

# EMERGING COMMERCIAL LAW AND UCC ISSUES FOR THE NEXT FARM AND BUSINESS CREDIT CRISIS\*

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## I. INTRODUCTION

This article covers selected issues relating to farming and business credit transactions that commonly arise under the Uniform Commercial Code (UCC)<sup>1</sup> and/or the United States Bankruptcy Code<sup>2</sup> (and sometimes other laws as noted in this Article). While no one can predict with certainty the topics that will domi-

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1. Citations herein to the UCC reference the 2010 Uniform Text, prior to the 2010 Article 9 amendments, unless otherwise noted.

2. Citations herein to the Bankruptcy Code reference Title 11 of the United States Code, unless otherwise noted.

nate the next credit crisis (or when or even whether that crisis will occur), these issues represent good candidates, based on past experience, recent developments, and current trends.

In certain instances discussed in this Article, such as wind farm issues, the 2010 UCC Article 9 amendments, and some certificate of title (CT) issues, the analysis is necessarily prospective as the legal issues are just beginning to emerge. In other examples, such as oil and gas lease rights, the problems are evident from past experience but the solutions may be less so. While this article does not purport to provide all of the answers, it may contribute to that process by highlighting likely problems and offering prospective solutions.

## II. PERFECTING A SECURITY INTEREST IN OIL AND GAS LEASE RIGHTS AND THE STREAM OF PAYMENTS DERIVED THEREFROM

### A. Background: *The SemGroup Case*

Security interests in oil and gas lease rights were highlighted when a significant oil and gas trading firm filed bankruptcy in 2008. SemGroup, L.P., a limited partnership organized in Delaware, together with its various affiliates (together, SemGroup), was in the business of purchasing oil and gas derived from wells in a number of jurisdictions, including Texas and Oklahoma.<sup>3</sup> Pursuant to industry custom, SemGroup paid the “interest owners” (persons owning an inter-

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3. For purposes of illustration, this discussion focuses on the Oklahoma law and accompanying issues. The facts and background of the Oklahoma-related issues in the litigation involving SemGroup (the *SemGroup* litigation) are also described in the June 2009 opinion of the bankruptcy court in the *SemGroup* litigation. See *Samson Res. Co. v. SemCrude, L.P.*, 407 B.R. 140 (Bankr. D. Del. 2009) (regarding Oklahoma Law). Companion orders were issued relating to Texas and Kansas law. See *Arrow Oil & Gas, Inc. v. SemCrude L.P.*, 407 B.R. 112 (Bankr. D. Del. 2009) (regarding Texas law); *Mull Drilling Co. v. SemCrude L.P.*, 407 B.R. 82 (Bankr. D. Del. 2009) (regarding Kansas law). The facts and issues in the *SemGroup* litigation have also been described in the popular media. See, e.g., Rod Walton, *SemGroup to Present Plan*, TULSA WORLD, Oct. 24, 2009, [http://www.tulsaworld.com/news/article.aspx?articleID=20091024\\_49\\_EI\\_SmruPs284393](http://www.tulsaworld.com/news/article.aspx?articleID=20091024_49_EI_SmruPs284393); Rod Walton, *Federal Judge OKs \$28 Million Settlement Against SemGroup Co-founder Kivisto*, TULSA WORLD, Oct. 6, 2011, [http://www.tulsaworld.com/business/article.aspx?subjectid=49&articleid=20011106\\_49\\_EI\\_afeder381723](http://www.tulsaworld.com/business/article.aspx?subjectid=49&articleid=20011106_49_EI_afeder381723); Rod Walton, *Judge Ends SemGroup Lawsuit*, TULSA WORLD, Oct. 7, 2011, [http://www.tulsaworld.com/news/article.aspx?subjectid=351&articleid=20111007\\_351\\_0\\_thefed860755](http://www.tulsaworld.com/news/article.aspx?subjectid=351&articleid=20111007_351_0_thefed860755). On related issues, see Rod Walton, *Producers Sue SemGroup LP Connections*, NEWSOK, May 18, 2010, <http://newsok.com/producers-sue-semgroup-lp-connections/article/3462006>; see also Fred H. Miller & Alvin C. Harrell, *Aftermath of the SemGroup Case: Oklahoma Enacts the Oil and Gas Owners' Lien Act of 2010*, 81 OKLA. BAR J. 2818 (2010) (to which the discussion below is indebted).

est in the oil and gas rights before the first sale of the oil or gas—the royalty interest owners<sup>4</sup>) on a lag-time basis. For example, the interest owners were paid for the purchased oil on the twentieth day of any given month, and for the gas on the twenty-fifth day for oil and gas produced in the previous calendar month.<sup>5</sup> Thus, there was always a balance owed to the interest owners.<sup>6</sup>

SemGroup, as the “first purchaser,” would then resell the oil and gas to subsequent purchasers.<sup>7</sup> “In these subsequent resales, the sale price could be paid by an exchange of oil and gas, by set-off and net-out of transactions, or by a cash equivalent or deferred cash payment (for example, by check or an ‘account’<sup>8</sup>).”<sup>9</sup> The extracted oil and gas might be stored temporarily in local storage tanks before delivery to the subsequent purchaser by pipeline.<sup>10</sup> Thus, at any given time, SemGroup had inventory on hand, as well as owning accounts, instruments, and deposit accounts.<sup>11</sup> SemGroup incurred debt for financing its purchases,<sup>12</sup> debt “secured by security interests in the oil and gas inventory held by SemGroup and by proceeds from the resales,”<sup>13</sup> including accounts, instruments, and deposit accounts pursuant to UCC Article 9.<sup>14</sup>

SemGroup also was engaged in hedging and derivatives transactions, including bets on falling oil prices.<sup>15</sup> These bets fared poorly when oil prices did not fall, and on July 22, 2008 SemGroup filed a petition under Chapter 11 of the United States Bankruptcy Code.<sup>16</sup> The filing occurred immediately before payment was due to interest owners for oil and gas purchased in June 2008, and as a result, the interest owners were not paid for oil and gas deliveries to SemGroup in June or July.<sup>17</sup> At the time it filed bankruptcy, SemGroup held unsold oil and

4. OKLA. STAT. ANN. tit. 52, § 549.2(6) (West 2011).

5. *Samson Res. Co.*, 407 B.R. at 147.

6. *See id.*

7. *Id.* at 144.

8. A “check” is an “instrument” under UCC Articles 3 and 9. *See* U.C.C. §§ 3-104(f), 9-102(a)(47) (2011). When an account is paid by check and the check is deposited in a bank checking account it becomes part of a “deposit account.” *See id.* § 9-102(a)(29) (defining a deposit account). This is separate from an “account.” *See id.* § 9-102(a)(2) (defining an account).

9. *Samson Res. Co.*, 407 B.R. at 144; Miller & Harrell, *supra* note 3, at 2818.

10. *Samson Res. Co.*, 407 B.R. at 146.

11. Miller & Harrell, *supra* note 3, at 2818.

12. *See Samson Res. Co.*, 407 B.R. at 143; Miller & Harrell, *supra* note 3, at 2818.

13. Miller & Harrell, *supra* note 3, at 2818.

14. *See Arrow Oil & Gas, Inc.*, 407 B.R. at 127; U.C.C. §§ 9-102(a)(48), (64), 9-315 (defining “inventory” and “proceeds” and describing the UCC’s treatment of proceeds).

15. *Arrow Oil & Gas, Inc.*, 407 B.R. at 119; Mull Drilling Co. v. SemCrude L.P. (*In re SemCrude, L.P.*) 407 B.R. 82, 89 (Bankr. D. Del. 2009); *Samson Res. Co.*, 407 B.R. at 144.

16. *See Arrow Oil & Gas, Inc.*, 407 B.R. at 118; Mull Drilling Co., 407 B.R. at 88; *Samson Res. Co.*, 407 B.R. at 143–44.

17. *Samson Res. Co.*, 407 B.R. at 147.

gas (inventory) from these sources and proceeds.<sup>18</sup> This inventory became assets of the bankruptcy estate<sup>19</sup> and was claimed by the interest owners and the Article 9 secured parties, all of whom asserted their claims to these assets in the bankruptcy case.<sup>20</sup>

There are significant differences in the oil and gas laws of the various states, so a somewhat different analysis is required in each state. There are also some fundamental consistencies, however, with some of the UCC issues. Focusing on Oklahoma for purposes of illustration and ignoring the deposit account issues, which implicate additional analyses under UCC Articles 3 and 4 and related laws, two Oklahoma statutes, in addition to UCC Articles 2 and 9, were relevant.<sup>21</sup>

One, the Oil and Gas Owners' Lien Act (Lien Act) created a lien, called a "continuing security interest," on extracted oil and gas and its proceeds and made the lien valid without possession but required a filing in the county in which the well was located. This lien was subordinate to buyers in ordinary course of business as defined in the UCC, but otherwise had [a general] priority from the time of extraction . . . and continued in proceeds for at least a year. Most importantly, however, section 548.6(C) stated that nothing in the Oil and Gas Owners' Lien Act should be construed to impair or affect the rights, priorities, or remedies of any person under the UCC.<sup>22</sup>

The other relevant Oklahoma statute was the Production Revenue Standards Act (Revenue Standards Act).<sup>23</sup> Section 570.10.A of the Revenue Standards Act provides essentially that "[a]ll proceeds from the sale of [oil or gas] production [should] be regarded as separate and distinct from all other funds of any person receiving or holding the same" (in this instance, SemGroup), until such time as the proceeds are paid to the interest owners, and that the proceeds are to be held for the benefit of the interest owners but that no express trust is created.<sup>24</sup> In the *SemGroup* litigation, the interest owners argued (among other things) that this imposed fiduciary duties in the nature of an implied or resulting trust, giving them priority over the competing Article 9 security interests in the inventory and proceeds held by SemGroup.<sup>25</sup>

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18. See *Mull Drilling Co.*, 407 B.R. at 93.

19. See 11 U.S.C. § 541(a) (2006).

20. See *Samson Res. Co.*, 407 B.R. at 144.

21. See OKLA. STAT. ANN. tit. 52, § 548 (West 2011); see also *id.* § 570.1.

22. Miller & Harrell, *supra* note 3, at 2819.

23. Tit. 52, § 570; see also Wade D. Gungoll, *The SemGroup Bankruptcy and the Ramifications for Oklahoma Producers*, OKLA. BAR ASS'N J. 1041 (2009).

24. Tit. 52, § 570.10(A).

25. See *Samson Res. Co.*, 407 B.R. at 143, 156; Gungoll, *supra*, note 23, at 1044.

Most of the *SemGroup* litigation was settled before appeal of the bankruptcy court decisions could be completed; this left standing the holdings of the Delaware bankruptcy court, the essential points of which were:

- Notwithstanding an Oklahoma Attorney General’s opinion (issued after the bankruptcy case began) holding that section 570.10(A) of the Revenue Standards Act creates an implied trust under Oklahoma law, the bankruptcy court rejected this theory;<sup>26</sup> and

- in the *SemGroup* litigation relating to Kansas and Texas (but in a broad interpretation relevant to all of the *SemGroup* litigation), the bankruptcy court concluded Delaware law controlled the issues relating to competing claims to the assets (including priority), rather than the laws of Kansas or Texas (where the production was located).<sup>27</sup>

Despite the definition in UCC section 9-102(a)(6) the bankruptcy court held that the assets were not “as extracted collateral” under UCC Article 9 (and thus Delaware law controlled perfection and priority).<sup>28</sup> Because the interest owners were unperfected under Delaware Article 9 (whatever financing statements were filed were filed in Kansas or Texas), they lost priority to the Article 9 secured parties who were so perfected.<sup>29</sup>

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26. See *Arrow Oil & Gas, Inc. v. SemCrude, L.P. (In re SemCrude, L.P.)*, 407 B.R. 112, 133 (Bankr. D. Del. 2009); Gungoll, *supra* note 23.

27. *Mull Drilling Co. v. SemCrude, L.P. (In re SemCrude, L.P.)*, 407 B.R. 82, 105 (Bankr. D. Del. 2009); *Samson Res. Co.*, 407 B.R. at 156; U.C.C. § 9-301 (2011). Under section 9-301(1), the law of the jurisdiction where the debtor is located governs perfection, the effect of perfection or nonperfection, and priority of a security interest. This is subject to section 9-301(3), however, which provides that the effect of perfection or nonperfection and priority as to a security interest in certain types of collateral (including goods, instruments and money) are governed by the law of the state where the collateral is located. *Id.* § 9-307(3) UCC section 9-307(e) provides that a “registered organization” is located in the state where it is organized. *Id.* § 9-307(e). In the *SemGroup* litigation the debtor was deemed to be located in Delaware. Thus, Delaware’s Article 9 applied and the nonuniform amendments to the Texas UCC did not apply. *Arrow Oil & Gas, Inc.* 407 B.R. at 133. In contrast, the bankruptcy court’s discussion of Oklahoma issues in its June 19, 2009 opinion does not significantly address these issues, being primarily limited to the Oklahoma Oil and Gas Owners’ Lien Act and section 570.10(A) of the Revenue Standards Act. See *Samson Res. Co.*, 407 B.R. at 157 (citing *Arkla Exploration Co. v. Norwest Bank of Minneapolis*, 948 F.2d 656 (10th Cir. 1991)); see also *Arrow Oil & Gas, Inc.*, 407 B.R. at 112; *Mull Drilling Co.*, 407 B.R. 82; Gungoll, *supra* note 23. Integral to the bankruptcy court’s decision was its conclusion that the extracted oil and gas was not “as-extracted collateral” as defined at U.C.C. § 9-102(a)(6), which would be subject to a different choice of law rule at U.C.C. § 9-301(4). It appears that this conclusion may deserve greater scrutiny.

28. See, e.g., *Mull Drilling Co.*, 407 B.R. at 109 (consolidating cases in Delaware, Kansas, Oklahoma, and Texas finding Delaware Law was controlling because of priority and perfection); see also U.C.C. §§ 9-102(a)(6), 9-301(4).

29. See 11 U.S.C. § 544 (2006) (defining the rights of a trustee as lien creditor); see also *Arrow Oil & Gas, Inc.*, 407 B.R. at 140; *Mull Drilling Co.*, 407 B.R. at 110; *Samson Res. Co.*, 407

### B. *The 2009 Oklahoma Legislative Response*

Bills were promptly introduced in the 2009 Oklahoma Legislature to address the issues in the *SemGroup* litigation. An initial bill favored by interest owners would have given them a position similar to the result provided in the legislation that ultimately passed in 2010 (SB 1615), but essentially equivalent to that of a purchase money security interest under UCC Article 9.<sup>30</sup>

As with the similar efforts in other states, however, an Oklahoma Article 9 solution would be dependent on application of the Oklahoma UCC, and hence would have been ineffective as to debtors (like SemGroup) incorporated elsewhere, unless considered “as extracted collateral” (which the Delaware court had already rejected).<sup>31</sup> This 2009 bill failed to pass.<sup>32</sup> A competing 2009 bill put forward by firms that purchase oil and gas from interest owners would have adopted a provision like the non-uniform amendment to Texas UCC Article 9 (“essentially giving interest owners the position of a purchase money security interest but without the UCC requirements of filing, notice and the like”).<sup>33</sup> Neither of the 2009 bills would have been effective to address the *SemGroup* issues,<sup>34</sup> and both failed to pass.<sup>35</sup>

### C. *The Result: Oklahoma Oil and Gas Owners’ Lien Act of 2010*

Before the 2010 legislative session was underway in Oklahoma, a compromise was negotiated that became the Oil and Gas Owners’ Lien Act.<sup>36</sup> The

B.R. at 158; U.C.C. § 9-317 (discussing priorities in conflicting security interests); *id.* § 9-322 (discussing the general rules regarding priorities among conflicting security interests and agricultural liens on same collateral).

30. Miller & Harrell, *supra* note 3, at 2819; *see* S.B. 1028, 52nd Leg., 1st Sess. (Okla. 2009).

31. According to the bankruptcy court’s opinion in the *SemGroup* litigation, the Delaware UCC applied because the debtor (SemGroup) was located in Delaware, pursuant to UCC sections 9-301 and 9-307, and because the assets were not “as-extracted collateral.” *See Arrow Oil & Gas, Inc.*, 407 B.R. at 137; *Mull Drilling Co.*, 407 B.R. at 105.

32. Miller & Harrell, *supra* note 3, at 2819.

33. H.B. 2055, 52nd Leg., 1st Sess. (Okla. 2009); *see also* Miller & Harrell, *supra* note 3, at 2819 (citing Terry I. Cross, *Oil and Gas Product Liens - Statutory Security Interests for Producers and Royalty Owners under the Statutes of Kansas, New Mexico, Oklahoma, Texas and Wyoming*, 50 CONSUMER FIN. L. Q. REP. 48 (1996)).

34. *See Arrow Oil & Gas, Inc.*, 407 B.R. at 112; *Mull Drilling Co.*, 407 B.R. at 82; *Samson Res. Co.*, 407 B.R. at 140.

35. Miller & Harrell, *supra* note 3, at 2819.

36. OKLA. STAT. ANN. tit. 52, § 549.1–.12 (West Supp. 2012).

Lien Act was signed by the Governor on April 19, 2010,<sup>37</sup> and became effective that same date.<sup>38</sup> This date is important since “[a]n oil and gas lien exists and is perfected from the effective date of the act.”<sup>39</sup>

The Oil and Gas Owners’ Lien Act of 2010 repealed the former Oil and Gas Owners’ Lien Act.<sup>40</sup> It did not repeal the Revenue Standards Act<sup>41</sup> “and thus leaves undisturbed the [Oklahoma] [A]ttorney [G]eneral’s opinion that a trust is created by [the latter statute],” which could have continuing relevance, not limited to the remaining litigation on these issues.<sup>42</sup> In Oklahoma, a subsequent state court opinion on the trust fund issue could control over the decision of the Delaware bankruptcy court to the contrary.<sup>43</sup> Judge Russell of the Western District of Oklahoma subsequently considered the issue and rejected the Attorney General’s opinion, instead adopting the reasoning of the Delaware bankruptcy court in the *SemGroup* litigation.<sup>44</sup> The Oklahoma statute, however, provides in part that a purchaser (defined under section 549.2(15) essentially as a subsequent buyer that is not an affiliate of the first purchaser)<sup>45</sup> who takes, receives, or purchases oil or gas from a first purchaser<sup>46</sup> is relieved of any obligations created by section 570.10(A) of the Revenue Standards Act, if either: (1) the purchaser is a Buyer in Ordinary Course of Business (BIOCOB) as defined in UCC Article 9;<sup>47</sup> or (2) “[t]he purchaser has paid all consideration due the first purchaser, including by exchange of oil or gas, net-out, or set-off, under all applicable enforceable contracts in existence at the time of payment.”<sup>48</sup> The second category of purchaser is important since BIOCOB status under the UCC may require the payment of new value and therefore a buyer making payment by net-out or set-off may not qualify, and also under the UCC a BIOCOB must have possession or a right to pos-

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37. S.B. 1615, 52nd Leg., 2nd Sess. (Okla. 2010) (including an emergency clause, which allowed it to become effective upon the Governor’s signature); *see also* Miller & Harrell, *supra* note 3, at 2819.

38. Tit. 52, § 549.1; S.B. 1615, 52nd Leg., 2nd Sess. (Okla. 2010).

39. Tit. 52, § 549.4.

40. S.B. 1615, 52nd Leg., 2nd Sess. (Okla. 2010).

41. Tit. 52, § 570.1.

42. *See* Miller & Harrell, *supra* note 3, at 2819. *But see* McKnight v. Linn Operating, Inc., No. CIV-10-30-R, slip op. at 5 (W.D. Okla. April 1, 2010) (finding the Attorney General’s argument in favor of a resulting trust unpersuasive).

43. *See* *Mcknight*, No. CIV-10-30-R, slip op. at 5. While the court could have reached the opposite conclusion of the bankruptcy court, it decided to adopt it as its own. *Id.*

44. *Id.*

45. Tit. 52, § 549.2(15) (defining a subsequent buyer as someone who is not an affiliate of the “first purchaser”).

46. *Id.* § 549.2(4).

47. *See* U.C.C. § 1-201(b)(9) (2011) (even though the Oklahoma legislature defined BIOCOB, it is actually defined in UCC Article 1).

48. Tit. 52, § 549.6.

session.<sup>49</sup> A subsequent purchaser from the purchaser is protected by the basic “shelter” doctrine.<sup>50</sup>

To the extent that an Oklahoma court might uphold an interest owner’s claim of a trust against the first purchaser (for example, under section 570.10(A) of the Revenue Standards Act), that trust is largely redundant with the idea that the interest owner also has a lien under the Oil and Gas Owners’ Lien Act. But as noted, retention of the trust concept in the Oklahoma statutes was viewed as a necessity in light of the potential continuing relevance of this issue, for example, in the ongoing *SemGroup* litigation on the trust fund issue (relating to claims arising before the effective date of the Oil and Gas Owners’ Lien Act).<sup>51</sup>

#### D. *Effect of the Oil and Gas Owners’ Lien Act of 2010*

The basic elements of the Oil and Gas Owners Lien Act are as follows: Section 549.3(A) grants each interest owner an oil and gas lien (oil and gas lien) to secure the obligations of the first purchaser to pay the purchase price, to the extent of the interest owner’s interest in oil and gas sales derived from the interest owner’s oil and gas rights.<sup>52</sup> Under section 549.2(9)(a), oil and gas rights include oil, gas, proceeds (“proceeds” are broadly defined under section 549.2(14) to include: what is paid or to be paid from the sale of oil or gas under an agreement to sell, including oil or gas on or after extraction; inventory of raw, refined or manufactured oil or gas; rights to products of same; and proceeds, whether cash, accounts, chattel paper, instruments, documents, or payment intangibles),<sup>53</sup> an oil and gas lease, a pooling order, and an agreement to sell.<sup>54</sup> Examples of oil and gas rights are noted at section 549.2(9)(b).<sup>55</sup> Section 549.3(A) also

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49. See U.C.C. § 1-201(b)(9).

50. See *id.* § 2-403. Discussed in UCC Permanent Editorial Bd., Commentary, Peb Commentary No. 6 (Section 9-301(1)) (1990); this is the basic law of assignment and subrogation. See, e.g., *LaSalle Bank, Nat’l. Ass’n. v. White*, 246 S.W.3d 616, 618–19 (Tex. 2007) (discussing longstanding Texas recognition of equitable subrogation after assignment); Julie R. Caggiano & Alvin C. Harrell, *Common Certificate of Title Litigation and UCC Article 9 Issues, and the Impact of CT Laws*, 65 CONSUMER FIN. L.Q. REP. 446, 458–59.

51. See tit. 52, § 549.3 (providing for oil and gas liens for certain interests).

52. *Id.* § 549.3(A). Compare *id.* § 549.2(4) (defining “first purchaser” as “the first person that purchases oil or gas from an interest owner, either directly or through a representative, under an agreement to sell”), with U.C.C. § 1-201(b)(29–30) (distinguishing between “buyers” and “purchasers” by including secured parties in the term “purchaser”).

53. Tit. 52, § 549.2(14). The Act used the term “severance” rather than the term “extraction,” but essentially defines “severance” as extraction. *Id.*

54. Compare *id.* § 549.2(9)(a) (definition of “oil and gas rights”), with U.C.C. § 9-102(a)(64) (Article 9 definition of “proceeds” as amended in 2011).

55. Tit. 52, § 549.2(9)(b) (illustrating examples of oil and gas rights).

states, “The oil and gas lien granted by this act is granted and shall exist as part of an incident to the ownership of oil and gas rights.”<sup>56</sup>

This makes clear that the interest owner’s oil and gas lien created by the Oil and Gas Owners’ Lien Act is not a UCC Article 9 security interest but rather arises as part of a real estate interest of the interest owner in the oil and gas before extraction; therefore, the governing law (with respect to choice of law) is the law of the jurisdiction in which the well is located, rather than being determined by the UCC Article 9 choice of law rules at section 9-301.<sup>57</sup> This avoids the Article 9 choice of law rules that resulted in the interest owners’ claims being determined under Delaware law in the *SemGroup* litigation.<sup>58</sup> Indeed, section 549.9 specifies that no provision in an agreement to sell or otherwise that would apply the law of another jurisdiction is valid as a matter of public policy (although the protections of the Oil and Gas Owners’ Lien Act may be waived under specified circumstances as also provided in section 549.9).<sup>59</sup>

Section 549.4 (somewhat redundantly) states that the oil and gas lien is granted and exists as part of, and incident to, the ownership of the interest owner’s oil and gas rights, and “exists and is perfected from the effective date of this act.”<sup>60</sup> Section 549.3 additionally provides, in essence, that the interest owner’s oil and gas lien continues uninterrupted and without lapse:<sup>61</sup> in all oil and gas produced, upon and after the extraction (except as qualified elsewhere in the Oil and Gas Owners’ Lien Act); in all proceeds (again, except as qualified in the Act); until the interest owner or other person entitled to receive the proceeds has been paid (with some elaboration as to who is entitled to payment and protection for good faith payment); and is not dependent on possession nor is it affected by a change in possession or ownership, and that the lien follows any transfer of the oil and gas rights. Section 549.4 provides that the interest owner’s oil and

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56. *Id.* § 549.3(A).

57. *See, e.g.*, ROBERT A. LEFLAR, LUTHER L. MCDUGAL, III & ROBERT L. FELIX, AMERICAN CONFLICTS LAW 473, 483–90 (4th ed. 1986) (law of the situs applies to real property issues). UCC Article 9 recognizes this basic principle with respect to other real estate-related collateral, including as-extracted collateral. *See* U.C.C. §§ 9-102(a)(6), 9-301(3)–(4).

58. *See* U.C.C. § 9-301(1) (location of the debtor controls); *see also id.* § 9-307. *But see* Arrow Oil & Gas, Inc. v. SemCrude, L.P., (*In re Semcrude, L.P.*), 407 B.R. 112 (Bankr. D. Del. 2009); Mull Drilling Co. v. SemCrude, L.P., (*In re SemCrude, L.P.*), 407 B.R. 82 (Bankr. D. Del. 2009); Samson Res. Co. v. SemCrude, L.P., (*In re SemCrude, L.P.*), 407 B.R. 140 (Bankr. D. Del. 2009).

59. *See* tit. 52, § 549.9.

60. *Id.* § 549.4; *see also id.* § 549.3. There are also provisions that are qualified by other provisions, but no cross-references. As a result, the provisions of Senate Bill 1615, or tit. 52, section 549, must be read *in pari materia* and with the understanding that any redundancy is a result of the political process rather than intending a different meaning.

61. *Id.* § 549.3.

gas lien is automatically perfected “without the need to file a financing statement or any other type of documentation,” and as to existing oil and gas rights is perfected as of the effective date of April 19, 2010.<sup>62</sup> In summary, the key concept to consider when attempting to escape the *Semcrude* result is that the lien is created as a “real estate” lien and therefore the law of location of the oil and gas prior to extraction governs the lien and proceeds of the lien.

Priority is addressed in section 549.7, specifying that, except for a “permitted lien” (see below) an interest owner’s oil and gas lien takes priority over any other lien or security interest.<sup>63</sup> In conjunction with sections 549.3(D) and 549.4, this creates an automatic super-priority without any public notice by a filing or possession.<sup>64</sup> This is intended to reject the result in the *SemGroup* litigation. The resulting “secret lien” is less troublesome than it may seem because those affected by it, intermediaries in the oil and gas industry—like SemGroup and those financing them, will be aware of this area of law and can act accordingly.<sup>65</sup> Whether this automatic super-priority will always apply in the face of other laws, which may provide their own requirements or priority rules, will be a task for courts to sort out on a case-by-case basis. Arguably, the Oil and Gas Owners’ Lien Act, as the later and more specific law, will be effective as stated against competing state laws. Moreover, many of the potential problems of application are avoided by the priority exceptions for BIOCObS and permitted liens, as noted below.<sup>66</sup>

Under section 549.2(11), a “permitted lien” is essentially a mortgage or security interest granted by a first purchaser, who “secures payment under a writ-

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62. *Id.* § 549.4; *see also id.* § 549.3. There are some redundancies in section 549. There are also provisions that are qualified by other provisions, but no cross-references. As a result, the provisions of section 549 must be read *in pari materia* and with the understanding that any redundancy is a result of the political process rather than intending a different meaning. *Id.*

63. *Id.* § 549.7.

64. *Id.* §§ 549.3(D), 549.4.

65. *See id.* § 549.9 (explaining that an interest owner may waive rights under the Act or agree to a provision applying law of another state).

66. *See id.* § 549.6. Another matter is the potential impact of the Bankruptcy Code. *See, e.g.*, 11 U.S.C. § 545 (2006) (avoidance of statutory liens). To the extent that section 545 is applicable (which is not entirely clear and may depend on the facts), this impact may be mitigated by a provision consenting to the oil and gas lien in the oil and gas lease, division order or other documentation, so as to create a consensual real estate lien consistent with the Oil and Gas Owners’ Lien Act of 2010. *Id.* Note that under Title 11 of the United States Code, section 544(a), the so-called “strong-arm” powers of the trustee give the trustee status as a hypothetical bona fide purchaser as to real property, but merely the status of a hypothetical judicial lienholder as to all other property. *Id.* § 544(a). Thus, in general, subject to preference and fraudulent transfer issues, the trustee’s rights in personalty are junior to those of a BIOCObS.

ten instrument of indebtedness signed by the first purchaser . . . .”<sup>67</sup> The “permitted lien” must be accepted in writing or in a record by the secured party (even if the instrument is a promissory note, which a payee normally does not accept in writing), *prior to the effective date of the Oil and Gas Owners’ Lien Act of 2010*, “with a principal amount and a fixed maturity date.”<sup>68</sup> The term “permitted lien” does not include security interests that involve a later modification, amendment of the Oil and Gas Owners’ Lien Act or restatement that increases the principal or extends the maturity after the effective date or a lien that does not have first priority under other law (a statutory or regulatory lien that has first priority by statute or regulation is recognized).<sup>69</sup> “A validly perfected and enforceable lien created by statute or by rule or regulation of a governmental agency for storage or transportation charges . . . owed by a first purchaser” is recognized as a permitted lien, unless claimed by an affiliate of the first purchaser (but an affiliate can assert a lien as authorized by statute, rule, or regulation creating the lien) or for charges in excess of ninety days past due.<sup>70</sup>

Section 549.5 deals with the tracing, continuation, and priority of the interest owner’s oil and gas lien in commingled oil and gas.<sup>71</sup>

### E. Conclusion

The Oil and Gas Owners’ Lien Act essentially gives UCC Article 9 secured parties who lend to the first purchaser of oil and gas (like SemGroup) the same position that they would occupy under UCC Article 9 if they were subject to a purchase-money security interest in favor of the prior interest owners’ claims,<sup>72</sup> except that the interest owners’ oil and gas liens arise under real prop-

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67. Tit. 52, § 549.2(11)(a). This instrument may include an electronically-signed record that is stored in an electronic or other medium and is retrievable in perceivable form, under both the federal E-SIGN Act and the Uniform Electronic Transactions Act. The latter is enacted in Oklahoma at *id.* tit. 12A, §§ 15-101 to 15-121.

68. *Id.* § 549.2(11)(a). The italicized language in the text above is intended to emphasize that this protects only those security interests created prior to the effective date of the Act.

69. *Id.* § 549.2(11)(a)(1)–(5).

70. *Id.* § 549.2(11)(b).

71. *Id.* § 549.5.

72. *See id.* § 549.1–12. It has been asserted by some observers that interest owners wishing such protection should be required to acquire and assert a purchase-money security interest under Article 9, and that remains an alternative to the Act under the law of every state. An approach based on the filing of financing statements by interest owners, however, could be complicated because of the extensive fractionalization of oil and gas royalty interests; and because of the large numbers of interest owners, such an approach could be burdensome for all parties involved. Thus, the transaction costs of that approach exceed those of the Act, without any significant compensating benefits.

erty law. Thus, the oil and gas lien under the Act is somewhat equivalent to recognition of a real estate mortgage lien.<sup>73</sup> In that sense, it is much like the rules governing fixtures under UCC section 9-334, in which secured parties under UCC Article 9 have to deal with competing real property interests, the difference being how Article 9 sets the accommodation rules in the case of fixtures.<sup>74</sup> In this context, however, the Act sets the accommodation rules, necessary because UCC Article 9 alone does not fully address these issues and oil and gas interests.<sup>75</sup>

### III. OKLAHOMA LIVESTOCK OWNER'S LIEN ACT

Apparently inspired by enactment of the Oklahoma Oil and Gas Owners' Lien Act and concerned about the interests of livestock sellers in a scenario similar to the plight of the mineral interest owners in the *SemGroup* litigation,<sup>76</sup> in 2011 Oklahoma enacted the Livestock Owner's Lien Act of 2011 (Senate Bill 530).<sup>77</sup> The Livestock Owner's Lien Act generally follows the pattern of the Oil and Gas Owners' Lien Act, but is instead adapted to sales of livestock.<sup>78</sup>

The Livestock Owner's Lien Act creates a statutory lien on all "livestock" sold by a "livestock owner," for the unpaid portion of the purchase price (owner's lien).<sup>79</sup> "Livestock" includes cattle, horses, sheep, goats, pigs, rabbits, chickens, turkeys, and the like (if raised primarily for human food consumption).<sup>80</sup> "Livestock owner" is the person owning the livestock prior to its acquisition by the "first purchaser."<sup>81</sup> "First purchaser" means the first person to pur-

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73. Compare *id.* § 549.2(9), with RESTATEMENT (THIRD) OF PROP.: MORTGAGES § 4.1 (1996).

74. U.C.C. § 9-334 (2011).

75. It should also be noted that the 1998 revisions to the uniform text of UCC Article 9, reflecting the Report of the American Bar Association, UCC Committee Task Force on Oil and Gas Law, contemplated the assertion of interest owner claims under real property law, outside of UCC Article 9, consistent with the Oil and Gas Owners' Lien Act. See U.C.C. § 9-320 cmt. 7. The uniform text and comments of UCC Article 9 endorse this view. See U.C.C. § 9-320, cmt. 7 (stating that Article 9 "leaves its resolution to other legislation"); Alvin C. Harrell, *Oil and Gas Finance Under Revised UCC Article 9*, 33 TEX. TECH. L. REV. 31, 52 (2001).

76. See Jeff Todd, *The Oklahoma Livestock Owner's Lien Act*, MCAFEE & TAFT AGLINC NEWSL. (McAfee & Taft A Prof. Corp., Okla. City, Okla.), June 2011, at 3, [http://www.mcafeetaft.com/info/11/1106\\_AgLINC\\_Newsletter1106.pdf](http://www.mcafeetaft.com/info/11/1106_AgLINC_Newsletter1106.pdf) (noting the bankruptcy filing by Eastern Livestock Company, LLC, in 2010 in the United States Bankruptcy Court for the Southern District of Indiana (Case No. 10-93904-BHL-11)).

77. OKLA. STAT. ANN. tit. 4, § 201 (West Supp. 2012).

78. Compare *id.* tit. 52, §§ 548, 549, with *id.* tit. 4, § 201.

79. Tit. 4, § 201.3(A).

80. *Id.* § 201.2(5).

81. *Id.* § 201.2(6).

chase the livestock.<sup>82</sup> The analogy to the first purchaser of oil and gas in the Oil and Gas Owners' Lien Act is apparent, although the analogy in the Livestock Owners' Lien Act of 2011 does not feature a direct counterpart to the transition from real to personal property that is so significant in the oil and gas context.<sup>83</sup>

Like the oil and gas lien, the livestock owner's lien attaches to all livestock as of the effective date of the Livestock Owner's Lien Act (November 1, 2011), and continues in the livestock or its proceeds until the livestock owner receives full payment.<sup>84</sup> The lien is not dependent on a filing or possession.<sup>85</sup> There is a separate provision for allocating claims against commingled livestock on a pro-rata basis,<sup>86</sup> which has no direct equivalent in the Oil and Gas Owners' Lien Act.<sup>87</sup> There is also a provision protecting purchasers from the first purchaser, who take free and clear of the owner's lien if they pay the purchase price in good faith.<sup>88</sup> This is similar to the BIOCOP rules in the Oil and Gas Owners' Lien Act and the UCC, only without some of the requirements for a BIOCOP as provided in the UCC.<sup>89</sup> Other than as provided in the Livestock Owner's Lien Act section 201.6, the owner's lien has priority over the rights of any purchaser.<sup>90</sup>

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82. *Id.* § 201.2(4).

83. In the oil and gas context the transition from real to personal property is crucial because it means the lien created by the Oil and Gas Owners' Lien Act of 2010 is rooted in real property law and therefore can be treated in bankruptcy as a security interest not governed by UCC Article 9 choice of law rules. *See* U.C.C. Art. 9 (2011). There is no equivalent real property anchor for livestock. This is apparent in the Livestock Owner's Lien Act of 2011 language. Tit. 4, § 201.4 (stating that the owner's lien is an "incident to the ownership of livestock"). The equivalent language in the Oil and Gas Owners' Lien Act of 2010 is important in tying the oil and gas lien to real property, but the Livestock Owner's Lien Act language serves no such purpose, necessitating a choice of law analysis for personal property interests. *Compare* tit. 52, § 549.3(A), *with* tit. 4 § 201.4, *and* U.C.C. Art. 9 (2011).

84. Tit. 4, § 201.3(B)–(C).

85. *See id.* § 201.3(D). Arguably this is not an "agricultural lien" as defined in the UCC. U.C.C. § 9-102(a)(5). In addition to agricultural liens as defined in the UCC, state laws provide for other types of statutory agricultural liens governed by other legal requirements that may include specialized notice requirements. *See, e.g.,* MINN. STAT. ANN. § 514.966 Subdiv. 3 (West Supp. 2012) (providing a livestock production input supplier with a priority lien if the supplier provides a specified notice and the competing secured party fails to respond in ten days), *construed in* *Minnwest Bank v. Arends*, 802 N.W.2d 412, 417 (Minn. Ct. App. 2011). Note that even if a statutory lien is an "agricultural lien" under UCC Article 9, it can still have priority if the statute creating the lien so provides, as in Senate Bill 530. *See* U.C.C. § 9-322(g) (priority); *Id.* § 9-302 cmt. 2 (proceeds).

86. Tit. 4, § 201.5.

87. *See* tit. 52, §§ 548, 549. *But see* U.C.C. § 9-336.

88. Tit. 4, § 201.6.

89. *Compare* tit. 52, § 549.6, *with* U.C.C. §§ 1-201(b)(9), 9-320(a).

90. Tit. 4, § 201.6(B). The definition of "purchaser" in the Livestock Owner's Act may be different than the UCC's definition. *See id.* § 201.2(12); U.C.C. § 1-201(b)(29)–(30).

The owner's lien, however, does not otherwise affect the transfer of ownership.<sup>91</sup> Like section 549 of the Oil and Gas Owners' Lien Act, there is a provision in section 201 of the Livestock Owner's Lien Act that limits a waiver of the lien rights.<sup>92</sup>

Clearly the effect of section 549 is to provide the livestock owner a lien on livestock sold to a first purchaser and, upon a resale of the livestock by the first purchaser, any proceeds paid to the first purchaser.<sup>93</sup> As noted, the owner's lien is automatically perfected, without filing or possession.<sup>94</sup> Interestingly, however, the result may not be as crystal clear as one would like regarding the priority of the owner's lien against competing UCC security interests and other liens.<sup>95</sup> Section 201.7<sup>96</sup> provides that, except for a "permitted lien,"<sup>97</sup> the owner's lien has priority over "any other lien, whether arising by contract, law, equity or otherwise."<sup>98</sup> A possible issue with this is that state law generally defines "lien" as an encumbrance acquired by attachment or levy, or by way of a bankruptcy or other insolvency proceeding.<sup>99</sup> This is to be distinguished from a "security interest."<sup>100</sup> In a broad sense, an Article 9 security interest is a property interest created by contract to secure an obligation, and therefore a lien, but the fact remains that under the UCC a security interest is not a "lien."<sup>101</sup> Perhaps this will not be a problem, but section 201 provides no alternative definition.<sup>102</sup>

91. Tit. 4, § 201.8.

92. Compare tit. 52, § 549.9, with tit. 4, § 201.9.

93. Tit. 4, § 201.3. To the extent that this is effective, it also protects the claim of the livestock owner's secured party. U.C.C. §§ 9-315, 9-317, 9-322; see, e.g., Todd, *supra* note 76, at 3 (noting "the purpose of the Act is to protect the rights of Oklahoma livestock owners by granting a statutory lien").

94. Tit. 4, § 201.4.

95. Cf. tit. 52, § 549.7 (oil and gas lien takes priority over any competing lien or security interest except for a "permitted lien"). This may create issues relating to the priority of competing claims arising under state or federal "trust fund" statutes, similar to those that arose in the oil and gas context in the *SemGroup* litigation. See, e.g., *Nickey Gregory Co. v. AgriCap*, 597 F.3d 591, 594 (4th Cir. 2010) (construing the federal Perishable Agricultural Commodities Act as establishing a trust on the proceeds from sale of agricultural commodities); see also 7 U.S.C. §§ 181–229(b), 196–97.

96. Tit. 4, § 201.7.

97. See generally tit. 4, § 201.2(9) (defining a "permitted lien"); *Id.* tit. 52, § 549.2(11) (also defining a permitted lien).

98. Tit. 4, § 201.7.

99. See, e.g., U.C.C. § 9-102(a)(52) (2011) (defining "lien creditor").

100. See *id.* §§ 1-201(b)(35), 9-103 (defining "security interest" and its creation).

101. See *id.* § 9-103 (describing creation of a security interest). But see *id.* § 1-201(b)(35) (outlining the definition of a security interest does not include a lien).

102. See *id.* § 201.2.

It is clear that the intent of the Livestock Owner's Lien Act section 201.7 is to provide for priority of the owner's lien over competing execution liens and the lien of a subsequent trustee in bankruptcy under Bankruptcy Code section 544(a), but not certain security interests that predate the Livestock Owner's Lien Act (permitted liens).<sup>103</sup> Probably the phrase "lien . . . arising by contract" in section 201.7 is also intended to subordinate other security interests to the owner's lien.<sup>104</sup> There is also a procedure for enforcing the owner's lien in the Livestock Owner's Lien Act in section 201.10 (with a one-year limitations period).<sup>105</sup>

#### IV. PERFECTION OF A SECURITY INTEREST IN WIND FARM LEASE RIGHTS<sup>106</sup>

##### A. Introduction

A wind farm presents a complex project finance with an overlap between areas of the law that generally do not overlap in a single transaction, like real estate, the UCC, agricultural law, utility issues, and extensive state and federal administrative laws and regulations. The key elements of collateral in a wind farm secured transaction include: a turbine, an inverter, substantial acreage of real estate, local transmission lines to the utility connection, and ample legal documentation to reflect ownership, easements, agreements, permits, security interests, and the like.<sup>107</sup> Previously obtained consents from all necessary parties both "upstream" and "downstream" of a security interest or foreclosure are critical; the inability to foreclose on one cog of the transaction can effectively leave a secured party with only the minimal liquidation value of disparate pieces.

##### B. Illustrative UCC Issues

An obvious approach to this diversity of collateral is to perfect the security interest in the debtor's or obligor's personal property by an "all assets" UCC filing; the important point is to cover all relevant asset classes—one answer is to use section 9-504(2), which allows for perfection by a financing statement covering "all assets."<sup>108</sup> The qualification, however, is that the collateral must be accu-

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103. See *id.* § 201.7; 11 U.S.C. § 544(a) (2006).

104. See tit. 4, § 201.7.

105. See *id.* § 201.10.

106. Your authors thank Adam M. Nathe, Esq., of the law firm Gray, Plant, Mooty in Minneapolis, Minn. for his assistance with this discussion.

107. See *infra* Exhibits A–D (showing some high level views and illustrative details associated with wind turbine placement).

108. U.C.C. § 9-504(2) (2011).

rately described in the security agreement by a class or category of the UCC or by specifically describing the item of collateral, pursuant to UCC section 9-108.<sup>109</sup> *In re Las Vegas Monorail Co.* illustrates the consequences of an error, where the bankruptcy court held that a security interest in the debtor's "Net Project Revenues" (but not any of its tracks or trains) meant just that: the "net amount left after certain operating expenses and deducted from gross revenues."<sup>110</sup> As a result, the secured party, an indenture trustee, did not have a security interest in all revenues, but only in the net revenues available for debt service, which only covered about ten percent of the debt.<sup>111</sup>

In a wind farm financing, perfection is needed as to multiple revenue streams, such as payback for power usage and receipts from "renewable energy certificates." This requires a recognition of the distinctions in the UCC, like between accounts and payment intangibles.<sup>112</sup> A payment intangible is "a general intangible under which the account debtor's principal obligation is a monetary obligation."<sup>113</sup> These UCC distinctions can raise a number of issues in the wind energy context, like what is the UCC category for a renewable energy certificate?<sup>114</sup> Recall in the old days, before the effective date of the 1998 revision to Article 9,<sup>115</sup> there was an argument that one could say "all assets" in the security agreement, but one had to list the collateral in the financing statement; now it is essentially the opposite rule.<sup>116</sup>

A simple example illustrating perfection of a security interest as to multiple revenue streams could go as follows. The debtor has solar panels on his roof. He receives a payback for power and can receive receipts from renewable energy certificates. Even this simple example raises various questions. How would a secured party perfect its security interest—as accounts,<sup>117</sup> payment intangibles (defined as "a general intangible under which the account debtor's princi-

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109. *Id.* § 9-108.

110. *In re Las Vegas Monorail Co.*, 429 B.R. 317, 337 (Bankr. D. Nev. 2010).

111. *Id.* at 323–24.

112. Compare U.C.C. § 9-102(a)(2) (defining "accounts"), with *id.* § 9-102(a)(61) (defining "payment intangible").

113. *Id.* § 9-102(a)(61).

114. Compare *id.* § 9-102(a)(2) (showing a renewable energy certificate is probably not an account), with *id.* § 9-102(a)(42) (demonstrating that a renewable energy certificate is probably a general intangible).

115. *Id.* § 9-101 cmt. 2. As noted, citations to Article 9 refer to the 1998 revisions, generally effective July 1, 2001, as amended through the 2010 text, unless otherwise noted. See *id.* § 9-701. Citations herein to the UCC reference the 2010 Uniform Text, prior to the 2010 Article 9 amendments, unless otherwise noted.

116. See *id.* §§ 9-108(b)–(c), 9-504(2).

117. See generally *id.* § 9-102(a)(2) (defining an "account").

pal obligation is a monetary obligation.”),<sup>118</sup> or something else? What is a renewable energy certificate? For a wind farm, the analysis also must go to the next level. The wind farm is usually dependent on federal grants like “green credits” and other government “incentive payments,”<sup>119</sup> which can be in the form of “renewable energy certificates.” Using Minnesota law as an example, pinning a name on this type of collateral is very difficult. Are these direct grant proceeds or tax-free treatment for equipment and supplies acquired to maintain a wind energy conversion system?<sup>120</sup> Are these UCC accounts, payment intangibles, or general intangibles?<sup>121</sup> Collateral assignments and control agreements, important if grant funding is advanced in a construction phase, may all be key items. Contracts that, in a sense, create perfection-by-privity also are important. “Lockbox” issues, like those regarding control agreements and perfection as to deposit accounts—depending on the source of construction financing and how the grant funding is provided—also may be relevant and feasible. If funds are coming from government agencies, a lockbox may not be feasible, in which event equity deposits and controlled reserve funds are sometimes used as backdrops. Turbines, inverters, towers, and parts of the mounting platform are probably fixtures covered by UCC section 9-334,<sup>122</sup> meaning there can be purchase-money security interests pursuant to sections 9-103 and 9-324.<sup>123</sup> The pad on which the turbine sits, an appropriate “blow-down” area surrounding it, and perhaps the air space above it, are real property often leased by the project (turbine or wind farm) owner.<sup>124</sup> As such, the pad and blow-down area, and perhaps the air space, will require a lease-hold mortgage, a proper legal description for fixture filing purposes under UCC section 9-501(b),<sup>125</sup> and close attention to the lease terms regarding assignability and removal of the turbine and pad following a termination

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118. See generally *id.* § 9-102(a)(61) (defining a “payment intangible”).

119. Jennifer Spang et al., PRICEWATERHOUSECOOPERS, LLP, UNDERSTANDING FINANCIAL REPORTING FOR GREEN AND STIMULUS INCENTIVES 2 (2009), <http://www.pwc.com/us/en/tax-accounting-services/publications/financial-reporting-green-stimulus.pdf>.

120. Compare MINN. STAT. ANN. § 336.9-102(a)(64) (West Supp. 2012) (defining “proceeds”), with *id.* § 272.02 Subdivs. 10, 22 (discussing personal property used for pollution control and wind energy conversion systems).

121. Compare U.C.C. § 9-102(a)(2), with *id.* § 9-102(a)(61), and *id.* § 9-102(a)(42).

122. See *id.* §§ 9-102(a)(41), 9-334.

123. See *id.* §§ 9-103, 9-324.

124. The “air space” above the pad may represent a separate real property interest. See, e.g., OKLA. STAT. ANN. tit. 60, § 820.1(E) (West Supp. 2012) (stating that a land right in the vertical space above real property for a wind or solar energy conversion system must be in writing and recorded in the appropriate office of the county clerk). Environmental and federal law issues also may be implicated. See, e.g., Ryan Tracy, *Wildlife Slows Wind Power*, WALL ST. J., Dec. 10, 2011, <http://www.wsj.com/article/SB10001424052970203501304577088593307132850.html>.

125. See generally U.C.C. § 9-501(b) (providing background on filing procedures).

or default. Estoppels are often used with landowner consent and consent of the landowner's lien holder at closing.

The equipment collateral also triggers issues in this context. For example, ordinary detachable equipment is treated largely the same as in any UCC transaction; but other equipment poses unique issues, such as the inevitable equipment shack (for voltage inversion and power output measurement and other maintenance monitoring), and either overground or underground lines that must be addressed by easements as well as fixture filings identifying the affected land.

If the debtor is a Transmitting Utility, there may be state non-uniform amendments which might include non-central UCC filing rules.<sup>126</sup>

Collateral assignments, estoppels, and consents from the power purchaser, under a power purchase agreement, may be needed, including: documentation of transmission rights from the regional transmission governing body and interconnection rights from the regional utility.<sup>127</sup> The secured party will need to perfect against these as general intangibles. The larger problem is to have a package with an agreement from the necessary third parties to permit effective enforcement of this security interest outside of a bankruptcy and recognition in a bankruptcy. Also, there is an issue of a one-time deal which reduced some parties' interest in devoting necessary attention to a transaction and its details. Is there an exclusion from Article 9 under section 9-109(d)(6) and (7) which can impact the scope of Article 9 and the secured party's enforcement rights?<sup>128</sup> Even so, the secured party would still want to make a precautionary filing.

For a transfer or assignment of permits and consents from local and state authorities, there will need to be acknowledgements from proper agencies—essentially using the same approach as noted in the prior paragraph. Mortgages and easements are outside Article 9 but fixtures are not.<sup>129</sup> Residential noise setbacks are another matter of concern—including issues of assignability and transferability. State constitutional requirements (for example, regulating the terms of encumbrances on agricultural land) also may apply, but are generally beyond the

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126. See generally *id.* § 9-501.

127. The Oklahoma statute authorizing the use of eminent domain by gas and electric utilities was amended in 2011 to prohibit eminent domain as a means to acquire land for siting or constructing wind turbines on private property. OKLA. STAT. ANN. tit. 27, § 7(B) (West Supp. 2012). But see *Okla. Gas & Elec. Co. v. Beecher*, 256 P.3d 1008, 1012–1014 (Okla. Civ. App. 2010) (electric utility has the authority to acquire land for easements by eminent domain, for the electric transmission line needed to serve a wind energy facility, even if the electricity may be sold out-of-state). An Oklahoma electric utility, Oklahoma Gas & Electric Company, has been active in developing wind farms. See, e.g., Jay F. Marks, *Oklahoma Gas and Electric Completes Latest Wind Farm*, NEWSOK.COM, Jan. 21, 2012, <http://newsok.com/oklahoma-gas-and-electric-co.-completes-latest-wind-farm/article/3642176>.

128. U.C.C. § 9-109(d)(6)–(7).

129. See *id.* §§ 9-103, 9-324, 9-334, 9-501.

scope of the UCC. This is important in the Midwest, as many of the states in this region have laws that render void or voidable encumbrances on agricultural land when the encumbrance is for a period greater than ten, fifteen, or twenty-one years. Other state law restrictions may apply. Maryland, for example, has strict rules governing ground rents in certain contexts.<sup>130</sup> Not only are there variations in the laws of the states, but there is relatively unsettled jurisprudence regarding many of these laws. Title companies have insured the issue, but with rising not-in-my-backyard (NIMBY) sentiments and landowners who may be pushed out or left out of what had been “community-based” projections, this is a difficult area. A controversy over the enforceability of the leases, or arguments that they are *void ab initio* could make for a difficult and costly dispute in which a secured party could become embroiled.

Another interesting issue is: How does the landowner ensure enforcement of the obligation to get the platform off the land when the wind farm or turbine owner decides it has had enough, or there is a default or termination? Typically, removal requirements are contained in the lease or easement, but enforcing the terms of the removal can be difficult. Traditionally, the towers rest on several feet of concrete on several feet of rock and are in the middle of a field. But, upon bankruptcy of the wind farm, who is going to provide the money for this removal? If the obligation to remove is not fully secured, it may be impossible to enforce. A few other unusual issues include: When is a good time of year to dig up this structure? Is a good time planting season, growing season, harvest season, or before the frost goes in or thaws out? This is an important, and possibly difficult issue in farming regions.<sup>131</sup>

It is beyond the scope of this Article to give a comprehensive solution, but in general, if a writing is focused on granting a lien or security interest in any collateral, all collateral classes potentially applicable to the collateral should be named as well as a description of the particular collateral, accompanied by an “all assets” security interest or lien filing.<sup>132</sup> If there is ambiguity as to whether collateral is removable, which implicates the issue of whether or not the collateral is

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130. MD. CODE ANN., Real Property § 8-110(a) (Lexis Nexis 2010).

131. Moreover, the issues are not necessarily limited to farming: The rights of oil and gas operators and interest owners may also be implicated. *See, e.g.*, OKLA. STAT. ANN. tit. 52, § 803 (West Supp. 2012) (prohibiting a wind or solar energy facility from unreasonably interfering with a mineral interest owner’s use of the land surface for the purpose of exploring for or capturing or producing minerals, and requiring certain notices to oil or gas operators and lessees (and published) in conjunction with wind or solar facility construction activities); *see generally* Ana Campoy & Stephanie Simon, *Wind Fuels Fight in Oil Patch*, WALL ST. J., Nov. 26, 2011, <http://www.wsj.com/article/SB10001424052970203710704577052831852364286.html>.

132. U.C.C. §§ 9-203, 9-502.

a fixture, the filing of a financing statement and perfection under real property law is necessary.<sup>133</sup>

## V. METHODS OF PERFECTION IN LLC MEMBERSHIP INTERESTS

### A. *Categorizing an LLC Membership Interest*

The limited liability company (LLC) structure is a popular form of ownership for business and agricultural operations due in part to the combination of tax benefits and limitations on liability. In circumstances when a secured party is taking a security interest in the membership interests, it is important to understand the interplay between UCC Articles 8 and 9 and the effect they may have on the treatment of those LLC membership interests.<sup>134</sup> The appropriate method of perfection will depend on that treatment.

Due to the similarity of membership interests in a LLC to other types of equity interests, an initial thought may be that LLC membership interests are a form of “security,” and thus should be categorized as investment property under UCC Article 9.<sup>135</sup> “Investment Property” is defined in Article 9 as “a security, whether certificated or uncertificated, security entitlement, securities account, commodity contract, or commodity account.”<sup>136</sup> Article 8 defines what is and is not a security, but most importantly UCC section 8-103(c) expressly provides that an interest in a LLC is not a security under Article 8 except in certain, very limited circumstances, which are not discussed here.<sup>137</sup> Thus, without certain express actions on the part of the members of the LLC, the membership interests in the LLC will not be securities under Article 8 and correspondingly cannot be investment property under Article 9. In this instance, the LLC membership interest is a general intangible under Article 9.<sup>138</sup>

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133. See generally *id.* § 9-502 (providing background on contents of a financing statement).

134. Gerald V. Niesar, *Charging Orders and the Single Member LLC*, 65 CONSUMER FIN. L. Q. REP. (forthcoming 2012); see, e.g., Louis G. Hering & David A. Harris, *2010 Update on Delaware Case Law Relating to Alternative Entities*, 64 CONSUMER FIN. L. Q. REP. 481 (2010) (discussing Delaware case law on LLC operations). See generally U.C.C. Art. 8–9 (regarding the structure, liability features, and operations of LLCs generally). Of course, it is also important to be sure the LLC member has authority to bind the LLC, if the LLC is to be an additional debtor. See, e.g., *Assets Resolution Corp. v. CHE LLC*, No. 09-05042, 2010 WL 1345284, at \*2 (W.D. Ark. Mar. 31, 2010) (noting that Arkansas law makes a person liable for an instrument if the person signs the instrument without authority).

135. See U.C.C. § 8-102(a)(15).

136. See *id.* § 9-102(a)(49).

137. *Id.* § 8-103(c).

138. See *id.* § 9-102(a)(42) cmt. 5(d).

If the members of the LLC want to have the LLC's membership interests treated as securities under Article 8, either at their own choosing or as required by a party taking a security interest in those membership interests, the LLC can "opt-in" to Article 8.<sup>139</sup> The process for opting-in is relatively simple: the LLC must explicitly state in its organic formation documents that the membership interests of the LLC are governed by UCC Article 8 as applicable in the state of organization, and should probably prohibit the members from changing this status.<sup>140</sup> If the LLC membership interests are certificated, the prudent practice would be for the LLC to also indicate in a legend or some other explicit fashion on the membership interest certificates that Article 8 governs the membership interest. Once the LLC has opted-in to Article 8, the membership interests will be treated as securities under Article 8 and thus investment property under Article 9.<sup>141</sup> This affects perfection of a security interest as noted below.

## B. *Perfection*

### 1. *LLC Membership Interest as a General Intangible*

As noted above, except for the limited circumstances detailed in Article 8 section 8-103(c), unless the LLC has opted-in to Article 8, the membership interest will be categorized under Article 9 as a general intangible.<sup>142</sup> Filing a financing statement is the only appropriate method of perfecting a security interest in a general intangible, which by its very nature cannot be controlled or possessed.<sup>143</sup> In order to perfect, the secured party must file a properly-prepared financing statement in the central UCC filing office of the state in which the LLC is organized.<sup>144</sup> Once this is filed, generally the "first to file" priority rules will apply to establish the priority of the secured party's filed financing statement as against that of another secured party.<sup>145</sup>

### 2. *LLC Membership Interest as Security and Investment Property*

If the organic documentation for the LLC explicitly states the membership interests are securities governed by UCC Article 8, the collateral is investment property under Article 9 and Article 9 permits any of three separate meth-

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139. *See id.* § 8-103(c) cmt. 4.

140. *See id.*

141. *See id.* §§ 8-103(c) cmt. 4, 9-102(a)(49).

142. *Id.* § 9-102(a)(42).

143. *See id.* § 9-310(a).

144. *See id.* §§ 9-301, 9-307, 9-501.

145. *See id.* §§ 9-322(a), 9-323.

ods of perfection: (1) filing; (2) possession of the LLC membership interest certificate, delivered in accordance with Article 8; or (3) control.<sup>146</sup>

- a. *Perfection by Filing.* Although filing a properly prepared financing statement is permitted as a method of perfection for investment property under Article 9 section 9-312, it may not be the preferred method of perfection, as the priority of any such perfected security interest is subordinate to a competing security interest in the same LLC membership units that is perfected by either possession, delivery, or control.<sup>147</sup> Additionally, perfection by filing does not give the secured party protection from other adverse claims, as the Article 8 rules cutting off adverse claims require “control.”<sup>148</sup>
- b. *Perfection by Possession or Delivery.* If the LLC membership interest is certificated investment property, then the secured party may perfect its security interest by taking delivery or possession of the certificate of membership interest.<sup>149</sup> “Delivery” is accomplished under Article 8 by the secured party either by acquiring possession of the membership interest certificate, or having an agent of the secured party acquire possession of the membership interest certificate.<sup>150</sup>
- c. *Perfection by Control.* Section 9-106 of Article 9 provides that a person has control of a certificated security or uncertificated security as provided in section 8-106 of Article 8.<sup>151</sup> In instances when the LLC membership interest is certificated and in registered form, a person has control if: the membership interest certificate is delivered as provided in section 8-301, and “(1) the certificate is indorsed to the purchaser or in blank by an effective indorsement; or (2) the certificate is registered in the name of the purchaser, upon original issue

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146. See *id.* §§ 9-310, 9-312 to 9-314.

147. See *id.* §§ 9-312, 9-328(1).

148. See *id.* §§ 8-510, 9-312 cmt. 4. Perfection by filing, however, is sufficient for priority over the lien of a bankruptcy trustee. See *id.* § 9-317. Perfection by filing also triggers the usual range of filing issues like the precise use of the debtor’s name. See, e.g., *id.* §§ 9-502, 9-503.

149. *Id.* § 9-313(a).

150. *Id.* § 8-301. There are other risks associated with perfection by filing. For example, in *Gugino v. Wells Fargo Bank Northwest, N.A.* the LLC changed its name after the secured party perfected by filing against their prior name, thereby rendering the perfection ineffective as to collateral acquired more than four months after the change. *Gugino v. Wells Fargo Bank Northwest, N.A. (In re Lifestyle Home Furnishings, L.L.C.)*, No. 08-00629-TLM, 2010 WL 148644, at \*4 (Bankr. D. Idaho Jan. 14, 2010); see U.C.C. § 9-507(c).

151. U.C.C. § 9-106(a).

or registration of transfer by the issuer.”<sup>152</sup> In short, if the LLC membership interest is evidenced by a certificate, a secured party’s best method of perfection is to take possession of the certificate either indorsed over to the secured party or endorsed in blank.<sup>153</sup>

In instances when the membership interest is uncertificated investment property, a purchaser has control if: (1) the uncertificated security is delivered to the person as provided by section 8-301; or (2) the LLC has agreed that it will comply with the instructions originated by the purchaser without further consent by the registered owner of the membership interest.<sup>154</sup> In other words, in the latter case the secured party and LLC will enter into a control agreement setting forth the secured party’s security interest in the membership interests and the secured party’s instructions for the LLC relating to these membership interests.<sup>155</sup> This may require careful drafting to ensure that the parties’ agreement is fully stipulated and understood.

### *C. Other Considerations as to Security Interests in LLC Membership Interests*

Because an LLC can opt-in to Article 8 at any time, thereby changing the Article 9 character of the collateral from a general intangible to investment property, and because a security interest in the membership interests of that LLC perfected either by control or delivery would then have priority over any security interests in the same membership interests previously perfected by filing, secured parties taking such security interests should consider whether to require the LLC to opt-in to Article 8.<sup>156</sup> By requiring the LLC to opt-in, the secured party can perfect by control and maintain its priority as to the LLC membership interest. In such a scenario, the risk of having a security interest that is perfected by filing against the LLC interest as a general intangible subordinated to a subsequent security interest perfected by delivery or control would be eliminated because the

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152. *Id.* § 8-106(b); *see id.* § 8-102(13) (defining a “registered form”); *id.* § 8-301(a) (discussing delivery).

153. *See id.* §§ 9-328, 9-106, 8-106(b).

154. *Id.* § 8-106(c); *see, e.g.*, *Brown v. Nat’l City Bank*, No. H-10-009, 2010 WL 4683706, slip op. at 5 (Ohio Ct. App. Nov. 19, 2010) (regarding certificates of deposit); *Nat’l Consumer Coop. Bank v. Morgan Stanley & Co.*, No. 3:10cv434, 2010 WL 3975847, slip op. at \*5 (M.D. Pa. Oct. 8, 2010) (holding an agreement by a securities intermediary to comply with written instructions of the secured party without further consent by the debtor was sufficient for perfection by control); *see* U.C.C. § 8-301(b).

155. U.C.C. § 8-106(c); *see Nat’l Consumer Coop. Bank*, 2010 WL 3975847, at \*5 (dealing with such an agreement).

156. *See* U.C.C. §§ 8-103(c), 9-328 (describing opt-in option and priority resolution between “control” and other perfection methods).

LLC could not subsequently opt-in to Article 8 and thereby convert the membership interests from general intangibles to securities and investment property.

If the LLC has already opted-in to Article 8, or after a secured party has required that the LLC opt-in to Article 8, it is also prudent for the secured party to require that the organic documents of the LLC and the security agreement include provisions or covenants prohibiting the LLC from subsequently opting-out of Article 8. Such provisions will protect against the reverse scenario in which the secured party's collateral would be converted from a security or investment property to a general intangible.<sup>157</sup> By placing such a covenant in the credit documents, non-compliance with the covenant would be an event of default.<sup>158</sup> By also placing the prohibition in the organic documents, the LLC would be required to amend the organic documents in order to approve any opt-out of Article 8.<sup>159</sup> An LLC debtor acting in bad faith can cause any number of problems for a secured party's security interest, and restricting that LLC's ability to take actions that could have a significant impact on a secured party's priority may slow down any such attempts or at least provide the secured party the possibility of advance notice of such actions. It may also enable a tort remedy against the wrongful actor(s), effectively piercing the LLC veil otherwise precluding individual member liability.

Finally, at a more basic level, it is prudent for a prospective secured party to review the organic documents of the LLC before taking any security interest in it. Further, the prospective secured party should check the records of the state of formation and be sure the name of the LLC in the state records matches that of the organic documents.<sup>160</sup> The organic documents may contain prohibitions against the transfer of the membership interest that must be addressed as a condition to any financing by the secured party. If such prohibitions are permitted to remain in place, it may hinder the ability of the secured party to take possession of the membership interests post-foreclosure.<sup>161</sup>

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157. Of course, assuming there is no prior filing against general intangibles, the secured party can also make a precautionary Article 9 filing against the collateral as general intangibles to guard against this scenario.

158. *See id.* § 9-601 cmt. 3 (providing default procedure and allowing default to be defined by the parties).

159. *Cf. id.* § 8-103(c) (providing opt-in procedure).

160. *See id.* § 9-503 (describing name requirements for valid financing statement).

161. *See, e.g.,* Hering & Harris, *supra* note 134 (regarding the structure, liability features, and operations of LLCs generally); Niesar, *supra* note 134; *cf.* U.C.C. § 9-203(b) (discussing enforceability of security interests). Of course, it is also important to be sure the LLC member has authority to bind the LLC, if the LLC is to be an additional debtor. *See, e.g.,* Assets Resolution Corp. v. CHE LLC, No. 09-05042, 2010 WL 1345284 (W.D. Ark. Mar. 31, 2010).

#### D. Conclusion

Without the LLC actively opting-in to Article 8, a membership interest in a LLC is neither a security under Article 8 nor investment property under Article 9, but rather a general intangible that is subject only to perfection by filing.<sup>162</sup> Once a LLC opts-in to Article 8, the membership interest becomes a security under Article 8 and investment property under Article 9, subject to perfection by control and with any security interest perfected by any method other than control being subordinate to the first security interest to be properly perfected by control.<sup>163</sup>

### VI. CASHIER'S CHECK ISSUES AND SCAMS<sup>164</sup>

#### A. Payment or Deposit Scams

There has recently been a surge in scams involving cashier's checks. Because, as noted below, these scams often involve commercial transactions such as a sale of goods, agricultural and other business entities may be targeted. A typical scam begins when the victim (including, for example, a business or even a lawyer) is contacted and agrees to collect a debt, provide other services, sell goods, or otherwise receive a cashier's check as a part of some underlying transaction.<sup>165</sup> Subsequently, after the cashier's check arrives, there is a request to send part of the funds to the fraudster (the "client," "buyer," or other counterparty in the underlying transaction) by wire transfer.<sup>166</sup>

The client may request the amount collected less the lawyer's fee. The client may have overpaid the retainer and want a refund; or the buyer may have paid for shipment of the goods being purchased and now says that this expense has been taken care of separately and the buyer would like a refund.<sup>167</sup>

An infinite number of variations exist, "but all follow the basic theme: (1) an apparently legitimate transaction; (2) arrival of a check; and (3) a request

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162. See U.C.C. §§ 9-102(a)(42), 9-310(a).

163. See *id.* §§ 8-102(a)(15), 9-102(49), 9-328(1).

164. This discussion is indebted to Robert T. Luttrell, III & Alvin C. Harrell, *Update on Deposit Account, Negotiable Instrument, and Payment System Issues and Developments*, 65 CONSUMER FIN. L. Q. REP. 76 (2011); see also John Kraemer, *Wire Transfers, Good Faith, and "Phishing,"* 65 CONSUMER FIN. L. Q. REP. 420 (forthcoming 2012).

165. Luttrell & Harrell, *supra* note 164, at 85-86.

166. *Id.* at 86.

167. *Id.*

to wire out funds.”<sup>168</sup> The victim may be enticed by the prospect of a profitable or needed transaction, and perhaps future business or profits.<sup>169</sup>

“Once the funds are wired out, they are virtually impossible to recover.”<sup>170</sup> The outgoing wire transfer is effective almost immediately and is often to another country; “in any event, upon receipt at the foreign bank the funds are wired out immediately to another institution, so they are no longer in the designated beneficiary’s bank.”<sup>171</sup> The victim is left only with the anticipation that the cashier’s check he or she received will be paid.”<sup>172</sup> “It never is.”<sup>173</sup>

### B. *The Law*

These transactions may work not only because the victim may desire to gain a new client, but also “in part because the victim has a basic misunderstanding of how checks are paid and when the funds represented by those checks are collected.”<sup>174</sup> Because of the delay between when checks were deposited and the funds made available to customers, and the subsequent complaints thereof, Congress enacted the Competitive Equality Banking Act of 1987 which included the Expedited Funds Availability Act (EFAA) in Title 6.<sup>175</sup> The EFAA essentially requires that the funds from a deposited check be made available for the customer to withdraw even if the deposited check has not yet been paid.<sup>176</sup> The Federal Reserve Board (FRB) issued Regulation CC to implement the EFAA.<sup>177</sup> Among other things, the EFAA and Regulation CC mandate the latest point in time at which funds from various types of deposits must be “made available” to the depositor, whether or not the customer’s deposit has been collected.<sup>178</sup> Subject to some potential exceptions, funds from cashier’s checks must be “made available” within two business days,<sup>179</sup> although for operational and compliance

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168. *Id.*

169. *Id.*

170. *Id.*; see U.C.C. §§ 4A-211, 4A-404 to 06. It is also possible, though less common, that the transfer or refund could be requested in the form of a valid cashier’s check, which is sent to the fraudster and then negotiated to a holder in due course. See *id.* §§ 3-104, 3-201, 3-302, 3-306. The results are essentially the same.

171. Luttrell & Harrell, *supra* note 164, at 86.

172. *Id.*

173. *Id.*

174. *Id.*

175. *Id.*; see Competitive Equality Banking Act of 1987, Pub. L. No. 100-86, tit. 6, 101 Stat. 552 (1987) (codified at 12 U.S.C. §§ 4001–10 (2006)).

176. 12 U.S.C. § 4002(b)(3)(A).

177. 12 C.F.R. § 229.1(a) (2011).

178. *Id.* § 229.12.

179. *Id.*

reasons many banks have adopted even shorter availability schedules. None of these availability schedules bear any relation to how long it takes to process the customer's deposited check and discover whether it is genuine and will be paid, and they do not prevent the depositor from being liable when a deposited check is bogus, is dishonored and returned unpaid, and is charged-back to the depositor's account.<sup>180</sup> As noted below, at the time Congress passed the EFAA some observers noted that it could be regarded as a forger and con artist's relief act, and so it has been.

Checks that are sent through the normal bank collection system as "cash items" (essentially all deposited checks) cannot be subject to any routine, affirmative confirmation of payment; there are simply too many of them. The bank customer who deposits the check receives provisional settlement from the depository bank and the deposited check is commonly presumed to be paid unless notice of dishonor is subsequently received.<sup>181</sup> But this process necessarily takes some time.

Entirely as a separate matter, the funds must become "available" for withdrawal based on the bank's EFAA availability schedule (with the maximum time limit governed by FRB Regulation CC). "Available" funds under the EFAA are not the same as collected funds; a check can be dishonored and returned unpaid after the funds have been "made available."<sup>182</sup>

Thus, having the funds made "available" under the EFAA is clearly not the same as having the deposited check paid. The EFAA requires the depository bank to notify the customer of this funds' availability. It is unlikely that most customers will fully understand what this means or its relation to the bank collection and payment system, and the EFAA prohibits banks from protecting customers by routinely withholding funds availability until the deposited check has been paid.<sup>183</sup> The depositor will receive notice that a deposited check has not been paid only when the deposited check is dishonored by the payor bank, notice or the item is returned to the depository bank, the item is charged-back to the customer's deposit account, and notice thereof is sent out and received by the customer.<sup>184</sup> This takes time, even if the check is processed electronically, and

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180. See, e.g., U.C.C. § 4-214(a) (2011) (regarding a customer's obligation to repay).

181. See *id.* §§ 4-201, 4-202, 4-215, 4-301, 4-302 (regarding provisional settlements, midnight deadlines, and notice of dishonor).

182. Luttrell & Harrell, *supra* note 164, at 86; see 12 U.S.C. § 4002 (2006) (regarding availability schedules); compare *id.* (explaining availability of funds), with U.C.C. § 4-302 (describing the payor bank's responsibility for late return of an item).

183. See 12 U.S.C. § 4003.

184. *Id.* Given the various "midnight deadlines" for each of these functions, the process may extend well beyond the EFAA and Regulation CC funds availability schedule and deadlines.

scammers may gain additional time by such ploys as using a fake bank routing number on the check's "MICR" line.<sup>185</sup> In that case, the bogus check (or its electronic image) may bounce around in the automated clearing system until it finally receives appropriate human attention.<sup>186</sup> This may take a week or more, further delaying the time it takes for the deposit customer to receive notice of dishonor. In the meantime, the customer may have spent or wired-out the money. The resulting problems are essentially a consequence of the EFAA divorcing funds availability from check collection and payment.<sup>187</sup>

Various time frames are commonly cited with regard to when it is safe to assume that a deposited check has been paid. This is likely to happen at the payor bank's "midnight deadline."<sup>188</sup> But the volume of checks is such that this cannot be individually communicated to every depositor, unless he or she specifically asks; barring that, there is no set period of time after which it is safe to assume that a check has been paid. Prior to the EFAA and Regulation CC, banks tried to monitor this on a general basis and limit their customers' withdrawals accordingly; the EFAA prohibits this.<sup>189</sup> The result is a made-to-order opportunity for check scam artists (as was recognized when the EFAA was enacted).<sup>190</sup>

### C. Solutions and Pitfalls

The best option under current law, if there is any reason for suspicion, is for the customer to go to his or her bank and ask it to send the cashier's check for "collection," rather than depositing it.<sup>191</sup> This precludes treatment of the check as a "cash item" and protects the customer because it takes the transaction out of the EFAA.<sup>192</sup> This is commonly done with oil and gas lease drafts.<sup>193</sup> Instead of being deposited, the check will be sent out by the customer's bank under a "collec-

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*See id.* § 4002; U.C.C. §§ 4-104(a)(10), 4-202(b), 4-301, 4-302 (regarding provisional settlements, midnight deadlines, and notice of dishonor).

185. *See generally* Northpark Nat'l Bank v. Bankers Trust Co., 572 F. Supp. 520 (S.D.N.Y. 1983) (describing a customer who defrauded a Dallas bank through misrouting a check by imprinting it with deceptive routing symbols).

186. *See* Northpark Nat'l Bank v. Bankers Trust Co., 572 F. Supp. 524, 526-27 (S.D.N.Y. 1983) (explaining a situation in which it took human attention to withdraw the bogus check from the automated system).

187. FRED H. MILLER & ALVIN C. HARRELL, THE LAW OF MODERN PAYMENT SYSTEMS AND NOTES 370 (West 2003); *see* 12 C.F.R. § 229.12 (2011).

188. *See* U.C.C. §§ 4-215, 4-301, 4-302.

189. *See* MILLER & HARRELL, *supra* note 187, at 370; 12 C.F.R. § 229.12.

190. *See generally* MILLER & HARRELL, *supra* note 187, at 370.

191. *See* U.C.C. §§ 3-104(g), 4-201 cmt. 2.

192. 12 C.F.R. pt. 229 app. E(u)(4) (2011).

193. Luttrell & Harrell, *supra* note 164, at 86; *see, e.g.*, U.C.C. § 4-501.

tion letter,” not through bulk clearing under a “cash letter.”<sup>194</sup> The customer will receive positive confirmation some days later as to whether or not the check has been paid.<sup>195</sup> Banks charge an extra fee for this special handling.<sup>196</sup> The bank can protect the customer, however, precisely because the transaction is not covered by the EFAA.

Of course, another option is to contact the drawer of the cashier’s check directly, to determine if it is genuine. If the check is an ordinary personal check, there will also need to be some confirmation that it is covered by sufficient funds.<sup>197</sup> All of this requires some effort, however, and even then is not entirely foolproof. Some bank customers apparently prefer to chat with the teller at his or her bank and then rely on this casual conversation as evidencing what the bank “said.” But what the bank teller “says” in casual conversation may not be what the customer thinks he or she “hears.” When talking to someone at the bank, either the depository or the payor bank, the customer should listen carefully to the legal terminology. The bank teller may well be explaining funds availability under the EFAA, which is what the law requires,<sup>198</sup> rather than collection and final payment under the UCC. The potential for confusion between funds availability under the EFAA and payment under UCC Article 4, is apparent.<sup>199</sup> Moreover, given the inherent complexity of the legal issues, it is not clear whether bank customers can ever be expected to understand the risks based on a brief and casual exposure to the matter. Even if the depository bank is requested to contact the payor bank at this time, generally all the payor bank will say is that “a check in that amount will clear on this account at this time,” not that “we will pay your particular check when presented.”<sup>200</sup> Or, the depository bank teller may tell the customer the “funds will be available on” a specified date under the EFAA, not “this check is valid and will be paid” under UCC Article 4.<sup>201</sup> Any commitment that a particular check is genuine or represents “good” funds and will be paid according to its terms would be an extraordinary commitment and should be in writing. While (as indicated below at Part VI.D.) anything is possible, your authors have never seen a bank give such an assurance.

Essentially, these scams work because the volume of checks and payment processing makes it impractical for deposited checks to be handled on an

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194. See U.C.C. § 4-501.

195. *Id.*

196. Luttrell & Harrell, *supra* note 164, at 86.

197. See MILLER & HARRELL, *supra* note 187, at 380.

198. 12 U.S.C. § 4004(a) (2006); 12 C.F.R. §§ 229.15(a), 229.16(a) (2011).

199. MILLER & HARRELL, *supra* note 187, at 369–70.

200. See generally *id.* at 351 (providing background information on disclosure); 12 C.F.R. § 229.15(a), 229.16(a).

201. 12 C.F.R. §§ 229.15(a), 229.16(a); MILLER & HARRELL, *supra* note 186, at 351.

individualized basis, and the EFAA mandates that the funds be made available for transfer by the customer before anyone knows whether the deposited check will be paid.<sup>202</sup> As noted, the standard check collection process cannot provide direct, individualized feedback as to whether each deposited check is “good” or has been paid; the volumes are simply too great.<sup>203</sup> If a customer wants to know that a check has been paid, this should be confirmed directly by the customer with the drawer and the payor bank, or the check should be sent “for collection.” But it is up to the customer to make a judgment on whether this should be confirmed or sent for collection, based on facts about the underlying transaction that only he or she knows. If the money is gone because the customer sent it to a crook, the customer is going to be liable.<sup>204</sup>

As a further aside, some of these scams involve alteration of a legitimate check.<sup>205</sup> The victim may be requested to send funds to the fraudster by personal check, which is then altered, or may receive a cashier’s check which has been altered by the fraudster.<sup>206</sup> In the latter case, the depository bank’s claim against the depositor for breach of warranty can exist for as long as three years.<sup>207</sup> Given reasonable diligence by the drawer, altered checks should be discovered by the drawer promptly (for example, after the drawer receives and reviews a statement of paid items).<sup>208</sup> But this only provides the depositor another cause of action against the fraudster when the altered check is charged-back to the depositor’s account; and normally the discovery of the fraud is well outside the time frame in which lawyers would be required to forward client funds or sellers would refund overpayments by a buyer.<sup>209</sup> The resulting overdraft and warranty liability runs to the depository bank and cannot be disclaimed by a non-recourse indorsement.<sup>210</sup>

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202. 12 C.F.R. § 229.12.

203. See generally MILLER & HARRELL, *supra* note 187, at 370 (discussing mandatory limits on hold periods).

204. See, e.g., U.C.C. § 3-415 (2011).

205. Clark H.C. Lacy, *The Witch’s Brew: Nigerian Schemes, Counterfeit Cashier’s Checks, and Your Trust Account*, 61 S.C. L. REV. 753, 756 (2010) (citing Gene A. Marsh, *Counterfeit Cashier’s Check Scams—Bank Liability. The Check Is Good. Or Is It?*, 40 UCC L.J. 417, 498 (2008)).

206. See *id.* at 756.

207. U.C.C. §§ 4-111, 4-207(a)(3); U.C.C. §§ 3-118(d), 3-416 (comparable provisions to Article 4).

208. See, e.g., *id.* § 4-406 (regarding items paid on a customer’s account).

209. See MODEL RULES OF PROF’L CONDUCT ANN. R. 1.15(d) (2007) (describing the requirement of safekeeping client property, which implies that a resulting charge-back of the fraudulent item to a lawyer’s client trust fund account may deplete funds owed to other clients and create an overdraft that is required to be reported (by the lawyer and the bank) to the state bar association).

210. U.C.C. §§ 4-207(b), 3-416(c).

It might be possible to disclaim this warranty in the context of a collection letter by sending the check without recourse and disclaiming any warranties created by the contract of indorsement, but that is an open question. In any case, as noted above, if the check is sent for collection it is less likely there will be a problem, because the funds are not available for transfer by the customer unless the check has been individually reviewed and paid.<sup>211</sup>

#### D. Selected Cases

##### 1. *The Chino Case*<sup>212</sup>

*Chino Commercial Bank, N.A. v. Peters* illustrates a typical cashier's check fraud scenario.<sup>213</sup> In *Chino*, Faux Themes Inc. (the corporation) and its President (Peters) were victims of a Nigerian-style email scam.<sup>214</sup> Peters agreed to an arrangement whereby the corporation would receive money purportedly owed to a person in Malaysia and then pay that money out as directed in exchange for a fifteen percent fee.<sup>215</sup> The corporation received checks totaling \$808,988.90 and Peters deposited them in the corporation's deposit account at Chino Commercial Bank, N.A. (the depository bank).<sup>216</sup> Peters then directed the bank to wire out \$468,000.<sup>217</sup> Thereafter, all of the checks that had been deposited were dishonored and returned unpaid.<sup>218</sup> The written deposit account agreement provided: "Each [depositor] agrees to be jointly and severally (individually) liable for any account shortage resulting from charges or overdrafts . . . ."<sup>219</sup>

The specific facts are as follows: On April 30, 2009, the corporation received a check for \$178,000; Peters had it deposited.<sup>220</sup> On May 8, 2009, the depository bank purportedly "confirmed that the check had cleared."<sup>221</sup> Charlnoes

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211. *See id.*

212. *Chino Commercial Bank, N.A. v. Peters*, 118 Cal. Rptr. 3d 866 (Cal. Ct. App. 2010).

213. *See id.*

214. *Id.* at 868–69.

215. *Id.* at 868.

216. *Id.*

217. *Id.*

218. *Id.* The depository bank rescinded the provisional settlement it had provided for the deposit, "charging back" the dishonored checks to the customer's account pursuant to the UCC. *Id.* at 869; *see* U.C.C. §§ 4-201, 4-202, 4-214 (2011).

219. *Chino*, 118 Cal. Rptr. 3d at 869.

220. *Id.*

221. *Id.* This aspect of the facts, as stated in the court's opinion, likely reflects loose terminology (and perhaps confusion with the EFAA funds availability schedule, as noted above at Part VI.C.) rather than an accurate recitation of the facts. *See, e.g.*, U.C.C. §§ 4-104(a)(10), 4-201,

then had the Bank wire \$80,000 to a [beneficiary's] bank in Hong Kong."<sup>222</sup> On May 8, 2009, the corporation received a second check, for \$373,988.90; Peters had it deposited.<sup>223</sup> On May 12, 2009, Charlnoes instructed the depository bank to wire another \$71,000 to the same beneficiary's bank in Hong Kong.<sup>224</sup> On May 15, 2009, the depository bank purportedly confirmed "that the second check had cleared, Charlnoes had the depository bank wire \$317,000 to a bank in China."<sup>225</sup> On May 21, 2009, the corporation "received a third check, for \$257,000; Peters had Charlnoes deposit it."<sup>226</sup> Peters later remarked that the entire arrangement "'seemed pretty fishy to me . . . but, times being what they are, I decided to take the chance."<sup>227</sup>

The *Chino* court held that under UCC section 3-406 Peters was "'[a] person whose failure to exercise ordinary care contribute[d] to an alteration of an instrument . . . .'"<sup>228</sup> Moreover, the depository bank exercised ordinary care in that it "properly charged back the account for the altered checks."<sup>229</sup> The loss fell on Peters and the corporation.<sup>230</sup>

## 2. *The Fischer & Mandell Case*<sup>231</sup>

In another typical case, a law firm received and deposited a check in the amount of \$225,351 and then wired funds to the client before the time for dis-

4-202, 4-215, 4-301, 4-302 (regarding provisional settlements; midnight deadlines, and notice of dishonor). In any event, in a footnote the *Chino* court stated, "Peters has not argued that the Bank's representations that the checks had cleared bar it from recovering. We deem any such contention forfeited for purposes of this appeal." *Chino*, 118 Cal. Rptr. 3d at 876 n.4 (citation omitted); see also U.C.C. §§ 4-214, 4-401. *But cf.* *Mandolfo v. Mandolfo*, 796 N.W.2d 603 (Neb. 2011) (holding payee's claims of conversion and negligence against a bank were displaced by the UCC).

222. *Chino*, 118 Cal. Rptr. 3d at 869.

223. *Id.*

224. *Id.*

225. *Id.*

226. *Id.*

227. *Id.*

228. *Id.* at 872; see U.C.C. § 3-406(a) (2010) (precluding Peters from asserting a forgery or alteration as a defense against the bank. This line of reasoning is not entirely clear, as the forgery of a deposited check should not afford the depositor a defense in any event).

229. See *Chino*, 118 Cal. Rptr. 3d. at 873; U.C.C. § 3-406(b) (therefore the bank was not liable for contributory or comparative negligence).

230. See *Chino* 118 Cal. Rptr. 3d at 876 (it should be noted again that Peters and the corporation were liable for the funds advanced by the depository bank against the dishonored deposited checks); see U.C.C. §§ 4-214, 4-401.

231. *Fischer & Mandell LLP v. CitiBank, N.A.*, 632 F.3d 793 (2d Cir. 2011). The case is ironic because it would seem that attorneys practicing law should know better. *Id.*

honor or payment of the deposited check by the payor bank had elapsed.<sup>232</sup> The deposited check was later dishonored, and the wired funds could not be recovered.<sup>233</sup> The law firm sued the depository bank, asserting that in making the wire transfer, the law firm relied on the bank's internet banking services website for assurance the funds from the check were "available."<sup>234</sup> The deposit account contract between the law firm and the bank included the following provision: "Please note that a check you deposit may be returned unpaid after we have made the funds *available* to you. If this happens, the amount of the returned check will be deducted from your account balance."<sup>235</sup>

This tracks UCC section 4-214, and defeated the law firm's claim.<sup>236</sup> Related negligence claims against the depository bank, relating to the wire transfer, were displaced by UCC Article 4A.<sup>237</sup> Because the holding applied New York law in the Second Circuit to one of the world's most important banking centers, the decision is particularly significant.<sup>238</sup>

### 3. *The Transcontinental Holding Case*<sup>239</sup>

*Transcontinental Holding Ltd. v. First Banks, Inc.* emphasizes that under the UCC, a cashier's check is not necessarily a "cash equivalent."<sup>240</sup> The facts and issue in *Transcontinental Holding* were stated by the court as follows:

The bank, upon learning that Kogan disputed Scharf's authority to withdraw funds from the Kogan account, stopped payment on the cashier's check. The dispute between Scharf and Kogan is not ours to decide. Rather, today we decide only the dispute between Scharf and the bank. In so doing, we must determine a matter of first impression: whether, under Missouri's Revised Uniform

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232. *Id.* at 795; see U.C.C. §§ 4-215, 4-301, 4-302; see also MODEL RULES OF PROF'L CONDUCT ANN., R. 1.15(d) (2007).

233. *Fischer & Mandell*, 632 F.3d at 796; see U.C.C. §§ 4-215, 4-301, 4-302; see also MODEL RULES OF PROF'L CONDUCT ANN., R. 1.15(d).

234. *Fischer & Mandell*, 632 F.3d at 799.

235. *Id.*

236. *Id.* at 801; U.C.C. §4-214.

237. *Fischer & Mandell*, 632 F.3d at 801; see generally *Mandolfo v. Mandolfo*, 796 N.W.2d 603, 609 (Neb. 2011) (holding UCC Article 3 displaces common law negligence and conversion claims). It is possible that a bank official could make affirmative representations that would create a separate negligence or estoppel argument for the customer. See, e.g., *Avanta Fed. Credit Union v. Shupak*, 223 P.3d 863, 865-67 (Mont. 2009); *Valley Bank of Ronan v. Hughes*, 147 P.3d 185, 188-89, 196 (Mont. 2006).

238. See *Fischer & Mandell*, 632 F.3d, at 801.

239. *Transcon. Holding Ltd. v. First Banks, Inc.*, 299 S.W.3d 629 (Mo. Ct. App. 2009).

240. *Id.* at 655-56.

Commercial Code, a bank may refuse payment and assert its own defenses against liability on its cashier's check. We answer that it may.<sup>241</sup>

The Bank argued that it could assert Scharf's lack of authority as a defense to the Bank's failure to pay the instrument, which was the Bank's own cashier's check.

The key to clarifying this issue is a change to the 1990 uniform text of the UCC. The court noted, "[p]re-revision Article 3, still in effect in a number of jurisdictions, does not specifically address cashier's checks. And pre-revision Article 3 contains no definitive answer to the question of whether a bank may dishonor its own cashier's check and assert a defense to payment of that check."<sup>242</sup> "Missouri's UCC states that a 'cashiers check' means 'a draft with respect to which the drawer and drawee are the same bank or branches of the same bank.'"<sup>243</sup> After enactment of the 1990 uniform text revision, Missouri UCC section 400.3-412 (section 3-412 in the uniform text) reads as follows:

400.3-412. Obligation of Issuer of Note or Cashier's Check.

The issuer of a note or cashier's check or other draft drawn on the drawer is obliged to pay the instrument (i) according to its terms at the time it was issued or, if not issued, at the time it first came into possession of a holder, or (ii) if the issuer signed an incomplete instrument, according to its terms when completed, to the extent stated in Sections 400.3-115 and 400.3-407. The obligation is owed to a person entitled to enforce the instrument or to an endorser who paid the instrument under Section 400.3-4 [UCC section 3-412].<sup>244</sup>

In *Transcontinental Holding*, "First Bank did not dishonor the cashier's check in order to assert a defense belonging to [the purchaser of the cashier's check]."<sup>245</sup> . . . Instead, First Bank has raised its own personal defense to paying the cashier's check, that being failure of consideration."<sup>246</sup> A cashier's check represents a contractual and statutory liability of the issuer, under UCC section 3-412.<sup>247</sup> If the issuing bank has its own defense to payment, like when the bank does not receive payment for the cashier's check, the bank can assert its defense as a basis for dishonor of the check, just like any obligor.<sup>248</sup> UCC sections 3-411

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241. *Id.* at 631-32.

242. *Id.* at 646 (citations omitted).

243. *Id.* at 645 n.17 (citations omitted); see MO. ANN. STAT. § 400.3-104(g) (West 1994) (defining a cashier's check). The 1990 revisions have now been enacted in all states except New York.

244. MO. ANN. STAT. § 400.3-412; see U.C.C. § 3-412 (2011).

245. See *Transcon. Holding*, 299 S.W.3d at 651.

246. *Id.*

247. U.C.C. § 3-412.

248. *Transcon. Holding*, 299 S.W.3d at 656.

and 3-412 permitted First Bank to assert its own defenses against liability on its cashier's check.<sup>249</sup>

In addition, the current uniform text of UCC section 3-411 reads:

(a) In this section, "obligated bank" means the acceptor of a certified check or the issuer of a cashier's check or teller's check bought from the issuer.

(b) If the obligated bank wrongfully (i) refuses to pay a cashier's check or certified check, (ii) stops payment of a teller's check, or (iii) refuses to pay a dishonored teller's check, the person asserting the right to enforce the check is entitled to compensation for expenses and loss of interest resulting from the nonpayment and may recover consequential damages if the obligated bank refuses to pay after receiving notice of particular circumstances giving rise to the damages.

(c) Expenses or consequential damages under subsection (b) are not recoverable if the refusal of the obligated bank to pay occurs because (i) the bank suspends payments, (ii) the obligated bank asserts a claim or defense of the bank that it has reasonable grounds to believe is available against the person entitled to enforce the instrument, (iii) the obligated bank has a reasonable doubt whether the person demanding payment is the person entitled to enforce the instrument, or (iv) payment is prohibited by law.<sup>250</sup>

Thus, a bank issuing a check (like a cashier's check) has the right to assert claims and defenses available to the bank under UCC section 3-305.<sup>251</sup> Clearly, under Missouri law, a forged or altered cashier's check, or a cashier's check issued in return for a forged cashier's check, or one issued without actual consideration or apparent authority, is subject to the issuing bank's defenses.<sup>252</sup> If a cashier's check is properly payable and is improperly dishonored, however, the bank may be liable for damages pursuant to UCC section 3-411(b), including consequential damages if the bank cannot reasonably assert a claim or defense and prove that it had "reasonable grounds" for the dishonor under section 3-411(c).<sup>253</sup>

## VII. LIMITATIONS ON SECURED PARTY CARVE-OUTS IN BANKRUPTCY

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249. *See id.*; U.C.C. §§ 3-411, 3-412.

250. U.C.C. § 3-411.

251. *Id.* § 3-305.

252. *See id.* §§ 3-305, 3-411. Note, however, that some of these defenses could be cut-off as against a holder in due course. *See id.* § 3-305(a)-(b).

253. *Id.* § 3-411(b)-(c).

## A. Background

### 1. Reasons for Bankruptcy Gifting or “Carve-Outs”

Bankruptcy issues are likely to become paramount in any agricultural or business credit crisis, including issues relating to a reorganization in Bankruptcy Code Chapter 11. In such a bankruptcy context, the terms “gifting” or “carve-out” commonly refer to the act of a creditor (or a class of creditors) giving up the right to part of its collateral, a distribution, or proceeds that the “giving” creditor is otherwise entitled to receive.<sup>254</sup> Typically, the recipient is a junior class of claims or interest holders (meaning that the claim or interest held by each recipient is subordinate in relative liquidation priority to the claim or interest held by the giver).<sup>255</sup> Gifting has been upheld even if the gifting results in unequal distributions to creditors within the same class, or when a more senior class has not received payment in full.<sup>256</sup>

Gifts can be used by creditors in bankruptcy cases as bargaining tools to achieve desired outcomes. For example, gifts have been used by secured creditors in Chapter 11 cases to: (1) gain the consent of equity holders to a plan of reorganization;<sup>257</sup> or (2) demonstrate to the presiding bankruptcy court that there is a benefit to the estate (meaning unsecured creditors) that might be derived from a sale of collateral in which the creditor’s interest is undersecured.<sup>258</sup>

### 2. Types of Gifting

Gifts or carve-outs may arise in practically any context in which a subordinate creditor or interest holder or class can exert leverage or influence in a bankruptcy case (such as withholding or conditioning such party’s consent).<sup>259</sup> In addition to Chapter 11 plans, gifting might arise in connection with cash collateral stipulations, Bankruptcy Code Section 363 sale orders, stipulations of set-

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254. See 11 U.S.C. § 510 (2006).

255. See 11 U.S.C. § 1129(b) (regarding the “absolute priority rule”); see, e.g., *Official Unsecured Creditors’ Comm. v. Stern (In re SPM Mfg. Corp.)*, 984 F.2d 1305, 1310, 1312 (1st Cir. 1993); *In re Exide Techs.*, 303 B.R. 48 (Bankr. D. Del. 2003).

256. See, e.g., *In re DBSD N. Am., Inc.*, 419 B.R. 179, 210–15 (Bankr. S.D.N.Y. 2009) (discussed below).

257. *DISH Network Corp. v. DBSD N. Am., Inc. (In re DBSD N. Am., Inc.)*, 634 F.3d 79, 100 (2d Cir. 2011).

258. See COLLIER ON BANKRUPTCY ¶ 506.02 (Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2011).

259. See *In re Armstrong World Indus.*, 320 B.R. 523 (D. Del. 2005) (regarding carve-outs in the context of a reorganization plan).

tlement, and many other types of agreements or orders.<sup>260</sup> Gifts and carve-outs can range from an immediate cash payment to a right to receive proceeds from a future liquidation of collateral.<sup>261</sup> Gifts can be made unconditionally, or subject to conditions, including the occurrence of future events which may be beyond the control of the parties.

### 3. *Prior Law*

Because gifting can result in unequal distributions to creditors within the same class, or payments to junior classes when a more senior class has not received payment in full, there is a constant tension between the “absolute priority rule” in Bankruptcy Code section 1129(b) and the practice of gifting.<sup>262</sup> Long before enactment of the Bankruptcy Code in the Bankruptcy Reform Act of 1978, courts recognized that distributions to creditors and holders of equity interests in liquidation of a company’s assets must be made in the order of priority of such interests. As the United States Supreme Court noted in its 1868 decision in *Railroad Co. v. Howard*, it is “well settled that stockholders are not entitled to [receive payment] until all the debts of the corporation are paid.”<sup>263</sup>

The Bankruptcy Code retains the absolute priority rule at section 1129(b). That section provides, in relevant part:

(b)(1) [I]f all of the applicable requirements [for confirmation] other than paragraph (8) [class acceptance] are met with respect to a plan, the court, on request of the proponent of the plan, shall confirm the plan notwithstanding the requirements of such paragraph if the plan does not discriminate unfairly, and is fair and equitable, with respect to each class of claims or interests that is impaired under, and has not accepted, the plan.

(2) For the purpose of this subsection, the condition that a plan be fair and equitable with respect to a class includes the following requirements: . . .

(B) With respect to a class of unsecured claims—

(i) the plan provides that each holder of a claim of such class receive or retain on account of such claim property of a value, as of the effective date of the plan, equal to the allowed amount of such claim; or

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260. See *In re DBSD*, 419 B.R. at 210–11 (explaining gifting doctrine).

261. See *In re Hotel Syracuse, Inc.*, 275 B.R. 679, 683 (Bankr. N.D.N.Y. 2002) (discussing the possibility of paying costs with unencumbered assets in the debtor’s estate).

262. See generally *The Gifting Doctrine v. the Absolute Priority Rule*, LAW360, <http://www.law360.com/appellate/articles/232097/the-gifting-doctrine-v-the-absolute-priority-rule> (last visited June 10, 2012) (describing First and Second Circuit split regarding application of the gifting doctrine or the absolute priority rule).

263. *R.R. Co. v. Howard*, 74 U.S. 392, 409–10 (1868).

(ii) the holder of any claim or interest that is junior to the claims of such class will not receive or retain under the plan on account of such junior claim or interest any property . . . .<sup>264</sup>

Notwithstanding the Bankruptcy Code's clear statement of the absolute priority rule, however, bankruptcy courts in recent years have permitted gifting or carve-outs in a variety of contexts. For example, in *Official Unsecured Creditors' Comm. v. Stern (In re SPM Mfg. Corp.)*, a decision issued by the United States Court of Appeals for the First Circuit in 1993, the court specifically authorized a sharing of the proceeds of an asset sale between the secured party and the debtor's unsecured creditors, which skipped over the intervening claim of the Internal Revenue Service (IRS).<sup>265</sup> This carve-out was given in the context of a Bankruptcy Code section 363 sale that occurred in the Chapter 11 case.<sup>266</sup> Following a subsequent conversion of the case to Chapter 7, however, the bankruptcy court refused to allow the Chapter 7 trustee to honor the carve-out, directing instead that the trustee distribute the sale proceeds in accordance with the Bankruptcy Code's provisions giving priority to tax claims.<sup>267</sup> In a decision that has been subsequently relied upon extensively by courts as the basis for "gifting," the First Circuit reversed, holding that because the secured party would have been entitled to receive the entire proceeds of the sale, it was free to share those proceeds with others as it saw fit (notwithstanding the priority scheme in the Bankruptcy Code).<sup>268</sup>

Although the *SPM Mfg.* case did not involve confirmation of a Chapter 11 plan (and therefore, Bankruptcy Code section 1129(b) was not directly applicable), its holding was later expanded by bankruptcy courts to permit gifting pursuant to Chapter 11 plans.<sup>269</sup>

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264. 11 U.S.C. § 1129(b)(1)–(2)(B) (2006).

265. *Official Unsecured Creditors' Comm. v. Stern (In re SPM Mfg. Corp.)*, 984 F.2d 1305, 1318 (1st Cir. 1993) (holding an agreement between the secured and unsecured creditors to split money from the bankruptcy proceedings may take priority over provisions of the Bankruptcy code). *Compare In re Exide Techs.*, 303 B.R. 48, 80 (Bankr. D. Del. 2003) (holding the distinction between general unsecured claimants and investor claimants is insufficient to meet the criteria of section 1129(b)(1) of the Bankruptcy Code), *with* 11 U.S.C. § 1129(b) (outlining the criteria necessary for a plan to be fair and equitable).

266. *See In re SPM*, 984 F.2d at 1307–09.

267. *Id.* at 1308–10.

268. *Id.* at 1312–13, 1318.

269. *See In re Exide Techs.*, 303 B.R. at 80.

B. *The DISH Network Corp. v. DBSD Case*

More recently, however, the United States Court of Appeals for the Second Circuit severely limited the use of gifting (at least in the context of a Chapter 11 plan) in *DISH Network Corp. v. DBSD N. Am., Inc. (In re DBSD N. Am., Inc.)*.<sup>270</sup> DBSD filed for Chapter 11 relief in the U.S. Bankruptcy Court for the Southern District of New York.<sup>271</sup> After negotiations with the parties in interest, DBSD proposed a plan of reorganization that provided, among other things, for holders of DBSD's second lien debt (DBSD's primary secured creditors) to receive the bulk of the shares of the reorganized entity, while holders of unsecured claims would receive shares estimated in value at four to forty-six percent of their original claims.<sup>272</sup> "[T]he existing shareholder would receive shares and warrants in the reorganized entity."<sup>273</sup> Because the second lien debt holders were found by the bankruptcy court to be unsecured, the distribution of shares and warrants to subordinate classes, both the unsecured creditors and the debtor's pre-petition shareholder, represented gifts from those secured parties' collateral.<sup>274</sup>

Sprint, the holder of a general unsecured claim that had been allowed for voting purposes only, objected to confirmation.<sup>275</sup> The bankruptcy court confirmed the plan over Sprint's objection, and the district court affirmed the confirmation order on appeal.<sup>276</sup> Sprint then appealed the district court's decision to the court of appeals (the Second Circuit).<sup>277</sup>

The argument that Sprint asserted in its appeal founded in the plain meaning of the absolute priority rule as set forth in section 1129(b) of the Bankruptcy Code.<sup>278</sup> Sprint argued that the proposed plan violated the absolute priority rule by giving shares and warrants to a junior class (the existing shareholder)

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270. *DISH Network Corp. v. DBSD N. Am., Inc. (In re DBSD N. Am., Inc.)*, 634 F.3d 79, 97 (2d Cir. 2011).

271. *Id.* at 86.

272. *Id.*

273. *Id.*

274. *Id.* at 87.

275. *Id.* at 86. The claim that Sprint asserted in the case was "an unliquidated, unsecured claim based on a lawsuit against a DBSD subsidiary" in which "Sprint had sued seeking reimbursement for DBSD's share of certain spectrum relocation expenses under an FCC order." *Id.* Also at issue in the *DBSD* opinion was Sprint's standing to appeal, in view of the unliquidated nature of Sprint's claim and the fact that Sprint was "out of the money" in a liquidation scenario. *Id.* at 88-93.

276. *Id.* at 88.

277. *Id.*

278. *Id.*

although a more senior class (the unsecured creditors) neither (1) approved the plan, nor (2) received the full value of its claim.<sup>279</sup>

In arriving at its decision, the Second Circuit looked to the text of the absolute priority rule in section 1129(b)(2)(B) which states that, to be fair and equitable to creditors that do not receive full distributions, a plan must provide “the holder of any claim or interest that is junior to the claims of such class will not receive or retain under the plan on account of such junior claim or interest any property . . . .”<sup>280</sup> According to the Second Circuit, the plan, which did not satisfy the claims of unsecured creditors in full, would contravene the absolute priority rule unless “the existing shareholder, whose interest is junior to [the unsecured creditors], does ‘not receive or retain’ ‘any property’ ‘under the plan on account of such junior . . . interest.’”<sup>281</sup> The Second Circuit determined that: (1) the junior interest received “property” because the meaning of “any property” includes the equity the second lien creditors granted to the junior interest; (2) the junior interest received this property “under the plan” because the plan stated that the junior interest was to receive this equity; and (3), the distribution was “on account of” the junior interest’s prepetition interest because it received the shares in exchange for its old shares.<sup>282</sup> This directly placed at issue the validity of the so-called “gifting doctrine” as approved by the First Circuit in *SPM Mfg.*<sup>283</sup>

In *DBSD*, the Second Circuit rejected the applicability of the “gifting doctrine.”<sup>284</sup> Even though the court acknowledged the policy arguments in favor of the gifting doctrine and the importance of achieving settlements in bankruptcy,<sup>285</sup> the court ruled that, by enacting section 1129(b)(2)(B) Congress established a policy that favors distribution in accordance with the priorities of the Bankruptcy Code over the ability to “make deals” without the consent of the intervening class(es).<sup>286</sup>

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279. *Id.*

280. *Id.* at 95 (quoting 11 U.S.C. § 1129(b)(2)(B) (2006)).

281. *Id.*

282. *Id.*

283. Compare *id.*, with *Official Unsecured Creditors’ Comm. v. Stern (In re SPM Mfg. Corp.)*, 984 F.2d 1305 (1st Cir. 1993).

284. *DISH Network Corp.*, 634 F.3d at 97–101.

285. *Id.*

286. See *id.* at 100; *Game Changer: Second Circuit Finds “Gifting” by Secured Creditor to Old Equity Pursuant to Chapter 11 Plan Violates Absolute Priority Rule*, PAUL HASTINGS 3 (Feb. 2011), [http://www.paulhastings.com/assets/publications/1828/.pdf?wt.mc\\_ID=1828.pdf](http://www.paulhastings.com/assets/publications/1828/.pdf?wt.mc_ID=1828.pdf).

### C. Implications of the DBSD Decision

#### 1. Chapter 11 Plans

After *DBSD*, the future of the gifting doctrine in the Second Circuit is unclear. Gifting has been an important tool in creating consensual plans of reorganization, because junior interests can bargain for something in exchange for their cooperation.<sup>287</sup> The *DBSD* decision indicates that the absolute priority rule definitively prohibits the provision of property to a junior stakeholder in a cram-down Chapter 11 plan, unless the senior stakeholder consents or is paid in full.<sup>288</sup>

Some commentators have argued that if the gifting takes place outside the confines of the plan, it should not run afoul of *DBSD*. In a recent article, Marc Abrams and Ana Alfonso cited *In re Journal Register Co.* as an example of a “gifting arrangement that entailed a distribution outside of a plan that was implemented in tandem with the plan and fully disclosed to the bankruptcy court and parties in interest.”<sup>289</sup> In *Journal Register*, the court examined whether the fact that certain plan provisions “facilitated” the gift, and provided that it was a “means of execution” of the plan, constituted sufficient grounds to invalidate the gift.<sup>290</sup> The court reasoned that these facts did not implicate the classification scheme (or the absolute priority rule).<sup>291</sup> The *Journal Register* court also noted if the gift provisions were removed from the plan distributions, the recoveries of disfavored unsecured creditors would not have been increased.<sup>292</sup>

It is also important to note that the *DBSD* decision applies to cram-down situations only.<sup>293</sup> As a result, if every impaired class votes to accept the plan, gifting by senior creditors clearly would be an option.<sup>294</sup> Because of *DBSD*, however, any class between the senior gifting class and the junior class receiving the gift will have more negotiating power than in the pre-*DBSD* world.<sup>295</sup> This is

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287. John J. Rapisardi, *Second Circuit Disapproves of Gifting, Affirms Designation in ‘DBSD,’* 245 N.Y. L. J. 86 (2011).

288. See *DISH Network Corp.*, 634 F.3d at 97.

289. Marc Abrams & Ana Alfonso, *Second Circuit Court of Appeals Holds “Gift” from Secured Creditor to Shareholder Under a Chapter 11 Plan Violates Absolute Priority Rule*, THE METRO. CORP. COUNSEL, Apr. 2011, at 46 (citing *In re Journal Register Co.*, 407 B.R. 520 (Bankr. S.D.N.Y. 2009)).

290. *In re Journal Register Co.*, 407 B.R. at 533.

291. *Id.*

292. *Id.*

293. See *DISH Network Corp.*, 634 F.3d at 105.

294. *Id.* at 105–06 (quoting 11 U.S.C. § 1126(c) (2006)).

295. *Id.*

because these intermediate classes now can defeat any such gift simply by voting against the plan, at least in the Second Circuit.<sup>296</sup>

## 2. Section 363 Asset Sales and Other Contexts

As noted, the Second Circuit's opinion in *DBSD* only addressed the applicability of gifting in the context of confirming a cram-down plan of reorganization.<sup>297</sup> The *DBSD* opinion leaves unanswered questions related to whether carve-outs or gifts that are created in other ways in a bankruptcy case, such as in an order approving a sale under section 363 of the Bankruptcy Code, are permitted.<sup>298</sup>

In view of the growing trend toward disposition of Chapter 11 cases through section 363 sales, it is likely that the *DBSD* holding may force debtors to recast reorganizational structures like the one advanced by *DBSD* as section 363 sales. If that occurs, it could force the Second Circuit to address the additional question of whether, in the post-*DBSD* world, the priority scheme of the Bankruptcy Code should be imposed to prohibit all gifts and carve-outs in a bankruptcy case.

## VIII. 2010 REVISIONS TO UCC ARTICLE 9—DEBTOR NAME CLARIFICATION<sup>299</sup>

### A. Introduction

One of the most vexing UCC Article 9 issues that remained unresolved after the 1998 uniform text revisions was the treatment of individual names on financing statements.<sup>300</sup> A focus of the 1998 revisions was to clarify the treatment of corporate names and other “registered organizations” as defined at UCC section 9-102(a)(71),<sup>301</sup> however, many agricultural operations and small businesses are still conducted by individual farmers, ranchers, or other proprietors. Trusts and various types of registered organizations (such as LLCs, see above at

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296. See *id.*

297. See *id.* at 105.

298. *DISH Network Corp.*, 634 F.3d at 79.

299. This discussion is indebted to Alvin C. Harrell, *The 2010 Amendments to the Uniform Text of Article 9*, 65 CONSUMER FIN. L.Q. REP. 138 (2011).

300. See U.C.C. § 9-503 (2011) (providing that a financing statement sufficiently provides the name of a debtor if it provides the individual name of the debtor).

301. Harrell, *supra* note 299, at 138; see U.C.C. §§ 9-102(a)(71), 9-102 cmt. 11 (defining registered organizations; the 2010 amendments revise the definition of “registered organization”).

Part V) are also common in agricultural financing. The 2010 amendments to the uniform text of UCC Article 9 are heavily focused on addressing these issues.<sup>302</sup>

This project to revise the uniform text of Article 9 (Secured Transactions) began in 2008 when the Uniform Law Commission (ULC)<sup>303</sup> and the American Law Institute (ALI) established a Joint Review Committee (JRC) to consider the need for possible revisions to the uniform text.<sup>304</sup> The JRC was chosen as the vehicle, rather than a drafting committee, because it was intended to cover only limited issues and no policy matters were to be addressed.<sup>305</sup> The JRC was given the mandate of addressing “ambiguities and propos[ing] clarifications as needed.<sup>306</sup> There was a stated preference for making changes to Official Comments [(Comments)] rather than the statutory text where possible.”<sup>307</sup>

As a result, in general the 2010 changes to the uniform text of Article 9 (the 2010 Amendments) are relatively modest. Since the state legislatures generally enact only the statutory text and not the Comments, the discussion below focuses on the 2010 Amendments to the uniform text.<sup>308</sup> In some instances, however, the only changes appear in the proposed 2010 Comments; therefore, some attention is directed at these as well. Moreover, the JRC’s emphasis on the Comments means that the Article 9 Comments, along with any supplementary, state-specific Comments that may be added, such as by state Bar Association legislative review committees,<sup>309</sup> may take on increased importance as to the issues addressed by the JRC.

While a variety of issues are addressed in the 2010 Amendments, in the text or Comments, probably the one with the most common application is the issue of the debtor’s name on a financing statement, which affects whether the

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302. See Harrell, *supra* note 299, at 138.

303. *Id.* Formerly known as the National Conference of Commissioners on Uniform State Laws or NCCUSL.

304. *Id.*

305. *Id.*

306. *Id.*

307. *Id.*

308. At the time of this Article, the 2010 Amendments to UCC Article 9 have been enacted in the following states: Indiana, Minnesota, Nebraska, Nevada, North Dakota, Texas, and Washington. *2010 Amendments to UCC Article 9 Enacted in Seven States*, UNIFORM LAW COMMISSION (June 15, 2011),

<http://www.uniformlaws.org/NewsDetail.aspx?title=2010%20Amendments%20to%20UCC%20Article%209%20Enacted%20in%20Seven%20States>. Enactments are pending in Oklahoma and a number of other states. See *id.*

309. See, e.g., Fred H. Miller & Robert T. Luttrell, *Local Comments to Uniform Laws: A Winning Combination*, 48 CONSUMER FIN. L.Q. REP. 60, 60 (1994).

security interest is perfected (and therefore enforceable in bankruptcy).<sup>310</sup> The primary aspects of the 2010 Amendments on this issue are noted below.

## B. *The Debtor's Name on a Financing Statement*

### 1. *Individual Debtors*

This is one of the most litigated issues under UCC Article 9.<sup>311</sup> As noted, the names of individual debtors have proved particularly challenging. As a result, the JRC devoted considerable attention to this issue. The basic thrust of the 2010 Amendments is to provide a statutory requirement based on the individual debtor's name as shown on an unexpired state-issued driver's license.<sup>312</sup> If the debtor does not have a driver's license, the financing statement is sufficient for perfection "only if the financing statement provides the individual name of the debtor or the surname and first personal name of the debtor . . . ."<sup>313</sup> If the state has issued more than one driver's license or identification card as described in

310. U.C.C. § 9-503, 9-503 cmt. 2 (2011); Harrell, *supra* note 299 at 138–39.

311. See, e.g., Hastings State Bank v. Stalnaker (*In re EDM Corp.*), 431 B.R. 459, 463–64 (B.A.P. 8th Cir. 2010); Farmers & Merchs. State Bank v. Larsen (*In re Larsen*), 2010 WL 909138, at \*2–3 (Bankr. S.D. Iowa 2010); Bankr. Estate of Wing Foods, Inc. v. CCF Leasing Co. (*In re Wing Foods, Inc.*), No. 09-40154-JDP, 2010 WL 148637, at \*5 (Bankr. D. Idaho 2010); Owens Trust v. Schwalbe (*In re Lohrey Enters., Inc.*), 2010 WL 147916, at \*2 (Bankr. N.D. Cal. 2010). In Part VIII., "current" or "old" Article 9 or "the existing text" refers to the uniform text as approved by the ALI and NCCUSL in 1998, with conforming and subsequent technical amendments, which was enacted and became effective in most U.S. jurisdictions on July 1, 2001 (the 2010 uniform text). See U.C.C. § 9-101 cmt. 4. References to "new" or "revised" material indicate the 2010 amendments. Material that is unchanged is indicated merely by the section or comment number. The 2010 amendments are not included in the 2010 uniform text, but are included in the 2011 uniform text.

312. See U.C.C. § 9-503(a)(4) (noting the 2010 amendments); H.B. 1833, 53d Leg., 1st Sess. (Okla. 2011) (proposing Alternative A from the uniform text).

313. See the 2010 Amendments at U.C.C. § 9-503(a)(5) alt. A; see H.B. 1833, 53d Leg., 1st Sess. (Okla. 2011); see also U.C.C. § 9-503 cmt. 2(d). As an interesting adjunct to these section 9-503 changes, the 2010 Amendments include revisions to section 9-502(c) (recording a mortgage in the real property records as a financing statement). See U.C.C. § 9-502(c)(3). These 2010 Amendments provide that: (1) the record (mortgage) filed pursuant to this subsection "need not indicate that it is to be filed in the real property records"; and (2) the record (mortgage) sufficiently provides the name of an individual debtor if it indicates the debtor's "individual name" or "surname and first personal name . . . even if the debtor is an individual to whom section 9-503(a)(4) applies . . ." *Id.* This recognizes that precise debtor names are not so important in the real estate records, which are commonly indexed by legal description, and therefore the precision otherwise required under section 9-503(a)(4) is not needed in this context. See *id.*

revised section 9-503(a)(4),<sup>314</sup> the secured party must use the “most recently” issued license or card.<sup>315</sup>

If the debtor is a decedent’s estate, the financing statement must provide the name of the decedent<sup>316</sup> and indicate (“in a separate part of the financing statement”) that the collateral is being administered by a personal representative.<sup>317</sup>

## 2. *Name of Registered Organization*

Although the 1998 revision to the uniform text of section 9-503 was directed in large measure at providing specific rules for “registered organizations,”<sup>318</sup> some problems still remain. For example, what if the debtor’s name as shown in the records of the Secretary of State is different from that in the Articles of Incorporation or Articles of Organization for an LLC? Or, what if those records are not publicly available, or are available only in truncated form? The 2010 Amendments to section 9-503(a)(1) answer these questions, specifying that, if the debtor is a registered organization, the debtor’s name on the financing statement is sufficient only if it “provides the name that is stated to be the registered organization’s name on the public organic record most recently filed with or issued or enacted by the registered organization’s jurisdiction of organization which purports to state, amend, or restate the registered organization’s name . . . .”<sup>319</sup> This makes clear that the secured party cannot rely on secondary or truncated sources but may rely on a primary source such as the state-issue certificate or filed articles of incorporation, or in the case of LLCs, filed articles of organization.<sup>320</sup>

## 3. *Trusts*

In the 2010 Amendments, extensive attention was also directed at trusts as debtors. Section 9-503(a)(3) was completely rewritten to provide that, “if the

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314. See *id.* § 9-503(a)(4) (showing Alternative A in the uniform text); see also H.B. 1833, 53d Leg., 1st Sess. (Okla. 2011).

315. U.C.C. § 9-503(g) alt. A.

316. See *id.* § 9-503(f). The name of the decedent as shown on the order appointing the personal representative is sufficient. *Id.*

317. *Id.* §§ 9-503(a)(2), 9-503 cmt. 2(c), 9-506 cmt. 2.

318. See *id.* § 9-102(a)(71) (revised definition of “registered organization”); see also *id.* § 9-102(a)(68) (reused definition of “public organic record”).

319. *Id.* § 9-503(a)(1); see *id.* §§ 9-503(a)(6) alt. A, 9-102 cmt. 11 (noting that not every organization with information about itself in public record is a “registered organization”).

320. See *id.* § 9-503(a)(1).

collateral is held in a trust that is not a registered organization,” the name of the debtor is that specified in the “organic record of the trust”<sup>321</sup> or, if no such name is specified, “the name of the settlor or testator . . . .”<sup>322</sup> In addition, a separate part of the financing statement must include an indication that the collateral is held in trust, and information must be provided to sufficiently distinguish the trust from other trusts of the same settlor or testator.<sup>323</sup> The “name of the settlor or testator” is defined to mean the name specified in the trust’s organic record or, if the settlor is a registered organization, the name specified in the organization’s organic record.<sup>324</sup>

## IX. CREDIT BIDDING IN BANKRUPTCY CASES

### A. *Credit Bid Protection for Secured Parties*

Another issue that affects the enforcement of a security interest in bankruptcy is the ability of a secured party to protect the value of its claim by “bidding” to purchase the collateral in any proposed sale by the bankruptcy trustee.<sup>325</sup> Secured parties have traditionally been able to “credit bid” their secured claims at sales conducted under the Bankruptcy Code.<sup>326</sup> A credit bid allows the secured party’s bid at a collateral disposition sale to be funded by an offset against the secured debt.<sup>327</sup> The credit bid authority comes from Bankruptcy Code section 363(k) and was previously effectuated in Chapter 11 cases via section 1129(b)(2)(A)(ii) and (iii).<sup>328</sup> The ability to credit bid is viewed as an additional layer of protection for a secured party’s claim because, at the end of the day, the secured party can better control disposition of the collateral asset, including any

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321. *Id.* § 9-503(a)(3) (meaning the trustees as named in the trust agreement); *see id.* §§ 9-503(a)(6) alt. A, 9-102 cmt. 11 (explaining that “when collateral is held in a trust, one must look to non-U.C.C. law to determine whether the trust is a “registered organization”).

322. *Id.* §§ 9-503(a)(3)(A)(ii), 9-503 cmt. 2(b) (listing alternatives for providing the name of an organizational debtor in a financing statement).

323. *Id.* § 9-503(a)(3)(B).

324. *Id.* § 9-503(h); *see id.* § 9-102 cmt. 11 (explaining that when collateral is held in trust, it is necessary to look to non-UCC law to determine whether it is a “registered organization”).

325. 11 U.S.C. § 363(k) (2006).

326. *See id.*

327. *Id.*

328. *See id.* §§ 363(k), 1129(b)(2)(A)(ii)–(iii). In fact, the right to credit bid in bankruptcy has its roots in early Bankruptcy Act cases (in addition to state real property law). For example, in *In re Harralson*, 179 F. 490 (8th Cir. 1910), the United States Court of Appeals for the Eighth Circuit held that credit bidding was permitted: “It would have been a useless ceremony for [the mortgagee/purchaser] to pay the \$1,500 [sic] into court and then have it repaid him after credit on his allowed claim.” *Id.* at 493.

increase in its value.<sup>329</sup> Until recently, as noted below at Part IX. C., this protection has been subject to uncertainty due to a split between U.S. courts of appeals.

## B. Credit Bidding is Generally Permitted in Bankruptcy

### 1. Sales Outside of a Plan

Under section 363 of the Bankruptcy Code, a trustee in bankruptcy (including a debtor in possession)<sup>330</sup> may sell property of the bankruptcy estate outside of the ordinary course of business, subject to approval of the court after notice and a hearing.<sup>331</sup> It is well settled that a decision to sell assets outside the ordinary course of business is to be based upon the sound business judgment of the trustee and justified with a good business reason.<sup>332</sup>

Bankruptcy Code section 363(k) provides specific statutory authority allowing a secured party to credit bid its allowed claim at a sale outside the ordinary course of business:

(k) At a sale under subsection (b) of this section of property that is subject to a lien that secures an allowed claim, unless the court for cause orders otherwise the holder of such claim may bid at such sale, and, if the holder of such claim purchases such property, such holder may offset such claim against the purchase price of such property.<sup>333</sup>

Although a court can deny the secured party the right to credit bid for cause, credit bidding is rarely prohibited. Moreover, the United States Court of

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329. See 11 U.S.C. § 363(k).

330. See *id.* § 1107(a).

331. *Id.* § 363(b)(1).

332. See, e.g., *Licensing by Paolo, Inc. v. Sinatra (In re Gucci)*, 126 F.3d 380, 387 (2d Cir. 1997) (citing *In re Lionel Corp.*, 722 F.2d 1063, 1071 (2d Cir. 1983) (“A sale of a substantial part of a Chapter 11 estate . . . may be conducted if a good business reason exists to support it.”)); *Myers v. Martin (In re Martin)*, 91 F.3d 389, 395 (3d Cir. 1996) (citing *Fulton State Bank v. Schipper (In re Schipper)*, 933 F.2d 513, 515 (7th Cir. 1991)); Official Comm. of Unsecured Creditors of LTV Aerospace & Def. Co. v. LTV Corp. (*In re Chateaugay Corp.*), 973 F.2d 141, 143 (2d Cir. 1992); *Stephens Indus., Inc. v. McClung*, 789 F.2d 386, 390 (6th Cir. 1986) (stating “a bankruptcy court can authorize a sale of all a Chapter 11 debtor’s assets under section 363(b)(1) when a sound business purpose dictates such action.”); Comm. of Equity Sec. Holders v. Lionel Corp. (*In re Lionel Corp.*), 722 F.2d 1063, 1070 (2d Cir. 1983); Comm. of Asbestos-Related Litigants and/or Creditors v. Johns-Manville Corp. (*In re Johns-Manville Corp.*), 60 B.R. 612, 616 (Bankr. S.D.N.Y. 1986) (“Where the debtor articulates a reasonable basis for its business decisions (as distinct from a decision made arbitrarily or capriciously), courts will generally not entertain objections to the debtor’s conduct” (citing *In re Curlew Valley Assoc.*, 14 B.R. 506, 513 (Bankr. D. Utah 1981))).

333. 11 U.S.C. § 363(k).

Appeals for the Third Circuit has held that a secured party may bid the total amount of its allowed claim and not just the value of its secured claim as determined under Bankruptcy Code section 506(a).<sup>334</sup>

## 2. Sales Pursuant to a Plan

A second way a debtor can sell assets of the bankruptcy estate is to propose a sale under plan of reorganization.<sup>335</sup> Bankruptcy Code section 1123(b)(4) provides the authority for a plan to “provide for the sale of all or substantially all of the property of the estate, and the distribution of the proceeds of such sale among holders of claims or interests . . . .”<sup>336</sup> If all creditors agree with the sale plan it can easily be confirmed under section 1129(a).<sup>337</sup> But if a creditor objects to the sale plan, and the debtor desires to “cram-down” confirmation of the sale plan over the creditor’s objection, the plan must comply with section 1129(b)(2)(A), which provides:

(2) For the purpose of this subsection, the condition that a plan be fair and equitable with respect to a class includes the following requirements:

(A) With respect to a class of secured claims, the plan provides—

(i)(I) that the holders of such claims retain the liens securing such claims, whether the property subject to such liens is retained by the debtor or transferred to another entity, to the extent of the allowed amount of such claims; and

(II) that each holder of a claim of such class receive on account of such claim deferred cash payments totaling at least the allowed amount of such claim, of a value, as of the effective date of the plan, of at least the value of such holder’s interest in the estate’s interest in such property;

(ii) for the sale, subject to *section 363(k)* of this title, of any property that is subject to the liens securing such claims, free and clear of such liens, with such liens to attach to the proceeds of such sale, and the treatment of such liens on proceeds under clause (i) or (iii) of this subparagraph; *or*

(iii) for the realization by such holders of the *indubitable equivalent* of such claims.<sup>338</sup>

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334. *Id.* § 506(a); see *Cohen v. KB Mezzanine Fund II, LP (In re SubMicron Sys. Corp.)*, 432 F.3d 448, 459–60 (3d Cir. 2006). *But see In re Phila. Newspapers*, 599 F.3d 298, 304–18 (3d Cir. 2010).

335. *See* 11 U.S.C. § 1123(b)(4).

336. *Id.*

337. *See id.* § 1129(a).

338. *Id.* § 1129(b)(2) (emphasis added).

Section 1129(b) sets forth the criteria under which a Chapter 11 plan may be “crammed down” over the objection of a dissenting impaired class if, in addition to obtaining the acceptance of an impaired non-insider class, “the plan does not discriminate unfairly, and is fair and equitable . . . .”<sup>339</sup> Section 1129(b)(2)(A), as set forth above, describes what it means for a plan to be fair and equitable with respect to a secured class.<sup>340</sup>

The secured party has credit bid protection if the plan proposes a sale of the secured party’s collateral under section 1129(b)(2)(A)(ii), because it is expressly subject to section 363(k), as indicated in the statutory text excerpted above.<sup>341</sup> Courts rarely disallow this statutory right to credit bid under this Bankruptcy Code provision; otherwise the plan is not considered “fair and equitable,” nor “proposed in good faith,” and both findings are required to confirm a plan.<sup>342</sup> Secured parties have traditionally argued that they are entitled to credit bid at any sale under this provision because the right to credit bid provides them the “indubitable equivalent” of such claim.

### C. *Whether the Right to Credit Bid is Guaranteed in All Sales Under a Plan Has Been Uncertain*

#### 1. *Pacific Lumber and Philadelphia Newspapers Cases*

In recent years, some courts have held that if a debtor decides to sell its assets under a plan of reorganization, that sale could take place without providing the secured party an opportunity to credit bid.<sup>343</sup> Two United States courts of appeals have issued opinions changing the well-established practice of credit bidding. In *Bank of N.Y. Trust Co., N.A. v. Official Unsecured Creditors’ Comm. (In re Pacific Lumber Co.)* and *In re Philadelphia Newspapers*, the United States Courts of Appeals for the Fifth and Third Circuits, respectively, held that under certain circumstances, a secured party is not permitted to credit bid its secured

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339. *Id.* § 1129(b)(1). The term “cram-down” is a common colloquialism, but does not appear in the statute. *See id.*

340. *See id.* § 1129(b)(2)(A).

341. *See id.* § 1129(b)(2)(A)(ii).

342. *See, e.g.,* *John Hancock Mutual Life Ins. Co. v. Cal. Hancock, Inc. (In re Cal. Hancock, Inc.)* 88 B.R. 226, 230–31 (B.A.P. 9th Cir. 1988); *Aetna Realty Investors, Inc. v. Monarch Beach Venture, Ltd. (In re Monarch Beach Venture, Ltd.)*, 166 B.R. 428, 433 (C.D. Cal. 1993); *In re 222 Liberty Assocs.*, 108 B.R. 971, 979 (Bankr. E.D. Pa. 1990).

343. *See In re Phila. Newspapers*, 599 F.3d 298, 318 (3d Cir. 2010); *Bank of N.Y. Trust Co. v. Official Unsecured Creditors’ Comm. (In re Pacific Lumber Co.)*, 584 F.3d 229, 243 (5th Cir. 2009). In 2012 the United States Supreme Court rejected this view. *See infra* this text at note 391.

claim at a sale.<sup>344</sup> These courts interpreted the three prongs of Bankruptcy Code section 1129(b)(2)(A), which are listed in the disjunctive, to provide that a debtor under certain circumstances can confirm a sale plan under the third “indubitable equivalent prong” while precluding a secured party from exercising its credit bid rights.<sup>345</sup>

## 2. *Pacific Lumber*

The United States Court of Appeals for the Fifth Circuit was the first circuit court to deny a noteholder the right to credit bid on its secured debt.<sup>346</sup> In *Pacific Lumber*, there were two competing plans of reorganization: one was proposed by an indenture trustee, and the other was a joint plan proposed by a secured party and a competitor (the Creditor Plan).<sup>347</sup> The Creditor Plan did not allow the noteholders to credit bid their debt.<sup>348</sup> One of the central issues regarding confirmation of the Creditor Plan was the valuation of the collateral securing the noteholder’s claim.<sup>349</sup> The bankruptcy court confirmed the Creditor Plan.<sup>350</sup> The noteholders and indenture trustee obtained a certification for appeal to the Fifth Circuit, but stay was denied pending appeal.<sup>351</sup> The relevant issue raised on appeal was whether the Creditor Plan was “fair and equitable” because it did not allow the noteholders to credit bid their claim in connection with the sale of their collateral.<sup>352</sup>

The noteholders argued that the Creditor Plan violated their rights as imbedded in Bankruptcy Code section 1129(b), in the absolute priority rule, and the fair and equitable standard for the treatment of claims in a Chapter 11 reorganization.<sup>353</sup> The Fifth Circuit noted that “the Bankruptcy Code requires a reorganization plan either to rest on the agreement of each class of creditors or to protect creditor classes according to the absolute priority rule, which enforces a strict hierarchy of their rights defined by state and federal law,”<sup>354</sup> and “a plan [must] be ‘fair and equitable, with respect to each class of claims of interest that

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344. *In re Pac. Lumber*, 584 F.3d at 246; see *In re Phila. Newspapers*, 599 F.3d at 318.

345. *In re Phila. Newspapers*, 599 F.3d at 310; *In re Pac. Lumber*, 584 F.3d at 245–46.

346. *In re Pac. Lumber*, 584 F.3d at 243.

347. *Id.* at 237.

348. *Id.* at 242–43.

349. *Id.*

350. *Id.* at 237.

351. *Id.* at 239.

352. *Id.*

353. *Id.* at 239, 243.

354. *Id.* at 244.

is impaired under, and has not accepted, the plan.”<sup>355</sup> The Fifth Circuit determined that the three subsections of section 1129(b)(2)(A) are “joined by the disjunctive ‘or’ [so] they are alternatives.”<sup>356</sup>

The Fifth Circuit held that the creditor plan could be confirmed if the noteholders obtained the indubitable equivalent of the value of their collateral, and determined that the abandonment of collateral to a class or granting a class a replacement lien would be the indubitable equivalent.<sup>357</sup> The Fifth Circuit reasoned that what is really at stake is the “repayment of principal and the time value of money,” so that paying creditors in cash is “hardly improper” as long as the value of the collateral is accurately reflected.<sup>358</sup> The court concluded that there is nothing in the Bankruptcy Code that “protect[s] a creditor’s upside potential; it [only] protects the [amount of a secured creditor’s] ‘allowed secured claim.’”<sup>359</sup> In the Fifth Circuit’s view, an oversecured creditor cannot keep collateral just to protect its upside potential, so neither can an undersecured creditor.<sup>360</sup>

### 3. *Philadelphia Newspapers*

In *Philadelphia Newspapers*, the debtors filed a plan of reorganization (Plan) which provided for a sale of all of the debtors’ assets “free and clear” of liens and encumbrances.<sup>361</sup> The Plan called for the secured parties to receive cash and the real estate housing the debtors’ headquarters.<sup>362</sup> After any such sale of the assets, however, the debtors were to receive a two-year, rent-free lease in the headquarters property.<sup>363</sup> In its bid procedures motion, the debtors sought to prevent the secured parties from using their secured claim to credit bid at the sale.<sup>364</sup> The debtors’ argument for this provision was that the sale was being conducted pursuant to the Plan under section 1123(a) and (b) rather than section 363 of the Bankruptcy Code.<sup>365</sup>

The bankruptcy court refused to approve the Plan, which precluded the secured parties from credit bidding, reasoning that even though the Plan proposed

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355. *Id.* (quoting 11 U.S.C. § 1129(b)(1) (2006)).

356. *Id.* at 245.

357. *Id.* at 246.

358. *Id.* at 246–47.

359. *Id.* at 247; *see* 11 U.S.C. § 1129(b) (2006).

360. *In re Pac. Lumber*, 584 F.3d at 247. *But see* 11 U.S.C. § 1111(b)(1)(A).

361. *In re Phila. Newspapers*, 599 F.3d 298, 301 (3d Cir. 2009).

362. *Id.* at 302.

363. *Id.*

364. *Id.*

365. *Id.*

to proceed under the section 1129(b)(2)(A)(iii) “indubitable equivalent” prong, “it was structured as a § 1129(b)(2)(A)(ii) plan sale in every respect other than credit bidding.”<sup>366</sup> The bankruptcy court read section 1129(b)(2)(A) together with sections 1111(b) and 363(k) in concluding that secured parties must be permitted to credit bid their secured claims at the sale.<sup>367</sup>

The United States Court of Appeals for the Third Circuit applied what it characterized as a “plain meaning” approach to the statutory interpretation of section 1129(b)(2)(A).<sup>368</sup> The Third Circuit found that the three prongs of section 1129(b)(2)(A)(i)–(iii) are “phrased in the disjunctive.”<sup>369</sup> Therefore, the court concentrated on the word “or” separating subsections (ii) and (iii).<sup>370</sup>

The Third Circuit found that it “ha[d] no statutory basis to conclude that [section 1129(b)(2)(A)(ii)] is the *only* provision under which a debtor may propose to sell its assets free and clear of liens.”<sup>371</sup> The court opined that “[w]hile the reasoning in the myriad cases touching upon this issue is *admittedly inconsistent*, no case cited by the Lenders reaches the conclusion they advance here: that credit bidding is required when confirmation is sought under subsection (iii).”<sup>372</sup>

Tellingly, in *Philadelphia Newspapers* the Third Circuit characterized the secured parties’ arguments as entitling them to “a potential upside in the collateral,” and then concluded that “an absolute right to such preferential treatment is plainly contrary to other provisions of the [Bankruptcy] Code . . . .”<sup>373</sup> The *Pacific Lumber* court had made the same point, finding that “[t]he Bankruptcy Code . . . does not protect a secured creditor’s upside potential; it [merely] protects the ‘allowed secured claim.’”<sup>374</sup>

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366. *Id.*

367. *Id.* at 302–03.

368. *Id.* at 304.

369. *Id.* at 305.

370. *Id.*

371. *Id.* at 308 (emphasis added).

372. *Id.* at 312 (emphasis added). Even before *Philadelphia Newspapers*, a court had the right to preclude credit bidding “for cause” under Bankruptcy Code section 363. 11 U.S.C. § 363(k) (2006). What constitutes cause for precluding a secured creditor’s right to credit bid under section 363(k) is within the discretion of the court; such “causes” have included the court’s finding that a credit bid would chill competitive bidding, deprive creditors of equal priority rights, or where there is a dispute as to the priority or validity of the secured party’s claim or enforceability of its lien. *Id.*; see *Calpine Corp. v. O’Brien Envtl. Energy, Inc.* (*In re O’Brien Envtl. Energy, Inc.*), 181 F.3d 527, 529, 537–38 (3d Cir. 1999); *In re 222 Liberty Assocs.*, 108 B.R. 971, 998 (Bankr. E.D. Pa. 1990); *In re Waterways Barge P’ship*, 104 B.R. 776 (Bankr. N.D. Miss. 1989).

373. *In re Phila. Newspapers*, 599 F.3d at 298, 316.

374. *Bank of N.Y. Trust Co., N.A. v. Official Unsecured Creditors’ Comm.* (*In re Pac. Lumber*), 584 F.3d 229, 247 (5th Cir. 2009).

In its conclusion in *Philadelphia Newspapers*, the Third Circuit held that a secured party's ability to bid the amount of its claim is not an absolute prerequisite to a finding of indubitable equivalence.<sup>375</sup> The court observed that, at the Plan confirmation hearing, it could consider and determine whether the secured parties had in fact received the indubitable equivalent of their claims.<sup>376</sup> The court stressed that its holding only prevented a secured party "from asserting that it has an absolute right to credit bid when its collateral is being sold pursuant to a plan of reorganization."<sup>377</sup>

The court in *Philadelphia Newspapers*, however, never reached the issue of whether the secured party would receive the indubitable equivalent of its claim at an auction where it was precluded from bidding the amount of its claim (because the secured parties prevailed at the sale with a cash bid);<sup>378</sup> consequently, the holding of the *Philadelphia Newspapers* decision is less sweeping than it might seem at first glance.

#### 4. *The Philadelphia Newspapers Dissent*

In a dissent which was to have a significant effect on a later court of appeals decision considering the same issue, Judge Thomas L. Ambro of the Third Circuit, a former bankruptcy practitioner and former Chair of the ABA Section of Business Law, wrote a lengthy and detailed objection to the majority opinion in *Philadelphia Newspapers*.<sup>379</sup> In his dissent, Judge Ambro framed the issue as "whether, when a plan provides for a sale of secured property free of liens, subsection (ii) [containing the reference to section 363(k)] is the *sole point of reference* for what is required to cram down a plan . . . ."<sup>380</sup>

In his dissent, Judge Ambro, opined that subsection 1129(b)(ii) is the sole reference point and incorporates the rights under section 363(k) for the benefit of the secured creditor.<sup>381</sup> He responded to the majority's "plain meaning" focus on the word "or" in section 1129(b)(2)(A), by arguing that "we 'do not read the [Bankruptcy Code] with the ease of a computer.'" <sup>382</sup> Judge Ambro reasoned that a "more plausible" and "longer lived" reading of section 1129(b)(2)(A) should take into account the fact that "a court 'must not be guided

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375. *In re Phila. Newspapers*, 599 F.3d at 318.

376. *Id.* at 302–03.

377. *Id.* at 317.

378. *See id.*

379. *Id.* at 319 (Ambro, J., dissenting).

380. *Id.* at 322 (emphasis added).

381. *See id.* at 338.

382. *Id.* at 324 (brackets in original) (quoting *Kelly v. Robinson*, 479 U.S. 36, 49 (1986)).

by a single sentence . . . but [it should] *look to the provisions of the whole law and to its object and policy.*”<sup>383</sup>

Judge Ambro’s reading of other sections of the Bankruptcy Code relating to plan sales of collateral, such as sections 1111(b) and 363(k), convinced him that these sections support an interpretation of section 1129(b)(2)(A) which requires section 363(k) to apply to section 1129(b)(2)(A)(iii).<sup>384</sup> To bolster this holistic approach to statutory interpretation, Judge Ambro quoted the legislative history: “‘Together with section 1111(b) . . . , this section [1129(b)] provides when a plan may be confirmed notwithstanding the failure of an impaired class to accept the plan under section 1129(a)(8). Before discussing section 1129(b)[,] an understanding of section 1111(b) is necessary.’”<sup>385</sup>

Judge Ambro saw this as a call to read section 1129(b)(2)(A) as a “‘complement to § 1111(b).”<sup>386</sup> This reading of section 1129(b)(2)(A) in the context of other sections of the Bankruptcy Code reinforced Judge Ambro’s analysis that the word “or” contained in section 1129(b)(2)(A) could not be read to mean that the debtor could pick freely among the three “options” contained in section 1129(b)(2)(A)(i)–(iii).<sup>387</sup>

Judge Ambro’s dissent also took into account actual practice since the Bankruptcy Code was drafted: “‘We have ‘been admonished not to read the Bankruptcy Code to erode past bankruptcy practice absent a clear indication that Congress intended such a departure.’”<sup>388</sup> In other words, because the vast majority of case law since the enactment of the Bankruptcy Code has interpreted section 1129(b)(2)(A) to require that a secured creditor be permitted to credit bid its claim, even a court of appeals should not change that practice merely because of its own attachment to a “‘plain meaning” approach to statutory interpretation.”<sup>389</sup>

Apart from the practical implications of the majority’s reading, the dissent read Bankruptcy Code sections 1129(b)(2)(A), 363(k), and 1111(b) together, which Judge Ambro asserted represent a:

comprehensive arrangement enacted by Congress to avoid the pitfalls of undervaluation . . . and thereby insure that the rights of secured creditors are protected while maximizing the value of the collateral to the estate and minimizing deficiency claims against other unencumbered [property].

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383. *Id.* at 328 (quoting *Kelly*, 479 U.S. at 43) (emphasis added).

384. *Id.* at 333.

385. *Id.* at 335 (quoting 124 Cong. Rec. 31,406 (1978)).

386. *Id.*

387. *See id.* at 325.

388. *Id.* at 335 (quoting *Centerpoint Props. v. Montgomery Ward Holding Corp. (In re Montgomery Ward Holding Corp.)*, 268 F.3d 205, 211 (3d Cir. 2001)).

389. *Id.* at 336.

Taken as a whole, the Code supports the reading that funnels all plan sales free of liens into clause (ii).<sup>390</sup>

5. *Another Court of Appeals Weighs in on Credit Bidding; Supreme Court Decides the Issue*

The United States Court of Appeals for the Seventh Circuit recently addressed the credit bidding issue in *River Road Hotel Partners, LLC v. Amalgamated Bank (In re River Road Hotel Partners, LLC)*; the United States Supreme Court granted certiorari and in May 2012 affirmed the decision of the Seventh Circuit.<sup>391</sup> *River Road* involved two separate bankruptcy cases (River Road Hotel Partners and RadLAX Gateway Hotel, LLC, together, the “Debtors”), each involving a hotel which failed to obtain the financing needed to keep it operating.<sup>392</sup> Both Debtors filed Chapter 11 petitions in August 2009.<sup>393</sup> Amalgamated Bank was the administrative agent and trustee of each project’s secured parties.<sup>394</sup> Both Debtors filed plans on June 4, 2010, that called for, among other things, the sale of encumbered assets free and clear of liens, without allowing their secured parties to credit bid at the auctions.<sup>395</sup>

Bankruptcy Court Judge Bruce W. Black, in an October 5, 2010 Order Denying Debtors’ Bid Procedures Motion, expressly prohibited the Debtors from using section 1129(b)(2)(A)(iii) to “circumvent the [secured parties’] right to credit bid.”<sup>396</sup> During an August 30, 2010 court hearing, in response to counsel’s remark that the dissent in *Philadelphia Newspapers* was “quite elaborate” and “got it right,” the Judge responded: “I keep reading [the dissent] and it keeps sounding better all the time.”<sup>397</sup>

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390. *Id.* at 334.

391. *River Rd. Hotel Partners, LLC v. Amalgamated Bank, (In re River Rd. Hotel Partners, LLC)* 651 F.3d 642 (7th Cir. 2011), *cert. granted sub nom.* *RadLAX Gateway Hotel, LLC v. Amalgamated Bank*, 132 S. Ct. 845 (2011). The case nickname comes from Radisson Hotel at Los Angeles International Airport (LAX). On May 29, 2012 the United States Supreme Court issued its decision, holding that debtors may not sell estate property free of liens without allowing the secured parties to credit bid pursuant to 11 U.S.C. § 1129(b)(2)(A)(ii). *RadLAX Gateway Hotel, LLC v. Amalgamated Bank*, No. 11–166 (U.S. May 29, 2012).

392. *See In re River Rd. Hotel*, 651 F.3d at 643–44.

393. *Id.* at 644.

394. *Id.*

395. *Id.* at 645.

396. Order Denying Debtors’ Bid Procedures Motion, *In re River Rd. Hotel Partners, LLC*, (No. 09-B-30029), 2010 WL 6634603 at \*2.

397. Transcript of Record at 6, *In re River Rd. Hotel Partners LLC.*, 2010 WL 6634603 (Bankr. N.D. Ill. 2011).

On November 4, 2010, Judge Black authorized the Debtors' Motion for Certification of Direct Appeal of that Order to the United States Court of Appeals for the Seventh Circuit (Seventh Circuit).<sup>398</sup> In affirming the bankruptcy court's decision, the Seventh Circuit found that the Debtors (and by extension, the *Philadelphia Newspapers* court's) "interpretation of [s]ection 1129(b)(2)(A) violates a cardinal rule of statutory construction."<sup>399</sup> The Seventh Circuit reasoned that a statute should be construed so that "no clause, sentence, or word shall be superfluous, void, or insignificant,"<sup>400</sup> in essence concluding that if the interpretation of section 1129(b)(2)(A)(iii) can be conducted in isolation (emphasizing the disjunctive, plain meaning of the word "or") then "it is difficult to see what, if any, significance *Subsection (ii)* can have."<sup>401</sup>

The Seventh Circuit also noted that prohibiting a secured party from credit bidding would conflict with Bankruptcy Code sections 363(k) and 1111(b), which ensure that secured parties are properly compensated, and would remove a "crucial check against undervaluation" of the collateral value.<sup>402</sup> All of these considerations led the Seventh Circuit to hold that a cram-down plan that calls for the sale of a secured party's collateral must allow that party to credit bid the amount of its debt.<sup>403</sup> As noted, on May 29, 2012 this decision was affirmed by the United States Supreme Court, firmly resolving this issue. As a result of the United States Supreme Court's decision, there is no longer a circuit split on the issue of a secured party's ability to credit bid at a sale pursuant to a confirmed plan.<sup>404</sup>

## X. WHAT CONSTITUTES "CONTROL" OF A DEPOSIT ACCOUNT FOR PURPOSES OF PERFECTION

### A. *The Law Governing "Control" of Deposit Accounts*

In any agricultural or business financing, the debtor's deposit accounts are likely to be an important asset and potential collateral. Under UCC Article 9, an effective security interest in a debtor's deposit account is likely to require per-

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398. *In re River Rd. Hotel*, 651 F.3d at 645.

399. *Id.* at 651.

400. *Id.* at 652 (quoting *Duncan v. Walker*, 533 U.S. 167, 174 (2001)); *see also* *Market Co. v. Hoffman*, 101 U.S. 112, 115–16 (1879) (stating "[a]s early as in Bacon's Abridgment, sect. 2, it was said that 'a statute ought, upon the whole, to be so construed that, if it can be prevented, no clause, sentence, or word shall be superfluous, void, or insignificant.'").

401. *In re River Rd. Hotel*, 651 F.3d at 652.

402. *Id.* at 651.

403. *Id.* at 653. *See also* subsequent case history, *supra* note 391.

404. *See supra* note 391.

fection by “control.” “Control” of a “deposit account” under Article 9 is highlighted in

- Section 9-104 (outlining requirements for control, including the secured party is the bank where the deposit is maintained, or by agreement of the secured party, debtor, and bank, or where the secured party becomes the bank’s customer),<sup>405</sup>
- Section 9-203(b)(3)(D) (outlining attachment by control),<sup>406</sup>
- Sections 9-310(b)(8), 9-312(b)(1), and 9-314 (outlining perfection by control),<sup>407</sup>
- Section 9-327 (outlining priority),<sup>408</sup>
- Section 9-341 (outlining a bank’s rights and duties).<sup>409</sup>

### B. Selected Cases

In *National Consumer Coop. Bank v. Morgan Stanley & Co.*, the debtor entered into a control agreement with a bank, creating a security interest in two of the debtor’s deposit accounts.<sup>410</sup> The agreement required the debtor to maintain a minimum aggregate balance of \$1,000,000 (subsequently lowered by the agreement to \$400,000).<sup>411</sup> When the balances declined to \$13,457.38, the bank

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405. U.C.C. § 9-104 (2011). The cases noted in Part X(B) are limited to issues regarding control of deposit accounts. *See id.* § 9-102(a)(29) (definition of “deposit account”). Additional issues may arise if the collateral is a certificate of deposit (CD). *See, e.g.*, *E53 Fed. Credit Union v. Perez (In re Perez)*, 440 B.R. 634, 640 (Bankr. D.N.J. 2010) (non-negotiable, non-transferable CD was a deposit account, not an instrument); *Flener v. Alexander (In re Alexander)*, 429 B.R. 876, 877 (Bankr. W.D. Ky. 2010) (electronic CDs); *Brown v. Nat’l City Bank*, No. H-10-009, 2010 WL 4683706, at \*1 (Ohio Ct. App. Nov. 19, 2010) (uncertificated CDs); *see also Fulcrum Fin. Inquiry, LLP v. NXTV, Inc.*, No. B218767, 2010 WL 3025802, at \*2 (Cal. Ct. App. Aug. 4, 2010) (ownership of the deposit account as control).

406. U.C.C. § 9-203(b)(3)(D).

407. *Id.* §§ 9-310(b)(8), 9-312(b)(1), 9-314.

408. *Id.* § 9-327; *see, e.g.*, *Platte Valley Bank v. Tetra Fin. Group, LLC*, No. 8:10CV59, 2011 WL 335595, at \*5 (D. Neb. Jan. 31, 2011) (holding bank with control over the deposit account was entitled to a priority over prior security interest in the deposit account as proceeds and original collateral); *LOL Fin. Co. v. Paul Johnson & Sons Cattle Co.*, 758 F. Supp. 2d 871, 874, 894 (D. Neb. 2010) (holding depository bank with control as to the deposit account had priority over a claim to the deposit account as proceeds from the sale of cattle); *Davis Forestry Prods., Inc. v. Downeast Power Co.*, 12 A.3d 1180, 1187 (Me. 2011) (citing U.C.C. § 9-341 cmt. 3 (2011) (holding that absent a control agreement, the depository bank had no obligation to follow the instructions of a non-bank secured party)).

409. U.C.C. § 9-341.

410. *Nat’l Consumer Coop. Bank v. Morgan Stanley & Co.*, No. 3:10cv434, 2010 WL 3975847, at \*1 (M.D. Pa. Oct. 8, 2010).

411. *Id.*

sued; the customer argued that the control agreement was not valid under UCC section 8-106(d)(2) because it did not reference “entitlement orders” as required by that provision.<sup>412</sup> The court seemed to have difficulty with this issue, though it ultimately rejected the debtor’s motion to dismiss on the secured party’s breach of contract claim.<sup>413</sup> The comment to Article 9 section 9-104 makes clear that section 8-106 does not apply to security interests in deposit accounts.<sup>414</sup>

In *Wiley v. Hicks*, a control agreement covering a deposit account was executed between a debtor, the bank, and a creditor.<sup>415</sup> The bank subsequently received a garnishment summons from a separate judgment creditor, which was refused.<sup>416</sup> The bank was then closed by the FDIC, and both the judgment creditor and the creditor with control claimed priority as to the funds in the deposit account.<sup>417</sup> The court held that the control agreement provided priority over the garnishment lien of the judgment creditor.<sup>418</sup> The court rejected the judgment creditor’s arguments that the control agreement was insufficient because: (1) it was undated; (2) it was not appropriately acknowledged by the bank; (3) it was “subservient” to the bank’s interest; and (4) the creditor with control was required to first exhaust its administrative remedies against the failed bank.<sup>419</sup> Notwithstanding the ruling sustaining the existence of the control agreement, the lack of date and signature would hardly be a “best practice.”

In *Arakaki v. C & S Electric, Inc. (In re C&S Electric, Inc.)*, a construction contractor, its subcontractor, and a materials supplier opened a joint checking account for the purpose of paying the supplier’s invoices.<sup>420</sup> The contractor was to pay the subcontractor who was to pay the supplier via the deposit account.<sup>421</sup> When a dispute arose and the subcontractor filed bankruptcy, the de-

412. *Id.* at \*2–4.

413. *Id.* at \*7.

414. U.C.C. § 9-104 cmt. 3 (2011); *see also, e.g.*, Harrell, *supra* note 299, at 144–45.

415. *Wiley v. Hicks*, No. 08-03056, 2010 U.S. Dist. LEXIS 101960, at \*4 (W.D. Ark. Sept. 24, 2010).

416. *Id.* at \*5.

417. *Id.* at \*6.

418. *Id.* at \*20; *see also* *Fifth Third Bank v. Peoples Nat’l Bank*, 929 N.E.2d 210, 217 (Ind. App. 2010) (allowing the customer to continue using the deposit account after the writ of garnishment was received did not negate the depository bank’s “control”); *Brown v. Nat’l City Bank*, No. H-10-009, 2010 WL 4683706, at \*5 (Ohio Ct. App. Nov. 19, 2010) (finding that “control” constituted perfection even though the customer retained possession of a certificate evidencing the deposit account); John Krahrmer, *2010–2011 UCC Update*, 65 CONSUMER FIN. L. Q. REP. 64, 71 (2011) (discussing *Fifth Third Bank*).

419. *Wiley*, 2010 WL 3829417, at \*\*16–20.

420. *Arakaki v. C & S Elec., Inc. (In re C & S Elec., Inc.)*, 433 B.R. 782, 785 (Bankr. D. Haw. 2010).

421. *Id.*

pository bank claimed a security interest in the deposit account to secure its loan to the subcontractor.<sup>422</sup> The court rejected this claim on grounds that, although a joint checking agreement can serve as a security agreement (with perfection by control), in this case the joint checking agreement did not contain language indicating such a intent.<sup>423</sup> Moreover, this was a “special” account,<sup>424</sup> established for the purpose of paying the supplier, so the subcontractor did not have sufficient rights in the collateral to support the bank’s claim.<sup>425</sup>

*Flener v. Alexander (In re Alexander)* involved an arrangement between a depository bank (debtor’s bank) and its debtor to place the debtor’s funds in federally-insured bank accounts through the Certificate of Deposit Account Registry Service (CDARS).<sup>426</sup> This involved the use of an intermediary bank to place certificates of deposit (CDs) in various participating banks, so that each deposit was within the FDIC insurance limit.<sup>427</sup> The intermediary bank was the record owner of the CDs, on behalf of the debtor.<sup>428</sup> When the CDs matured, the intermediary bank transferred the funds to the debtor’s bank, for deposit to the debtor’s deposit account.<sup>429</sup> The debtor’s bank set off the funds against a debt owed to the bank, claiming a security interest perfected by control.<sup>430</sup> When the debtor filed bankruptcy two weeks later, the bankruptcy trustee sought to avoid the set-off as a preferential transfer under the Bankruptcy Code section 547.<sup>431</sup> The court agreed, on grounds that the bank did not have continuous “control” while the funds were held by the other banks, and therefore the redeposit of the funds two weeks before bankruptcy constituted reperfecting by control within the ninety-day preference period and an improvement in position subject to avoidance under the Bankruptcy Code section 547.<sup>432</sup>

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422. *Id.*

423. *See id.* at 789; U.C.C. § 9-203(b)(3)(A) (2011) (listing requirements for security agreement).

424. *See In re C & S Elec., Inc.*, 433 B.R. at 790; *see also* MILLER & HARRELL, *supra* note 187, at 442–44.

425. *See In re C & S Elec., Inc.*, 433 B.R. at 790; *see also* MILLER & HARRELL, *supra* note 187, at 442–44.

426. *Flener v. Alexander (In re Alexander)*, 429 B.R. 876, 877 (Bankr. W.D. Ky. 2010).

427. *Id.*

428. *Id.* at 877–78.

429. *Id.* at 878.

430. *Id.*

431. *Id.* at 877; *see* 11 U.S.C. § 547(b)(4)–(5) (2006) (improvement in a transferee’s position during the ninety-day preference period before bankruptcy is avoidable as a preference).

432. *In re Alexander*, 429 B.R. at 878–80; *see* 11 U.S.C. § 547(b)(4)–(5). The *C & S* court also held that the bank’s description of the collateral in the security agreement was inadequate because it failed to describe the CDARS collateral as a “securities entitlement.” *See In re C & S Elec., Inc.*, 433 B.R. 782, 789 (Bankr. D. Haw. 2010); *see also* *Monticello Banking Co. v. Flener*, No. 1:10-CV-121-R, 2010 WL 5158989, at \*4 (W.D. Ky. Dec. 14, 2010) (concluding the descrip-

In *Joseph Stephens & Co. v. Cikanek*, the bank was recognized as having perfection by control by maintaining the debtor's deposit account.<sup>433</sup>

### C. Article 9 Section 9-332

Related issues may arise under UCC section 9-332, which provides that a transferee of money, or funds from a deposit account, takes free of a security interest in the money or deposit account unless the transferee "acts in collusion with the debtor in violating the rights of the secured party."<sup>434</sup> This is a rare example of a third party having priority over perfection by "control" (though it can be noted that, in any case, "control" is lost once the funds are transferred out of the deposit account, leaving only a claim to proceeds).<sup>435</sup>

While one may think of this as working against the depository bank, in *City Bank v. Compass Bank* a bank that did not have control nonetheless made a set-off against its debtor's deposit account and claimed priority over a competing, perfected security interest on grounds the bank was a transferee protected by section 9-332.<sup>436</sup> The court described this as an "uncertain point of state law" and declined to decide the issue pending the resolution of other issues.<sup>437</sup>

## XI. ENTRUSTMENT AND CONSIGNMENT

### A. *The Law of Entrustment and Consignment*

#### 1. *Entrustments*

UCC section 2-403 provides that "[a]ny entrusting of goods to a merchant that deals in goods of that kind gives the merchant power to transfer all of the entruster's rights . . . to a [BIOCOB]."<sup>438</sup> This has particular relevance in

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tion on the account was not sufficient to grant a security interest); Luttrell & Harrell, *supra* note 164, at 78–79 (regarding CDARS).

433. See *Joseph Stephens & Co. v. Cikanek*, 588 F. Supp. 2d 870, 875 (N.D. Ill. 2008).

434. U.C.C. § 9-332 (2011); see also *id.* § 9-331 (recognizing the primacy of the rights of a holder in due course under U.C.C. Article 3); Limor v. First Nat'l. Bank of Woodbury (*In re* Cumberland Molded Prods., LLC), 431 B.R. 718, 724 (B.A.P. 6th Cir. 2010) (bankruptcy trustee is not a "transferee" under section 9-332).

435. U.C.C. § 9-332; see also *id.* § 9-322(d)–(f) (priority rules consistent with § 9-332).

436. *City Bank v. Compass Bank*, 717 F. Supp. 2d 599, 615–17 (W.D. Tex. 2010).

437. *Id.* at 617.

438. U.C.C. § 2-403(2). But see *id.* § 2-402(2) (creditors of seller can void a sale not accompanied by transfer of possession if the seller's retention of possession is fraudulent under other law). "Entrustment" and BIOCOB status should be distinguished from the scenario of a pre-paying buyer. Absent a delivery of possession, this is not an entrustment and the buyer is not a

agricultural operations and finance, where various types of bailments (such as livestock or grain) are common. Some of these issues are illustrated in the discussion below. In addition, as noted below, an entrustment can be in the form of a consignment. The reader should also note that statutory material such as the Oklahoma Livestock Owner's Lien Act discussed in Part III above can implicate the entrustment and consignment discussion presented here.

## 2. Consignment

The UCC Article 2 consignment rules at sections 2-326 and 2-327 largely exclude issues relating to claims of creditors in a "sale or return" consignment to a merchant (for example, a consignment for purposes of resale rather than for the consignee's use).<sup>439</sup> This largely relegates such issues to UCC Article 9.<sup>440</sup>

Article 9 applies to consignments, as defined at section 9-102(a)(20).<sup>441</sup> This defines a consignment as a delivery of goods to a merchant for resale if: (1) the merchant deals in goods of that type under a name other than the consignor and is not "generally known by its creditors to be substantially engaged in selling the goods of others"; (2) the goods are valued at \$1000 or more; (3) the goods were not consumer goods in the hands of the consignor; and (4) it is not otherwise a security interest.<sup>442</sup> The result is that the consignee acquires the rights of the consignor, for purposes of creditor claims and remedies, and the consignor is deemed to have a "security interest" for some purposes, under the definition at section 1-201(b)(35).<sup>443</sup> This is a purchase-money security interest under section 9-103(d), and as such must be perfected in accordance with section 9-324 in order to have purchase-money priority over prior parties and claims such as inven-

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BIOCOB. See, e.g., *In re Hatfield 7 Dairy, Inc.*, 425 B.R. 444, 455 (Bankr. S.D. Ohio 2010) (prepaying buyer was not a BIOCOB); *Speth v. Whitham Farms Feedyard, L.P. (In re Sunbelt Grain WKS, LLC)*, 427 B.R. 896, 904 (D. Kan. 2010) (also finding prepaying buyer was not a BIOCOB).

439. U.C.C. §§ 2-326, 2-327.

440. See, e.g., *Woven Treasures, Inc. v. Hudson Capital, L.L.C.*, 46 So. 3d 905, 912 (Ala. 2009) (consignors' failure to file a financing statement left them without a perfected security interest—absent such perfection the consignee can convey the rights of the consignor pursuant to UCC section 9-319). Note that sales by consignees to BIOCOBs also may be governed by the entrustment rule. U.C.C. § 2-403; see also *id.* § 9-320(a) (sale to a BIOCOB cuts off a security interest). But see *In re Music City RV, LLC*, 304 S.W.3d 806, 809 (Tenn. 2010) (true consignments have been removed from UCC Article 2 and are either covered by Article 9 or are outside the UCC).

441. See U.C.C. § 9-109(a)(4).

442. *Id.* § 9-102(a)(20); see, e.g., *Jahn v. Joeb Enters., LLC (In re WFG, LLC)*, 2010 WL 4607614 (Bankr. E.D. Tenn. 2010) (question of fact as to the purpose of the consignment).

443. See U.C.C. §§ 9-109 cmt. 6, 9-319, 1-201(b)(35).

tory security interests.<sup>444</sup> The consignor does not, however, have the duties of a secured party under Article 9 Part 6.<sup>445</sup>

### B. Selected Cases

In *In re Niblett*, the owner of an antiques store filed bankruptcy and the Chapter 7 trustee moved to sell items held by the store as consignee, free and clear of the consignors' ownership claims.<sup>446</sup> Among other things, the consignors countered that: the store was generally known to be selling the property of others, the items in question were delivered for storage, not sale, and the items were tagged with stickers denoting the consignors' ownership.<sup>447</sup> The court rejected all of these arguments, concluding that the goods were consigned under UCC section 9-102(a)(20), and because the consignors did not file a financing statement their claims had the status of an unperfected security interest, subject to avoidance under Bankruptcy Code section 544(a).<sup>448</sup> The court noted that the "stickers" attached to the consigned items, denoting the consignors' interests, were for the store's internal use only and did not communicate notice of the consignment to customers and consignments for storage are covered by Article 9 if they meet the requirements of the definition in section 9-102(a)(20).<sup>449</sup>

In *Rayfield Investment Co. v. Kreps*, the owner of a painting delivered it to an art gallery for display and sale.<sup>450</sup> This was a consignment under UCC section 9-102(a)(20) as well as an entrustment under UCC section 2-403, although it was not necessary to argue the latter in the case.<sup>451</sup> Because the consignor did not perfect by filing a financing statement, or attach a label to the painting to provide notice of the consignment, or post a conspicuous notice of the consignment in the art gallery, the consignor was relegated to the status of an unperfected secured party whose interest was subordinate to a perfected security interest in the gal-

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444. *Id.* §§ 9-103(d), 9-324.

445. *See id.* §§ 9-109 cmt. 6, 9-601(g) (obligations of secured party enforcing a security interest).

446. *In re Niblett*, 441 B.R. 490, 492 (Bankr. E.D. Va. 2009).

447. *Id.* at 493.

448. *Id.* at 496.

449. *Id.* at 493.

450. *Rayfield Inv. Co. v. Kreps*, 35 So. 3d 63, 64 (Fla. Dist. Ct. App. 2010).

451. *Id.* at 65.

lery's inventory.<sup>452</sup> Note, however, in some states, there is a separate statute providing special protections for consignors of certain types of art objects.<sup>453</sup>

The precise extent of a notice that will be sufficient to protect the consignor (absent a filed financing statement) is not always clear. The definition of "consignment" at section 9-102(a)(20) requires delivery of goods to a merchant "not generally known by its creditors to be substantially engaged in selling the goods of others . . . ."<sup>454</sup> This is a somewhat vague test, at best, and somewhat odd in view of the overall effort in Article 9 to eliminate subjective factors in priority disputes.<sup>455</sup> In applying this test, some courts seem to focus on notice to the creditor in the case rather than notice to creditors generally. Obviously, a prominent sign or notice would impart notice to creditors generally, but what about actual notice given separately to the creditor in question?

In *Fariba v. Dealer Servs. Corp.*, a consignor delivered vehicles to a dealer, where they became inventory subject to the prior perfected security interest of an inventory lender.<sup>456</sup> The consignor did not perfect by filing, as required by section 9-311(d).<sup>457</sup> The dealer defaulted on the inventory loan and there was a priority dispute between the consignor and the inventory lender.<sup>458</sup> The court awarded priority to the consignor, on grounds that the inventory lender had "actual knowledge" that the vehicles were consigned.<sup>459</sup> The court concluded that the UCC notice requirements are intended to protect innocent parties who are unaware of the consignor's interest, and the inventory lender's knowledge of the consignments took the inventory lender outside of this protection.<sup>460</sup>

In contrast, in *French Design Jewelry, Inc. v. Downey Creations, LCC* (*In re Downey Creations, LLC*), a consignor was subordinated to a competing perfected security interest because the consignee's creditors did not know the

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452. *Id.* at 65, 67; see U.C.C. § 9-102(a)(20) (2011) (defining "consignment"); *id.* § 9-319 (providing rights and title of consignee); *id.* § 9-322 (providing first-in-time priority rule). The result would be the same if the painting was sold to a BIOCOB, or the entrustment rule. See *id.* §§ 9-320a, 2-403(2)–(3); see also *id.* §§ 2-326, 2-327 (sale on approval and sale on return file).

453. See, e.g., TEX. OCC. CODE ANN. § 2101.003–.004 (West 2012).

454. U.C.C. § 9-102(a)(20)(iii).

455. Compare *id.*, with *id.* §§ 9-317, 9-322 (for relatively more precise priority rules).

456. *Fariba v. Dealer Servs. Corp.*, 178 Cal. App. 4th 156, 159 (2009).

457. *Id.* at 170.

458. *Id.* at 161–62.

459. *Id.* at 159.

460. See *id.* at 169.

consignee was “substantially engaged” in selling consigned goods.<sup>461</sup> The consignor’s interest was treated as an unperfected security interest.<sup>462</sup>

Under UCC section 2-402, in a variation of the entrustment scenario, a seller’s retention of possession of goods following their sale may result in the sale being voided.<sup>463</sup> As illustrated in *Speth v. Whitham Farms Feedyard, LP (In re Sunbelt Grain WKS, LLC)*,<sup>464</sup> this result can be reached via other legal avenues. In *Sunbelt*, the debtor (a grain elevator) contracted for the sale of grain to a buyer.<sup>465</sup> The buyer did not take possession.<sup>466</sup> The grain was subject to a prior perfected security interest.<sup>467</sup> The buyer was subordinate to the seller’s secured party, because the seller’s retention of possession meant that ownership did not pass to the buyer under UCC section 2-401.<sup>468</sup> Thus, the buyer was not a BIOCIB under section 9-320 and was subject to the prior security interest.<sup>469</sup>

## XII. SUBORDINATION ISSUES AND RECENT CASE LAW IMPACTING ENFORCEABILITY OF SENIOR LIEN HOLDER’S RIGHTS IN THE CONTEXT OF A BANKRUPTCY

### A. Introduction

With an increase in the number and size of second lien financing arrangements, the importance of the enforcement of intercreditor agreements in bankruptcy has increased over the last decade.<sup>470</sup> As the battle lines between senior and junior secured parties have developed, the issue of whether a junior credi-

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461. Fr. Design Jewelry, Inc. v. Downey Creations, LLC (*In re Downey Creations, LLC*), 414 B.R. 463, 472 (Bankr. S.D. Ind. 2009).

462. *Id.* at 472–73. Even if there had been no competing perfected security interest, the bankruptcy trustee would have avoided the consignor’s secured claim in the bankruptcy case. See 11 U.S.C. § 544(a) (2006); Excel Bank v. Nat’l Bank of Kan. City, 290 S.W.3d 801, 803 (Mo. Ct. App. 2009) (consignor argued unsuccessfully that it was merely a bailor because it retained ownership and the certificates of title for the consigned vehicles).

463. U.C.C. § 2-402 (2011).

464. See *Speth v. Whitham Farms Feedyard, LP (In re Sunbelt Grain WKS, LLC)*, 406 B.R. 918 (Bankr. D. Kan. 2009).

465. *Id.* at 926.

466. *Id.* at 927.

467. *Id.* at 931.

468. *Id.* at 933–34.

469. *Id.* at 934; see U.C.C. §§ 9-201, 9-317, 9-320 (2011).

470. Douglas G. Baird & Robert K. Rasmussen, *Antibankruptcy*, 119 YALE L.J. 648, 672 (2010). “Today . . . we see a new trend in the capital markets. The debtor accesses the difference between the senior loan and [the company’s] full enterprise value through a second lien loan.” *Id.*

tor's waiver of fundamental bankruptcy rights in the intercreditor agreement are enforceable has become more relevant.<sup>471</sup>

Of course, the terms of an intercreditor agreement between senior and junior lenders will be driven by the lenders' relative negotiating power. Senior lenders typically bargain for terms under which the junior lenders have as few rights as possible in the event of a default or bankruptcy filing.<sup>472</sup> The rights that senior lenders most often seek in an intercreditor agreement include: The exclusive right to all proceeds of shared collateral; the right to make decisions affecting the sale of shared collateral; and the ability to waive or amend specified provisions of the credit documents without the consent of the junior lenders.<sup>473</sup> The types of restrictions that senior lenders may attempt to place on the junior lenders' rights include: Blocking the junior lender's ability to propose debtor in possession (DIP) financing, or offer their own Chapter 11 plans; imposing payment subordination clauses in which junior lenders receive no payment until the senior lender is paid in full; and limiting the junior lenders' ability to foreclose on the collateral.<sup>474</sup> Some intercreditor agreements also provide that the junior lender waives its right to vote on any plan of reorganization.<sup>475</sup>

On these issues, a core provision of the Bankruptcy Code is section 510(a), which provides that “[a] subordination agreement is enforceable in a case under this title to the same extent that such agreement is enforceable under applicable nonbankruptcy law.”<sup>476</sup>

This single section of the Bankruptcy Code, however, does not provide a definitive answer to all of the issues likely to arise with respect to a contested intercreditor agreement. As noted by one commentator “[w]hen it comes to subordination agreements during bankruptcy reorganizations . . . [section 510(a)] must be read alongside the power of the bankruptcy court to confirm plans under

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471. For purposes of this article, the terms “intercreditor agreement” and “subordination agreement” are used interchangeably.

472. Jennifer Martin, *Enforcement of Intercreditor Agreements in Recent Disputes Among Creditors in Bankruptcy*, LEXIS NEXIS COMMUNITIES (July 29, 2011, 10:49 AM), <http://www.lexisnexis.com/community/corpsec/blogs/bus-law-analysis/archive/2011/07/29/enforcement-of-intercreditor-agreements-in-recent-disputes-among-creditors-in-bankruptcy.aspx>.

473. *Id.*

474. Rick Hyman & Jane Kang, *Enforceability of the “Bankruptcy Waiver”: Where Are We Now?* 5 BLOOMBERG L. REP. 1–2 (2011), <http://www.mayerbrown.com/news/Enforceability-of-the-Bankruptcy-Waiver-Where-Are-We-Now-03-14-2011/>.

475. Mark N. Berman & David Lee, *The Enforceability in Bankruptcy Proceedings of Waiver and Assignment of Rights Clauses Within Intercreditor or Subordination Agreements*, BANKRUPTCY LAW ALERT: DEVELOPMENTS IN BANKRUPTCY LAW (Nixon Peabody, LLP, New York, N.Y.), Jan. 24, 2012, at 14.

476. 11 U.S.C. § 510(a) (2006).

§ 1129, approve sales under § 363(b), and the mandate that the court appoint examiners in certain cases under § 1104(c).<sup>477</sup>

*B. May a Junior or Subordinating Creditor's Express Waiver of Its Right to Vote in an Intercreditor Agreement be Enforced in Bankruptcy?*

In *In re Suncruz Casinos, LLC*, the bankruptcy court interpreted a subordination agreement authorizing the senior lender to do the following: File proofs of claim with respect to the junior lender's indebtedness; enforce any security interest or lien of the junior lender; vote the junior lender's claim; and receive distribution on the junior lender's unsecured claim.<sup>478</sup>

Because the debtor's plan in *Suncruz* violated several of the subordination agreement's provisions, the court declined to confirm the debtor's plan.<sup>479</sup> The *Suncruz* court found "[a]ll of the provisions of the Subordination Agreement are fully enforceable in this case," not only because of section 510(a), but also because the subordination agreement expressly stated that "the rights and priorities set forth in this Agreement shall remain binding irrespective of the terms of any plan of reorganization in a Bankruptcy Case or other provisions of the Bankruptcy Code or any similar federal or state statute."<sup>480</sup>

Similarly, in *Blue Ridge Investors, LP v. Wachovia Bank, N.A., (In re Aerosol Packaging, LLC)* the junior lender objected that the provision in the subordination agreement it had signed which permitted the senior lender to vote the claim of the junior lender was unenforceable.<sup>481</sup> The *Aerosol* court found that Federal Rules of Bankruptcy Procedure (Bankruptcy Rules), Rules 9010 and 3018, permit agents or other representatives to vote on behalf of other parties.<sup>482</sup> The court held that section 1126(a), which grants the holder of a claim the right to vote to accept or reject a plan, did not prevent that right from being delegated or bargained away.<sup>483</sup>

In *In re Erickson Retirement Communities, LLC*, the bankruptcy court examined and found to be enforceable an agreement in which the subordinating lender agreed not to oppose any agreement by the nonsubordinating lender to

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477. Martin, *supra* note 472.

478. *In re Suncruz Casinos, LLC*, 298 B.R. 833, 846–47 (Bankr. S.D. Fla. 2003).

479. *Id.* at 847.

480. *Id.* at 844.

481. *Blue Ridge Investors, LP v. Wachovia Bank, N.A., (In re Aerosol Packaging, LLC)*, 362 B.R. 43, 45 (Bankr. N.D. Ga. 2006).

482. *Id.* at 47.

483. *Id.*

provide DIP financing, or to allow use of cash collateral.<sup>484</sup> The *Erickson* court, however, did not go as far as the *Suncruz* or *Aerosol* decisions; the *Erickson* court specifically noted that the subordination agreement at issue did not prevent the subordinating lender from seeking adequate protection of its interest, and that it did not contain a provision entitling the senior lender to vote the junior lender's claim.<sup>485</sup>

There is a decision holding that the junior subordinating lender's right to vote its claim may not be waived in a subordination agreement.<sup>486</sup> In *Bank of America, N.A. v. North LaSalle Street, LP (In re 203 North LaSalle Street Partnership)*, the junior lender executed a subordination agreement which provided, among other things, that the senior lender could vote the junior lender's claims.<sup>487</sup> The court's basic approach to this issue was "prebankruptcy agreements do not override contrary provisions of the Bankruptcy Code."<sup>488</sup> The court reasoned that bankruptcy is meant to result in a reorganization and distribution regime distinct from what one would obtain under nonbankruptcy law, so parties should not be allowed to contract around provisions of the Bankruptcy Code.<sup>489</sup>

The *North Lasalle* court quoted an earlier decision regarding the reach of section 510:

The intent of [Bankruptcy Code Section] 510(a) . . . is to allow the consensual and contractual priority of payment to be maintained between creditors among themselves in a bankruptcy proceedings. There is *no indication that Congress intended to allow creditors to alter, by a subordination agreement, the bankruptcy laws unrelated to distribution of assets.*<sup>490</sup>

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484. *In re Erickson Retirement Cmty., LLC*, 425 B.R. 309, 313–14 (Bankr. N.D. Tex. 2010).

485. *Id.* at 315. The *Erickson* court held that "subordination agreements are interpreted and enforced in accordance with general contract principles." *Id.* at 314. Other courts have held it is state law that controls. See *In re Best Prods. Co.*, 168 B.R. 35, 69 (Bankr. S.D.N.Y. 1994) (the applicable nonbankruptcy law referred to in section 510(a) is state law). *But see* *HSBC Bank USA v. Branch (In re Bank of New England Corp.)*, 364 F.3d 355, 363 (1st Cir. 2004) (New York courts do not appear to have developed any rules of interpretation that apply specifically to subordination agreements). The issue of which law applies, however, is not relevant to a court's interpretation of other sections of the Bankruptcy Code or Bankruptcy Rules relied upon by the majority of the decisions cited in this article, such as Bankruptcy Code sections 1126(a) and 1129(b)(1) and Bankruptcy Rule 3018.

486. *Bank of Am., N.A. v. N. LaSalle St. LP (In re 203 N. LaSalle St. P'ship)*, 246 B.R. 325, 330–32 (Bankr. N.D. Ill. 2000).

487. *Id.* at 327.

488. *Id.* at 331.

489. *Id.*

490. *Id.* (quoting *Beatrice Foods Co. v. Hart Ski Mfg. Co. (In re Hart Ski Mfg. Co.)*, 5 B.R. 734, 736 (Bankr. D. Minn. 1980) (emphasis added)).

The *North LaSalle* court also found that Bankruptcy Rule 3018(c) does not allow a senior lender to vote a junior lender's claim.<sup>491</sup> The court opined "subordination affects only the *priority* of payment, not the *right* to payment."<sup>492</sup> The court concluded by noting that its interpretation of Bankruptcy Code section 510(a) (declining to approve a waiver of voting rights) "assures that the holder of a subordinated claim has a potential role in the negotiation and confirmation of a plan, a role that would be eliminated by enforcing contractual transfers of Chapter 11 voting rights."<sup>493</sup>

### C. Recent Developments in the Enforcement of Intercreditor Agreements in Bankruptcy

A leading bankruptcy treatise presently contains a footnote which reads, in relevant part: "The courts have not yet resolved whether a plan may modify a subordination agreement through the cram-down mechanism of section 1129(b)."<sup>494</sup>

A recent New Jersey bankruptcy court decision, however, held that the Bankruptcy Code allows for the confirmation of a cram-down plan over the objections of dissenting senior secured parties (senior lien creditors), without requiring that the plan comport with the terms of an intercreditor agreement with the junior secured parties (junior lien creditors).<sup>495</sup> *In re TCI 2 Holdings, LLC* involved competing plans of reorganization for the Atlantic City casinos of Trump Entertainment Resorts, Inc.<sup>496</sup> The senior lien creditors' class voted against the plan of the debtor and junior lien creditors, which proposed to pay the senior lien creditors in a combination of a restructured secured note and cash.<sup>497</sup> Thus, cram-down of the senior lien creditors was required under Bankruptcy Code section 1129(b).<sup>498</sup> The senior lien creditors argued that the debtor's or junior creditors' plan violated the intercreditor agreement, and that section 510(a) provides that intercreditor agreements are enforceable just as they would be under nonbankruptcy law.<sup>499</sup> Shortly before the confirmation hearing, the senior

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491. *Id.*

492. *Id.* at 332 (emphasis added).

493. *Id.*

494. COLLIER ON BANKRUPTCY, *supra* note 258, at ¶ 510.03[3] n.20.

495. *See In re TCI 2 Holdings, LLC*, 428 B.R. 117, 181 (Bankr. D.N.J. 2010).

496. *Id.* at 128–30.

497. *Id.* at 139–40.

498. 11 U.S.C. § 1129(b) (2006); *see In re TCI 2 Holdings, LLC*, 428 B.R. at 141.

499. *In re TCI 2 Holdings, LLC*, 428 B.R. at 139–40. The intercreditor agreement at issue provided that no proceeds of the shared collateral would be paid to the subordinated or junior creditors until the senior secured creditors were paid in full, in cash. The senior lien creditors ar-

lien creditors also sued the junior lien creditors in state court for violation of the intercreditor agreement.<sup>500</sup>

The *TCI* court did not reach a determination as to whether or not the intercreditor agreement had been violated by the proposed plan. Instead, the court held that

“[e]ven though section 510(a) requires the enforceability of [a] subordination agreement in a bankruptcy case to the same extent that the agreement is enforceable under nonbankruptcy law, if a nonconsensual plan meets all of the § 1129(a) and (b) requirements, the court ‘shall confirm the plan.’” The phrase “notwithstanding section 510(a) of this title” [contained at 11 U.S.C. section 1129(b)(91)] *removes section 510(a) from the scope of § 1129(a)(1), which requires compliance with “the applicable provisions of this title.”*<sup>501</sup>

This holding may be restated as standing for the proposition that the phrase “notwithstanding section 510(a) of this title” in section 1129(b)(1) means that a class of senior lien creditors that rejects a plan because of a perceived violation of an intercreditor agreement may still have that plan crammed-down over their objection.<sup>502</sup>

It is clear that the *TCI* decision places real restrictions on a senior lien creditor’s rights in bankruptcy.<sup>503</sup> Moreover, it is conceivable that junior lien creditors could seek to use this same reasoning to, say, challenge adequate protection payments or section 363 sales.<sup>504</sup> As a result, there could be an increase in junior lien creditors seeking to end exclusivity so that they can put forward cram-down plans that do not follow the terms of their intercreditor agreements.

In *In re Boston Generating, LLC* the court determined, among other things, that a second lien secured party that had executed an intercreditor agreement, which provided that the “Second Lien Secured Party . . . agrees not to take any action that would hinder any exercise of remedies under the First Lien Documents . . .,” still had standing to object to a sale of the debtor’s assets.<sup>505</sup> The *Boston Generating* court, in what should serve as an admonishment to future drafters of intercreditor agreements, found:

If a secured lender seeks to waive its rights to object to a § 363 sale, it must be clear beyond peradventure that it has done so. Under New York law, the First Lien Lend-

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gued that the debtor’s plan would make deferred cash payments to the senior lenders, so that they were “not being paid in full, in cash.” *Id.*

500. *Id.* at 140.

501. *Id.* at 141 (emphasis added).

502. 11 U.S.C. § 1129(b)(1) (2006); see *In re TCI 2 Holdings, LLC*, 428 B.R. at 140.

503. See *In re TCI 2 Holdings, LLC*, 428 B.R. at 140–41.

504. See *id.*

505. *In re Boston Generating, LLC*, 440 B.R. 302, 317–20 (Bankr. S.D.N.Y. 2010).

ers must point [the court] to some provision that reflects an express or intentional waiver of rights.<sup>506</sup>

One other issue that senior lien secured parties must consider is the ability to file a claim if the junior class refuses to file a claim. A junior creditor might simply refuse to file absent assurance by the senior claimant of some distribution to the junior creditor.

### XIII. CERTIFICATES OF TITLE

#### A. Introduction

Even prior to the 1998 revisions to the uniform text of Article 9 of the UCC, it was long and well established that the proper method of perfecting a security interest in collateral covered by a certificate of title (CT)—often including boats, manufactured homes, recreational vehicles, automobiles, trucks, motorcycles, and some trailers (CT collateral)—was by submission of a lien entry form pursuant to a state CT law providing for indication of the security interest on the CT.<sup>507</sup> This rule was continued and reinforced under the 1998 revisions

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506. *See id.* at 319–20. The court referred to this finding as a “hollow victory” for the second lien secured party, as the court ruled against the objection, finding that the proposed section 363 sale met all the statutory requirements and should proceed. *Id.* at 320–21, 336.

507. U.C.C. § 9-311(a)–(b) (2011). There is an exception for CT collateral held as inventory. *See id.* § 9-311(d). As noted previously, the 2010 uniform text of the UCC includes the 1998–99 revisions to Article 9—with a few technical amendments—but not amendments approved by the sponsoring organizations in 2010 (2010 Amendments). States generally began to embrace lien entry perfection as to CT collateral in the mid-twentieth century, and all states had done so with regard to vehicles by the late 1970s. The picture remains mixed, however, with respect to watercraft and manufactured homes, with some states requiring CT lien entry perfection and others relying on UCC Article 9 perfection by filing, and many permitting a real estate mortgage to cover manufactured homes. Outdated terms such as “lien entry” are commonly used in CT statutes, presumably because many CT statutes and perfection systems pre-date Article 9 and the modern term “security interest.” The Uniform Certificate of Title Act (UCOTA) replaces the term “lien” with the term “security interest.” *See Uniform Certificate of Title Act*, NATIONAL CONFERENCE OF COMMISSIONERS ON UNIFORM STATE LAWS (2005), [http://www.uniformlaws.org/Act.aspx?title=Certificate of Title Act](http://www.uniformlaws.org/Act.aspx?title=Certificate%20of%20Title%20Act) (follow “Final Act, no comments” hyperlink).

The sponsors of the UCC are the American Law Institute (ALI) and the Uniform Law Commission (ULC), formerly known as the National Conference of Commissioners on Uniform State Laws (NCCUSL). Harrell *supra* note 299, at 138. Other uniform laws, such as UCOTA, are sponsored separately by the ULC. Following the approval of UCOTA by NCCUSL in 2005 (and technical amendments approved in 2006), the ULC created separate drafting committees to draft a uniform CT law for watercraft and to deal with CT and related issues for manufactured homes. The Uniform Certificate of Title Act for Vessels (UVCOTA) was approved by the ULC in 2011. *See* Press Release, Uniform Law Commission, Uniform Certificate of Title Act For Vessels Approved (July

and again in the 2010 amendments to Article 9.<sup>508</sup> These revisions and the retention of this rule, however, did not entirely resolve all related questions involving the relationship between CT laws and the UCC, for example, when CT collateral is sold without execution of the CT, when there is a forged lien release, or when a dispute arises as to the priority of a security interest in CT collateral.<sup>509</sup> The discussion below describes two illustrative cases addressing these issues and illustrating some remaining problems with the relationship between CT laws and the UCC.<sup>510</sup>

### B. Entrustment—the Role of UCC Article 2

In *Madrid v. Bloomington Auto Co.*, the U.C.C. Article 2 entrustment provisions rather than the CT statute determined the rights to ownership of a vehicle because a CT statute is a registration system and not an exclusive ownership system.<sup>511</sup> In *Madrid*, defendant 1 (Used Car Dealer) operated a used car dealership and from time to time utilized defendant 2 (New Car Dealer), a new car dealership, to share sales leads.<sup>512</sup> Typically, the arrangement between Used Car Dealer and New Car Dealer was that a purchaser would pay the New Car Dealer for one of its new vehicles as sold by the Used Car Dealer, and New Car Dealer would pay Used Car Dealer a finder's fee.<sup>513</sup>

12, 2011), available at

<http://www.nccusl.org/NewsDetail.aspx?title=Uniform%20Certificate%20of%20Title%20Act%20for%20Vessels%20Approved>. The manufactured homes project remains ongoing. See *Committees: Manufactured Housing Act*, UNIFORM LAW COMMISSION (2012), <http://www.uniformlaws.org/Committee.aspx?title=Manufactured%20Housing%20Act> (select “April 2012 Committee Meeting Draft” hyperlink) (providing access to draft Manufactured Housing Act); Mark J. Lifset, *Proposed ULC Manufactured Home Titling Act*, 65 CONSUMER FIN. L.Q. REP. (forthcoming 2012).

508. See U.C.C. §§ 9-303, 9-311(a)(2), (b). As noted, there is an exception in U.C.C. section 9-311(d) for CT collateral held by the debtor as inventory. See generally *Hardy Rawls Enters. LLC v. Cage (In re Moye)*, No. H-09-2747, 2010 WL 3259386, at \*12 (S.D. Tex. 2010) (security interest in vehicle inventory requires perfection by filing and was not perfected by possession of the CTs); *Quality Leasing Co. v. Dealer Servs. Corp.*, No. 29A02-0908-CV-747, 2010 WL 2145492, at \*2 (Ind. Ct. App. 2010) (consignor of vehicle to auto dealer had only an unperfected security interest).

509. See, e.g., *Sovereign Bank v. Hepner (In re Roser)*, 613 F.3d 1240 (10th Cir. 2010) (Article 9 defers to the CT law for the method of perfection but not the rules governing priority of a security interest).

510. See Caggiano & Harrell, *supra* note 50.

511. See U.C.C. § 2-403; *Madrid v. Bloomington Auto Co.*, 782 N.E.2d 386, 395 (Ind. Ct. App. 2003).

512. *Madrid*, 782 N.E.2d at 389.

513. *Id.*

The *Madrid* plaintiffs contacted Used Car Dealer, from whom they had previously purchased new and used cars, about purchasing a used car.<sup>514</sup> Used Car Dealer located an appropriate vehicle at New Car Dealer's premises and requested that New Car Dealer deliver it to Used Car Dealer so the plaintiffs could inspect it.<sup>515</sup> After the plaintiffs purchased the car via Used Car Dealer, the latter collected the proceeds and promised to deliver the CT, paperwork, and a mobile phone the next day.<sup>516</sup> Unbeknownst to the plaintiffs, Used Car Dealer was not authorized to sell the vehicle because it had not purchased it from New Car Dealer.<sup>517</sup> When Used Car Dealer failed to deliver any of the sales or title documentation or promised accessories to the plaintiffs, the plaintiffs sued to recover the CT.<sup>518</sup>

The *Madrid* court addressed two issues: (1) whether the transfer of ownership of a vehicle is governed by the state CT statute or by the U.C.C. Article 2 sales of goods provisions; and (2) whether the buyers of the vehicle received ownership under the entrustment provisions of U.C.C. Article 2.<sup>519</sup>

The *Madrid* court correctly concluded that the UCC provisions on the sale of goods apply to the transfer of ownership of a vehicle.<sup>520</sup> The court correctly reasoned that the purpose of a CT law is to create procedures and methods for filing and registering public notice of ownership and security interests, and thus it serves only as a registration system.<sup>521</sup> Unlike an exclusive ownership system, where rights do not pass until specified formalities are completed, under a registration system standard commercial and property law governs issues relating to vehicle ownership. The *Madrid* court determined that the vehicle buyers received ownership pursuant to the entrustment provisions of UCC Article 2, because New Car Dealer entrusted the vehicle to Used Car Dealer, Used Car Dealer was a merchant who dealt in goods of that kind, and the buyers were BIOCOS.<sup>522</sup> The court observed that this result is consistent with the UCC policy of placing the burden on the entrusting party (New Car Dealer), as the party in the best position to prevent fraud in such transactions.<sup>523</sup>

The *Madrid* decision was correct, but still reflects some all-too-common confusion over the relation between CT laws and the UCC (here, UCC Article 2).

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514. *Id.*

515. *Id.*

516. *Id.* at 389–90.

517. *Id.* at 389.

518. *Id.* at 390.

519. *Id.* at 391, 395.

520. *Id.* at 395.

521. *See id.*

522. *Id.* at 396–97.

523. *Id.* at 397 (citing *Mowan v. Anweiler*, 454 N.E.2d 436, 439 (Ind. Ct. App. 1983)).

Of course Article 2 applies to the sale of a vehicle (as a sale of goods); but that does not mean the CT law is inapplicable.<sup>524</sup> The appellee-defendant's apparent efforts to get the case outside the CT law, by reasoning that the CT law covered only registration, and not ownership, is potentially misleading.<sup>525</sup> In fact, although the court was essentially correct that a CT law is a registration rather than an exclusive ownership system, it is also true that both laws may apply in a scenario like this, and often it is the interaction between them that resolves the ownership issues.<sup>526</sup>

The dispositive rule in *Madrid* was indeed the Article 2 entrustment rule, but the CT law may be relevant, for example to determine whether the buyers qualified as BIOCObS, an essential element of the entrustment rule, despite the lack of a CT. For example, UCOTA confirms the *Madrid* result and clarifies these issues by essentially adopting U.C.C. section 2-403 at UCOTA section 18 and specifying that BIOCObS can prevail in these circumstances despite the lack of a CT.<sup>527</sup> This makes clear the correct result without the necessity of the analytical gyrations of the *Madrid* decision.

### C. *Fraudulent Lien Release and Subsequent Purchasers: The NXCESS Case*

In *NXCESS Motor Cars v. JPMorgan Chase Bank*, the Texas Court of Appeals, affirmed a questionable analysis by the trial court as to the impact of a fraudulent lien release.<sup>528</sup> In *NXCESS*, James Cavazos (Cavazos) purchased a new Mercedes-Benz automobile (vehicle) from a Mercedes dealer, and financed the purchase by granting a purchase-money security interest to JPMorgan Chase (Chase), which was duly perfected by a lien entry on the original Texas CT.<sup>529</sup>

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524. See generally *id.* at 392–93 (discussing certificate of title process); U.C.C. § 2-401 (2011) (covering sales and passing title).

525. See *Madrid*, 782 N.E.2d at 392.

526. See *id.* at 395 (stating their interpretation gave effect to both the U.C.C. and the Certificate of Title Act).

527. U.C.O.T.A. § 18(b) (2005). A Reporter's Note discusses UCC section 2-403 in the draft version of the UCOTA. See *Uniform Certificate of Title Act*, NATIONAL CONFERENCE OF COMMISSIONERS ON UNIFORM STATE LAWS (2002), <http://www.law.upenn.edu/bll/archives/ulc/ucota/draft1102.pdf> (including reporter's notes for § 2-203(b) in the 2002 draft—a section that subsequently became § 18(b) of the 2005 draft).

528. *NXCESS Motor Cars, Inc. v. JPMorgan Chase Bank*, 317 S.W.3d 462 (Tex. App. 2010) (on rehearing); see also 2010 Tex. App. LEXIS 1143 (Feb. 18, 2010). For further background, and analysis of the decision of the court below, see David B. McCrea & Alvin C. Harrell, *Overview and Update on Vehicle Secured Transactions, Certificates of Title, and Related Issues*, 64 CONSUMER FIN. L. Q. REP. 642, 366–67 (2010).

529. *NXCESS Motor Cars*, 317 S.W.3d at 464.

Cavazos then executed a forged lien release and obtained a certified copy of the original CT.<sup>530</sup>

The duplicate CT was executed to Avatar Trust by execution of the assignment of title form on the back of the certified copy of the CT, and along with the forged lien release this was used to sell the vehicle to Avatar Trust.<sup>531</sup> Avatar Trust then submitted this documentation to the Texas CT office and obtained a new CT indicating Avatar Trust as the owner and that there was no security interest in the vehicle.<sup>532</sup> The validity of this CT is a crucial issue in the court's analysis, affecting the ability of innocent parties to rely on a CT. The analysis on this issue is also the most questionable aspect of the court's opinion.

The vehicle was then sold by Avatar Trust to NXCESS, which resold the vehicle to Xavier Valeri ("Valeri"), who financed the purchase by granting a security interest to U.S. Bank.<sup>533</sup> There is every indication that each of these parties, beginning with Avatar Trust, was a good faith purchaser (GFP) under UCC Article 2,<sup>534</sup> and NXCESS specified alleged that it "performed the usual and customary due diligence to determine good, clean, clear title . . . ."<sup>535</sup> Of course, no amount of ordinary due diligence would have discovered the Chase security interest, as it had been released of record by reason of the forged lien release.<sup>536</sup>

When all of this came to light, Chase sued Cavazos for fraud and conversion, and the Texas DOT office, Valeri, and U.S. Bank for conversion and a declaration that its security interest had priority over all subsequent ownership and secured claims.<sup>537</sup> When Chase moved for summary judgment, NXCESS responded because Valeri and U.S. Bank in turn had sued NXCESS on various breach of contract, warranty, and Deceptive Trade Practices Act claims.<sup>538</sup> NXCESS argued that it and Valeri were BIOCObS who took free and clear of Chase's security interest.<sup>539</sup> The trial court granted Chase's motion for summary judgment, ordered Valeri to deliver possession of the vehicle to Chase, declared Chase's security interest superior to all other claims and interests, and directed the CT office to issue a new CT to Chase.<sup>540</sup>

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530. *Id.*

531. *Id.*

532. *Id.*

533. *Id.*

534. *See id.*; U.C.C. § 2-403 (2011).

535. *NXCESS Motor Cars*, 317 S.W.3d at 464.

536. *Id.*

537. *Id.*

538. *Id.* at 465; *see also* U.C.C. § 2-312 (warranty of title). If Chase prevailed against Valeri and U.S. Bank, presumably in turn Valeri and U.S. Bank would prevail against NXCESS. *See, e.g., NXCESS Motor Cars*, 317 S.W.3d at 465.

539. *NXCESS Motor Cars*, 317 S.W.3d at 464–65.

540. *Id.* at 465–68.

On rehearing, the court of appeals again rejected the argument that NXCESS and Valeri qualified as BIOCOBs.<sup>541</sup> It is here that the court of appeals, like the trial court, went astray.<sup>542</sup> It is quite true that NXCESS was not a BIOCOB, but for the reason that it did not buy the vehicle ““from a person . . . in the business of selling goods of that kind,”” as required in the definition of BIOCOB at UCC section 1-102(b)(9).<sup>543</sup> In addition, even if NXCESS was a BIOCOB, the security interest was not created by its seller (Avatar Trust) and therefore would not have been cut off pursuant to UCC section 9-320(a).<sup>544</sup> Instead of recognizing this basic point as dispositive, the court of appeals ventured into an unnecessary (and erroneous) analysis as to whether the CT issued to NXCESS was void.<sup>545</sup>

It should be noted that the court’s errors in this respect were merely a compounding of identical errors in a very similar case from the Court of Appeals in Austin, Texas.<sup>546</sup> Both *NXCESS* and *Lee* extrapolated, from the Texas Supreme Court’s very reasonable conclusion that a forged CT does not transfer ownership,<sup>547</sup> that an otherwise effective transfer of ownership is rendered ineffective if accompanied by a forged lien release.<sup>548</sup> There is no apparent basis, in any law, for this extrapolation. Clearly, there are numerous ways that the owner of a vehicle can transfer ownership to a buyer, and without a doubt one of those ways is execution of a duplicate CT by the owner to the buyer. A forged lien release is not effective to terminate the security interest, and also does not render void an otherwise effective transfer of ownership.<sup>549</sup>

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541. *Id.* at 467.

542. *See* *McCrea & Harrell*, *supra* note 528, 366–67.

543. *NXCESS Motor Cars*, 317 S.W.3d at 467 (quoting TEX. BUS. & COM. ANN. CODE § 1.201(b)(9) (West 2009)).

544. *Id.*

545. *Id.* at 467–69.

546. *Lee v. Bank, N.A.*, 23 S.W.3d 129 (Tex App. 2000). The factual similarity of *NXCESS* to *Lee* is striking and lends credence to the notion that these issues and scenarios are not uncommon. *See id.*

547. *Drake Ins. Co. v. King*, 606 S.W.2d 812, 817 (Tex. 1980) (holding a forged certificate of title does not pass on title absent, of course, a dispositive preclusion or estoppel).

548. *NXCESS Motor Cars*, 317 S.W.3d at 467. In *Lee*, the “Austin Court of Appeals . . . extended [the Texas Supreme Court’s *Drake*] holding to include situations in which the [CT] itself is not forged, but a release of lien, on which the [CT] is based, is forged.” *Id.* An obvious flaw in this reasoning is that the CT issued to NXCESS by the Texas CT office was not based on the lien release, it was based on an assignment of the valid duplicate CT, executed by the owner of the vehicle. This was clearly sufficient to transfer ownership and is a far cry from the forged CT at issue in *Drake*.

549. U.C.C. § 9-303 cmt. 4 (2011).

The *NXCESS* and *Lee* courts reasoned that “the buyer acquires no title when any link in his chain of title is forged.”<sup>550</sup> But, of course, there was no ownership link forged in either of those cases.<sup>551</sup> A lien or security interest is a property interest, but it is not ownership.<sup>552</sup> A bogus lien or lien release may inappropriately impair rights relating to an encumbrance, and this may create hidden risks for parties claiming an ownership interest.<sup>553</sup> These issues and scenarios may require (as in UCC Article 9 for interstate transactions) perfection and priority rules to sort out the priorities of competing claims,<sup>554</sup> but they do not represent any break in the chain of title or impair otherwise valid transfers of ownership rights.

The *NXCESS* court’s analysis of these issues does not support its conclusion that this was a case “where a forged document on which the [CT was] based void[ed] that [CT].”<sup>555</sup> If this statement were true, an unauthorized signature on documentation separate from the assignment of ownership could be used to void the assignment and CT, impairing the ownership interests of innocent parties who reasonably relied on a CT issued by the state.<sup>556</sup> This would sharply reduce the traditional utility of CTs in facilitating thousands of routine transactions; as illustrated in *NXCESS*, there would be no practical means to protect against these risks (except perhaps by adding an expensive new layer of title insurance requirements).<sup>557</sup> Moreover, as noted, this entire line of analysis was unnecessary, as *NXCESS* clearly did not qualify as a BIOCOP and therefore took subject to Chase’s security interest for that reason.<sup>558</sup>

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550. *NXCESS Motor Cars*, 317 S.W.3d at 467 (quoting *Lee*, 23 S.W.3d at 131).

551. *Id.* at 467; *Lee*, 23 S.W.3d at 131.

552. *See, e.g.*, U.C.C. §§ 9-601 to 9-624 (governing the post-default procedures involving disposition of collateral, such as the circumstances when a secured party may purchase collateral or accept the collateral as full payment and the debtor’s right of redemption).

553. *See, e.g.*, U.C.C. §§ 9-317, 9-322 (stating priority rules).

554. *See, e.g.*, U.C.C. §§ 9-316(d)–(e), 9-337.

555. *NXCESS Motor Cars*, 317 S.W.3d at 467 (quoting *Lee*, 23 S.W.3d at 131). The *NXCESS* court quoted *Dublin*: “Proof of the forgery of a link of title is tantamount to proof that the claimant of such title has none, or, in other words that he is not the owner of the property.” *Id.* (quoting *Dublin Nat’l Bank v. Chastain*, 167 S.W.2d 795, 797 (Tex. App. 1942)). As noted, however, it could not be clearer that there was no forgery of a link of title in *NXCESS*. Moreover, note that the rationale of the *NXCESS* court means that a fraudster can execute a valid CT to an innocent party and then claim that the fraudster is still the owner of the vehicle by reason of an intentional forgery of extraneous documentation. The *NXCESS* court recognized that none of the CTs involved in this chain of transactions are forged. *Id.* However, the court did not seem to recognize the implications of this lack of forgery for its analysis.

556. *See id.* (explaining that Avatar Trust, the buyer who received execution of the CT from the owner, had no title).

557. *See id.*

558. *Id.* at 467–68.

In a proper analysis, Avatar Trust received a valid transfer of ownership from Cavazos (the owner of record), subject to Chase's perfected security interest (the forged lien release being ineffective).<sup>559</sup> Avatar Trust was not a BIOCOP, because Cavazos was not a merchant; some of the subsequent owners (such as Valeri) probably were BIOCOPs, because (unlike Avatar Trust) they bought the vehicle from a seller who was a merchant selling goods of that kind in the ordinary course of business; however, this status would do them no good as against Chase, because UCC Article 9 section 9-320(a) only protects a BIOCOP from security interests created by his or her seller.<sup>560</sup> In *NXCESS*, Cavazos (who granted the security interest to Chase and therefore created it, pursuant to UCC section 9-203) was not the seller to *NXCESS* or Valeri, and therefore the Chase security interest was unaffected even if the subsequent buyers (*NXCESS* and Valeri) were BIOCOPs.<sup>561</sup> Instead of recognizing this, however, the *NXCESS* court concluded that the subsequent buyers (*NXCESS* and Valeri) were not BIOCOPs because "[n]one of the subsequent purchasers took valid title to the car"; this is a clearly erroneous view under any of the applicable laws.<sup>562</sup>

The *NXCESS* court similarly mishandled its analysis of the argument that *NXCESS* acquired good title under the voidable title rules at UCC Article 2 section 2-403.<sup>563</sup> *NXCESS* argued that its transferor (Avatar Trust) acquired voidable title, not a void title, from Cavazos (the fraudster), and therefore could transfer good title to a good faith purchaser for value (GFP) such as *NXCESS*.<sup>564</sup> In fact, there should be no doubt that *NXCESS* was a GFP and acquired good title (such as ownership), though this ownership was subject to Chase's security interest.<sup>565</sup> Indeed, since Cavazos had good title (again, subject to Chase's security interest), and transferred that ownership interest to Avatar Trust by execution of a valid CT, Avatar Trust had more than voidable title: Avatar Trust acquired full ownership, good against any competing ownership claims and subject only to the security interest of Chase.<sup>566</sup> This ownership was properly transferred to *NXCESS*.<sup>567</sup> It was disingenuous (and unnecessary) for *NXCESS* to argue that it became the owner only because its transferor had a lesser, voidable title.<sup>568</sup> But,

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559. *Id.* at 467.

560. U.C.C. § 9-320(a) (2011).

561. *NXCESS Motor Cars*, 317 S.W.3d at 467.

562. *Id.* at 468.

563. *Id.* at 468–69. The court's opinion does not address the alternative transaction of purchase rules at U.C.C. § 2-403. *See id.*

564. *Id.* at 468.

565. *See* U.C.C. § 9-315 (continuation of security interest after sale).

566. *See NXCESS Motor Cars*, 317 S.W.3d at 467 (describing transfer of valid CT).

567. *Id.* at 464.

568. *See id.* at 468.

even if NXCESS had succeeded with this dubious (and unnecessary) argument, it would not have affected the outcome: the voidable title (and transaction of purchase) rules of section 2-403 merely allow the transfer of a seller's rights free of adverse claims by former owners; they do not cut off previous security interests perfected under Article 9—only Article 9 does that.<sup>569</sup>

Because of this, the NXCESS court's thoroughly tortured line of reasoning (for example, that Avatar Trust did not acquire even voidable title because it did not defraud Cavazos, the fraudster!) was entirely unnecessary (and irrelevant, as was the NXCESS argument on the same issue).<sup>570</sup> In the end, the NXCESS court relied on the mistaken notion that a forged lien release voids the entire CT, so that Avatar Trust (and consequently NXCESS and Valeri) received no ownership interest whatsoever by reason of the successive executions of otherwise valid CTs.<sup>571</sup>

#### XIV. COLLECTIONS

UCC section 9-607 provides as follows:

(a) If so agreed, and in any event after default, a secured party:

(1) may notify an account debtor or other person obligated on collateral to make payment or otherwise render performance to or for the benefit of the secured party;

(2) may take any proceeds to which the secured party is entitled under § 9-315;

(3) may enforce the obligations of an account debtor or other person obligated on collateral and exercise the rights of the debtor with respect to the obligation of the account debtor or other person obligated on collateral to make payment or otherwise render performance to the debtor, and with respect to any property that secures the obligations of the account debtor or other person obligated on the collateral; . . .

(c) A secured party shall proceed in a commercially reasonable manner if the secured party:

(1) undertakes to collect from or enforce an obligation of an account debtor or other person obligated on collateral; and

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569. See U.C.C. §§ 2-403 cmt. 3, 9-320, 9-337 (allowing termination of security interests as applied to certain buyers or transferors).

570. See *NXCESS Motor Cars*, 317 S.W.3d at 468.

571. *Id.* at 467. The court took this opportunity to repeat its prior error and, quoting an earlier case, stated that “the protection usually afforded to a bona fide purchaser for value without notice does not apply when such purchaser's claim is dependent upon a forged instrument,” but without apparent consideration of the fact that none of the ownership interests in *NXCESS* were dependent on a forged instrument. See *id.* at 468–69 (quoting *Kirkpatrick Joint Venture v. Loots*, 826 S.W.2d 205, 210 (Tex. App. 1992)).

(2) is entitled to charge back uncollected collateral or otherwise to full or limited recourse against the debtor or a secondary obligor.

(d) A secured party may deduct from the collections made pursuant to subsection (c) reasonable expenses of collection and enforcement, including reasonable attorney's fees and legal expenses incurred by the secured party.

(e) This section does not determine whether an account debtor, bank, or other person obligated on collateral owes a duty to a secured party.<sup>572</sup>

This provision can be utilized to collect debts such as credit card receipts owed a credit card company by its customer, but as held in *Agri-Best Holdings, LLC v. Atlanta Cattle Exchange, Inc.*, cannot be used against a bank.<sup>573</sup>

In the cited case, Agri-Best filed a Chapter 7 bankruptcy petition.<sup>574</sup> Wells Fargo, holding a perfected security interest in the debtor's accounts, obtained a modification of the automatic stay pursuant to Bankruptcy Code section 362.<sup>575</sup> Wells-Fargo then sent a section 9-607 notice to the Agri-Best account debtors.<sup>576</sup> The debtors sued.<sup>577</sup> The court found that Agri-Best was not the real-party-in-interest; Wells-Fargo was the real party in interest.<sup>578</sup> On a motion to dismiss by the account debtor, Atlanta Cattle Exchange, Inc. (referred to as TACE in the case), the court denied the motion to dismiss and held that Wells Fargo was the proper party to enforce the collection of some \$1,000,000 in damages related to collection of the accounts receivable, pursuant to UCC section 9-607.<sup>579</sup>

## XV. CONCLUSION

Of course, as noted in the Introduction to this Article, no one can safely predict when a credit crisis will hit (or, perhaps, even whether the previous one has ended),<sup>580</sup> much less precisely which legal issues will be paramount. None-

572. U.C.C. § 9-607.

573. See, e.g., *Agri-Best Holdings, LLC v. Atlanta Cattle Exchange, Inc.*, No. 10 C 6980, 2011 WL 3325847 (N.D. Ill. Aug. 2, 2011).

574. *Id.* at \*1.

575. 11 U.S.C. § 362 (2006); *Agri-Best Holdings, LLC*, 2011 WL 3325847, at \*1.

576. *Agri-Best Holdings, LLC*, 2011 WL 3325847, at \*1.

577. *Id.*

578. *Id.* at \*\*2-4.

579. *Id.* at \*\*1, 4.

580. See, e.g., Tom Lauricella, *Bridgewater Takes Grim View of 2012*, WALL ST. J., Jan. 3, 2012, <http://online.wsj.com/article/SB10001424052970204368104577136531481564726.html> (quoting the co-chief investment officer at Bridgewater Associates, "the world's biggest hedge fund firm": "We're in a secular deleveraging that will probably take fifteen to twenty years to work through and we're just four years in.").

theless, based on the discussion in this Article, your authors present the issues noted here as good candidates for attention by interested parties wishing to be alert to possible trouble spots in agricultural and commercial transactions.

**Exhibit A**  
Residential Noise Setback Map

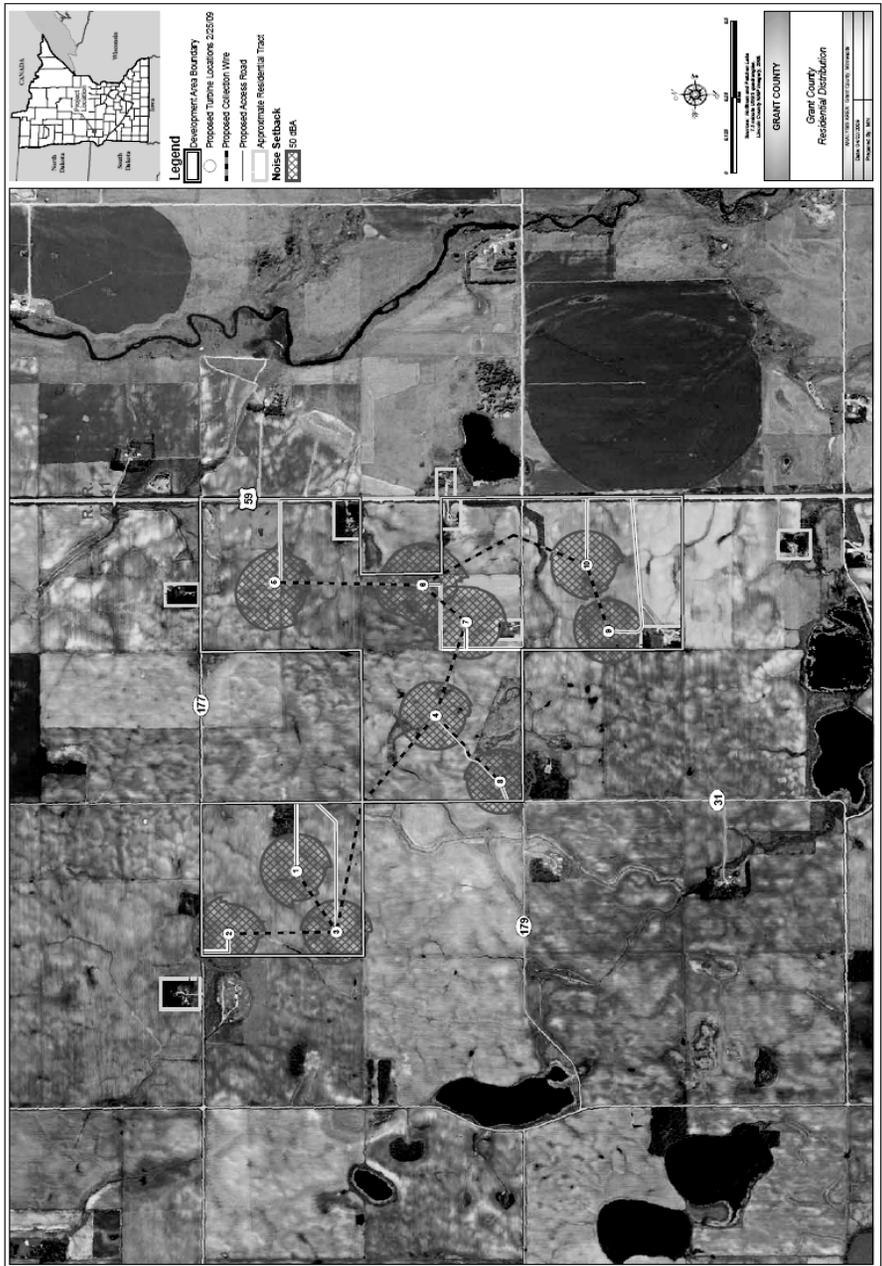


Exhibit B

Depiction of Substation Easement Premises

