PERFECTION ISSUES UNDER REVISED ARTICLE 9

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Barkley Clark
Partner, Stinson Morrison Hecker LLP
Washington, D.C.

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TEXAS COURT REQUIRES ASSIGNEES OF VEHICLE CONTRACTS TO GET THEIR LIENS NOTED ON NEW CERTIFICATES OF TITLE

A recent decision from a Texas bankruptcy court has sent shock waves through the motor vehicle finance industry. The court, in a decision by Judge Leif Clark, has ruled that the Texas Certificate of Title Act (COTA) requires assignees of security interests to apply for a new title showing the name of the assignee as lienholder. Simply taking possession of the title with the name of the assignor on it is insufficient. In the absence of a new title reflecting the name of the assignee, the court held, the assignee's security interest was unperfected and the debtor-in-possession prevailed under the strong-arm clause of the Bankruptcy Code. <u>In re Clark Contracting Services, Inc.</u>, 2008 WL 5459818 (Bankr. W.D. Tex. 11/28/08).

The decision could have a big negative impact on motor vehicle consumer credit, particularly in Texas. It is already having a chilling effect on the securitization of motor vehicle installment contracts subject to the Texas COTA. Industry players predict that, if the decision stands, consumers will face higher lending costs and less available credit.

As far as we can tell, no other court has ever construed a state certificate of title statute to impose such a re-titling requirement. Based on the language of the Texas COTA, the relationship of that statute to Article 9 of the UCC, and public policy concerns, we respectfully contend that the Texas decision is wrong.

The facts in the Texas case. Because the facts are undisputed and straight-forward, the case was decided on cross-motions for summary judgment. Clark Contracting is a construction company that provides services related to the clearing and paving of land for commercial developments. In late 2006 and early 2007, Clark financed the acquisition of six large pieces of construction equipment (specialized trucks), each of which was subject to the Texas COTA. The secured lender was CIT Group/Equipment Financing, Inc. Clark signed promissory notes for each piece of equipment and a Master Security Agreement covering all of the collateral. Certificates of title were issued for each truck; CIT noted its lien on each vehicle and took possession of the titles. Out of an abundance of caution, CIT also filed a UCC financing statement with the Texas secretary of state.

In June 2007, Wells Fargo Equipment Finance (Wells Fargo) purchased CIT's notes and security interests, and took delivery of the six certificates of title. Relying on CIT's lien as noted on each title, Wells Fargo did not apply for new titles with its own name shown as lienholder. It felt that Texas law did not impose such a requirement. In early 2008, facing potential foreclosure actions by a number of creditors, Clark filed Chapter 11 bankruptcy, becoming a debtor-in-possession with the avoidance powers of a trustee. Then, in April 2008, Clark brought an adversary proceeding against Wells Fargo seeking to avoid the six liens on the theory that, when Wells Fargo acquired CIT's secured position, it should have applied for new titles showing it (instead of CIT) as lienholder. Failure to do so, the debtor argued, meant that Wells Fargo's security interest was unperfected under the Texas COTA and subject to avoidance under Section 544 of the Bankruptcy Code. Clark did not dispute the "validity or enforceability of the assignment—just perfection of the security interest. In response, Wells Fargo argued that the

Texas COTA does not **require** an assignee to take any additional steps to perfect liens that were already duly perfected by the assignor; instead, re-titling under the Texas COTA is **optional** only.

Wells Fargo relies on the UCC. Wells Fargo also relied on UCC 9-310(c), which states that assignees of perfected security interests in titled vehicle enjoy the perfected status of their assignors without the need for an additional Article 9 filing. Wells Fargo also cited Official Comment 4 to UCC 9-310, which emphasizes the no-retitling principle:

> Subsection (c) concerns assignment of a perfected security interest or agricultural lien. It provides that no filing is necessary in connection with the assignment by a secured part to an assignee in order to maintain perfection as against creditors and transferees from the original debtor.
>
> Similarly, Subsection (c) applies to the assignment of a security interest perfected by compliance with a statute, regulation, or treaty under Section 9-311(b), such as a certificate-of-title statute. Unless the statute *expressly provides to the contrary,* the security interest will remain perfected against creditors of and transferees from the original debtor, even if the assignee takes no action to cause the certificate of title to reflect the assignment or to cause its name to appear on the certificate of title. (Emphasis added.)

Wells Fargo agreed that the Texas UCC defers to the Texas COTA insofar as the original secured creditor must get its lien noted on the title in order to perfect. 9-311(a). But, if the original security interest is perfected by lien notation, an assignment of the security interest does not affect its perfected status, and no new titling is required because the Texas COTA does not "expressly provide to the contrary." That was Wells Fargo's position.

Bankruptcy court finds that Texas COTA trumps UCC. The key issue, in the court's mind, was "how the UCC and the Certificate of Title Act interact with respect to the assigned liens on motor vehicles." Finding that the TCOTA conflicts with the more lenient UCC rule, the Texas court sided with the debtor-in-possession. It ruled that Wells Fargo made a fatal mistake by electing not to record the assignments because "the Certificate of Title Act was enacted specifically to ensure that assigned liens on vehicles [subject to the statute] must be reflected on the certificates of title as a condition of continuous perfection."

In the realm of motor vehicle financing, the court felt that "the UCC prescribes a completely different set of rules for perfection….Rather than relying on a generally searchable database; the perfection scheme relies on physical notation of security interests on the very document required to legally transfer a motor vehicle. This scheme reflects the Act's larger purpose to assure the ability to sell vehicles without the need of enforced disclosure to the purchaser of the existence of a lien on the vehicle." In short, under the certificate of title regime, third parties "are entitled to rely on what appears on the certificate of title, and look no further. Indeed there is nowhere else *to* look because a searchable database of filings is not publicly available." In the court's view, to further the purpose of the Texas COTA, it is necessary for the title to reflect the name of the current lienholder.

The Texas court then turned to the precise language in § 501.114 of the Texas COTA. The statute lays out a procedure to document the assignment of a security interest in a titled motor vehicle:

> A lienholder **may** assign a lien recorded under Section 501.113 by…applying to the county assessor-collector for the assignment of the lien…and…notifying the debtor of the assignment….On receipt of the completed application and fee, the department….may amend the department's records to substitute the subsequent lienholder for the previous lienholder…and…shall issue a new certificate of title….The issuance of a certificate of title…is recordation of the assignment. The time of recordation of a lien assigned under this section is considered to be the time the lien was recorded under Section 501.113. (Emphasis added.)

Under this procedure, the application for a new title must be signed by the assignee and accompanied by (1) the applicable fee, (2) a copy of the assignment and (3) the original certificate of title.

Wells Fargo contended that the word "may" as used in § 501.114 means that the procedure laid out in the statute is optional, not mandatory. If the assignee chooses to rely on the assignor's lien notation, it runs the risk of the assignor's release of its lien and sale to a bona fide purchaser, but that is a business decision. Without a release, the lien in the name of the assignor remains perfected and should stand up in bankruptcy.

The Texas court rejected this argument on the ground that, if it were correct, the re-titling option would have been granted to the assignee rather than the assignor. The court also reasoned that, under the statutory procedure, the assignee enjoys the benefit of relation-back perfection. The court summed it up this way: "Because of the importance of the correctness of the information on the certificate of title to innocent third parties acquiring the vehicle, the statute may be understood as an *authorization* to assign liens, *provided that* the parties to the assignment follow the procedures laid out there." (Emphasis the court's.)

Texas court ignores UCC Comments, rejects PEB Commentary and other state certificate of title laws. In short, the court felt that the focus must be on the Texas COTA, not Article 9 of the UCC. In fact, the court never even cited Comment 4 to 9-310. In arguing that no re-titling is required for an assignment of a security interest, Wells Fargo also relied heavily on Commentary No. 12 penned by the Permanent Editorial Board of the UCC back in 1994 and adopted as part of Comment 4 to UCC 9-310. The court acknowledged that the "general thrust of the Commentary" shows an intention by the drafters of the UCC that, when perfection is governed by lien notation on a certificate of title, the COT statutes should only be read to apply to the **original perfection of the security interest, not assignment of a perfected security interest.** The Texas court then quoted this language from the Commentary: "It is first necessary to ascertain whether the certificate of title statute applicable to the particular transaction contains provisions concerning an assignment of a security interest and, if so, whether such provisions relate to perfection." The court viewed this language as reflecting complete deference by the UCC to state COT statutes:

> The Commentary then discusses a variety of situations in which the state's certificate of title enactment might be ambiguous regarding assignment, or might not tie the assignment of a security interest to its perfection. While there is a strongly expressed policy in favor of continued perfection, there is also a recognition that, when a given state *has* been specific about tying assignment to perfection, the state enactment must be respected.

For the Texas court, the bottom line was that the Texas statute expressly mandates re-titling when a lien is assigned from one secured creditor to another, and that the UCC defers to such explicit language.

Finally, the court rejected Wells Fargo's citation of a number of certificate of title laws from other states, where the legislature uses language such as "The assignee may, **but need not** perfect the assignment, have the certificate of title endorsed or issued with the assignee named as holder of a security interest or lien…." (Florida statute; emphasis added) The court simply concluded that other states have other statutory language, but that has no bearing on the language of the Texas COT law. In other words: Don't mess with Texas.

Critique of the Texas decision. We think the decision is wrong, for the following reasons:

*The decision ignores basic rules of statutory construction. The word "may" as used in §501.114 of the Texas COTA seems clearly optional, not mandatory. If the Texas legislature had intended to require re-titling upon assignment of a security interest, it could have used language such as: "If a perfected security interest in a motor vehicle is assigned, a person **may** continue that perfected status **only by** noting the name of the new lienholder on a new certificate of title." (Emphasis added.) In fact, the Texas legislature used the "may…only by" language in § 501.111, which sets forth the general requirement for perfection by lien notation:

> Sec. 501.111. PERFECTION OF A SECURITY INTEREST. (a) Except as provided in subsection (b) [dealing with motor vehicles held as inventory], a person **may** perfect a security interest in a motor vehicle that is the subject of a first or subsequent sale **only by** recording the security interest on the certificate of title as provided by this chapter. (Emphasis added.)

The contrast between the simple use of "may" in § 501.114 and "may…only by" in § 501.111 seems to reflect a legislative decision to **require** the name of the first lienholder on the title as a condition of perfection, while making a re-titling in the name of the assignee **optional.** The language carefully distinguishes between perfection and assignment. The negative implication stands out strong. Read this way, the Texas statute harmonizes with the general rule under the

UCC. The Texas court seems wrong in its failure to mention the language in § 501.111 and in ruling that "may" means "shall".

*The Texas court makes much of the fact that the option to apply for a new title is given to the assignor rather than the assignee. But why should that make a difference? It does not necessarily follow that re-issuance of the title in the name of the assignee is required just because the assignor is charged with the responsibility of documenting the assignment. After all, at that point the assignor is in control of security interest. Under the statute, the application for a new title must be signed by the assignee. It takes two to tango.

*The court relies on relation-back language in the Texas statute: "The time of the recordation of a lien assigned under this section is considered to be the time the lien was recorded [by the assignor] under Section 501.113." The court concludes that the only way for the lien of an assignee to relate-back to the time of the assignor's notation is by using the re-titling procedure. But the statute doesn't say that. It simply gives assurance to both assignor and assignee that the act of re-titling doesn't negate the date of the original perfection. If the assignor's lien remains on the title, there is no reason that the assignee's perfected status should not relate-back; it is a continuously perfected lien.

*The court is concerned that failure to show the name of the assignee in place of the assignor will mislead third parties. But any third party, such as a bona fide purchaser or a subsequent secured lender, would see that the vehicle is encumbered and could obtain further information about the assignment from the assignor. Their reliance interest is fully protected. Surely a non-relying bankruptcy trustee or debtor-in-possession would not be prejudiced. The salutary principle of "notice filing" should apply just as strongly to a certificate of title regime as to UCC financing statements. If the BPF and the assignor collude to release the lien, that's a risk that the assignee has chosen to take by failing to use the optional re-titling procedure.

*The Texas decision creates an unnecessary conflict between the Texas COTA and Article 9 of the Texas UCC. The court ignored Comment 4 to UCC 9-310, which clearly excuses re-titling upon assignment of the security interest unless the state certificate of title law "expressly provides to the contrary." Texas courts recognize the Official Comments to the UCC as persuasive guidance of legislative intent. <u>Morgan Buildings and Spas, Inc. v. Turn-Key Leasing, Ltd.</u>, 97 S.W.3d 871 (Tex. App. 2003). Then the court cited—and promptly rejected—the rationale of Commentary No. 12 of the Permanent Editorial Board of the UCC. Yet that Commentary could not be clearer on the key point: While the UCC defers to state certificate of title laws regarding **perfection**, there is no deference on the issue of **assignment**—unless the state COT law is unambiguous in mandating re-titling upon assignment:

*The PEB Commentary clearly states that, if there is any doubt about whether a state certificate of title statute requires the assignment to be noted on the certificate of title, the doubt should be resolved in favor of the Article 9 rule that no further steps of perfection are required when a security interest is assigned. This furthers the UCC policies of (i) clarifying and modernizing the law, (ii) promoting established commercial practices (especially here, given the long-established practices in the securitization of motor vehicle receivables) and (iii) harmonizing commercial laws (i.e. Article 9 and the Texas COTA). At the very least the Texas COTA is ambiguous. This is clear from the length of Judge Clark's opinion on the subject.

*The PEB Commentary points out that the Uniform Certificate of Title Act, enacted in a number of states, provides that the "assignee may, but need not perfect the assignment." The Commentary notes that a number of other jurisdictions use the word "may" but don't include the phrase "but need not perfect the assignment". Then the Commentary concludes that, even without this phrase, "it would be consistent with [the UCC rule] to view these statutes as permitting but not requiring the assignment to be noted on the certificate of title." That describes the situation in Texas exactly.

*The Texas court also never mentions § 501.005 of the Texas COTA, which expressly states that, in case of a conflict with the UCC, the UCC controls. We don't think there's a conflict between the Texas COTA and the UCC; but even if there were a conflict, the Texas COTA itself states that the UCC rule prevails.

*As far as we can tell, no other court in the country has held that its certificate of title statute mandates a re-titling showing the assignee as lienholder when a security interest is assigned. The consistency of other state statutes cited by Wells Fargo, coupled with the general rule under the UCC, suggests that, if possible, an ambiguity in the statute on the assignment point should be construed against mandatory re-titling. This the Texas court refused to do.

NEGATIVE IMPACT ON SECURITIZATIONS?

As a matter of public policy, the Texas court decision will lead to increased transaction costs and inconvenience in a commercial environment where secured positions in motor vehicles, like other assets, are constantly assigned. For example, motor vehicle paper is often securitized as a way to create liquidity and thus encourage the extension of credit to consumers and businesses alike. When motor vehicle notes and security interests are assigned from originators to special-purpose vehicles in a securitization, it would be commercially impracticable to require massive re-titling in the name of the special-purpose vehicle in order to protect against the risk of debtor bankruptcy. In fact, many of these securitization transactions are structured so that the debtor will continue to deal with the assignor after the assignment because the assignor is obligated to service the contract. Re-titling in this context only creates confusion.

Is the fallout from the new decision limited to Texas? A number of states have certificate of title laws stating that "the assignee may, but need not perfect the assignment." In those states, securitization should be unaffected by the decision. That's the good news. The bad news is that a number of other states have "may" language but don't have "need not" language. In those states, the status of security interests in titled vehicles remains clouded. In any case, we understand that the Texas decision is being appealed.

II. EIGHTH CIRCUIT RULES THAT "SUPERGENERIC" COLLATERAL DESCRIPTION CAN CURE ERROR IN UCC FINANCING STATEMENT

- ProGrowth Bank, Inc. v. Wells Fargo Bank, N.A., 2009 WL 415249 (8th Cir. 2009), a case of first impression

- Secured creditor incorrectly describes the collateral as "All of Debtor's right, title, and interest in and to, assets and rights of Debtor…whether now owned or hereafter acquired...,and all proceeds and products in that certain Annuity Contract No.: LE900015 issued by Lincoln Benefit Life…."

- The UCC provides two ways to describe collateral

- UCC 9-502 provides that a financing statement is sufficient only if it "[i]ndicates the collateral covered by the financing statement." Under 9-504, a financing statement sufficiently indicates the collateral that it covers if it provides: (1) a description of the collateral pursuant to 9-108 or (2) "[a] indication that the financing statement covers all assets or all personal property." Under 9-108, a "description of personal or real property is sufficient, whether or not it is specific, if it reasonably identifies what is described." And 9-506 states that a financing statement is effective even if it contains "minor errors" unless the errors make it "seriously misleading."

- Court suggests that it would be probably invalidate the financing statement as "seriously misleading" if there were no supergeneric language.

- The all-inclusive "assets of the Debtor" language and the principle of notice filing under the UCC

- Financing statements were not "seriously misleading"

- The proper relationship between security agreement and financing statement descriptions

EIGHTH CIRCUIT: SUPERGENERIC COLLATERAL DESCRIPTION CAN CURE ERROR IN UCC FINANCING STATEMENT

If a secured creditor misdescribes a specific item of collateral in a UCC financing statement, is that error cured if the financing statement also includes a "supergeneric" collateral description like "all assets now or hereafter owned by the debtor"? In a recent case of first impression, the Eighth Circuit found a cure for the secured creditor.

The Eighth Circuit decision. In ProGrowth Bank, Inc. v. Wells Fargo Bank, N.A., 2009 WL 415249 (8th Cir. 2009), Global One Financial made a $1 million loan to the Christopher Hanson Insurance Agency on September 8, 2005. As collateral for the loan, Hanson assigned his interest in two separate annuity contracts, both issued by Fidelity & Guaranty Life Insurance Company. The two annuity contracts were valued at $1 million and were issued as "L9E00015" and "L9E00016" respectively. That same day, Wells Fargo, acting as collateral agent for Global One, filed a financing statement with the Missouri secretary of state. The financing statement identified the debtor as "Christopher J. Hanson" and described the collateral as follows:

> All of Debtor's right, title, and interest in and to, assets and rights of Debtor, wherever located and whether now owned or hereafter acquired or arising, and all proceeds and products in that certain Annuity Contract No.: LE900015 issued by Lincoln Benefit Life in the name of Debtor….

Unfortunately, the number of the annuity contract was shown as "LE900015" rather than "L9E00015" (a simple transposition) and the financing statement erroneously identified the issuer as Lincoln Benefit Life instead of Fidelity & Guaranty. A week later, another financing statement was filed using the same supergeneric "all assets" language followed by a description of "Annuity Contract No.: L9E00016 issued by Lincoln Benefit Life…." During the same period, Wells Fargo filed financing statements covering at least two other annuity contracts, not involved in this suit, owned by Hanson and issued by "Lincoln Benefit Life." Two errors.

On February 9, 2006, Hanson obtained a loan from ProGrowth. As collateral, Hanson assigned his interest in the F&G annuity contracts to ProGrowth. Several days later, ProGrowth filed two financing statements with the Missouri secretary of state. Both financing statements accurately described the collateral as "Fidelity and Guaranty Life Insurance Annuity Contracts Number L9E00015 and Number L9E00016." No errors.

ProGrowth sued Global One and Wells Fargo seeking a declaratory judgment that its perfected security interest in the two annuity contracts was prior to any perfected security interest claimed by the defendants. ProGrowth also asserted a claim for conversion. It argued that it had priority to the annuity contracts over the defendants, based on the "seriously misleading" nature of the defendants' collateral descriptions. The federal district court concluded that Wells Fargo's security interest was unperfected because of the misdescriptions of the annuity contracts.

Erroneous collateral descriptions cured by supergeneric language. The Eighth Circuit reversed. The court first turned to UCC 9-502, which provides that "[a] financing statement is sufficient only if it: (1) [p]rovides the name of the debtor; (2) [p]rovides the name of the secured party or a representative of the secured party; and (3) [i]ndicates the collateral covered by the financing statement." Under UCC 9-504, a financing statement "sufficiently indicates the collateral that it covers if the financing statement provides: (1) [a] description of the collateral pursuant to 9-108 or (2) [a]n indication that the financing statement covers all assets or all personal property." Under 9-108, a "description of personal or real property is sufficient, whether or not it is specific, if it reasonably identifies what is described." 9-506 states that "[a] financing statement substantially satisfying the requirements of this part is effective, even if it has minor errors or omissions, unless the errors or omissions make the financing statement seriously misleading."

The court then turned to an older Eighth Circuit decision holding that the function of a financing statement is not to "identify the collateral and define property which the creditor may claim, but rather to warn other subsequent creditors of the prior interest." <u>Thorp Commercial Corp. v. Northgate Industries, Inc. v. ERB Equip. Co.</u>, 654 F.2d 1245, 1248 (8th Cir. 1981). This is the "notice-filing" principle. In the court's view, the issue was whether the financing statement provides adequate notice that a person **may** have a security interest in the collateral. The UCC allows for "imperfect financing statements" and it recognizes that sometimes "further inquiry from the parties concerned will be necessary to disclose the complete state of affairs."

ProGrowth argued that Wells Fargo's financing statements were seriously misleading because they identified the annuity contracts as issued by Lincoln Benefit instead of Fidelity & Guaranty, and because contract No. L9E00015 was identified as No. LE900015. If this were the only language in the financing statement, the court stated, it would "be inclined to agree." However, the item-specific description in the financing statement "cannot be read in isolation." The supergeneric reference to "all of Debtor's right, title, and interest in and to, assets and rights of Debtor" stands independent of the item-specific description because of the word "and" between the two.

By identifying the collateral as "all assets" or "all personal property", the filer insures that if "the property in question belongs to the debtor and is personal property, any searcher will know that the property is covered by the financing statement." While supergeneric language is insufficient in the security agreement (UCC 9-502, Comment 2), "it is sufficient to describe collateral in a financing statement because it puts subsequent searchers on notice that any item of collateral owned by the debtor *may* be encumbered, which is the purpose of the filing system." (Emphasis the court's). In short, the financing statements satisfied the filing provisions of the UCC because they indicated coverage of all Hanson's assets.

The district court construed the "all assets" clause as simply referring to rights contained in, or derived from, the annuity contracts. The Eighth Circuit rejected that interpretation as "unduly restrictive". Even if the descriptive language is ambiguous, the court felt that it's better to read it in a way that is consistent with the broad "notice filing" principle. The court also held that nothing in the UCC prevents a creditor from filing "redundant or precautionary financing statements", or setting forth alternative means of describing collateral.

Financing statements not "seriously misleading". The district court noted that it was unable to find a single case in which a seriously misleading description of a specific item was cured by a supergeneric reference to "all assets" of the debtor. The appellate court countered that there is also no case holding that a valid identification of the collateral under an "all assets" provision is rendered invalid because a financing statement subsequently provides a description of a specific item that it deemed seriously misleading.

The Eighth Circuit concluded its decision this way:

> The UCC gives two methods for identifying collateral in a financing statement: a description of the collateral, or an indication that the financing statement covers all of the debtor's assets. It then provides that errors or omissions do not render the statements ineffective unless they are seriously misleading. The relevant question is whether the statements—judged in their entirety—are seriously misleading, not whether one alternative, and ultimately unnecessary, means of describing the collateral therein is seriously misleading. While Defendants' specific descriptions 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 Hanson's assets. It was then incumbent upon subsequent creditors to inquire whether specific collateral owned by Hanson is the subject of a prior security agreement.

Bottom line. The Eighth Circuit decision seems correct. It gives a strong boost to supergeneric descriptions of collateral in financing statements. Supergenerics are a good cure for what otherwise ails the financing statements.

III. DEBTOR NAME PROBLEMS

The "Assumed" or "Fictitious" Name Problem for Registered Entities

- Precise designation of the debtor's name on a financing statement is of obvious importance because that is the basis for alpha indexing of the financing statement. Revised Article 9 has generated relatively few problems with respect to the name of a "registered organization", where the name must be as indicated on the "public record of the debtor's jurisdiction of organization" (this is sometimes referred to as the "birth certificate" name of the entity). UCC 9-503(a)(1). The "public record" of registered entities is typically found in the office of the corporation commission or secretary of state.

- The biggest issue that has arisen with respect to registered entities is whether an "assumed" or "fictitious" name of a debtor is sufficient on the ground that it is of "public record". A recent bankruptcy court decision from Tennessee holds that an "assumed" name is not sufficient, even though registered with the secretary of state.

- The Tennessee decision is <u>In re Silver Dollar, LLC</u>, 388 B.R. 317, 65 UCC Rep.Serv.2d 516 (Bankr. Tenn. 2008). In that case, the debtor was organized as a Tennessee limited liability company under the name "Silver Dollar, LLC". A few days later, the debtor applied to the Tennessee secretary of state to adopt the assumed name "Silver Dollar Stores, LLC" and that name was registered with the secretary of state. A year later, the debtor borrowed money from a bank, which filed its financing statement with the Tennessee secretary of state under the assumed name "Silver Dollar Stores LLC". When the debtor filed bankruptcy, the trustee sought to avoid the bank's security interest on the ground that designating the debtor on the financing statement by its assumed name was insufficient to perfect its security interest.

- The court agreed with the trustee that use of the assumed name was insufficient under the UCC. The court relied on 9-503(c), which states: "A financing statement that provides only the debtor's trade name does not sufficiently provide the name of the debtor." The bank countered that the assumed name was more than a "trade name", and that the debtor had **two sufficient names** that met the UCC requirement of a "name…indicated on the public record of the debtor's jurisdiction of organization…." The court concluded that the debtor had only one "true name"—its "actual organizational name". Use of the word "the" in 9-503(a)(1) supports that conclusion. Moreover, the Official comment states that "the actual individual or organizational name of the debtor on a financing statement is both necessary and sufficient." Finally, the court made the policy argument that the bank's construction of 9-503 "would place an undue burden on subsequent creditors, requiring them to both know and search the UCC records under each assumed name of the debtor before extending credit." The court found that the UCC's reference to "public record" is "not referring to just any public record that indicates the debtor's name, but instead to the public record that establishes the debtor's organization."

- However, even though use of the debtor's assumed/fictitious name on the financing statement was not sufficient under 9-503, another section (9-506(c)) provides that the incorrect name does not make the financing statement "seriously misleading" if it would be discovered in a search under the debtor's correct name, using the filing office's standard search logic. Since the parties had not developed this point, the court remanded to determine whether searching under the correct name "Silver Dollar, LLC" would pull up the erroneous financing statement. This was a material issue of fact that precluded summary judgment for the trustee.

- The Article 9 Review Committee will probably codify the holding in the Tennessee case by amending UCC 9-503 to provide that the name of a registered organization must be "the name of the debtor indicated on the public organic record". The term "public organic record" will be defined to mean the record by which an organization is formed or organized, i.e. its "birth certificate". This would clearly exclude records reflecting assumed or fictitious names for "doing business" purposes.

Individual Debtor Name Problems

- The broad scope of the problem in small business and agricultural lending: In contrast to the certainty with respect to registered organization filings, there is much uncertainty with respect to individual debtor names. UCC 9-503(a)4) requires use of the debtor's "individual" name. The Official Comment unhelpfully refers to the individual debtor's "actual" name. The drafters also use the term "correct name" in 9-506(d). Finally, the language in the financing statement form set forth in 9-521 requires the preparer to designate the "DEBTOR'S EXACT FULL LEGAL NAME". How's that for confusion?

- The litigation has been heavy in this area, particularly for agricultural lending, where many of the debtors operate as sole proprietorships. The leading case is In re Kinderknecht, 308 B.R. 71 (10th Cir. BAP 2004). It was undisputed that the debtor's "legal name" was "Terrance Joseph Kinderknecht", but he went by his nickname "Terry". When he borrowed money from John Deere Credit to buy two new farm implements, Deere filed its financing statement using the name "Terry J. Kinderknecht" to designate the debtor. The debtor's trustee sought to avoid the security interest under the strong-arm clause on the ground that use of the debtor's "nickname" on the financing statement was "seriously misleading." The court agreed with the trustee. The BAP held that the secured creditor must list an individual name by "legal name", not "nickname". The court analogized a nickname to a trade name. Moreover, since a search under the debtor's legal name came up empty, the secured creditor could not use the "safe harbor" provided by UCC 9-506.

- Cases like Kinderknecht don't really answer the big question: How do you determine the debtor's "legal name"? In Kinderknecht, that critical issue was stipulated. If there's no stipulation, should the court be controlled by the name on the bankruptcy petition? The debtor's driver's license? His social security card? His birth certificate? Do middle names count? What about initials? By analogy to registered entities, the best test may be the name on the debtor's birth certificate.

- Another leading case is In re Borden, 353 B.R. 886, 61 UCC Rep.2d 223 (Bankr. D. Neb. 2006), where the debtor was a farmer who ran his business as a sole proprietorship. A purchase-money secured creditor filed its financing statement using "Mike Borden" as the debtor's name. A competing creditor with a blanket security interest had filed earlier under the name "Michael R. Borden". The court found that the name "Mike Borden" was seriously misleading because that was not his "legal name". The court concluded that Mr. Borden's legal name was "Michael Ray Borden", based on his birth certificate, driver's license, tax returns and—last but not least—his bankruptcy petition. Affidavits filed by the blanket lender indicated that a search under "Michael Ray Borden" didn't turn up the PMSI financing statement filed under "Mike Borden", so the safe harbor of 9-506 didn't change the result.

- Texas and Tennessee have enacted "driver's license" amendments to the UCC. The Texas amendment to UCC 9-503(a), effective in 2007, adds a new subsection (4):

> (4) A financing statement sufficiently provides the name of the debtor:…if the debtor is an individual, if the financing statement provides the individual's name shown on the individual's driver's license or

identification certificate issued by the individual's
state of residence;…

This appears to be a "safe harbor' provision rather than an "exclusivity" provision, giving the court leeway to find that the debtor's "legal name" is other than the one on his/her driver's license. If so, then either name would satisfy the UCC requirement and the security interest would be **perfected** against a trustee in bankruptcy. Yet the Texas statute remains unclear on who would win a **priority** contest between two creditors, one who used the debtor's driver's license name and another who used the "correct legal name", e.g. based on the debtor's birth certificate.

- Resolving this knotty issue is at the very top of the agenda of the Article 9 Review Committee. According to an interim report issued February 17, 2009, the Committee appears to have decided to use the Texas model under which the debtor's driver's license name will be "sufficient" to perfect a security interest. The Committee is looking at three competing proposals:

  *Under the "safe harbor" proposal, a financing statement providing the name on the debtor's driver's license is sufficient even if the name on the driver's license is not the debtor's legal "name". A financing statement providing the debtor's legal name would also be sufficient. The normal priority rules of the UCC (i.e. first-to-file and PMSI) would apply.

  *Under the "only if" proposal, a financing statement providing the name on the debtor's driver's license would be necessary and sufficient, regardless of the debtor's "correct" or "legal" name. A financing statement providing a name other than the one on the driver's license would **not** be sufficient and would be ineffective to perfect unless a search conducted under the name on the driver's license would disclose the competing financing statement.

  *Under the "priority" proposal, which is a variation of the "safe harbor" proposal, a financing statement using the debtor's driver's license name would be sufficient even if this is not the debtor's "legal" name. The "legal" name would also be sufficient. However, unlike the "safe harbor" proposal, if the name on the driver's license is not the debtor's "legal" name, a security interest perfected by the filing of a financing statement using the driver's license would always have priority over the competing security interest using the "legal" name.

- The continuing problem of IRS tax lien filings.

Certificate of Title Name Problems

- How do the rules governing debtor names on motor vehicle certificates of title differ from those governing debtor names on financing statements under Article 9?

- In a case of first impression, a recent Idaho bankruptcy court decision holds that a one-digit error in the debtor's name on a certificate of title was not fatal to the lienholder because searches for liens on motor vehicles are done by VIN number rather than the debtor's name. In re Laursen, 391 B.R. 47, 2008 WL 2745352, (Bankr. D. ID, June 26, 2008)(certificate of title listed debtor's name as "Whitnet" Laursen rather than "Whitney" Laursen). The Idaho court properly distinguishes the certificate of title situation from the UCC financing statement situation, based on the difference in indexing for each system.

- On the other hand, there are a number of recent decisions that construe certificate of title laws in a crabbed way that is inconsistent with the rules and policies of the UCC. For example, in In re Hicks, 491 F.3d 1136, 63 UCC Rep.2d 62 (10th Cir. 2007), a certificate of title that didn't reflect the secured lender's lien was held to be invalid in bankruptcy even though the secured lender tendered all the right information to the Kansas Department of Transportation and the case would clearly come out differently under the filing rules of the UCC. The courts should apply the UCC rules by analogy to certificate of title disputes unless (1) the state certificate of title law clearly provides otherwise or (2) there is a justified distinction between the two filing systems, as in the Idaho case.

IV. WHAT IS A STATE'S "STANDARD SEARCH LOGIC"?

- This issue was front and center in In re Augusta Tissue Mill, LLC, 2007 WL 2572451, 63 UCC Rep.Serv.2d 882 (Bankr. M.D.N.C. 2007).

- First, the court held that an equipment lease was a disguised installment sale, requiring the filing of a UCC financing statement.

- When the equipment was sold from the original debtor (Laurel Hill, a Georgia corporation) to a new debtor (August Tissue Mill, a North Carolina corporation), the secured party was required to file a new financing statement in North Carolina in the name of the new debtor within one year. UCC 9-316.

- The new North Carolina financing statement mistakenly indicated the name of the debtor as "Augusta Tissue Mills" rather than "Augusta Tissue Mill".

- Under UCC 9-506, a financing statement with "minor errors or omissions" is still effective, "unless the errors or omissions make the financing statement seriously misleading." Though the single-letter error might seem "minor", the real test was whether "a 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 [the] financing statement."

- The UCC filing guide in Georgia didn't describe or identify what constitutes the state's "standard search logic." The only evidence of that was based on three different searches. In the "exact legal name" search done on-line, the creditor's financing statement didn't come up. When the debtor's legal name was plugged into a "stem search", the financing statement came up. A third search, conducted by the Georgia filing office itself, yielded mixed results.

- Based on the uncertainty of which of the three searches used Georgia's "standard search logic", the bankruptcy court asked the parties to develop more evidence on the point.

- In a growing number of these debtor-name cases, the key issue is the third-party searcher test and the "standard search logic" of the relevant filing office.

FOR FILING PURPOSES, WHAT IS A STATE'S "STANDARD SEARCH LOGIC"?

Over the last three years or so, this newsletter has frequently reported on bankruptcy cases where the secured lender fouled up the debtor's name on the financing statement by a simple one-character typo. That's fatal if the financing statement wouldn't be found through a search using the filing office's "standard search logic". A recent decision from North Carolina shows that it's not always easy to determine the state's "standard search logic".

The Carolina case. In <u>In re Augusta Tissue Mill, LLC</u>, 63 UCC Rep.2d 882, 2007 WL 2572451 (Bankr. M.D.N.C. 2007), RCA Capital Corp. loaned funds to Laurel Hill Paper Co. in November 2005 to enable Laurel Hill to buy certain equipment. RCA perfected its purchase-money security interest in the equipment by filing a proper financing statement with the North Carolina secretary of state. In May 2006, Laurel Hill and the debtor, Augusta Tissue Mill, LLC, entered into an equipment lease that listed the lessor as "Laurel Hill Paper Co." and the lessee as "Augusta Tissue Mills, Inc." Use of the word "Mills" rather than "Mill" was clearly a simple spelling error. The lease included a provision by which Augusta Tissue Mill agreed to buy the equipment at the end of the lease term for $1. Augusta Tissue was a Georgia corporation.

Since the equipment lease was a disguised installment sale of the equipment because of the nominal purchase option, the court concluded that Augusta Tissue became the new "debtor". Aware of the lease/sale transaction, RCA filed a new financing statement in Georgia in September 2006. Unfortunately, the financing statement carried forward the one-character misspelling, i.e. "Mills" instead of "Mill". In March 2007, Augusta Tissue Mill, LLC filed Chapter 11 bankruptcy. The debtor and the unsecured creditor's committee contested RCA's motion to lift the automatic stay, and challenged RCA's security interest based on the misspelling.

The new-debtor issue. The Carolina court first turned to the conflict-of-law rules found in Revised Article 9. UCC 9-316(a)(3) provides that a security interest granted by Debtor A becomes unperfected one year after the collateral is transferred to Debtor B unless the secured lender files a new financing statement in the name of Debtor B. In the case at hand, there was a sale of the equipment from Laurel Hill to Augusta Tissue in May 2006, even though it was characterized as a "lease". The nominal purchase option at the end of the lease term made the deal a disguised secured transaction rather than a "true" lease. See UCC 1-201(37). That means that, under 9-316(a)(3), RCA needed to file a financing statement within the one-year period. Since Augusta Tissue was a Carolina corporation, it was necessary to file the new financing statement in Carolina. UCC 9-301, 9-307. However, the new filing must be done in the correct name of the debtor in order to be effective. That was the rub.

The debtor-name error. The court then turned to the filing rules of the UCC. Revised Article 9 provides that a financing statement with "minor errors or omissions" is still effective, "unless the errors or omissions make the financing statement seriously misleading." UCC 9-506(a). Although the inadvertent addition of an "s" in the debtor's name would appear to be a minor error, a financing statement that fails to sufficiently provide the debtor's name is "seriously misleading" unless "a 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 [the] financing statement." UCC 9-506(b) and (c). In Georgia, the "filing office" is any office of the clerk of the superior court and the Georgia Superior Court Clerks' Cooperative Authority administers Georgia's UCC central indexing system. UCC 9-519(b)(1). Because the Authority makes these records accessible to the public, it is the Authority's "standard search logic" that had to be determined.

So the peanut issue was whether a search under the name "Augusta Tissue Mill, LLC" would disclose RCA's financing statement. Unfortunately, the UCC Filing Guide used by the Georgia filing officers does not describe or identify what constitutes the "standard search logic" of the Authority. As a result, the only evidence of Georgia's "standard search logic" were the results of three different searches of the Authority's UCC Central Indexing system. The first and second search results were obtained online from the Authority's website. The first way to search online is an "exact name search" and the second is a "stem search." When the debtor's legal name was plugged into the "exact name search", the RCA financing statement did not come up. By contrast, when the debtor's legal name was plugged into the stem search, the RCA financing statement popped up.

Therefore, if the online stem search represented the Authority's "standard search logic", then RCA had a perfected security interest. Yet the court could not reach a conclusion without more evidence. The court noted that, in Kansas, the stem search was implemented by the filing officer as a 'more flexible search logic so as to identify UCC filings under the old law, which employed different name requirements." <u>Pankratz Implement Co. v. Citizens Nat'l Bank</u>, 130 P.3d 57, 59 UCC Rep.d2d 53 (Kan. 2006). In Georgia, by contrast, the court couldn't tell from the Filing Guide nor the Authority website what the purpose of the stem search was.

The third search result before the Georgia court contained the financing statements revealed in the Certified Search Report conducted by the Authority itself. The unsecured creditors committee argued that the Certified Search Report is the best evidence of the Authority's "standard search logic" because it is done in-house. That report didn't disclose the RCA financing statement. However, the report contained an attachment with the following language: "The search information under the above name also revealed the following filings for debtors with the same or similar names [including Augusta Tissue Mill, LLC]. This additional information is not part of the attached certified search report, and therefore is not certified by the [Authority]." In the court's view, this statement by the filing officer only muddied the waters further.

Bottom line. Based on the mixed messages it had received, the Carolina court concluded that the automatic stay would remain in place, but that the parties could produce more evidence of Georgia's "standard search logic" in a full adversary proceeding.

A few parting thoughts.

*Filing litigation like this is continuing apace. The first big batch of cases involved the use of "nicknames" and other variations of the debtor's name when the debtor is an individual. The key legal issue in this first batch is the "correct" or "legal" name of the debtor. The second big batch involves debtors such as corporations which operate as "registered entities" but whose financing statements contains some silly typo. In this second batch of cases—including the

Carolina case--the key issue is the third-party searcher test and the "standard search logic" of the relevant filing office.

*The best advice for the secured lender is to pay extra attention when the debtor is not a registered entity. If the debtor is an individual, most courts will okay use of the name on the debtor's driver's license or other state-issued identification. (The new Texas statute that gives safe harbor protection for using the debtor's driver's license is a model likely to be followed by other states.) Avoid nicknames and trade names like the plague. If the debtor is a general partnership, there is no substitute for using the name on the partnership agreement, if there is one. If the debtor is a registered entity such as a corporation or LLC, make sure that the name on the financing statement exactly matches the name in the company's "birth certificate" filed with the appropriate state agency. And have a monitoring system in place to protect against silly typos that can be fatal. Some creditors do a search in the debtor's correct name after they complete their own filing.

V. MORE CONFLICTS BETWEEN ARTICLE 9 AND CERTIFICATE OF TITLE LAWS

- In re Kierl, 2007 WL 3355501, 64 UCC Rep.Serv.2d 474 (Bankr. D. Kan. 2007): late perfection by a vehicle financer considered a voidable preference even though tardiness was due to an error by the state motor vehicle filing officer. Filing officer delayed forwarding the application for title based on alleged tax delinquency of the debtor. In fact, there was no such delinquency.

- Court finds that filing officer error is irrelevant under COT law providing that notation of the bank's lien on the title was the "exclusive" method of perfection.

- Contrast with the UCC rule that "filing" occurs when the secured creditor tenders the proper paperwork and fee. UCC 9-516. The UCC filing is good against all third parties except a BFP. Trustee in bankruptcy is not a BFP, but a hypothetical lien creditor.

- The broader issue of the proper fit between Article 9 of the UCC and state certificate of title laws.

KANSAS CONTINUES AS EPICENTER OF CONFLICT BETWEEN ARTICLE 9 AND CERTIFICATE OF TITLE STATUTE

In several recent stories, this newsletter has highlighted judicial decisions from Kansas that feature the clash between the filing rules of the UCC and those of the Kansas certificate of title law. In general, the courts in the Sunflower State have not been willing to transplant the principles of Article 9 to certificates of title.

For example, in In re Hicks, 63 UCC Rep.2d 62, 2007 WL 1810102 (10th Cir. 2007), the Tenth Circuit, applying Kansas law, holds that issuance of a "clean" title renders the secured lender's lien invalid in bankruptcy, even though the lender did everything required of it under the certificate of title law and its lien was omitted because of an administrative error in the Department of Motor Vehicles. Similarly, in In re Villa, 2007 WL 397373, 62 UCC Rep.2d 1 (Bankr. D. Kan. 2007), the court refused to invoke the principle of relation-back to protect a secured lender who failed to file its "Notice of Security Interest" on a new motor vehicle within the ten-day window allowed by the certificate of title law. In both situations, the case would have come out differently had a UCC financing statement been involved.

Now comes another Kansas bankruptcy case where late perfection by a vehicle financer was considered a voidable preference even though the tardiness was due to an error by the state motor vehicle filing officer. Let's review this new case, then turn to a 2007 amendment to the Kansas UCC that should solve the problem going forward.

The late-perfection case. In In re Kierl, 2007 WL 335501, 64 UCC Rep.2d 474 (Bankr. D. Kan. 2007), Community Bank of Wichita made a loan to Melisa Kierl in the amount of $28,832. The loan was secured by a 2003 GMC Yukon Denali, which the debtor owned before the loan was made and which was subject to a prior lien in favor of GMAC. The debtor signed a Kansas Application for Secured Title dated December 29, 2005. There was no paper title for the vehicle, since Kansas had gone to an e-title system several years earlier. On January 4, 2006, GMAC issued a lien release for the Yukon and transmitted it to the bank. Later that month the bank issued a check for $20 payable to the County Treasurer and delivered the title application and check to the Treasurer.

On January 25, 2006, the Treasurer bounced the title application on the ground that the debtor/owner owed delinquent taxes. It turns out that this was not the case. After unsuccessful attempts to have the debtor pay the $153.74 delinquency so that a title could be issued with the bank showing as lienholder, the bank paid the taxes itself in July 2006. The bank then resubmitted the title application to the County Treasurer, and this time the application was accepted. On July 11, 2006, the Kansas Department of Revenue finally issued a title showing the bank's lien.

Unfortunately, the debtor filed Chapter 7 bankruptcy on September 7, 2006. The trustee jumped up and argued that the bank's security interest in the vehicle was unperfected until July 11, 2006. Since the debtor filed bankruptcy within 90 days of the perfection, the bank's lien was voidable as a preference under Section 547 of the Bankruptcy Code.

Filing officer error is irrelevant. Not surprisingly, the bank argued that it filed the Application for a Secured Title way back in December 2005, together with the proper fee, and that the seven-month delay was due to the filing officer's wrongful assertion that the debtor owed taxes to the country. Therefore, the bank argued, the filing in July 2006 should relate back and the bank's security interest should be considered continuously perfected and thus protected against avoidance as a preference.

The bankruptcy court began its analysis by quoting the relevant language of the Kansas certificate of title law:

> …When a person acquires a security agreement on a vehicle subsequent to the issuance of the original title on such vehicle, such person shall require the holder of the certificate of title to surrender the same and sign an application for a mortgage title in form prescribed by the [motor vehicle] division. Upon such surrender such person shall immediately deliver the certificate of title, application, and a fee of $10 to the division. Upon receipt thereof, the division shall issue a new certificate of title showing the liens or encumbrances so created, but no more than two liens or encumbrances may be shown upon such a title.

Under this statutory language, the court concluded, notation of the bank's lien on the title was the "exclusive" method of perfection. The statute required the secured creditor to submit an application for a secured title and the proper fee, which the bank did in January. The treasurer was then required to forward the paperwork and the state's portion of the fee to the Department of Revenue, which would then issue a new electronic certificate of title showing the bank's lien. In the case at hand, the county treasurer did not forward the application and fee in January because of the dispute regarding the unpaid taxes. Therefore, as to the bank's security interest, the statutory procedure was not completed until the bank submitted its application a second time in July 2006—within 90 days of bankruptcy.

UCC rules not relevant. The bank cited Article 9 of the UCC for authority that "filing" occurs when the secured creditor tenders the proper paperwork and fee, and that the filing is effective against any third party other than a bona fide purchaser when the filing officer wrongfully refuses to accept the documents. UCC 9-516. The bank argued that the court should apply the UCC rule to the certificate of title situation, which would protect the bank against trustee, who qualifies as a hypothetical lien creditor, but not a "bona fide purchaser."

The Kansas court rejected the bank's argument. It concluded that UCC 9-516 does not apply to liens perfected under certificate of title statute. Section 9-516 is captioned "**What constitutes filing"** and "filing" is neither necessary nor sufficient for titled motor vehicles. The Kansas certificate of title law has no provision parallel to UCC 9-516. Moreover, the Kansas cases have consistently held that strict compliance with the certificate of title law is required to perfect, even though failure to comply is not the secured creditor's fault and no bona fide purchaser is prejudiced by protecting the bank's lien. See Mid American Credit Union v. Board of County Commissioners, 806 P.2d 479 (Kan. Ct. App. 1991 and In re Anderson, 351 B.R. 752 (Bankr. D. Kan. 2006). So the trustee prevailed.

Two parting thoughts about the Kansas case:

*We think the recent Kansas bankruptcy decision is wrong. The Kansas certificate of title statute does not include a provision parallel to UCC 9-516, providing that "filing" is deemed effective when the proper paperwork and fee are tendered to the public official. But neither does it say that such a tender is **not** an effective filing. The statute is stone-silent on the point. Given that silence, it seems reasonable for a court to turn to UCC 9-516 by way of analogy. Such an approach harmonizes two filing systems that are supposed to operate in tandem. The UCC rule is preferable because it doesn't prejudice a secured creditor based on negligence of the filing office, yet it protects bona fide purchasers who rely on the public record. We hope that courts in other states facing similar issues will look to Article 9 to fill gaps left in certificate of title law.

*In response to the outpouring of litigation over the last several years, the Kansas legislature amended UCC 9-311, effective April 26, 2007, to provide as follows:

> Such security interest [i.e. noted on a certificate of title] shall be deemed perfected upon…the delivery of the documents appropriate under any such law to the appropriate state agency and tender of the required fee to the state agency [as required by the certificate of title law].

This amendment should protect secured lenders from bankruptcy trustees in Kansas going forward, though it remains unclear whether a bona fide purchaser of a vehicle claiming under a "clean" title would prevail where the secured lender's lien was not noted due to an error by the filing officer. The question is whether, when the Kansas legislature amended UCC 9-311, it also intended to incorporate the BFP protection found in UCC 9-516.

VI. ARE CONSUMER DRAGNET CLAUSES ENFORCEABLE?

- The concept of the "floating lien" under Revised Article 9, particularly after-acquired property and future advances.

- The UCC's broad protection of dragnet clauses under Comment 5 to 9-204.

- A typical decision upholding dragnet clause in consumer credit context: In re Branch, 62 UCC Rep.2d 585 (D. Colo. 2006).

- Consider a case where the credit union security agreement covering a closed-end car loan provides that "[i]t also secures any other loans you have with the credit union now or in the future and any other amounts you owe the credit union for any reason now or in the future." This is typical credit union boilerplate. If the consumer falls into default later on a Visa or MasterCard issued by the credit union, may the credit union foreclose on the car? Based on Comment 5, the answer should be yes. But does the credit union still have a PMSI in the car?

- The Truth in Lending disclosure requirement: Reg. Z, 12 CFR § 226.6(c) and Supp. I, 6(c) provide that later loan subject to earlier dragnet clause only requires disclosure of "[t]he fact that the creditor has or will acquire a security interest in property…identified by item or type."

- Some courts ignore Comment 5 (or don't have it brought to their attention by counsel for the secured creditor). See, e.g., Wooding v. Cinfed Employees Federal Credit Union, 872 N.E.2d 959, 2007 WL 547655 (Ohio App. 2007).

COLORADO BANKRUPTCY COURT OKAYS DRAGNET CLAUSE IN CREDIT UNION LOAN DOCUMENTATION

In prior issues of this newsletter, we have reported on cases that test the enforceability of future advances or "dragnet" clauses in consumer loan documentation. We have pointed out that Revised Article 9 aids the creditor's cause mightily in these disputes. In particular, UCC 9-204(c) provides: "A security agreement may provide that collateral secures…future advances or other value, whether or not the advances or value are given pursuant to commitment." Moreover, Official Comment 5 to that section makes it clear that the key to enforceability is the language of the contract, whether the debtor be a business or a consumer:

> **Future Advances; Obligations Secured.** Under subsection (c) collateral may secure future as well as past or present advances if the security agreement so provides. This is in line with the policy of this Article toward security interests in after-acquired property under subsection (a). Indeed, the parties are free to agree that a security interest secures any obligation whatsoever. Determining the obligations secured by collateral is solely a matter of construing the parties' agreement under applicable law. This Article rejects the holdings of cases decided under former Article 9 that applied other tests, such as whether a future advance or other subsequently incurred obligation was of the same or a similar type or class as earlier advances and obligations secured by the collateral.

A few courts ignore the Comment (or don't have it brought to their attention by counsel for the secured lender). See, e.g., Wooding v. Cinfed Employees Federal Credit Union, 872 N.E.2d 959, 2007 WL 547655 (Ohio App. 2007). But most courts that read the UCC closely uphold the dragnet clause if the language in the loan documentation is clear enough. See, e.g., In re Watson, 286 B.R. 594, 49 UCC Rep.2d 674 (Bankr. D.N.J. 2002).

The Colorado case. A recent bankruptcy court decision from Colorado (applying Louisiana law) properly reads Comment 5 to UCC 9-204. In *In re* Branch, 62 UCC Rep.2d 585, 2006 WL 4476469 (D. Colo. 2006), the debtors had taken out two loans from their credit union. They signed their first note in July 2002. That note was secured by their 1999 Chevy Malibu. The loan documents included a dragnet clause under which the Chevy would also stand as security for any loan made by the credit union in the future:

> WHAT THE SECURITY INTEREST COVERS—The security interest secures the loan described in the Truth in Lending Disclosure and any extensions, renewals or refinancings of that loan. It also secures any other loans you have with the credit union now or in the future and any other amounts you owe the credit union for any reason now or in the future. If the property description is marked with one star (*), or the property is

> household goods as defined in the Credit Practice Rule, the property will secure only this loan and not other amounts you owe.

In December 2002 the debtors borrowed additional money from the credit union to purchase a Chevy Trailblazer. The same documents were used for the second loan. When they were unable to make payments on the second loan, the credit union repossessed the Trailblazer and sold it at foreclosure. Unfortunately, the foreclosure sale left a deficiency of $8,876.97 on the second note. The credit union then sought to satisfy this deficiency by repossessing and selling the Malibu, even though the debtors were not in default on that first note.

Dragnet/cross-collateral clause held enforceable. The debtor raised three defenses. First, they asserted that dragnet/cross-collateral clauses were invalid under Louisiana law. Second, they contended that the car was "household goods" as defined in the FTC/FRB Credit Practices Rule, 16 CFR Pt. 444; 12 CFR Pt. 227. Third, they argued that the credit union violated Truth in Lending by failing to adequately disclose the nature of the security interest given in connection with the first note. The debtors indicated that they wouldn't have obtained either loan had they known about the dragnet/cross-collateral clause.

The Colorado court rejected all three defenses. The validity of the dragnet clause under state law must be measured by the applicable statute—UCC 9-204(c). The court cited Comment 5 in full, and the Watson case from New Jersey, in holding that the language of the dragnet clause was clearly broad enough to cover a loan deficiency arising out of a future secured transaction. The court rejected the debtors' second defense, on the ground that the Credit Practices Rule is not broad enough to cover motor vehicles. Finally, the court turned back the TILA defense on the ground that the credit union documentation for both loans passed muster under Reg. Z, 12 CFR 226.6(c) and 12 CFR 226, Supp. I, 6(c) (later loan subject to earlier dragnet clause only requires general disclosure of "[t]he fact that the creditor has or will acquire a security interest in property… identified by item or type."

Bottom line. The New Jersey and Colorado cases show the breadth of allowable dragnet clauses under Revised Article 9 and federal consumer protection legislation.

VII. PITFALLS IN PERFECTING SECURITY INTERESTS IN IP

- PATENTS: In In re Coldwave Systems, Inc., 368 B.R. 91 (Bankr. D. Mass. 2007), a secured creditor wrongly assumed that perfection of a security interest in a patent is achieved by filing with the Trademark and Patent Office in Washington. It's not.

- The Federal Patent Law (35 U.S.C. § 261) provides that "[a]n assignment, grant or conveyance shall be void as against any subsequent purchaser or mortgagee for valuable consideration without notice unless it is recorded in the Patent and Trademark Office…" The court held that the key phrase "assignment, grant or conveyance" does not include security interests, but only patent ownership rights. Therefore, a security interest in patents must be perfected under Article 9 of the UCC by filing a financing statement. In the Massachusetts case, the secured creditor, who had originally filed in the TPO rather than under the UCC, suddenly realized the mistake and made a new UCC filing with the Massachusetts secretary of state. In response, the debtor filed Chapter 11 bankruptcy 89 days later and the court voided the security interest as a preference.

- The court also held that the creditor had not accomplished a "strict foreclosure" under UCC 9-620 several months before the Chapter 11 filing in an attempt to take the patent out of the bankruptcy estate. Sending a letter to the debtor valuing the patent at $300,000 and accepting the patent in "partial satisfaction" of the debt did not constitute a valid "strict foreclosure" because the debtor never assented to it.

- Another leading case holding that the UCC fills a hole left by the federal statute, so that a UCC filing is both necessary and sufficient, is In re Cybernetic Services, Inc., 252 F.3d 1039, 44 UCC Rep.2d 639 (9^{th} Cir. 2001), *cert. den.,* 534 U.S. 1130 (2002).

- TRADEMARKS**:** Under the Lanham Act (15 U.S.C. § 1060), the same rule applies to security interests in trademarks as applies to patents. The courts have uniformly held that the "assignment" language of the Lanham Act applies to transfers of outright ownership of registered trademarks, but not collateral assignments. The hole that is left is filled by the filing requirements of the UCC. In the leading case, In re TR-3 Industries, 41 B.R. 128, 39 UCC Rep. 179 (Bankr. C.D. Cal. 1984), the court held that the secured creditor who had filed a financing statement describing "all general intangibles of the debtor, now owned or hereafter acquired" had a perfected security interest in the trademark and related goodwill. See also In re Chattanooga Choo-Choo

Co., 98 B.R. 792, 8 UCC Rep.2d 795 (Bankr. E.D. Tenn. 1989). Even a supergeneric collateral description in the financing statement such as "all assets of the debtor, now owned or hereafter acquired" would perfect a security interest in the patent or trademark.

- COPYRIGHTS: A security interest in a registered copyright requires a federal filing in the federal copyright office (17 U.S.C. § 205): In re Peregrine Entertainment Ltd., 116 B.R. 194, 11 UCC Rep.2d 1025 (C.D. Cal. 1990). By contrast, a security interest in an unregistered copyright requires a UCC filing because the federal statute does not contemplate collateral assignments of unregistered copyrights. In re Auxiliary Power Co., 2002 WL 31017352 (9th Cir. 2002).

SECURITY INTERESTS IN PATENTS CAN ONLY BE PERFECTED BY FILING A UCC FINANCING STATEMENT

In recent years, intellectual property has become a crucial asset in the collateral mix for secured loans. A recent bankruptcy court decision from Massachusetts shows how a secured lender can get into trouble in this tricky area by wrongly assuming that perfection on a patent is achieved by a filing with the Trademark and Patent Office in Washington. It's not.

The Massachusetts case. In In re Coldwave Systems, LLC, 368 B.R. 91 (Bankr. D. Mass. 2007), the debtor was a Massachusetts limited liability company engaged in the design, development and manufacture of shipping, freezing and storage systems. It owned a patent protecting its proprietary freezing technology, used in containers for the shipping of frozen food. Gateway Management Services was in the business of leasing insulated shipping containers into which the debtor's patented technology was incorporated. The debtor was indebted to Gateway under the terms of an equipment finance lease. To secure obligations under the lease, the debtor signed a blanket security agreement covering most of the debtor's assets, including the patent.

In order to perfect its security interest in the patent, the debtor filed a "Recordation Form Cover Sheet" with the U.S. Patent and Trademark office (PTO) on June 28, 2003. On November 24, 2004, Gateway's counsel notified the debtor of its default under the finance lease, and that it was exercising all its rights and remedies under the security agreement, including the right to accelerate and pursue its foreclosure remedies. On November 30, 2004, Gateway filed a "Transfer Statement" with the PTO indicating the transfer of ownership of the patent from the debtor to Gateway. On December 1, Gateway filed a UCC financing statement in the District of Columbia covering the patent, and on December 2 filed another financing statement in Massachusetts. On December 8, Gateway notified the debtor of its filing of the "Transfer Statement" with the PTO and made an offer to "place a value" of $300,000 on the patent "in partial satisfaction" of the secured debt. Gateway requested a "timely response to this offer."

On March 1, 2005 the debtor filed Chapter 11 bankruptcy. The case was quickly converted to a Chapter 7 liquidation. In an adversary proceeding, the trustee argued that Gateway's security interest in the patent was unperfected until December 2, 2004, when it filed its financing statement in Massachusetts. Since that was only 89 days before bankruptcy, the UCC filing was a "transfer for antecedent debt" that was voidable as a preference. Gateway contended that its security interest in the patent was perfected when it filed the "Recordation Form Cover Sheet" with the PTO on June 28, 2003, well before the preference period. It also argued that its November 24, 2004 letter constituted a "partial strict foreclosure" of its security interest covering the patent, taking the asset out of the bankruptcy estate well before the preference period.

No strict foreclosure. The Bankruptcy court ruled against Gateway on all issues. It first concluded that the December 8 letter valuing the patent at $300,000 did not constitute a "strict foreclosure" under UCC 9-620 because, though Gateway's letter asked for a "timely response", there was no evidence that the debtor ever accepted the offer by responding to the letter. Under UCC 9-620(a), the triggering condition for a strict foreclosure is that "the debtor consents to the acceptance [of the collateral in partial satisfaction of the secured debt]". Under 9-620(c)(1), "a debtor consents to an acceptance of collateral in partial satisfaction of the obligation it secures only if the debtor agrees to the terms of the acceptance in a record authenticated after default." In this case, the debtor never responded. The court held that silence is not a response because it is not an "authenticated record". 9-620, Comment 3. Because the December 8 letter did not constitute a valid "strict foreclosure", the patent remained an asset of the debtor's bankruptcy estate, subject to the trustee's avoiding powers.

PTO filing doesn't perfect a security interest in a patent. The court then turned to the issue of whether Gateway perfected its security interest more than 90 days before bankruptcy was filed. Gateway relied on its PTO recording on June 28, 2003. To determine the validity of that recording, the court turned to UCC 9-311, which provides that no UCC filing is necessary to perfect a security interest in property subject to "a statute, regulation, or treaty of the United States whose requirements for a security interest's obtaining priority over the rights of a lien creditor with respect to the property preempt" the normal UCC filing rules. The court concluded that the Federal Patent Law (35 U.S.C. §261) does **not** preempt the normal Article 9 requirement of filing a financing statement.

The federal statute provides:

> An assignment, grant or conveyance shall be void as against any subsequent purchaser or mortgagee for valuable consideration without notice unless it is recorded in the Patent and Trademark Office within three months from its date or prior to the date of such subsequent purchase or mortgage.

The leading case construing the federal statute holds that the key phrase "assignment, grant or conveyance" does **not** include security interests, but only patent ownership rights. In re Cybernetic Services, Inc., 252 F.3d 1039, 44 UCC Rep.2d 639 (9th Cir. 2001), *cert. denied*, 534 U.S. 1130 (2002). Therefore, the federal statute does not preempt the filing rules of Article 9. The Ninth Circuit case involved an attack on a security interest in a patent where the secured party filed under the UCC but not with the PTO. The court held that the UCC filing was sufficient.

The Massachusetts bankruptcy court noted that the case before it was the converse of the Ninth Circuit decision: a PTO filing but no UCC filing. The Massachusetts court put it this way: "There is nothing in §261 that addresses in any way the conflict between one who is not a holder of an interest by way of assignment, grant, or conveyance and a bankruptcy trustee. We must look to other law for the answer." So the court turned to Gateway's UCC filing. No correct filing was done under the UCC until the financing statement describing the patent was filed in Massachusetts on December 2, 2004. Though Massachusetts was the correct state based on the debtor's status as a Massachusetts LLC, this filing was within 90 days of the debtor's bankruptcy. It was therefore a transfer for antecedent debt, made when the debtor was admittedly insolvent, and it gave Gateway a bigger slice of the pie than it would have had without the transfer. In short, it met all the requirements of a voidable preference under §547 of the Bankruptcy Code. The bottom line was that Gateway lost its security interest in the patent.

Some thoughts about the Massachusetts case. We would offer these parting thoughts:

*The decision seems correct. It turns on a finding that the federal Patent Act simply drops out of the picture for recording of security interests, leaving the riling rules of Article 9 as the sole determinant of perfection. The argument the other way is that, if a PTO recording will do the job against a subsequent outright purchaser of the patent, why should it not do the job, as a matter of federal law, against a subsequent lien creditor like a trustee in bankruptcy? Isn't a lien creditor is **lesser** status than an outright purchaser? Yet the Massachusetts decision reflects a judicial determination that the UCC fills the hole left in the federal statute. To the same effect is In re Pasteurized Eggs Corp., 296 B.R. 283 (Bankr. D.N.H. 2003).

*We note the cat-and-mouse nature of the underlying facts in the Massachusetts case, where Gateway must have discovered its filing error after the debtor's default, and rushed to make its UCC filing; in response, the debtor filed bankruptcy just in the nick of time to avoid Gateway's secured claim as a preference.

*The Massachusetts court quickly rejected two last-gasp arguments made by Gateway: (1) that it perfected on the patent by "possession" when it filed its PTO "Transfer Statement" on November 30, 2004 (the court points out that you can't perfect on an intangible asset by possession) and (2) that the debtor was "estopped" by failing to list the patent as an asset in its bankruptcy schedules (estoppel requires an intent that a third party rely on the conduct—not the situation in this case).

*The case law suggests that a third-party searcher relying on a patent as part of its collateral must check the UCC records in addition to the PTO records. Due diligence required dual searches.

*A secured lender that wants to cover patents need not describe the patent with any particularity, so long as it uses the "general intangibles" category in its security agreement. In the financing statement, a supergeneric description such as "all assets of the debtor, now owned or hereafter acquired" would cover patents and other types of intellectual property.

*Though Gateway could not show a proper "strict foreclosure" because of the debtor's failure to accept the offer, the case illustrates how a "partial strict foreclosure" on intangibles such as intellectual property is possible under Revised Article 9, if the proper hoops are jumped under 9-620.

VIII. STRIPPING PAYMENT STREAMS FROM CHATTEL PAPER: BANKRUPTCY IMPLICATIONS

- A noted California decision holds that payment streams may be "stripped" from chattel paper covering equipment leases and sold outright to an investor without the need for the investor to file a financing statement against the originator. In re Commercial Money Center, Inc., 350 B.R. 465, 60 UCC Rep.2d 584 (BAP 9th Cir. 2006). The payment streams (which totaled $47 million) constituted "payment intangibles" for which an outright transfer is perfected automatically under UCC 9-309(3). CMC's trustee in bankruptcy contended that the payment streams were "chattel paper" requiring the filing of a financing statement or possession by the investor, neither of which occurred. The BAP rejected this argument based on the plain language of Article 9, particularly the definitions of "chattel paper" and "payment intangible".

- The priority issue under UCC 9-330(b) when the originator strips the payment streams from chattel paper and sells them to an investor, then delivers the chattel paper to a competing secured creditor or outright buyer. Section 9-330(b) provides that a purchaser of chattel paper has priority over competing claimants if the purchaser takes possession or obtains control of the chattel paper, in good faith and in the ordinary course of business. How would the BFP know about the prior sale of the payment stream if there were no financing statement filed against the originator? Who has priority?

- On remand, the bankruptcy court held that the transaction between the originator and the investor was not a "true sale", but a secured loan, so that investor was required to file a UCC financing statement in order to perfect.

- The movement to amend Revised Article 9 to reverse the BAP decision in Commercial Money Center

IN CALIFORNIA "LIEN STRIPPING" CASE, COURT ON REMAND FINDS THAT TRANSFEREE OF PAYMENT STREAMS IS UNPERFECTED

In last September's issue of this newsletter, we reported on a Ninth Circuit BAP decision holding that payment streams may be stripped from chattel paper and sold to an investor. In re Commercial Money Center, Inc., 350 B.R. 465, 60 UCC Rep.2d 584 (BAP 9th Cir. 2006). The chattel paper in this case was a bunch of equipment leases originated by the bankrupt, Commercial Money Center, Inc. (CMC). The investor was NetBank, a federal savings bank. The BAP held that the payment streams qualified as "payment intangibles" under Revised Article 9 of the UCC and thus could be bought outright from the originator without the need to file a financing statement. UCC 9-309(3). In a second holding, however, the court found that the structured finance deal at issue was not an outright sale to the investor, but a secured transaction so that there could be no automatic perfection. The BAP then remanded the case so that the bankruptcy court could determine whether the investor had perfected in the collateral by possession through an agent, even though it had not filed a financing statement.

On June 7, 2007, the bankruptcy court held that, in a loan transaction, the payment streams which the BAP had characterized as payment intangibles under the UCC could be perfected only by filing. Possession didn't do anything for the investor. Moreover, even assuming that the investor could perfect on the payment streams by taking possession of the chattel paper (equipment leases), it never did take possession of the leases through an agent (a surety company). On a related point, the bankruptcy court rejected NetBank's argument that the surety bonds backing the payment obligations of the equipment lessees were "instruments" under the UCC and thus were perfected by possession; the court found that this argument was precluded by NetBank's earlier position in the litigation that the bonds were "supporting obligations" requiring the filing of a financing statement. The bottom line was that the trustee in bankruptcy was able to void the $47 million in payment obligations that CMC had transferred to NetBank in the structured financing. Given the amount involved and the novelty of the issues, we can expect further appellate action in this case.

The structured financing transaction. CMC's business consisted of originating commercial equipment leases, primarily in the subprime market, on a nationwide basis. The obligations of the lessees were backed by a surety company, Royal Indemnity Co. CMC would then package these insured leases into a "lease pool" and assign the payment streams due under the leases, along with rights under the surety bonds, to third-party investors such as NetBank. Netbank purchased seven pools for more than $47 million. With respect to each of the seven pools, Royal Indemnity entered into a separate "Sale and Servicing Agreement" (SSA) under which CMC transferred to NetBank certain rights associated with the pools. .

The SSA appointed Royal as "servicer" of the leases and the debtor (CMC) as "sub-servicer" to perform duties such as paying all taxes and insurance on the leased equipment, collecting the payment streams from the lessees, and holding the leases and associated files on NetBank's behalf. Thus, it was contemplated at the closing that CMC would retain the leases themselves. In late 2001 and early 2002, CMC failed to remit the payment streams to NetBank. On February 1, 2002, Royal commenced an action in California to remove CMC as sub-servicer. Based on a court order, CMC resigned as sub-servicer and Royal was authorized to take possession of the leases in March 2002. When CMC filed Chapter 11 bankruptcy, the trustee sought to avoid the payments as preferences on the ground that NetBank had never filed a financing statement against CMC.

When a secured loan is involved, filing is the only way to perfect on payment intangibles. The Ninth Circuit BAP had categorized the payment streams as "payment intangibles", perfected automatically if an outright sale was involved. The BAP contrasted the definition of "chattel paper" found in UCC 9-102(a)(11)(a "record or records that evidence both a monetary obligation and a security interest" in goods), with the definition of "payment intangible" in UCC 9-102(a)(61)(a "general intangible under which the account debtor's principal obligation is a monetary obligation"). The appellate court concluded that payment streams stripped from the underlying equipment leases are not "records" that evidence monetary obligations—they *are* the monetary obligations. In so holding, the BAP invoked the "plain meaning" rule of statutory construction.

Under Revised Article 9 of the UCC, however, automatic perfection only applies when the underlying transaction is a true sale rather than a secured loan. The BAP looked at a variety of factors in the case before it and found that the deal between CMC and NetBank wasn't a true-blue sale, but was instead a secured loan. In reaching this conclusion, the court emphasized the proprietary risks that CMC retained, including ultimate liability if the lessees defaulted on their payments and the surety company chose to go after CMC for reimbursement.

On remand, the bankruptcy court held that, (1) since the payment streams were payment intangibles under the BAP's reasoning and (2) payment intangibles can only be perfected by filing if the underlying transaction is a secured loan rather than a sale, possession would not do the trick for NebBank. The court also looked at UCC 9-313(a), which lists the types of collateral that can be perfected by possession. Tangible chattel paper can be perfected by possession, but not payment intangibles. Comment 2 to UCC 9-313 makes it quite clear that the only way to perfect on payment intangibles is by filing a UCC financing statement. This NetBank never did. In short, the BAP's earlier holding that the payment streams, when stripped from the chattel paper became payment intangibles, precluded NetBank from arguing that its possession of the chattel paper perfected its security interest in the payment streams, as suggested by an earlier Massachusetts case, <u>In re Commercial Management Svc., Inc.</u>, 127 B.R. 296 (Bankr. D. Mass. 1991).

NetBank never had constructive possession of the leases through its agent. Then, on the assumption that the <u>Commercial Management</u> case was correct; the bankruptcy court addressed the question of whether NetBank retained possession of the chattel paper through Royal Indemnity, the surety. It was undisputed that NetBank didn't itself take actual possession of the equipment leases. Instead, it argued that possession through an agent is okay under UCC 9-313, Comment 3, so long as the agent isn't the debtor. NetBank argued that the court orders entered in the California suit between Royal and CMC gave Royal constructive possession of the leases outside the 90-day preference period. In particular, the February 1, 2002 court order restrained CMC from withdrawing any lease payments and required it to make all lease records available to Royal. In other words, once CMC lost control of the leases and payment streams, NetBank had possession through its agent, Royal.

The bankruptcy court rejected this argument on the ground that actual physical possession remained at all times with CMC, in spite of the court orders. Royal was never seeking possession of anything. Rather, it wanted to obtain access to information and restrain the debtor from removing monies out of the accounts. In short, constructive possession can't come into play if the debtor retains actual possession.

Were the surety bonds supporting obligations or instruments? Finally, NetBank argued that some of the bonds might not be "supporting obligations" requiring filing to perfect, since these leases were either nonexistent or void. If the bonds were not supporting obligations, they were "instruments" which could be perfected by possession. And because NetBank had continuous possession of the bonds, its interest in them could not be avoided by the trustee.

The bankruptcy court also rejected this argument, invoking the "law of the case" doctrine. In its first summary judgment motion, filed in 2004, NetBank conceded that the bonds were "supporting obligations". It could not now switch its position on that issue.

Some thoughts about the case. We would offer these parting thoughts about the California case:

*It's bewildering to think that this huge piece of litigation could have been avoided if NetBank had filed a UCC financing statement when the structured financing deal was closed. In most states, the cost of a filing is around $20. Perhaps there were concerns about the need for multiple filings, but such filings were routinely done under the rules of old Article 9. Even if NetBank was convinced that perfection was automatic, a "protective filing" could not hurt.

*In spite of the bankruptcy court's ruling on remand, the BAP decision remains the "law of the case" that payment intangibles may be stripped from chattel paper, triggering the automatic perfection rule if the transaction is considered a true sale rather than a disguised secured loan. The BAP decision also remains an important precedent on the factors that courts should consider in determining whether the transaction is a "loan" or a "sale". This is a critical question that is not answered by Article 9 of the UCC.

*The California case still doesn't give us a good answer on how a court should come out if the originator (1) strips out payment intangibles from chattel paper and sells them outright to an investor who relies on automatic perfection and then (2) delivers the tangible chattel paper to another investor or pledges it to another secured lender. Who has priority? UCC 9-330(b) provides that a good faith purchaser of chattel paper perfected by possession always has priority over a competing interest **in the chattel paper.** In riposte, the buyer of the payment intangibles would argue that 9-330(b) doesn't apply because the buyer's interest was **in the payment intangibles.** The BAP in the <u>Commercial Money Center</u> case identified this priority problem, but left its resolution to another day. We think that 9-330(b) should control this priority dispute, and that the holding in the <u>Commercial Money Center</u> case should be limited to its facts, i.e. the originator retained the chattel paper and then filed bankruptcy.

IX. STANDING TO ENFORCE LOST PROMISSORY NOTES

- A recent Alabama supreme court decision holds that an assignee of a lost promissory note has standing to sue on the note based on a "lost instrument affidavit" signed by the assignor (who had lost the note) and a copy of the lost original note. Atlantic Nat'l Trust, LLC v. McNamee, 984 So.2d 375, 64 UCC Rep.Serv.2d 70 (Ala. 2007).

- UCC 3-309 allows a person to enforce a lost or stolen note if the person was entitled to enforce it when the loss occurred. The maker of the Alabama note argued that, when a note has been lost, it can be enforced only by the person in possession at the time it was lost, and the loser can't assign the right to enforce the note.

- The Alabama supreme court noted that, while UCC 9-309 doesn't expressly authorize the assignment of a right to enforce a lost instrument, neither does it prohibit such an assignment. And under Alabama common law, a valid assignment transfers to the assignee all the rights that the transferor had. So the assignee had standing to sue the maker on the note. To the contrary is Dennis Joslin Co. v. Robinson Broadcasting Corp., 977 F. Supp. 491, 33 UCC Rep.2d 1170 (D.D.C. 1997)(person suing on note must have been in possession of the note when it was lost and must have been entitled to enforce it at that time).

- The industry practice of using lost instrument affidavits

- Could the transferee of a lost note take free of the claims and defenses of the maker, like a traditional holder in due course? Probably not.

- The 2002 version of UCC 9-309, enacted in some states, codifies the Alabama case.

- Implications for subprime lending, where the original promissory note is often lost in the pipeline. Does that block foreclosure? Does UCC 9-309, coupled with the Alabama decision and a lost instrument affidavit; provide standing in a foreclosure action?

STANDING TO ENFORCE PROMISSORY NOTES: IMPLICATIONS FOR SUBPRIME LENDING

Does an assignee of a promissory note who was not in possession of the note at the time it was lost have standing to enforce the note? That was the question certified to the Alabama supreme court by a federal court. The Alabama supreme court held that the assignee did have standing to enforce the note, combining the rules of the UCC with the common law of assignment.

The Alabama case also has implications for the subprime lending crisis. One emerging aspect of that crisis is the unwillingness of courts to allow foreclosures to proceed unless the plaintiff can prove ownership of the mortgage note.

The Alabama case. In Atlantic Nat'l Trust, LLC v. McNamee, 984 So.2d 375, 64 UCC Rep.2d 70 (Ala. 2007), SouthTrust Bank (now Wachovia) made a loan to Jack McNamee (the defendant) on December 22, 2003 in the amount of $150,000. McNamee signed a promissory note. At some point after the execution of the note, SouthTrust Bank inadvertently misplaced, lost or destroyed the original note. The loan matured on August 5, 2005. The bank assigned the note to Atlantic National Trust (the plaintiff) on December 21, 2005. The plaintiff made a demand on the defendant for payment of the note, but the defendant did not repay the loan in full. The principal balance remaining on the note was $138,620, with interest accruing. So Atlantic sued McNamee for the balance.

Atlantic moved for summary judgment, based on the affidavit of one of its asset managers. Attached to the manager's affidavit was a "lost instrument affidavit" signed by a Wachovia officer stating that SouthTrust had somehow lost the original note, but that a true copy of the original was attached. The affidavit contained language assigning the note from SouthTrust to Atlantic. McNamee opposed the motion for summary judgment on the ground that, under Alabama law, Atlantic had no right to enforce the note because it was never in possession of the original. In other words, an assignee of a lost note has no standing to sue the maker. since the assignor didn't have a right to enforce the lost note, neither did the assignee.

Does the UCC protect only the loser of a promissory note? The UCC defines "person entitled to enforce" an instrument as (a) the holder of the instrument, (b) a nonholder in possession of the instrument who has the rights of a holder and (c) a person not in possession of the instrument who is entitled to enforce the instrument under §3-309. Section 3-309 then sets forth the rights of a person not in possession:

> A person not in possession of an instrument is entitled to enforce the instrument if (i) the person was in possession of the instrument and entitled to enforce it when loss of possession occurred, (ii) the loss of possession was not the result of a transfer by the person or a lawful seizure, and (iii) the person cannot reasonably obtain possession of the instrument because the instrument was destroyed, its whereabouts cannot be determined, or it is in the wrongful

possession of an unknown person or person that cannot be found or is not amenable to service of process.

McNamee contended that the "plain language" of these provisions means that when a promissory note has been lost, it can be enforced **only** by the person or entity that was in possession of the note at the time it was lost, and that that person can't assign the right to enforce the note. On that point, McNamee cited two cases, Dennis Joslin Co. v. Robinson Broadcasting Corp., 977 F. Supp. 491, 33 UCC Rep.2d 1170 (D.D.C. 1997)(person suing on the note must have been in possession of the note when it was lost and must have been entitled to enforce it at that time) and Cadle Co. of Conn. v. Messick, 45 UCC Rep.2d 563, 2001 WL 822231 (Conn. Super. Ct. 2000)(UCC rule doesn't give standing to assignee of person who lost the instrument). In short, these cases hold that the UCC rule protects only the loser of the note, not an assignee who buys the obligation after the original note has been lost.

Court protects assignee under the common law. Atlantic contended that, because UCC 3-309 is silent with regard to the assignability of the right to enforce a lost note, doesn't mean that assignees aren't protected under some other rule. Atlantic pointed to UCC §3-203, which provides that the transfer of a negotiable instrument vests in the transferee all of the transferor's rights in the instrument, including the right to enforce it. Atlantic had some good cases of its own to cite as authority. Bobby D. Assocs. V. DiMarcantonio, 751 A.2d 673, 41 UCC Rep.2d 878 (Pa. Super. 2000); NAB Asset Venture II, L.P. v. Lenertz, Inc., 36 UCC Rep.2d 474 (Minn. Ct. App. 1998). The court was not persuaded by this theory, however. The court reasoned that, if an instrument is lost, it is no longer "possessed" by its owner and, as a result, can't be "delivered to the transferee", as required by §3-203.

Yet the court ultimately held in favor of the assignee on the ground that, while UCC 3-309 doesn't specifically **authorize** the assignment of the right to enforce a lost instrument, neither does it **prohibit** such an assignment. In other words, no negative implication flows from 3-309. Therefore, the court felt free to turn to the Alabama common law of assignment to fill the gap. Under Alabama common law, "[a] valid assignment gives the assignee the same rights, benefits, and remedies that the assignor possesses" such that the assignee "simply steps into the shoes of the assignor…." Nissan Motor Acceptance Corp. v. Ross, 703 So.2d 324 (Ala. 1997). Applying this law to a lost promissory note, the court held that if the assignor of the note was entitled to enforce the note under UCC 3-309 before it lost it, the assignee of the note steps into the assignor's shoes and acquires the right to enforce it under 3-309. The court felt justified in using these common law principles based on UCC 1-103, which provides that "[u]nless displaced by the particular provisions of this title, the principles of law and equity…supplement its provisions."

Some thoughts about the Alabama case.

*We think the decision is correct. The drafters of UCC 3-309 were careful to protect those who inadvertently lose a promissory note. All they need to enforce the note in court is a "lost note affidavit", usually accompanied by a photocopy of the original note. If the drafters intended to give the original payee this protection, which would they not have wanted to extend that protection to assignees of the payee. Otherwise, the payee will have no market for the obligation. We understand that a surprisingly large percentage of notes are lost or destroyed inadvertently, and that the lost instrument affidavit had become the trade substitute for the original note. We think the Alabama supreme court made good use of UCC 1-103, which encourages common law principles like "the assignee of a note of a debt obligation steps into the shoes of the assignor". The same result could be reached by a liberal construction of UCC 3-203.

*Could a court take the analysis one step further, and allow an assignee of a lost note to enforce the obligation free of any claims or defenses of the maker? For example, suppose that the original note in the Alabama case was a negotiable instrument, but that the maker of the note, NcNamee, had a defense to paying SouthTrust such as a lender liability claim. If SouthTrust executed a lost instrument affidavit and indorsed the photocopy of the original note to Atlantic, could Atlantic have enforced the note free of McNamee's defense or claim, as the holder in due course of a negotiable instrument? This is clearly a tougher case, because the benefits of negotiability seem inconsistent with an attempt to enforce the obligation without the original negotiable instrument in hand. The court would have to reason by analogy, or use UCC §1-103 to bring in "supplementary" principles. Given the special nature of negotiable instruments law, this would seem to be an uphill battle. In short, though principles of contract assignment should be available to enable assignees to step into the shoes of their assignors when seeking to enforce lost notes, using principles of negotiable instruments to give the assignee even greater rights than the assignor seems to be a stretch.

*Some states have enacted the 2002 version of UCC 9-309, which substantially broadens the rights of assignees of lost instruments. Section 3-309(a)(1) gives standing to enforce a lost note if (1) the person was entitled to enforce it when loss of possession occurred or (2) the person seeking to enforce it "has directly or indirectly acquired ownership of the instrument from a person who was entitled to enforce the instrument when loss of possession occurred." This language basically codifies the Alabama decision and overrules cases cited above like Dennis Joslin.

Implications for subprime. In the good old days, a lender made a mortgage loan to a consumer and held the note for the duration. If it became necessary to foreclose, the mortgagee would file suit. There would be no question as to standing because the mortgagee had possession of the original mortgage note and could cite the principle that "the mortgage follows the note. In today's world, by contrast, many home mortgages are sold into the secondary market, sometimes to large quasi-government agencies like Freddie Mac or Fannie Mae.

Some subprime mortgages are splintered even further as they enter a complex pipeline. During the housing boom of the last decade, many originators bundled their subprime mortgages into collateralized securities by transferring ownership to remote trust entitles. Sometimes the mortgages are sold several times before ending up in a trust entity. The ultimate beneficial owners of the mortgage notes are long-term investors. To make matters more complicated, a separate entity often services the mortgages, collecting monthly payments and making various types of disbursements.

In all of this structured finance, whither goest the notes? No one has worried much about the original promissory notes—until the housing bubble burst in 2006. Now, aided by adjustable mortgage features that have snuck up on unwitting homeowners, we have seen a huge increase in foreclosures. In its March 2008 issue, the American Bar Association Journal reports that 202,000 foreclosure filings were made in November 2007, a 70 percent increase over the 120,000 filings in November 2006. Many of these foreclosures are brought in federal courts, based on diversity of citizenship.

On October 31, 2007, Judge Boyko of the U.S. District Court in Cleveland dropped a bombshell by dismissing 14 mortgage foreclosures brought by a California-based servicer as plaintiff. Judge Boyko insisted on solid proof of ownership of the mortgages, which the plaintiff could not provide. Failure to prove up ownership of the notes and mortgages, the court said, meant that the plaintiffs had no standing, and that there was no diversity jurisdiction because the plaintiff couldn't prove it was a party in interest. In re Foreclosure Cases, Nos. 1:07CV2282 (N.D. Ohio 2007). The notes and mortgages were somewhere, but the plaintiff couldn't find them because of the fractionalization of ownership brought about by securitization. Other judges—in Ohio and elsewhere--have followed Judge Boyko's lead.

Of course it should not be surprising that judges would be sympathetic to adjustable mortgage-challenged homeowners, just as legislatures have often imposed statutory moratoria on foreclosures in hard times. In some foreclosures, the plaintiff will be armed with the proper proof of ownership. In states which allow non-judicial foreclosures, the same problems don't arise. But with $6.75 **trillion** in the securitized mortgage pipeline, the number of challengeable foreclosures remains very big. In many cases, the lack of paperwork is used as leverage for homeowners to get a re-negotiation of the loan. Many debtors' attorneys are very much aware of this defense to foreclosure.

This is where the recent Alabama case comes in. Can mortgagee plaintiffs attain standing in foreclosures through the use of "lost instrument affidavits" or something similar? The use of lost note affidavits (often coupled with a photocopy of the original note) has grown by leaps and bounds in foreclosure litigation in recent years. In the Alabama case, the plaintiff persuaded the court that it was the owner of the lost note—by assignment from the original owner--through such an affidavit. In reaching that result, the Alabama court relied on UCC 3-309 and common law principles of assignment. The problem with such an approach in a subprime foreclosure is that the UCC provision only applies where the instrument is "lost, destroyed or stolen."

In the subprime mortgage setting, the original note and mortgage are out there somewhere in the pipeline. In some cases, they have been archived under a mountain. It may not be accurate to say they are "lost, destroyed or stolen"; in most cases it just takes some extra due diligence to find them. Since 1997, the home mortgage industry has had a central electronic database to trace the chain of mortgage ownership. This database is run by MERSCORP, located in Vienna, Virginia. Trouble is, MERSCORP's 3,246 mortgage company members—including Fannie Mae, Freddie Mac and Ginnie Mae—only cover about one half of the home mortgage market. For the other half, which includes most subprime mortgages, there is no e-tracking of assignments. For these securitizations, original paper documents must be found. In short, we think it is a stretch to use the UCC "lost instrument" rule, coupled with affidavits, to obtain standing in these foreclosures. Subprime mortgagees who seek to file foreclosure actions need to beef up their due diligence to find the proper loan documents.