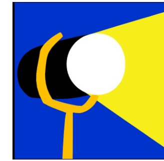
SPOTLIGHT



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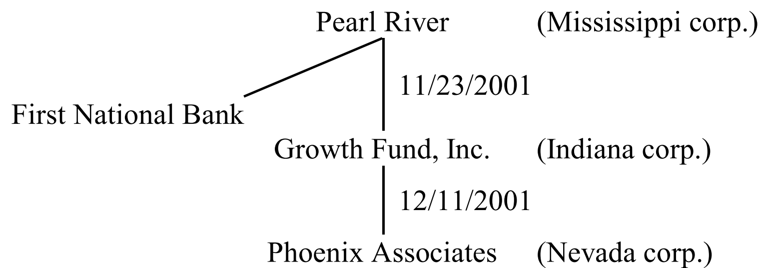
The purpose of this column is to identify some of the most disconcerting judicial decisions interpreting the Uniform Commercial Code or related commercial laws. The purpose of the column is not to be mean. It is not to get judges recalled, law clerks fired, or litigators disciplined for incompetence.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

First National Bank of Picayune v. Pearl River Fabricators, Inc., 2007 WL 3407401 (La. 2007)

This case presents a priority dispute between a creditor with a security interest in equipment and a buyer located in a jurisdiction different from the original debtor. Unfortunately, what should have been a fairly straightforward application of § 9-316(a)(3), and § 9-317(b) became muddled with analysis of irrelevant issues and inapplicable law. Nevertheless, the court's ultimate conclusion in favor of the buyer was correct.

The facts of the case are depicted in the following chart.



Pearl River, a Mississippi corporation, manufactured some equipment and granted First National Bank of Picayune a security interest in that equipment. First National perfected its interest by filing a financing statement in Mississippi. A year later, in violation of the security agreement, Pearl River sold the equipment to Growth Fund, Inc. ("GFI"), an Indiana corporation. Less than three weeks later, GFI sold the equipment to Phoenix Associates Land Syndicate, Inc. ("Phoenix"), a Nevada corporation with its principal place of business in Louisiana. Pearl River then delivered the equipment directly to Phoenix.

Approximately two years later, First National filed a new financing statement in Louisiana.[1] It then tried to enforce its security interest and Phoenix claimed to have taken free of First National's security interest pursuant to § 9-317(b).

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[1] That financing statement listed Pearl River as the debtor. There was no discussion of whether that would have been effective, given that Phoenix was now the debtor, as that term is defined in § 9-102(a)(28)(A), because it had purchased the collateral.

The court's analysis is a bit difficult to follow, perhaps because the counsel had not framed the issues properly, perhaps because the court did not understand the argument. In any event, it appears that First National raised two related arguments. First, that it remained perfected despite the transfers. Specifically, it claimed that § 9-316(a)(3) did not apply because that provision requires re-filing in response to a sale only if the sale occurs after the collateral has been moved to a new state. Second, First National claimed that Phoenix knew of its security interest because it had purchased the equipment when it was located in Mississippi, where First National had an effective filing. From this, First National reasoned, Phoenix could not take free of First National's security interest.

The court began its analysis by discussing – for reasons passing understanding – whether Phoenix's purchase of the equipment occurred in Mississippi, where the equipment was located, or in Indiana, where GFI was located. In reality, of course, the location of the sale is immaterial. So too is the location of the collateral. The only thing relevant to the proper place to file is the location of the debtor. *See* § 9-301(1). Nevertheless, the court eventually and correctly rejected this argument, noting that nothing in § 9-316(a)(3) requires that the collateral be transferred "after removal."[2] The court then turned to whether Phoenix took free of First National's security interest despite alleged knowledge of it. The court noted that First National did not actually contend that Phoenix knew of the security interest, merely that Phoenix had received shipment of the equipment from Mississippi, and thus should be charged with knowledge of it. This, the court correctly concluded, did not satisfy the definition of "knowledge" in Article 1.[3] To further support its conclusion, the court then pointed to Louisiana's version of § 9-317(b), which contains non-uniform language. The official text allows a buyer of goods to take free of an unperfected security interest if the buyer gives value and takes delivery without knowledge of the security interest. Louisiana's verison omits the knowledge requirement and allows buyers to take free of an unperfected security interest regardless of the buyer's knowledge.[4]

The court's analysis would be well taken if Louisiana law governed. What the court failed to appreciate, however, was that the collateral's location in Louisiana did not make Louisiana the fount of governing law. Phoenix, as the owner of the equipment, was now the debtor.[5] As a Nevada corporation, Phoenix was located in Nevada.[6] Thus, Nevada law, not Louisiana law, should have governed perfection and the effect of perfection or nonperfection, and priority.[7] First National was incorrect when it re-filed in Louisiana and the court was incorrect when it looked to Louisiana law to resolve the priority dispute. Nevada has no non-uniform variation to its enactment of § 9-317(b),

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[2] *Cf.* pre-revision § 9-103(1)(d), which referred to "a person who became a purchaser after removal."

[3] *See* § 1-202(b). *See also* pre-revision § 1-201(25).

[4] *See* La. Rev. Stat. § 10:9-317(b).

[5] *See* § 9-102(a)(28)(A).

[6] *See* § 9-307(e).

[7] *See* § 9-301(1).

so the buyer's knowledge of the security interest at the time of the sale should indeed been relevant to whether the buyer took free of the unperfected security interest.[8]

So, to sum up, the court correctly ruled that § 9-316(a)(3) applies and that First National had lost perfection by not re-filing within one year. The court overlooked the fact that First National never re-filed in the appropriate state, but that is immaterial. The court also correctly ruled that the knowledge referred to in § 9-317(b) is not merely notice, but actual knowledge. Accordingly, the court was correct in ruling that Phoenix took free of First National's security interest. Unfortunately, the court looked to the wrong law to reach its conclusion and, in the process, has given lenders and buyers the wrong signal about where to file and search for financing statements.

***In re Eckert*, 2007 WL 3243922 (D.N.J. 2007)**

In 2002, Chinatrust Bank extended a line of credit to Eckert Enterprises. This line of credit was secured by Eckert Enterprises' inventory and receivables and the home of Mr. and Mrs. Eckert.

In 2004, Eckert Enterprises filed for bankruptcy protection. The trustee abandoned the inventory and accounts. Nevertheless, Chinatrust Bank never took possession of or foreclosed on the inventory or collected the accounts, believing that it had lost the right to do so and that the storage costs for the inventory would be more than the inventory was worth.

Approximately two years later, one of the Eckerts filed for bankruptcy under Chapter 13, and Chinatrust filed a proof of claim representing the value of its security interest in the Eckert home. In response, the debtor objected to Chinatrust's claim and sought to avoid its lien due to its failure to pursue the inventory and receivables. The bankruptcy court ruled that Chinatrust had acted in a commercially unreasonable manner by failing to ascertain whether the costs of caring for and selling the business collateral exceeded its value and, having failed to pursue this collateral, could not now "cherry pick" among the items of collateral by proceeding against the Eckert home. It therefore "zeroed out" Chinatrust's claim and avoided its security interest on the home.

On appeal, the district court affirmed. Citing § 9-602 comment 5, it acknowledged that there can be no constructive strict foreclosure. Nevertheless, it ruled that Chinatrust Bank had not acted in a commercially reasonable manner. In so doing, the court misconstrued Chinatrust's rights and obligations. The obligations imposed by § 9-607(c) to act in a commercially reasonable manner when collecting on collateral and by § 9-610(b) to act in a commercially reasonable manner when disposing of collateral apply only when the secured party in fact undertakes to exercise those rights. The court's ruling, in effect, converted Chinatrust's right to foreclose into a duty to foreclose, a point clearly contrary to the permissive language in § 9-601(a).[1] Moreover, § 9-610(a) refers expressly

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[8] *See* Nev. Rev. Stat. § 104.9317(2).

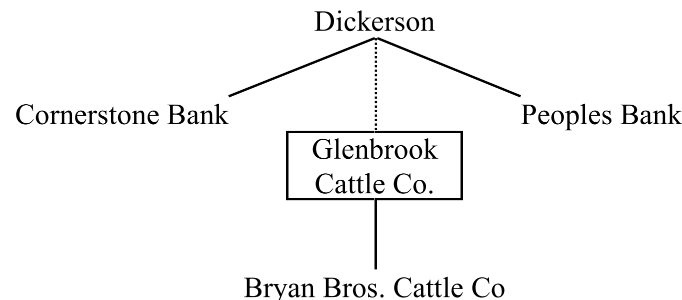
[1] While liability could have been imposed under § 9-207 for failure to care for collateral in the secured party's possession, see § 9-625 comment 2, Chinatrust Bank never took possession of any of the collateral. While it may have been possible to construe the bankruptcy court's abandonment order in the first bankruptcy case as one abandoning the inventory and receivables to Chinatrust Bank, that argument was not developed and neither court purported to rely on § 9-207.

to a secured party's right to dispose of "any or all" of the collateral. Thus, and contrary to the court's holding, Article 9 does permit a secured party to "cherry pick" among the collateral, proceeding only after those items it chooses. The court's holding to the contrary is simply erroneous and could significantly decrease the efficacy of obtaining a security interest in multiple items of collateral. There is no reason that Chinatrust should have been obliged to proceed against certain items of collateral to maintain its rights in the other.

***Peoples Bank v. Cornerstone Bank*, 504 F.3d 549 (5th Cir. 2007)**

This case pits two putative secured parties and a buyer against each other in a priority dispute. Unfortunately, the court's partial resolution of the dispute contains three analytical flaws relating to: (1) the ability of an agent to bind a principal through a security agreement; (2) the efficacy of a financing statement that used the debtor's nickname; and (3) the proper treatment of after-acquired livestock not expressly included within the written security agreement.

The parties' relationships are depicted by the following chart:



In 1999, Brooks L. Dickerson gave a security interest in his cattle, along with all "additions" and "replacements," to Cornerstone Bank. Cornerstone filed a financing statement listing the debtor by his nickname, "Louie Dickerson." In 2002, Dickerson gave a security interest in his existing and after-acquired cattle to Peoples Bank. Peoples Bank filed three financing statements, each using the debtor's legal name, "Brooks L. Dickerson."

In between those transactions, Dickerson established a bank account in the name of "Louie Dickerson, d/b/a Glenbrook Cattle Company." Glenbrook was a business entity that Dickerson was in the process of establishing with three other individuals. Later on, a certificate of formation for a Limited Liability Corporation was filed for Glenbrook. Even so, the evidence was in conflict as to whether Glenbrook actually did business as an LLC, a sole proprietorship, or a partnership.

Bryan Brothers Cattle Co. was one of Glenbrook's customers; Bryan Brothers purchased pre-conditioned cattle from Glenbrook. In 2003, the arrangement was changed so that, rather than purchasing cattle from Glenbrook at the end of the pre-conditioning program, Bryan paid for the cattle before Glenbrook acquired them, and then took delivery after Glenbrook completed the pre-conditioning.

In 2004, due to Glenbrook's financial difficulties, Bryan Brothers sought to retrieve its cattle from the pre-conditioning program and was in the process of doing so when Peoples and Cornerstone

obtained a judicial order enjoining shipment of the cattle, contending their interests in the cattle had priority over the rights of Bryan Brothers. A priority battle among the parties ensued and the trial court ruled in favor of the buyer, Bryan Brothers.

On appeal, the Fifth Circuit first dealt with Bryan Brothers' claim to priority under the Food Security Act. The court noted that a buyer in ordinary course of farm products normally takes free of a security interest created by the seller, but there is an exception if the buyer has failed to register and the security interest is perfected by the filing of a proper financing statement.[1] Bryan Brothers had admittedly not registered, so the issue became whether the two Banks had properly filed. The court ruled that, if Glenbrook operated as a partnership or LLC, the bank's financing statements naming Dickerson as the debtor could not cover the cattle in question because the banks could not have a valid security interest in them. While not incorrect, the court's analysis on this point seems oversimplified as it relates to Article 9 and could be misleading to an attorney seeking to apply this case as precedent. As White & Summers have noted, financing statements and security agreements are to be treated differently on this point: for financing statements, including the debtor's name is crucial for purposes of providing notice of the creditor's interest; for the security agreement, however, the debtor's authentication serves the purpose of a "statute of frauds" and should be deemed valid notwithstanding the absence of the true business name, so long as: (1) an authorized agent has authenticated the agreement; and (2) the evidence shows that the agent intended to bind the principal by its signature.[2] Thus, if Dickerson were an agent of Glenbrook (as a matter of agency law), the fact that the security agreement bears his name rather than the name of the business entity should not prevent the security agreement from becoming effective. However, if the debtor truly were a partnership or LLC operating under the name of Glenbrook, then none of the filings would have properly identified the debtor.[3] As a result, the court correctly noted that Bryan Brothers would have taken free of the banks' security interests on such facts. Because the facts were in dispute, the court properly remanded the case for further proceedings on this issue.

The court then moved on to resolve the competing priorities between Cornerstone Bank and Peoples Bank, in the event Bryan Brothers did not take free of their interests. It was here where the court made its greatest error. Peoples Bank argued that Cornerstone's filing using the debtor's nickname, "Louie Dickerson" rather than his legal name, "Brooks L. Dickerson" was seriously misleading. The circuit court disagreed. Without discussing or even citing the exacting standard of § 9-506(c), and after quoting cases decided before the revision to Article 9, the court ruled perfect accuracy is not needed as long as the financing puts the searcher on inquiry notice. Because the debtor held himself out by his nickname and Peoples Bank knew of that, the court ruled that Cornerstone Bank's filing was effective. This is, of course, patently wrong. To be effective, the filing must either use the debtor's "correct name" or be revealed in a search under the debtor's correct name.[4] In short, revised Article 9 puts the burden on the filer to get it right, rather than on the searcher to check against an unknown number of incorrect variations. Moreover, the case law

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[1] *See* 7 U.S.C. § 1631(d), (e)(2).

[2] White & Summers, Uniform Commercial Code, Sec. 31-3 (5th ed. 2002).

[3] *See* § 9-503(a)(1), (4)(A).

[4] *See* § 9-506(c).

on this point is remarkably uniform; any deviation from this standard will render the financing statement ineffective.[5]

Having concluded that Cornerstone Bank's filing was effective, the court then moved on to a more fundamental issue: whether Cornerstone Bank's security interest covered the cattle at issue. Because Dickerson's security agreement with Cornerstone did not expressly include after-acquired property, although it did refer to "accessions," "additions," "replacements," and "substitutions," and because Dickerson had acquired the cattle more than five years after he executed the security agreement with Cornerstone, Peoples Bank claimed that Cornerstone had no interest in the cattle. The court rejected this argument, ruling that Cornerstone's security interest included after-acquired cattle under the same theory that is commonly applied to inventory; namely, that after-acquired inventory is presumptively included unless the agreement makes it clear that only current inventory

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[5] *See In re Borden*, 2007 WL 2407032 (D. Neb. 2007) (filing against "Michael R. Borden" that identified him as "Mike Borden" was seriously misleading because the filing apparently was not disclosed in a search using the longer first name, which the court identified as the debtor's "legal name" and, therefore, his "correct name" under § 9-506(c)); *In re Berry*, 2006 WL 2795507 (Bankr. D. Kan. 2006) (financing statement must provide the legal name of an individual debtor, and hence listing the debtor's first name as "Mike," instead of "Michael," will be inadequate if the filing is not uncovered in a search using the full name); *In re Jones*, 2006 WL 3590097 (Bankr. D. Kan 2006) (financing statement filed against a man whose "legal name" was "Christopher Gary Jones" that identified the debtor as "Chris Jones" was seriously misleading because a search under the fuller name did not disclose the filing); *In re Kinderknecht*, 308 B.R. 71 (10th Cir. BAP 2004) (filing against "Terry J. Kinderknecht" was ineffective against debtor whose legal name was Terrance Joseph Kinderknecht). *See also In re Jim Ross Tires, Inc.*, 2007 WL 2264701 (Bankr. S.D. Tex. 2007) (filings against "Jim Ross Tire, Inc." instead of "Jim Ross Tires, Inc." was ineffective because the parties did not dispute that a search under the debtor's correct name would not disclose the filings); *In re John's Bean Farm of Homestead, Inc.*, 2007 WL 3256579 (Bankr. S.D. Fla. 2007) (filing that identified the debtor as "John Bean Farms, Inc." instead of its registered name, John's Bean Farm of Homestead, Inc.," was ineffective because an on-line search of the filing office's database did not produce the filing unless the searcher pushed "previous" 60 times); *In re Fuell*, 2007 WL 4404643 (Bankr. D. Idaho 2007) (filing against Andrew Fuell that identified the debtor as "Andrew Fuel" was ineffective to perfect because the debtor's on-line search failed to produce the filing); *Pankratz Implement Co. v. Citizens National Bank*, 130 P.3d 57 (Kan. 2006) (filing against "Roger House" not effective against debtor whose name was "Rodger House" because filing was not disclosed in official search); *Host America Corp. v. Coastline Financial, Inc.*, 2006 WL 1579614 (D. Utah. 2006) (filing against "K W M Electronics Corporation" was inadequate against K.W.M. Electronics Corporation because standard search logic used by filing office did not compensate for any errors, even the absence of periods); *In re Tyingham Holdings, Inc.*, 354 B.R. 363 (Bankr. E.D. Va. 2006) (financing statements filed against "Tyringham Holdings" was ineffective against debtor's whose registered name was "Tyringham Holdings, Inc." because an official search under correct name did not yield the filing even though an unofficial search using an abbreviated portion of the debtor's name did yield the filing); *Corona Fruits & Veggies, Inc. v. Frozsun Foods, Inc.*, 48 Cal Rptr. 3d 868 (Cal. Ct. App. 2006) (filing against "Armando Munoz" ineffective against Armando Munoz Juarez); *In re Stewart*, 2006 WL 3193374 (Bankr. D. Kan. 2006) (filing identifying the debtor as "Richard Stewart" was ineffective because the debtor's legal name is "Richard Morgan Stewart IV" and a search under the debtor's legal name did not uncover the filing).

should fall within the agreement.[6] Notably, Article 9 leaves this issue to be addressed by the courts.[7] White & Summers suggest that after-acquired property should be presumptively included even if not specifically mentioned in the written security agreement if "the property is contemplated to turn over during the loan." This test has been commonly applied to inventory, but not to livestock in a pre-conditioning program.[8] Moreover, the court never even mentioned what the original term was of Cornerstone's loan to Dickerson, and thus whether turn over was contemplated. Therefore, the court's reasoning on this point is a bit suspect. However, the security agreement's express coverage of "additions" – a point which the court did not discuss or rely upon – may provide an independent basis for the court's ultimate conclusion.

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[6] *Cf. In re Filtercorp, Inc.*, 163 F.3d 570 (9th Cir. 1998) (security interest covering inventory and accounts presumptively included after-acquired collateral; the presumption was rebutted for the inventory because of a reference to inventory on an attached list).

[7] *See* 9-108 comment 3.

[8] *See* White & Summers, Uniform Commercial Code, Sec. 31-3 (5th ed., 2002).