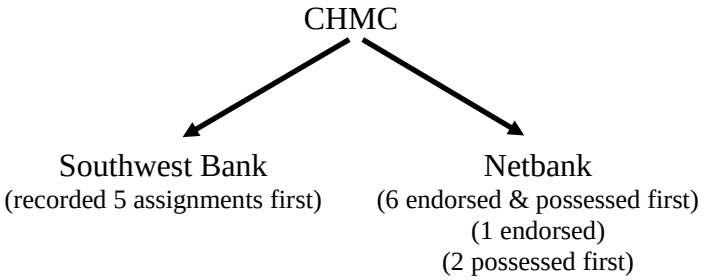
SPOTLIGHT

The purpose of this column is to identify some of the most disconcerting judicial decisions interpreting the Uniform Commercial Code to be published after the previous edition of the Newsletter. The purpose of the column is not to be mean. It is not to get judges recalled, law clerks fired, or litigators disciplined for incompetence. Instead, it is to shine a spotlight on analytical errors, and thereby provide practitioners and judges with reason to disregard the opinion as precedent.

Featured Case

Provident Bank v. Community Home Mortgage Corp., 2007 WL 1350262 (E.D.N.Y. 2007), is a disturbing case reminiscent of the notorious OPM Leasing scandal of the early 1980s, which involved the fraudulent "double booking" of equipment leases. This case, however, involved the double booking of home mortgage loans.

Community Home Mortgage Corporation ("CHMC") originated residential mortgage loans and pledged them to its warehouse lenders. For nine mortgage loans, CHMC required the borrowers to execute duplicate original promissory notes. It then sold one set of originals to NetBank and another set to Southwest Securities Bank. CHMC did not endorse any of the notes it sold to Southwest. In contrast it endorsed seven of the nine it sold to Netbank. Netbank also took possession of eight notes (including the two not endorsed) before Southwest took possession of its corresponding notes. However, for five of the notes, Southwest recorded its assignment of mortgage before Netbank. This set up a priority battle between the two lenders:



As an initial matter, the court assumed that the mortgagors were not required to pay on both original notes. In addition, both Southwest and Netbank had given value for notes that were not overdue and that were devoid of facial irregularities. Thus, the court faced the unenviable task of assigning priority to one of two innocent parties.

The court then ruled that Article 9, not real-property law, governed the priority in the mortgage loans. In doing so, the court correctly noted that attachment and perfection in a note automatically extend to any mortgage supporting the note. U.C.C. §§ 9-203(g), 9-308(e). Thus, the court's analysis focused exclusively on the notes, rather than the

mortgages. As a result, the court rejected Southwest's argument that it should win as to the five loans for which Southwest had recorded an assignment of mortgage before Netbank.

With respect to Article 9 priority, the court ruled that Netbank was a holder in due course of the seven endorsed notes, and thus entitled to priority of them under § 9-331. As to the other two notes, Netbank won because it took possession before Southwest took possession of its corresponding notes.

The decision is troubling for several reasons. First, the fact that holder-in-due course status could be used to resolve the priority battle with respect to seven notes was merely fortuitous. Because CHMC never indorsed the notes that it sold to Southwest, Southwest was not a holder of the notes, and thus automatically disqualified from holder-in-due-course status. However, the facts could have easily been otherwise. Both parties might have received endorsed certificates. Then the court would have faced a priority battle between two apparent holders in due course. Nothing in Article 3 or Article 9 is designed to resolve such a dispute.

Second, the court's conclusion that the first to possess would have priority when holder-in-due-course status did not resolve the issue was likewise troubling. The court never indicated from where it derived this rule. Although § 9-330(d) does give priority to a purchaser of a note who takes possession, its language does not refer to the first to take possession. Indeed, it does not seem to contemplate that purchasers could simultaneously be in possession. The first-to-file-or-perfect rule of § 9-322(a)(1) might apply, but the court nowhere discussed whether or when either party filed a financing statement.

In short, none of the priority rules relied upon by the court was designed to deal with this type of problem. Perhaps that was because the court implicitly treated the two original notes in each transaction as the same piece of property. While doing so has the advantage of protecting the unsophisticated home buyer duped into making the duplicate notes, it ignores an assumption underlying both Articles 3 and 9 that anything capable of being possessed is unique.

Perhaps because of this, Southwest had exhorted the court to exercise its equitable powers to divide the loan interests equally. The court gave that argument rather short shrift. We think it merited more attention.

Honorable Mentions

The following recent decisions, while not as disconcerting as the featured case, are also noteworthy for their questionable analysis.

In re Yelverton, 2007 WL 841393 (Bankr. M.D. Ala. 2007)

This is yet another decision putting judicial limits on a dragnet clause. The court ruled that neither the first loan agreement, which included a clause indicating that

collateral securing other loans also secures this one, nor the second loan agreement, which included a clause purporting to make the collateral secure all other debts of the borrowers, was adequate to make the collateral granted in the second agreement secure the debt created in the first. The court relied in part on the fact that the first loan was made more than 10 days before the debtor acquired the collateral and the second loan was made to three co-debtors whereas the first loan was made to only one of them.

In re TXNB Internal Case, 2007 WL 914983 (5th Cir. 2007)

In this troubling opinion, the court ruled that the party deemed to have somehow had no cause of action for interference with its property rights. Specifically, the court ruled that a buyer who took gas in part payment of an antecedent debt and was therefore not a buyer in ordinary course was not liable to a secured party for conversion for selling the gas to purchasers who were buyers in ordinary course because it had no knowledge or notice of the lien. In addition, the buyer was not liable for conversion of the sale proceeds because an action for conversion of money requires a segregated fund or a transfer for safekeeping. However, the court ruled that the buyer may be liable in a collection action.

In re Cook, 2007 WL 680170 (Bankr. W.D. Mo. 2007)

The court rued that a security interest in an automobile perfected by notation on an Arkansas certificate of title for the car became unperfected after the car was re-certificated in Missouri because the new certificate failed to list the lien. The court correctly noted that, pursuant to § 9-303, Missouri law begins to govern perfection and priority upon issuance of the Missouri certificate. However, it missed § 9-316(d), (e), pursuant to which the previously perfected security interest should have remain perfected.

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