Personal Property Secured Transactions

*By Steven O. Weise and Stephen L. Sepinuck**

I. The Scope of Article 9

The first task for a lawyer involved in a secured transaction is to determine whether Article 9 of the U.C.C. applies to the transaction. Reaching an incorrect conclusion on this issue can lead to a disastrous result. For example, if a person is unaware that Article 9 applies, the person might fail properly to perfect a security interest and end up losing all rights in the collateral to someone else claiming an interest in it.

A variation of this problem occurred in *F.R.S. Development Co. v. American Community Bank & Trust*,[1] which involved a bank loan to real estate developers. After the developers defaulted, the bank brought an action to foreclose on the real property and related personal property. As part of a settlement, the developers consented to a judgment of foreclosure except as to intangible collateral. They also transferred to the bank the developers' right to recapture from the local government amounts they had expended on sewer improvements. In return, the bank released its interest in all other general intangibles.[2] A dispute later arose relating to the developers' right to recapture some of the cost of roadway and intersection improvements that benefitted property outside of the development. The court ruled these rights were personal property—specifically, a general intangible—and thus the bank did not acquire those rights when it acquired the real property in the foreclosure. Instead, the bank had released its security interest in those rights when the bank released its security interest in general intangibles.[3] The decision serves as a reminder to lenders to real estate developers that take an interest in collateral other than the real property—e.g., recapture rights, architectural plans, trademarks and trade names—that the security interest in such collateral is governed by Article 9, not by real property law.

Article 9 also governs several transactions that do not involve the use of collateral to secure an obligation. In particular, it applies to many consignment

* Steven O. Weise is a partner in the Los Angeles office of Proskauer Rose LLP. Stephen L. Sepinuck is the Frederick N. & Barbara T. Curley Professor of Law at Gonzaga University School of Law and the director of its Commercial Law Center.

1. 58 N.E.3d 26 (Ill. App. Ct. 2016).
2. *Id.* at 30–31.
3. *Id.* at 34–37.

transactions.[4] Article 9 treats the consignment as a security interest, the consignor as a secured party, the consignee as the debtor, and the consigned goods as the collateral.[5] More important, if the consignor's security interest is unperfected, Article 9 treats the consignee as having sufficient rights in the consigned goods to grant a security interest in them to someone else.[6] However, if the consignee is "generally known by its creditors to be substantially engaged in selling the goods of others," the transaction falls outside the Article 9 definition of "consignment"[7] and outside the scope of Article 9.

In *Overton v. Art Finance Partners LLC*,[8] an individual delivered expensive works of art to a broker for sale, but failed to file a financing statement. The broker's secured lenders claimed a security interest in the artworks. However, the court noted that the broker was generally known by his creditors to be engaged in selling the works of others, a fact supported by statements on the debtor's own website. Thus, the transaction between the broker and the owner did not qualify as a "consignment" governed by Article 9.[9] As a result, the secured lenders of the broker had no interest in the artworks.[10]

II. Attachment of a Security Interest

A. In General

In general, there are three requirements for a security interest to attach; that is, for the interest effectively to encumber collateral: (i) the debtor must authenticate a security agreement that describes the collateral; (ii) value must be given; and (iii) the debtor must have rights in the collateral or the power to transfer rights in the collateral.[11] There were interesting cases on the first two requirements last year.

B. Description of the Collateral in the Security Agreement

The requirement of an authenticated security agreement is fairly easy to satisfy. When the security interest secures an obligation,[12] the agreement must include language indicating that the debtor has transferred an interest in personal property to the secured party to secure payment or performance of an obligation,[13] and must describe the collateral.[14] No specific language is required

4. *See* U.C.C. §§ 9-102(a)(20), 9-109(a)(4) (2013).
5. *See id.* § 9-102(a)(12), (28)(C), (73)(C); U.C.C. § 1-201(b)(35) (2011).
6. *See* U.C.C. § 9-319(a) (2013).
7. *Id.* § 9-102(a)(20)(A)(iii).
8. 166 F. Supp. 3d 388 (S.D.N.Y. 2016).
9. *Id.* at 409–10.
10. *Id.* at 410.
11. *See* U.C.C. § 9-203(b) (2013).
12. Some security interests arise from an outright sale of most types of payment rights. *See id.* § 9-109(a)(3). In such a transaction, the security interest does not secure an obligation.
13. *See* U.C.C. § 1-201(b)(35) (2011).
14. *See* U.C.C. § 9-203(b)(3)(A) (2013).

and, if no single document satisfies these requirements, multiple writings may do so collectively, under what is known as the "composite document rule."[15]

Despite the simplicity of this requirement, a credit union encountered difficulty in satisfying it in *In re White*.[16] That case involved the documents for a third loan between a credit union and one of its customers. The documents described the collateral as including "all property securing other plan advances and loans received in the past or in the future" and also stated "[c]ollateral securing other loans with the credit union may also secure this loan."[17] The court concluded that the language—particularly the phrase "may also secure"—was ambiguous.[18] Consequently, the credit union was not entitled to summary judgment on the customer's claim for violation of the automatic stay and discharge injunction.[19]

In general, the description of collateral in a security agreement does not need to be specific or expressly list every item, it needs only to "reasonably identif[y]" the collateral.[20] In other words, the security agreement must "make [it] possible" to identify the collateral.[21] For most types of property, a description by a type defined in the U.C.C. is sufficient.[22] However, section 9-108(e)(1) makes such a description insufficient for commercial tort claims,[23] and hence the security agreement must describe the claim with greater specificity. In *Bayer CropScience, LLC v. Stearns Bank*,[24] the court misapplied this rule to *proceeds of* a commercial claim.

The facts of the case are fairly simple. In 2002, Stearns Bank acquired and perfected a security interest in the debtor's existing and after-acquired general intangibles. In 2007, Amegy Bank acquired and perfected a security interest in the debtor's commercial tort claim against Bayer AG and several related entities (collectively, "Bayer"). In 2012, Bayer agreed to pay $2.1 million to settle the suit. After a portion of the proceeds were distributed and the remainder deposited with the court, each of the two banks claimed a prior security interest in the balance on hand.[25]

The proper way to analyze and resolve this dispute is not all that complicated. When the commercial tort claim was settled, a payment intangible was created. Amegy Bank's security interest attached to the payment intangible as proceeds of

15. *See, e.g.*, *In re* Outboard Marine Corp., 300 B.R. 308, 323 (Bankr. N.D. Ill. 2003); *see generally In re* Weir-Penn, Inc., 344 B.R. 791, 793 (Bankr. N.D. W. Va. 2006) (citation omitted) (referencing "a collection of documents . . . [that] in the aggregate disclose an intent to grant a security interest in specific collateral").

16. No. 10-14503, 2016 WL 3177247 (Bankr. D.N.M. June 3, 2016).

17. *Id.* at *1 (quoting agreement describing collateral securing the third loan).

18. *Id.* at *4.

19. *Id.* at *7.

20. *See* U.C.C. § 9-108(a) (2013).

21. *Id.* cmt. 2.

22. *Id.* § 9-108(b)(3).

23. *Id.* § 9-108(e)(1).

24. 837 F.3d 911 (8th Cir. 2016).

25. *Id.* at 912–14.

the commercial tort claim.[26] That security interest was automatically perfected.[27] At the same moment, Stearns Bank's security interest attached to the payment intangible as after-acquired property.[28] That security interest was also immediately perfected.[29] When the payment intangible was paid, both security interests attached to, and were perfected in, the cash proceeds, again simultaneously. Under the first-to-file-or-perfect priority rule,[30] Stearns Bank should have had priority because it filed before Amegy Bank either filed or perfected.

Unfortunately, the court fixated on section 9-108(e)(1), which requires extra specificity in the description of a commercial tort claim as collateral. The court concluded—without any textual support in the Code—that this rule must also apply to a payment intangible arising from the settlement of a commercial tort claim, as well as to any payment made pursuant to that settlement agreement.[31] In short, the court concluded that "the drafters of the [U.C.C.], in implementing the heightened identification requirements of commercial tort claims . . . intended for the proceeds of a commercial tort claim to be excluded from an after-acquired general intangible clause."[32] This is incorrect.[33]

C. Value Given

The requirement for attachment that "value has been given"[34] is intentionally written in the passive voice. The value need not come from the secured party and need not go to the debtor (that is, the value need not go to the owner of the collateral).[35] In fact, Article 9 contemplates that the debtor need not be the principal obligor or even owe the secured obligation at all, but might instead be someone other than the person to whom the secured party extended credit.[36] However, lenders sometimes run into trouble when the person to whom the security interest is granted is not the person to whom the secured obligation is owed.[37]

26. *See* U.C.C. § 9-315(a)(2) (2013).
27. *See id.* § 9-315(c), (d).
28. *See id.* §§ 9-203(b)(2), 9-204(a).
29. *See id.* § 9-502(d).
30. *See id.* § 9-322(a)(1).
31. *Bayer*, 837 F.3d at 916.
32. *Id.*
33. *See* Carl S. Bjerre & Stephen L. Sepinuck, *UCC Spotlight*, 2016 Com. L. Newsl. 9, 11–12 (ABA Bus. Law Section, Chicago, IL, Fall 2016), http://www.americanbar.org/content/dam/aba/administrative/business_law/newsletters/CL190000/full-issue-201611.pdf (collecting court rulings that misunderstand and misapply Article 9's rules regarding commercial tort claims).
34. U.C.C. § 9-203(b)(1) (2013).
35. *Id.* § 9-102(a)(28)(A) (defining "debtor").
36. *See, e.g.*, *id.* § 9-102(a)(59), (72) (defining "obligor" and "secondary obligor," respectively); *id.* § 9-611(c)(1), (2) (specifying to whom notification of a disposition must be sent); *id.* § 9-621(b) (indicating when a secondary obligor is entitled to be sent a proposal to accept collateral); *id.* § 9-623(a) (indicating who may redeem collateral); *id.* § 9-625(b) (indicating who is entitled to damages if a secured party fails to comply with Part 6 of Article 9).
37. *See, e.g.*, *In re* Adirondack Timber Enter., Inc., No. 08-12553, 2010 WL 1741378 (Bankr. N.D.N.Y. Apr. 28, 2010) (debtor that authenticated an agreement granting a security interest to a farm implements manufacturer to secure all obligations owed to the manufacturer and its affiliates

Such was the case in *In re Southeastern Stud & Components, Inc.*,[38] in which a supplier of steel obtained a security agreement from a customer identifying the supplier as the secured party. Initially, the supplier sold steel to the debtor through one of its "divisions."[39] However, after about two years, the supplier formed a new limited liability company, of which the supplier was the sole member, to operate the division. It was the LLC that sold steel to the debtor thereafter.[40] After the debtor filed for bankruptcy protection, the trustee objected to the supplier's secured claim.

The court concluded that, even though the invoices to the debtor were in the LLC's name, the LLC was the steel supplier's delegate under the contract with the debtor. In so concluding, the court noted that the LLC sought authorization from the supplier prior to each transaction with the debtor.[41] Further, all payments made by the debtor on account of the transactions' invoices were remitted to the supplier lockbox account and were applied to reduce the debtor's indebtedness.[42] Thus, the debtor's obligation to pay the purchase price was an obligation owed to the supplier (and not to the LLC), and hence the collateral secured that obligation.[43] The decision seems correct, but the supplier could have avoided this problem if the entity identified as the secured party in the security agreement and the entity identified in the invoices as the seller to which the debt is owed were the same.

III. Perfection of a Security Interest

A. Method of Perfection and Governing Law

In general, perfection of a security interest is necessary, but not always sufficient, for the secured party to have priority over the rights of lien creditors, other secured parties, and buyers, lessees, and licensees of the collateral.[44] The method or methods by which a secured party can perfect a security interest depend on the type of collateral and the nature of the transaction. The dominant method of perfection is by filing a financing statement, but other methods include taking possession or control of the collateral, complying with a certificate-of-title statute, and complying with any preemptive federal law.[45] Some security interests—including a purchase-money security interest in consumer goods not covered by a certificate of title—are perfected automatically upon attachment.[46] The first steps in determining how to perfect are often to identify and classify the collateral and then to ascertain whether

did not grant a security interest *to* the bank subsidiary of the manufacturer, and thus the bank was not entitled to adequate protection).

38. No. 14-32906-DHW, 2016 WL 2604535 (Bankr. M.D. Ala. May 3, 2016).

39. *Id.* at *1.

40. *Id.* at *1–2.

41. *Id.* at *5.

42. *Id.*

43. *Id.* (adding that, even if the LLC was not a delegate, it was the steel supplier's agent).

44. *See* U.C.C. §§ 9-317, 9-322(a) (2013).

45. *See id.* §§ 9-310 to -314.

46. *Id.* § 9-309.

Article 9 applies to a security interest in that collateral. Two cases from last year deal with the intersection of Article 9 and real property law.

In *In re Blanchard*,[47] the Blanchards contracted to sell their home to the Hoffmans for $30,000 up front with the balance due in five years. Also as part of the deal, the Blanchards obtained a $142,000 mortgage loan on the property and leased the property to the Hoffmans, apparently with the expectation that the Hoffmans would eventually pay off the mortgage, probably by getting a loan in their own names. The mortgage lender received an assignment of rents and leases but neglected to obtain an assignment of the land contract between the Blanchards and the Hoffmans. After the Blanchards filed for bankruptcy protection, the trustee claimed that the mortgage lender did not have a perfected interest in the land contract, because that was personal property, and any security interest in it needed to be perfected pursuant to Article 9.[48]

The court ruled that a vendor's interest in a land contract—bare title and the right to be paid—is real property under Wisconsin law and that recording a mortgage was effective to perfect a real property lien in the land contract.[49] The court acknowledged that the right to payment for real property sold is now an "account" under Article 9,[50] and that perfecting under Article 9 might also be effective,[51] but, it did not have to resolve whether perfecting under Article 9 would have been effective.

The court's decision creates potential problems. If the Hoffmans had reified their payment obligation in a promissory note secured by a mortgage, perfection of a security interest in the note would undoubtedly be governed by Article 9,[52] and the mortgage would follow the note.[53] Structuring the transaction as a land contract should not make any difference. Consequently, under the court's approach, a lender with a security interest in a vendor's interest in a land contract could perfect either under real property law (by recording a mortgage) or under Article 9 (by filing a financing statement in the appropriate office). That means a prospective lender needs to search in both systems. Even worse, there is no clear rule for determining priority between an Article 9 security interest and a mortgage in the same property (other than fixtures).

In *In re Story*,[54] a lender advanced funds to consumers to purchase an HVAC unit for installation in their home. Although the lender never filed a financing statement, the court held that the lender had an automatically perfected

47. 819 F.3d 981 (7th Cir. 2016).

48. *Id.* at 982–83.

49. *Id.* at 985–89.

50. *Id.* at 987 (citing Wis. Stat. § 409.102(1) (2015)); *see also* U.C.C. § 9-102(a)(2) (2013). Prior to enactment of revised Article 9, a vendor's right to payment under a land contract was a "general intangible." *In re Blanchard*, 819 F.3d at 987.

51. *In re Blanchard*, 819 F.3d at 988.

52. *See* U.C.C. § 9-109(a)(1) (2013). Indeed, Article 9 applies to a *sale* of a promissory note as well as to a transaction in which a promissory note secures an obligation. *See id.* §§ 9-109(a)(3), 9-309(3).

53. *See id.* § 9-308(e).

54. No. 16-40102, 2016 WL 5210572 (Bankr. W.D.N.C. Sept. 21, 2016).

purchase-money security interest in the unit as a consumer good, and that the lender did not lose perfection when the unit was installed in the consumers' home and became a fixture.[55] Because fixtures and consumer goods are overlapping terms, the court reasoned, the unit remained a consumer good even after becoming a fixture.[56] Moreover, the court noted, a fixture filing is not necessary to perfect a security interest in fixtures, merely to have priority over certain real estate interests.[57] The decision is correct.

After determining that Article 9 applies to a security interest, the next step in determining how to perfect is to ascertain which state's law governs. In general, the law in which the debtor is located governs perfection and the effect of perfection.[58] This rule tripped up a secured party in one case of note from last year.

In *PHI Financial Services, Inc. v. Johnston Law Office, P.C.*,[59] Choice Financial Group ("Choice") loaned a North Dakota general partnership $6.75 million in 2007 and 2008, secured by the partnership's interest in, among other things, its right to government payments under crop insurance programs. Choice filed in Texas, where the crops were located. In 2008, PHI Financial Services, Inc. ("PHI") loaned the partnership $6.6 million, secured by general intangibles. PHI filed in North Dakota. Subsequently, Choice filed in North Dakota. In 2011, the debtor received a payment of $328,000 from the federal government for crop losses in 2009, and the two secured parties each claimed priority in what remained of those funds.[60]

The trial court ruled that PHI had priority because it filed first in North Dakota. The North Dakota Supreme court affirmed. It ruled that the insurance payments were neither crops nor proceeds of crops, but general intangibles.[61] Because the law that governs perfection of a security interest in general intangibles is the jurisdiction of the debtor's location, and hence that is the jurisdiction in which to file a financing statement, PHI had priority as the first to file or perfect in North Dakota.[62]

B. Adequacy of a Financing Statement

To be sufficient to perfect a security interest, a filed financing statement must provide the name of the debtor, provide the name of the secured party or a rep-

55. *Id.* at *2.
56. *Id.*
57. *Id.* (citing N.C. Gen. Stat. § 25-9-334(d), (e)).
58. *See* U.C.C. § 9-301(1) (2013).
59. 874 N.W.2d 910 (N.D. 2016).
60. *Id.* at 912–13.
61. *Id.* at 920, 921.
62. *Id.* at 921–22. The court offered no explanation of why the partnership was located in North Dakota, other than to note that the issue was undisputed. *Id.* at 922. A general partnership is not a registered organization, *see* U.C.C. § 9-102(a)(71) & cmt. 11 (2013), so its location is: (i) if it has one place of business, at that place of business; or (ii) if it has more than one place of business, at its chief executive office. *Id.* § 9-307(b)(2)–(3). The debtor clearly "conduct[ed] its affairs," *id.* § 9-307(a), in Texas, so it is not clear why it was—or whether it should have been—regarded as located in North Dakota.

resentative of the secured party, and indicate the collateral.[63] In *In re Fairmont General Hospital, Inc.*,[64] a filed financing statement identified the initial secured party as the debtor and the secured party's assignee as the secured party. The court correctly ruled that the financing statement was ineffective to perfect because the financing statement did not identify the debtor.[65] The court then ruled that a subsequently filed financing statement properly identifying the debtor as debtor and identifying the initial secured party as the secured party was also ineffective to perfect because the initial secured party no longer had a security interest.[66] This conclusion is questionable; the court never addressed whether the initial secured party was an agent or representative of the assignee.

C. Compliance with Certificate-of-Title Statute

When collateral, other than inventory held for sale or lease by a person in the business of selling goods of that type, is covered by a certificate-of-title statute, the way to perfect the security interest is through compliance with that statute.[67] Filing a financing statement is ineffective,[68] and there is no automatic perfection even if the collateral is consumer goods subject to a purchase-money security interest.[69] Some take the position that taking possession of the certificate of title is sufficient to perfect, but in most states more must be done to comply with the certificate-of-title statute.

Such was the case in *In re Hadley*,[70] in which the debtor's attorney claimed to have a lien on two vehicles. The debtor had given the attorney possession of the unendorsed certificates of title in 2008 as a form of security for payment of unpaid legal fees, although no security agreement was ever executed. In the spring of 2012, when another creditor began to pressure the debtor for payment, the debtor transferred possession of the vehicles to the attorney. In August of 2012, six days prior to filing for bankruptcy protection, the debtor endorsed the certificates. The trustee sued to avoid the attorney's interest as a preference in the bankruptcy proceeding.[71]

The absence of an authenticated security agreement was a problem for the attorney, and much of the discussion by the court centered on whether the attorney had a lien on the vehicles at all.[72] But, the court concluded, even if the attorney had a valid common-law pledge of vehicles,[73] that lien was not perfected

63. *See* U.C.C. § 9-502(a) (2013).
64. 546 B.R. 659 (Bankr. N.D. W. Va. 2016).
65. *Id.* at 666.
66. *Id.* at 666–67.
67. *See* U.C.C. § 9-311(a)(2), (d) (2013).
68. *See id.*
69. *See id.* § 9-309(1).
70. 561 B.R. 384 (B.A.P. 6th Cir. 2016).
71. *Id.* at 388–89.
72. *See id.* at 390–92.
73. *Id.* at 392–93. This portion of the opinion seems misguided. Article 9 governs transactions previously constituting a pledge under the common law. *See* U.C.C. § 9-109(a)(1) (2013). Moreover, it is clear that no authenticated security agreement is needed if the secured party has possession of the

by the attorney's possession of either the unendorsed title certificates or the vehicles. Instead, because Ohio law requires that the security interest be *noted* on the certificates, perfection occurred, at the earliest, when the debtor endorsed the certificates, which occurred during the preference period.[74]

IV. Priority of a Security Interest

A. Competing Secured Parties

In general, when there are two perfected security interests in the same collateral, priority is determined under the first-to-file-or-perfect rule. The first security interest perfected or subject to an effective financing statement has priority, provided there was no period thereafter when there was neither filing nor perfection.[75] This reasonably simple rule was misapplied in *WM Capital Management, Inc. v. Stejksal*,[76] a case that provides a cautionary tale for the buyers of secured loans.

The facts are reasonably straightforward. In 2010, Edgebrook Bank made a loan to Global Cash Network ("Global"), secured by substantially all of Global's assets. The bank perfected the security interest by filing a financing statement. The security agreement contained a future advances clause. In 2011, the bank made a second loan to Global. Although there was no need to do so, due to the future advances clause in the initial security agreement, Global authenticated a second security agreement covering the same collateral. Although the court did not mention it, the bank also filed a second financing statement. This too was unnecessary. The bank then sold the 2010 loan to Republic Bank "(Republic") and the 2011 loan to WM Capital Management ("WM Capital"). After Global defaulted, the two buyers disputed the relative priority of their security interests.[77]

The court first ruled that WM Capital could claim no benefit from the future advances clause in the initial security agreement because it was not an assignee or third party beneficiary of that security agreement.[78] From this premise the court concluded that Republic's security interest had priority.[79] The court did not indicate what the basis for this conclusion was; perhaps it was because Republic's interest was first in time. That is, Republic's security interest was both created and perfected before WM Capital's security interest was created or perfected. Unfortunately, this analysis is flawed.

While it is clear that Edgebrook Bank made the second secured loan, it is not clear whether the bank held one security interest in Global's collateral or two. If

collateral pursuant to an unauthenticated agreement (which can be oral). *See id.* § 9-203(b)(3)(B). Thus, the attorney apparently did have an attached security interest in the vehicles as of the moment the attorney received possession of them.

74. *See In re Hadley*, 561 B.R. at 393–94 (citing Ohio's Certificate of Title Act, Ohio Rev. Code Ann. § 4505.13(B)).

75. U.C.C. § 9-322(a)(1) (2013).

76. No. 15 C 8105, 2016 WL 6037851 (N.D. Ill. Oct. 14, 2016).

77. *Id.* at *2.

78. *Id.*

79. *Id.*

Global had not authenticated a second security agreement, the future advances clause in the original security agreement would undoubtedly have been sufficient to make the collateral secure the 2011 loan (as well as the 2010 loan).[80] Thus, there would have been one security interest securing two obligations. The fact that a second security agreement was created might not change things. Certainly, there are occasions when it is appropriate to treat a single lender as having two different liens on the same collateral, such as when the liens secure different obligations and have different priorities because the intervening interest of someone else is subordinate to one of those liens and superior to the other. However, this was not such a case, at least not before the bank sold the loans.

More to the point, regardless of whether the bank had one security interest or two, there was but a single priority date. Priority of competing security interests is generally based on the first-to-file-or-perfect rule of section 9-322(a)(1). Thus, even if the bank's 2011 loan was *also* secured by a separate security interest, the priority of the first security interest dated from when the initial financing statement was filed, not when the second security agreement was authenticated or when the second financing statement was filed. Thus, even if the bank had two security interests, they were of equal priority.

The bank's sale of the loans did not alter the priorities. There are three different ways to analyze the issue, but they each lead to the same result. First, if the bank initially had only one security interest despite the existence of two security agreements and two financing statements, and if selling the loans did not affect that but was instead akin to creating a participation interest, then the two buyers undoubtedly continued to share priority. After all, there would still be only one security interest. Second, if the bank initially had only one security interest but the act of selling one of the secured obligations caused the security interests to bifurcate or sever, then each security interest would remain perfected.[81] Moreover, the priority of each would date back to the bank's first financing statement because there was never a period thereafter—for either security interest—when there was neither filing nor perfection. Third, if the bank initially had two security interests in the same collateral, each security interest remained perfected after the sale, with the result that again their priorities date back to when the first financing statement was filed. Thus, under no theory was the court's conclusion correct.

This analysis is important for buyers of secured loans: it suggests what they need to do as part of their due diligence. In most cases, such a buyer makes some assessment of the creditworthiness of the borrower and the value of the collateral. It also either gets the originator to represent and warrant that the security interest is perfected or it independently so concludes after conducting a search for filed financing statements. What the buyer also needs to do, however, is inquire whether the originator has made any other loans to the borrower. If the originator has made another loan, and if that loan is secured by the same collateral—which it

80. *See* U.C.C. § 9-204(c) (2013).
81. *See id.* § 9-310(c).

might be pursuant to either a separate security agreement or the terms of the security agreement associated with the loan to be sold—the buyer would be getting a security interest of equal priority with the security interest securing the other loan. If that is the case, the buyer needs some intercreditor agreement to protect its interest in the collateral.

B. Other Claimants

Although a perfected security interest has priority over a subsequent judicial lien,[82] section 9-332(b) provides that a transferee of funds from a deposit account takes free of a security interest in the deposit account unless the transferee acts in collusion with the debtor to violate the rights of the secured party.[83] These two rules came into play last year in *Stierwalt v. Associated Third Party Administrators*.[84]

After Stierwalt obtained a judgment against his former employer for improper termination, Stierwalt obtained a writ of execution to levy on funds that the employer had in a deposit account. After the U.S. Marshal levied and, apparently, obtained the funds from the bank, but before the funds were remitted to Stierwalt, a secured party intervened, claiming to have a perfected security interest in the debtor's deposit account as identifiable proceeds of other collateral.[85]

Both Stierwalt and the court readily acknowledged that the secured party had priority in the deposit account over a levying judgment creditor.[86] Nevertheless, the court ruled that, when the marshal levied on or received the funds, Stierwalt took free of the security interest under section 9-332(b), because he did not act in collusion with the debtor to violate the secured party's rights. The decision is wrong.

Although the court correctly concluded that section 9-332(b) protects a "transferee," not just a "purchaser," and, therefore, could apply to a judicial lien creditor,[87] Stierwalt was not yet a transferee because he had not received the funds.[88] The marshal is, after all, an agent of the court, not an agent of the levying creditor. There are no public policy reason to interpret section 9-332(b) as the *Stierwalt* court did. Recall that a secured party with a perfected security in-

82. *See id.* §§ 9-201(a), 9-317(1).

83. *See id.* § 9-332(b).

84. No. 16-mc-80059-EMC, 2016 WL 2996936 (N.D. Cal. May 25, 2016).

85. *Id.* at *1.

86. *Id.* at *3.

87. *Id.* at *6–8 (citing Orix Fin. Servs., Inc. v. Kovacs, 83 Cal. Rptr. 3d 900 (Ct. App. 2008)); *see also* U.C.C. § 1-201(b)(29), (30) (2011) (defining "purchase" and "purchaser," respectively).

88. *Cf.* Zimmerling v. Affinity Fin. Corp., 14 N.E.3d 325 (Mass. App. Ct. 2014) (an account debtor's wire of funds to an escrow account, pursuant to a court order in action brought by a judgment creditor, did not cause either the escrow agent or the judgment creditor to take free of the secured party's perfected security interest under section 9-332(b), particularly given that the court order was intended to preserve the existing priorities); Sonic Eng'g, Inc. v. Konover Constr. Co. S., No. CV030824817S, 2003 WL 22133874 (Conn. Super. Ct. Sept. 3, 2003) (a levying judgment creditor that received a bank check from the debtor's bank was not a "transferee" within the meaning of section 9-332(b), and thus did not have priority over a creditor with a perfected security interest in the deposit account, because a stop payment order was placed on the check before it was paid).

terest does, and is supposed to, have priority over the rights of a subsequent lien creditor. Section 9-332(b) is an important exception to that rule, designed not to "impair the free flow of funds."[89] Put another way, it is intended to protect finality by not upsetting a completed transaction.[90] The transaction in *Stierwalt* was not completed. For that reason, the policy underlying section 9-322(b) was not implicated and the court misapplied that provision to rule for Stierwalt.[91]

VI. Enforcement of a Security Interest

A. Notification of Disposition

After default, a secured party may repossess and dispose of the collateral.[92] Before most dispositions, the secured party must send notification of the disposition to the debtor and any secondary obligor.[93] This duty cannot be waived or varied in the security agreement,[94] but can be waived in an agreement authenticated after default.[95]

In *In re Knight*,[96] after the debtors experienced a difficult crop year in which they incurred financial losses, the debtors decided to discontinue farming. They sold their crops and remitted the proceeds to their secured lender. They then sold their equipment and again used the proceeds to pay down their secured obligation.[97] In their later bankruptcy proceeding, they objected to the secured lender's deficiency claim on the basis that the lender had not provided notification of the sale. The court ruled for the secured lender. Because the debtors were the ones who orchestrated the sale by, among other things, selecting the auctioneer and choosing the auction date, the court concluded that the secured party had not foreclosed and, thus, was not required to provide notification.[98] The decision is consistent with other cases ruling that the secured party's duties to provide notification of a disposition and to conduct a disposition in a commercially reasonable manner do not apply when the debtor sells the collateral.[99]

89. U.C.C. § 9-332 cmt. 3 (2013).

90. *See id.*

91. Under *Orix*, 83 Cal. Rptr. 3d at 902–05, a secured party loses if it waits too long and allows a judgment creditor to receive funds from the debtor's deposit account. Under *Stierwalt*, a secured party loses priority much sooner: as soon as funds credited to the deposit account are levied upon (or transferred to) the sheriff or marshal. If the secured party is not the depositary itself, and thus might not have immediate notice of the judgment creditor's actions, that leaves the secured party with remarkably little time to act. For further discussion of the *Stierwalt* case, see Bjerre & Sepinuck, *supra* note 33, at 10–11; *California Court Confirms Rule Giving Priority to Judgment Creditor as a "Transferee" from the Debtor's Deposit Account*, 32 Clarks' Secured Transactions Monthly 1, 1–3 (Sept. 2016) (suggesting the decision is correct, but acknowledging good arguments to the contrary).

92. *See* U.C.C. §§ 9-609, 9-610 (2013).

93. *See id.* § 9-611(b)–(d).

94. *See id.* § 9-602(7).

95. *See id.* § 9-624(a).

96. 544 B.R. 141 (Bankr. E.D. Ark. 2016).

97. *Id.* at 144.

98. *Id.* at 149–53.

99. *E.g.*, Border State Bank v. AgCountry Farm Credit Servs., 535 F.3d 779 (8th Cir. 2008) (lenders were not required to give junior secured party notification of a sale of the collateral, although held at their insistence, because the debtor itself conducted the sale and remitted the proceeds to the

B. Conducting a Commercially Reasonable Disposition

A secured party may dispose of collateral by a sale, lease, or license.[100] The disposition may be public—that is, typically an auction—or private.[101] However, every aspect of a disposition must be "commercially reasonable."[102] If a secured party's compliance with this standard is challenged, the secured party has the burden of proof.[103] There were several notable cases about commercial reasonableness last year.

In *395 Lampe, LLC v. Kawish, LLC*,[104] a secured party purchased the debtor's minority membership interest in an LLC at a public auction conducted by the largest Pacific Northwest-based auction-marketing firm. The sale was preceded by newspaper ads and direct marketing to 150 targeted prospects and fifteen prospective bidders, which all signed confidentiality agreements, allowing them access to a data room.[105] The court concluded, on a motion for summary judgment, that the sale was conducted in a commercially reasonable manner even though the secured party was the only bidder, made a credit bid, and acquired a controlling interest.[106] The court also discounted the fact that the sale was delayed by three years. Because (i) the debtors did not show that the collateral had declined in value during that period, (ii) the collateral generated more in income during that period than the amount of default-rate interest that accrued on the secured obligation, and (iii) much of the delay was attributable to the debtor's litigation, the court ruled that the debtor failed to raise a genuine issue of material fact regarding the commercial reasonableness of the disposition.[107]

Delay was also the central issue in *WM Capital Partners, LLC v. Thornton*.[108] In that case, the debtor, a trucking company, defaulted on the secured obligation after losing its largest customer and repeatedly asked the secured party to repossess and sell the collateral. The secured party declined, each time directing the debtor to continue operating. About two years later, the secured party's assignee

lenders); Wells Fargo Bank, N.A. v. Witt, No. 4:13-CV-477-VEH, 2014 WL 1373633 (N.D. Ala. Apr. 8, 2014) (because the debtor—not the secured party—sold the collateral, the secured party had no duty to provide notice of the sale to the guarantor and the requirement that the sale be conducted in a commercially reasonable manner did not apply); *cf. In re* Reno Snax Sales, LLC, No. NV-12-1512-DKICO, 2013 WL 3942974 (B.A.P. 9th Cir. July 31, 2013) (a sale of collateral by bankruptcy trustee was not a disposition by the secured party under Article 9 or under a state statute requiring a secured party disposing of a repossessed vehicle to notify all obligors, even though the secured party received most of the sale proceeds; thus the secured party had no duty to notify a co-obligor of the sale). *But cf.* Regions Bank v. Trailer Source, Inc., 72 U.C.C. Rep. Serv. 2d 434 (Tenn. Ct. App. 2010) (a senior secured creditor's control over and approval of debtor's sale of collateralized trailers after default was sufficient to trigger the requirement, with respect to junior secured creditor, that the sale be conducted in a commercially reasonable manner).

100. U.C.C. § 9-610(a) (2013).
101. *See id.* § 9-610(b).
102. *Id.*
103. *Id.* § 9-626(a)(1), (2).
104. No. C12-1503-RAJ, 2016 WL 1449205 (W.D. Wash. Apr. 12, 2016).
105. *Id.* at *1.
106. *Id.* at *4–6.
107. *Id.* at *6–8.
108. No. M2015-00328-COA-R3-CV, 2016 WL 7477738 (Tenn. Ct. App. Dec. 29, 2016).

sold the collateral and then sought a deficiency judgment against the two guarantors.[109] The court ruled that, because a secured party has no obligation to repossess the collateral, a delay in acquiring possession or control has no bearing on the commercial reasonableness of a subsequent disposition.[110] However, because a delay between the secured party's acquisition of possession or control of the collateral and the disposition can affect the commercial reasonableness of the disposition, and the debtor had put commercial reasonableness at issue, summary judgment was not appropriate.[111]

Another interesting case about the timing of a disposition, *Highland CDO Opportunity Master Fund, L.P. v. Citibank*,[112] arose out of the financial crisis. The debtor invested in collateralized debt obligations ("CDOs") and collateralized loan obligations ("CLOs"). It had substantial loans from Citibank affiliates, secured by its mezzanine and equity tranches of CDOs and CLOs.[113] In the fall of 2008, when the value of the collateral collapsed, Citibank issued margin calls.[114] By the end of the year, the debtor was unable to comply with the margin calls and, on December 24, Citibank declared a default and issued a "bids wanted in competition" with respect to the collateral.[115] Bids were due at 10:00 am on December 31. A total of sixty-eight bids were received, resulting in ten sales of thirty-four assets for $2.5 million. The debtor claimed, when sued for a deficiency, that this amount was at least $6.3 million less than the fair market value of the assets.[116] Although Citibank was not the high bidder, its trading desk was "interested in bidding . . . , given the lack of liquidity and the likely low bids for the assets."[117]

The court began by noting that, under section 9-627(b), "[a] disposition of collateral is commercially reasonable manner if it is made: '(1) in the usual manner on any recognized market; (2) at the price current in any recognized market at the time of the disposition; or (3) otherwise in conformity with reasonable commercial practices among dealers in the type of property that was the subject of the disposition.'"[118] Although the debtor acknowledged that the public auction conformed to the practices used by dealers of such assets, the court denied both sides' motions for summary judgment. There was some expert evidence that the request for bids was "poorly timed and poorly executed," and the auction

109. *Id.* at *1–2.
110. *Id.* at *3–6.
111. *Id.* at *6–7; *see also* VFS Fin., Inc. v. Shilo Mgmt. Corp., 372 P.3d 582 (Or. Ct. App. 2016) (even though the secured party had, early in its post-default litigation against the debtor, obtained possession of the collateral, the secured party was nevertheless entitled to summary judgment on the debt because, under New York law, it is not commercially unreasonable or bad faith for a creditor to seek damages on the note or guaranty while continuing to hold the collateral).
112. No. 12 Civ. 2827 (NRB), 2016 WL 1267781 (S.D.N.Y. Mar. 30, 2016).
113. *Id.* at *2–3.
114. *Id.* at *4–8.
115. *Id.* at *8.
116. *Id.* at *9.
117. *Id.* at *8 (quoting plaintiffs' motion for summary judgment).
118. *Id.* at *18 (quoting N.Y. U.C.C. LAW § 9-627(b) (Consol. 2016)); *see also* U.C.C § 9-627(b) (2013).

was not conducted "under normal business conditions when market participants are fully staffed and have available balance sheet and appetite to purchase securities."[119] More to the point, it is notable that section 9-610(b) requires every aspect of a disposition of collateral to be commercially reasonable, including "the method, manner, time, place, and other terms."[120] In contrast, when it applies, section 9-627(b) creates a safe harbor only for the method of a disposition, not for its timing or other terms.

C. Collecting on Collateral

Upon default, or when the debtor agrees otherwise, a secured party may instruct account debtors to make payment directly to the secured party.[121] After receipt of such an instruction, along with proof of the secured party's security interest, if requested and not previously provided, an account debtor may discharge its obligation only by paying the secured party; payment to the debtor will not discharge the obligation.[122] Two cases from last year deal with the efficacy of such an instruction.

In *TemPay, Inc. v. Tanintco, Inc.*,[123] a factor's initial written instruction to an account debtor to pay the factor had four errors: (i) it misidentified the account debtor, (ii) it was directed to the "Accounts Payable Manager" but the account debtor employed no one with that title, (iii) it instructed the account debtor to pay the debtor, and (iv) it used an incorrect entity designation for the debtor.[124] The account debtor nevertheless paid the factor directly for a year after receiving wiring instructions. The following year, the account debtor paid more than $500,000 directly to the debtor after being verbally instructed to do so by the debtor's president.[125] The factor then sued the account debtor. The court concluded that, despite the errors in the factor's written instruction, the account debtor's history of paying the factor for more than a year created a factual issue about whether the instruction reasonably identified the rights assigned.[126] The court then ruled that, because the instruction purported to apply "until further notice,"[127] but did not expressly indicate that such notice had to come from the factor, there was a factual issue about whether the debtor's president had properly revoked the instruction.[128]

In *Northwest Business Finance, LLC v. Able Contractors, Inc.*,[129] the court also ruled that summary judgment was properly denied on a factor's claim against an account debtor for paying the debtor directly. Although a notification

119. *Highland*, 2016 WL 1267781, at *18–19 (quoting Highland's expert).
120. U.C.C. § 9-610(b) (2013).
121. *See id.* § 9-607(a)(1).
122. *See id.* § 9-406(a), (c).
123. No. 05-15-00130-CV, 2016 WL 192596 (Tex. App. Jan. 15, 2016).
124. *Id.* at *1.
125. *Id.* at *2.
126. *Id.* at *7.
127. *Id.*
128. *Id.* at *7–9.
129. 383 P.3d 1074 (Wash. Ct. App. 2016).

attached to most of the debtor's invoices to the account debtor instructed the account debtor to remit all payments to the factor, the invoices on which the account debtor made direct payment to the debtor lacked that notification.[130] Moreover, the court noted, an instruction to pay must identify the accounts it covers and a statement that "all" accounts have been assigned does not reasonably identify the covered accounts.[131] The court's conclusion about the insufficiency of a reference to "all" accounts is questionable.

Even when an account debtor is obligated to make payment directly to the secured party, the secured party's rights are subject to all the terms of the agreement between the account debtor and the debtor, including any defense arising from the transaction that gave rise to the account debtor's payment obligation, and any other defense or claim the account debtor has against the debtor and that arose before the account debtor received notification of the assignment to the secured party.[132]

In *Factor King, LLC v. Block Builders, LLC*,[133] a general contractor on a parking garage construction project entered into a subcontract for materials and services with a subcontractor. The agreement expressly provided that the subcontractor would hold progress payments it received from the general contractor in a "trust fund to be applied first to the payment of any person furnishing labor materials or services."[134] The subcontract also authorized the general contractor to make progress payments in the form of joint checks to the subcontractor and its suppliers.[135]

The following month, the subcontractor entered into a factoring agreement with a factor. The factor then notified the general contractor of its interest in the subcontractor's accounts and, a few days later, instructed the general contractor to pay the factor directly.[136] Thereafter, two invoices were generated. The first was for $404,000. Apparently, $184,000 was due to suppliers and, with no objection from the factor, the general contractor paid that amount directly to the suppliers and the remaining balance of $220,000 to the factor.[137] The second invoice was for $215,000. The factor sent a letter to the general contractor requesting confirmation that the invoice would be paid to the factor "without recoupment, setoff, defense or counterclaim."[138] A representative of the general contractor signed that confirmation. Nevertheless, the general contractor issued a change order which reduced the amount owed by $6,000, further reduced the invoice by $20,000 for work allegedly not completed, and then paid the revised amount directly to suppliers.[139] The factor sued.

130. *Id.* at 1076.
131. *Id.* at 1078–79.
132. *See* U.C.C. § 9-404(a) (2013).
133. 193 F. Supp. 3d 651 (M.D. La. 2016).
134. *Id.* at 653 (quoting the subcontract).
135. *Id.*
136. *Id.* at 654.
137. *Id.*
138. *Id.* (quoting the factor's letter).
139. *Id.* at 654–55.

The court granted summary judgment to the general contractor, concluding that the factor's rights were subject to all terms of the agreement between the contractor and the subcontractor, that the subcontract provided that the subcontractor was entitled only to the funds that remained after the suppliers were paid, and that the joint pay agreements authorized the general contractor to pay the suppliers.[140] The court also rejected the factor's argument of detrimental reliance, finding that the assignment agreement only "constitute[d] an agreement to pay [the f]actor the amount it was owed under the subcontract."[141]

Two cases last year dealt with a security interest in a law firm's accounts due from clients, and whether the assignment or collection of such accounts violates public policy. In *Santander Bank v. Durham Commercial Capital Corp.*,[142] the court ruled that the agreement by which a law firm sold its accounts receivable to a factor was not void as against public policy, even though the agreement required the law firm to forward to the factor copies of invoices that contained information regarding the names of a bank client's borrowers, their addresses, their account numbers, and a description of actions taken by the law firm in representing the bank.[143] The court held that, even if these disclosures violated the law firm's duty of confidentiality, it did not render the factoring agreement void.[144] Moreover, the court added that, although the factor's notification to the bank client instructing it to make payment to the factor included a signature line for the bank's representative to accept, and the bank did not, the notification was nevertheless effective.[145] However, the court concluded that the bank had a claim in recoupment for the law firm's breach of its confidentiality agreement.[146] Because the amount of the bank's damages were in dispute, summary judgment was not proper on the factor's claim against the bank for paying the law firm after it received the instruction to pay the factor.[147] Moreover, the bank's conduct in making payments to the law firm did not unequivocally waive its right to recoupment, especially given that many of the facts giving rise to its recoupment claim had yet to occur.[148]

In *Durham Commercial Capital Corp. v. Select Portfolio Servicing, Inc.*,[149] the court similarly ruled that an agreement by which a law firm sold its accounts receivable to a factor was not void as against public policy, even though the agreement required the law firm to provide the factor with copies of the law firm's invoices to its clients.[150] Moreover, the court ruled that the law firm's client

140. *Id.* at 655–57.

141. *Id.* at 658. As to the reduction in the amount, however, the court granted summary judgment against the general contractor. *Id.* at 657–58.

142. No. 14-13133-FDS, 2016 WL 199408 (D. Mass. Jan. 15, 2016).

143. *Id.* at *7.

144. *Id.*

145. *Id.* at *8–9.

146. *Id.* at *9–10.

147. *Id.* at *10.

148. *Id.* at *9–10.

149. No. 3:14-cv-877-J-34PDB, 2016 WL 6071633 (M.D. Fla. Oct. 17, 2016).

150. *Id.* at *10–11.

was not entitled to summary judgment as to whether the law firm had breached its agreement with the client by disclosing confidential information to the factor because the client had consented to the factoring agreement, which implicitly required disclosure of the client's need for representation and the fees it was charged.[151] On the other hand, the factor was not entitled to summary judgment because the law firm might have breached the agreement with its client and the client had not waived its right to set-off by making payments to the law firm after being instructed to pay the factor, especially because, at that time, it might not have known of the alleged breach.[152]

D. Other Enforcement Issues

After default, a secured party may propose to accept some or all of the collateral in full or partial satisfaction of the secured obligation.[153] To have an effective acceptance, the secured party must send the proposal to the debtor and not receive an objection from the debtor or anyone else with an interest in the collateral subordinate to the secured party's security interest.[154] The secured party is also required to send the proposal to anyone else who has filed a financing statement or otherwise notified the secured party of an interest in the collateral,[155] and the secured party's failure to do so is actionable,[156] but does not prevent the acceptance from becoming effective.[157]

In *Agri-Science Technologies, L.L.C. v. Greiner's Green Acres, Inc.*,[158] a secured party with the senior security interest failed to send to a junior secured party a proposal to accept the collateral in satisfaction of the debt. The court properly ruled that the acceptance was nevertheless effective.[159] It also ruled that the junior secured party was unable to show any damage from the senior secured party's failure to send the proposal because the collateral was worth less than the amount of the secured obligation owed to the senior secured party.[160]

V. Liability Issues

There was an interesting case last year about liability in connection with a secured transaction. In *Mac Naughton v. Harmelech*,[161] a security agreement authenticated by the debtor purported to grant a security interest in "all of [the

151. *Id.* at *12–13.
152. *Id.* at *22–24.
153. *See* U.C.C. § 9-620 (2013).
154. *See id.* § 9-620(a)(1)–(2), (c).
155. *See id.* § 9-621(a).
156. *See id.* § 9-625(b).
157. *See id.* § 9-620(a), (c).
158. No. 325182, 2016 WL 1072509 (Mich. Ct. App. Mar. 17, 2016).
159. *Id.* at *2.
160. *Id.* at *3. For further discussion of the *Agri-Science* case, see *Strict Foreclosure on Agricultural Equipment Extinguishes Junior Lien Even in Absence of Notice*, 32 Clarks' Secured Transactions Monthly 5, 5–8 (Sept. 2016).
161. No. 09-cv-5450 (KM) (MAH), 2016 WL 3771276 (D.N.J. July 13, 2016).

debtor's] . . . personal property wherever located," and authorized the secured party to sign on the debtor's behalf "any UCC-1 or other documents reasonably necessary to perfect the security interest."[162] The collateral description in the security agreement was ineffective because the super-generic language did not reasonably describe the collateral.[163] The debtor claimed that the putative secured party was therefore liable under section 9-625(e)[164] for filing an unauthorized record or for failing to file a termination statement after demand that he do so. The court rejected the debtor's claims. It concluded that, by authenticating the security agreement, the debtor authorized the putative secured party to file a financing statement, even though no security interest attached.[165]

VI. Other Cases Affecting Secured Transactions

Three federal circuit court decisions from last year, although not interpreting or applying Article 9, have important implications for secured transactions. The first deals with patent rights; the other two concern fraudulent transfer claims against a secured party.

In *Lexmark International, Inc. v. Impression Products, Inc.*,[166] a re-sale buyer of printer cartridges purchased cartridges knowing that the manufacturer/patentee had initially sold the cartridges pursuant to agreements that prohibited re-use and resale. The manufacturer sued the buyer for infringing on the patent by engaging in restricted resale and use.

Hearing the case en banc, the Federal Circuit began its analysis by noting that section 271 of the Patent Act provides that "whoever without authority makes, uses, offers to sell, or sells any patented invention, within the United States . . . during the term of the patent therefor, infringes the patent."[167] The court acknowledged the existence of the first-sale doctrine (otherwise known as exhaustion), which addresses when the sale of a patented good by the patentee authorizes the buyer to engage in acts involving the good, such as resale, that would otherwise infringe on the patent. However, the court regarded the first-sale doctrine as only an "interpretation" of the "without authority" language in section 271, and hence subject to the supremacy of the statute itself.[168] It then concluded that a sale made under a clearly communicated, otherwise-lawful restriction as to post-sale use or resale does not confer on the buyer or on a subsequent purchaser with knowledge of the restriction the authorization to engage in the use or resale that the restriction precludes.[169]

162. *Id.* at *3 (quoting plaintiff's motion for summary judgment). Note, since the revisions to Article 9, neither the debtor nor the secured party needs to sign a financing statement. Instead, the debtor's "authoriz[ation]" is needed to file a financing statement. *See* U.C.C. § 9-509(a)(1), (b) (2013).

163. *Mac Naughton*, 2016 WL 3771276, at *5 (quoting Mac Naughton v. Harmelech, No. 09-5450 (PGS), 2010 WL 3810846, at *5 (D.N.J. Sept. 22, 2010)); *see also* U.C.C. § 9-108(c) (2013).

164. *See* U.C.C. § 9-625(e)(3), (4) (2013).

165. *Mac Naughton*, 2016 WL 3771276, at *13–14.

166. 816 F.3d 721 (Fed. Cir. 2016) (en banc), *rev'd*, 137 S. Ct. 1523 (2017).

167. *Id.* at 726, 732 (citing 35 U.S.C. § 271(a)).

168. *Id.* at 742–43.

169. *Id.* at 750.

The *Lexmark* decision suggests that, absent the consent of manufacturers with patent rights, a secured party can be subject to the same restrictions on resale that limit the debtor. For example, if the debtor is a distributor or retailer of patented products, the debtor buys the goods from the manufacturer subject to restrictions on resale—e.g., a limitation to sales in a specified geographic area or to sales in the ordinary course of business—and the secured party, as part of its due diligence, learned of those restrictions, any disposition of the goods by the secured party would be similarly restricted.

A secured party is not normally bound by the debtor's contractual promises to third parties. The decision in *Lexmark* does not alter that rule; it does not impose *contractual* duties on the secured party.[170] However, it does preserve and extend a patentee's *patent rights* in goods sold to the debtor and which constitute all or part of the collateral. This is potentially more serious than the imposition of contractual duties because it subjects a secured party that knows of and violates those patent rights to statutory damages and injunctive relief, even if the patentee had no provable damages under contract law. However, the Supreme Court reversed the Federal Circuit.[171] The Supreme Court held that "a patentee's decision to sell a product exhausts all of its patent rights in that item, regardless of any restrictions the patentee purports to impose or the location of the sale."[172]

The first of the two fraudulent transfer cases is *In re Sentinel Management Group, Inc.*[173] Sentinel was a cash management firm: it invested cash, lent to it by persons or firms, in liquid low-risk securities. It also traded on its own account, using money borrowed from Bank of New York ("BONY"). In violation of federal law, Sentinel pledged securities that it had bought for its customers "with their money" to secure the loans used for trading on its own account.[174]

In August 2007, Sentinel experienced trading losses that prevented it from both maintaining its collateral with BONY and meeting the demands of its customers for redemption. It filed for bankruptcy, owing BONY $312 million.[175] The trustee refused to regard BONY as a senior secured creditor and claimed that transfers of customer assets to accounts that Sentinel could (and did) use to collateralize its loans from BONY to be avoidable intentionally fraudulent transfers under section 548(a)(1)(A) of the Bankruptcy Code.[176]

The issue came down to whether BONY had accepted the pledge of the assets "in good faith," and was therefore entitled to a defense to avoidance under section 548(c).[177] The court stated that BONY would not have been in good faith if it had "inquiry notice," which the court described as "knowledge that would lead a rea-

170. A secured party might, however, risk liability for interference with contract.
171. Impression Prods., Inc. v. Lexmark Int'l, Inc., 137 S. Ct. 1523 (2017).
172. *Id.* at 1529.
173. 809 F.3d 958 (7th Cir. 2016).
174. *Id.* at 960.
175. *Id.* at 961.
176. *Id.* (citing 11 U.S.C. § 548(a) (2012)).
177. *Id.* (quoting 11 U.S.C. § 548(c) (2012)).

sonable, law-abiding person to inquire further—make him in other words—suspicious enough to conduct a diligent search for possible dirt."[178]

Applying that standard, the court then quoted a note that the bank's Managing Director of Financial Institutions Credit sent to other bank employees, which stated: "How can they [i.e., Sentinel] have so much collateral? With less than $20 [million] in capital I have to assume most of this collateral is for somebody else's benefit. Do we really have rights on the whole $300 [million]?"[179] He received a nonresponsive answer to the question and no further inquiry was conducted. The court concluded that this was more than sufficient to create inquiry notice.[180] The managing director was suspicious, and that was enough to place him on notice of a possible fraud and so require that he or others at the bank investigate. The "obtuseness" of the recipient of the managing director's note was immaterial.[181] Moreover, the bank had in its possession documents that would show, on even a casual perusal, that Sentinel lacked authority to pledge all the assets that it pledged to BONY.[182]

The second fraudulent transfer case is *In re Fair Finance Co.*,[183] which involved the purchase of a business in a leveraged buyout, followed by the use of the business as the front for a Ponzi scheme. As part of the buyout, Textron and United Bank made extensive loans and acquired a security interest in the debtor's existing and after-acquired assets. As early as 2002, Textron became aware of extensive insider loans and expressed concern, both internally and to the debtor. As the 2004 maturity date of the loans approached, Textron sought some assurances from the debtor. After (i) reviewing the debtor's offering circulars, (ii) receiving accountant assurances that insiders had sufficient assets to repay the debts, (iii) receiving a promise to have insiders pay down a portion of the loans, and (iv) introducing a covenant that limited future insider loans, Textron felt comfortable renewing the loan. United Bank did not, and wanted out. Accordingly, Textron and the debtor entered into a new loan and security agreement. The loan documents provided for a new interest rate, a new fee schedule, new events of default, and new covenants.[184]

In 2007, the debtor found alternative financing and paid Textron the $17 million it then owed. Two years later, the debtor's business collapsed and an involuntary bankruptcy petition was filed against the debtor. During the bankruptcy proceeding, the trustee sought to avoid the payoff to Textron as an intentionally fraudulent transfer.[185]

178. *Id.* at 962.
179. *Id.* (quoting note).
180. *Id.* The circuit court, however, ruled that there was insufficient evidence that BONY knew of the fraud, and thus the trustee's claim to equitably subordinate the bank's then-unsecured claim failed. *Id.* at 965.
181. *Id.* at 962.
182. *Id.* at 962–64.
183. 834 F.3d 651 (6th Cir. 2016).
184. *Id.* at 656–61.
185. *Id.* at 663–64.

The Uniform Fraudulent Transfer Act excludes from the term "asset," which can be the subject of an avoidable fraudulent transfer, "property to the extent it is encumbered by a valid lien."[186] The debtor had paid Textron with encumbered funds, but if the trustee could avoid the grant of the security interest, then the payment would have been of unencumbered funds and, thus, also avoidable.

The trustee argued that the 2004 transaction constituted a novation. Thus, upon execution of the 2004 loan documents, the earlier security interest was extinguished. As a result, the debtor's assets were not encumbered by a preexisting valid lien and that the trustee could, therefore, treat the 2004 transfer of the security interest as a new "transfer."[187]

The court agreed. It concluded that there was sufficient evidence that the 2004 transaction was a novation. In so doing, the court stressed the language of the agreement—the part about "superseding"[188] prior agreements—the new terms, the new notes, and the new guarantees.[189]

The case is very troubling. The court never discussed why characterization of the 2004 transaction as a novation would matter. After all, even if it was a novation, and even if that means it involved a new security interest, there was never an instant when the collateral was unencumbered. It went from being encumbered by the original loan documents to being encumbered under the 2004 loan documents. Perhaps this issue will be explored on remand. In any event, the advice to secured parties is to think hard before structuring a refinancing so that a court might later treat it as a novation.

186. Unif. Fraudulent Transfer Act § 1(2)(i) (1984), *amended by* Unif. Voidable Transactions Act § 1(2)(i) (2014) (amending and retitling the act).

187. *In re Fair Fin. Co.*, 834 F.3d at 666–67.

188. *Id.* at 668.

189. *Id.* at 667–70.