, accounts receivable owing to the debtor from sales of consigned fuel prior to the petition, and cash in the debtor’s bank accounts on that date. The receivables and cash were identifiable proceeds from the sale of the fuel. The debtor’s trustee claimed priority to the fuel, receivables and cash in the bank account, based on the fact that the supplier never bothered to make a UCC filing.

In an adversary proceeding, the Washington bankruptcy court upheld the trustee’s position. The court turned to the UCC’s definition of “consignment” found in 9-102(a)(20), which provides that a consignment means a transaction, regardless of form, in which a person delivers goods to a merchant for the purpose of sale and (1) the merchant “deals in goods of that kind under a name other than the name of the person making delivery”; (2) is not an auctioneer; (3) is “not generally known by its creditors to be substantially engaged in selling the goods of others”; (4) with respect to each delivery, the aggregate value of the goods is $1,000 or more at the time of delivery; and (5) the goods are not consumer goods in the hands of the consignor immediately before delivery.

In the Washington case, the consignor conceded that the supply contract included all the statutory elements. The debtor/consignee was a fuel merchant and the supplier delivered fuel products to the consignee for sale. The consignee “dealt” in fuel under its own name rather than the supplier’s name, and was not an auctioneer. Perhaps most important, nothing in the record indicated that the consignee was “not generally known by its creditors to be substantially engaged in selling the goods of others.” It was also undisputed that the consignor had failed to file a financing statement to warn third parties about the consignor’s interest in the goods and proceeds. As a result, the consignee’s trustee in bankruptcy would normally have priority under the “strongarm” clause of the Bankruptcy Code, Section 544(a).

Court rejects consignor’s “constructive trust” defense. In an effort to sidestep the perfection and priority rules of the UCC, the supplier made a creative argument. Although the consignor did not contest the trustee’s priority to the fuel in the consignee’s tanks at the time of the petition, it contended that the trustee was subordinated with respect to (1) the accounts receivable owing for pre-bankruptcy purchases of consigned fuel and (2) the cash proceeds of consigned fuel sales to third parties that were in the debtor’s bank account on the petition date. Under the terms of the consignment agreement, the account debtors were to make their payments to the consignee, which would then remit periodic payments to the consignor. This the consignee failed to do.

The bankruptcy judge recognized that some courts have found a “constructive trust” based on debtor misbehavior toward the secured creditor. The leading case is In re Howard’s Appliance Corp., 874 F.2d 88 (2nd Cir. 1989), where the debtor had moved collateral out of state without informing the secured lender. As a result, the lender’s security interest became unperfected. The Second Circuit ruled

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that the debtor’s misbehavior created a constructive trust in the collateral that prevented the debtor’s trustee from claiming priority under the strongarm clause. The court cited other cases where the inequitable conduct of the debtor was enough to deprive a trustee from taking free of a security interest. In re Bake-Line Group, LLC, 359 B.R. 566 (Bankr. D. Del. 2007) (debtor deposited misdelivered check that had been made out to creditor); In re DVI, Inc., 306 B.R. 496 (Bankr. D. Del. 2004) (debtor wrongfully transferred joint business venture to its sole control and had been sued for such actions pre-bankruptcy). The Washington court rejected these cases on the ground that the imposition of a constructive trust “requires a wrongdoing greater than the nonpayment of a monetary debt.”

In the present case, by contrast, the court concluded that the consignee’s misbehavior in failing to turn over account-debtor payments to the consignor was not sufficient to block the trustee’s claim to priority. In addition, the Washington bankruptcy judge noted that courts have “routinely rejected an argument that a constructive trust should be imposed when doing so alters the priority scheme of creditors set forth in the Bankruptcy Code.” Perhaps most important, the Washington court concluded that a constructive trust “is not the proper remedy to allow a creditor to avoid the impacts of its failure to properly perfect a security interest.”

On this point, the court cited In re Royal West Props., Inc., 441 B.R. 158 (Bankr. S.D. Fla. 2010) (rejecting constructive trust for investors whose security interests had lapsed); In re K-Ram, Inc., 451 B.R. 154 (Bankr. D. N.M. 2011) (rejecting constructive trust over funds placed in court registry pre-petition where creditor was unsecured due to its own failure to perfect, not due to any wrong committed by the debtor); In re The Bennett Funding Group, Inc., 234 B.R. 600 (Bankr. N.D.N.Y. 1999) (denying constructive trust to lessor who had failed to obtain possession of leases or to file a proper financing statement).

In short, the heavy weight of authority properly rejects attempts by a secured creditor who fails to play by the rules of Article 9. For a detailed discussion that criticizes courts’ use of equitable principles to modify the clear priority rules of Article 9, see Clark & Clark The Law of Secured Transactions under the UCC, § 3.14.

Some parting thoughts:

"It is hard to have much sympathy for a commercial supplier of fuel to distributors who fails to jump through the hoops of Article 9. Yet we suspect that many suppliers still aren’t aware of the need to file a UCC financing statement when they deliver goods in a consignment transaction. Nor will special “title retention” language in the sales contract do any good. In this area, substance rules over form. If the consignor has failed to file, usually the best defense is to prove to the court that the consignee was “generally known by its creditors to be substantially engaged in selling the goods of other.” This will be a highly fact-intensive issue.

"In the Washington case, the beneficiary of the consignor’s negligence was the consignee’s trustee in bankruptcy using the strongarm clause; there was no competing lender in the picture. In other cases, the competitor may be a traditional secured lender to the consignee who has properly made its UCC filing and sent notification to earlier filers. If the consignor has failed to file (probably because it does not realize that Article 9 controls), the competing lender’s perfected security interest should have priority over both the consignor and the consignee’s trustee in bankruptcy.

"In an important bit of consumer protection, Article 9 defines “consignment” to exclude goods that are “consumer goods immediately before delivery.” In turn, “consumer goods” are defined to mean “goods primarily used for personal, family, or household purposes.” So, if grandma delivers her Steinway baby grand to a merchant on a consignment basis, she need not worry about complying with Article 9.

"There has been a fair amount of litigation regarding the consignment of fine art, particularly paintings. For a comprehensive law review article on the topic, see Hillary Jay, "A Picture Imperfect: The Rights of Art Consignor-Collectors When their Art Dealer Files for Bankruptcy, 58 Duke L.J. 1858 (2009)."