SPOTLIGHT

December, 2007

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

In re Jersey Tractor Trailer Training, Inc.,
2007 WL 2892956 (Bankr. D.N.J. 2007)

Few cases from last year contain as many serious errors as this one. Fortunately, some of the errors countered each other, such that the court floundered into the correct result, at least in part.

The case is essentially a priority battle between two secured parties. It began in 2002, when Wawal Savings Bank granted the debtor, Jersey Tractor Trailer Training, Inc., a $315,000 line of credit secured by an interest in substantially all of the debtor's assets. Wawal perfected its interest by a filing a proper financing statement and the security agreement allowed the debtor to collect its own accounts and use the proceeds in its business.

The following year, to alleviate severe cash flow problems, the debtor sought to sell some of its accounts to Yale Factors. In its credit check of the debtor, Yale conducted a UCC search against "Jersey Tractor Trailer Training," an incomplete version of the debtor's name that omitted the corporate identifier. The search failed to disclose Wawal's filing. Relying on its apparent priority, Yale then purchased some of the debtor's accounts and filed its own financing statement.

In late 2005, as the debtor's finances deteriorated, Wawal and Yale each learned of the debtor's relationship with the other. Wawal asserted its priority in the debtor's accounts and the debtor informed Yale that it would not renew its factoring contract. Nevertheless, Yale continued to collect the debtor's accounts and even went so far as to obtain an ex parte restraining order that prohibited the debtor from collecting. The debtor filed for bankruptcy protection and Wawal bought an adversary proceeding to determine the priority of its interest in the debtor's remaining accounts as well as in amounts that Yale had already collected.

The court began its analysis with a lengthy discussion of a seemingly irrelevant issue: whether the debtor's factoring arrangement with Yale was a sale of accounts or a borrowing against accounts. In fact, the issue could be relevant under § 9-315(a)(1) because, if it were a sale, and if Wawal had authorized the debtor to conduct the sale free of its security interest, then Yale would have taken the accounts free of Wawal's interest. Indeed, this was one of Yale's arguments. The court properly concluded that the transaction was a sale but then – again properly – concluded that Wawal had not authorized the sale free and clear because it did not know of the factoring arrangement with Yale. So far, so good.

The court then addressed whether Yale took priority in the accounts as a holder in due course. This is, if course, an absolute impossibility. A person can be a holder in due course of a negotiable instrument, *see* § 3-302, but there is no such thing as a holder in due course of accounts. Nevertheless, Yale argued – and the court accepted for the purposes of discussion, *see* n.4 – that the debtor's invoices to its customers were negotiable instruments. This is absurd. A negotiable instrument is either a promise to pay or an order to pay issued by the person making the promise or order (that is, by the drawer or maker of the instrument), not a writing issued by the person claiming a right to be paid. §§ 3-104(a), 3-105(a). A creditor's invoice thus cannot possibly be a negotiable instrument; it is the wrong kind of document and is issued by the wrong party. Error one.

In evaluating whether Yale was a holder in due course, the court focused on the requirement of good faith. This is the most disturbing aspect of the decision. The obligation of good faith requires "honesty in fact and observance of reasonable commercial standards of fair dealing."[1] The latter half of this standard – reasonable commercial standards of fair dealing – is not a requirement that the holder act in a commercially reasonable manner, *cf.* §§ 9-607(c), 9-610(b) (requiring that collections on collateral and dispositions of collateral be conducted in a commercially reasonable manner), it is a requirement of fair dealing. As such, it is a requirement that applies only to people in contract with each other. *See* § 1-304 ("every contract or duty within the Uniform Commercial Code imposes an obligation of good faith in its performance and enforcement"). This point is borne out by P.E.B. Commentary No. 10 (February 10, 1994), which makes it quite clear that the obligation of good faith attaches only to contractual promises and statutory duties; a person simply cannot owe a duty of good faith to a stranger. Beyond that, § 9-331(c) provides that a filed financing statement is not notice of a claim against an instrument, and thus cannot prevent a holder from qualifying as a holder in due course. Unfortunately, there is language in comment 5 to § 9-331 that indicates otherwise, and expressly suggests that a junior secured party may have a duty to search to determine if a senior lender has contractually prohibited the debtor from granting a junior security interest in accounts.

The court picked up on this comment and took it a step further. It concluded that Yale had failed to act in good faith because Yale had conducted an improper search. Although the record failed to explain why the search firm had missed the filing, and thus it was unclear whether the error was Yale's or its search firm's, the court ruled that did not matter. It noted that a search revealing no significant secured debt at a time the debtor faced severe liquidity problems "should have raised red flags" and required further inquiry. It described Yale's loan officer as "inexperience[d]" and Yale's conduct as "reckless." Error two.

At this point, the court appears headed to the correct result. Wawal should win this case. It has the senior security interest. It should win as to the remaining accounts under § 9-322(a)(1) as the first to file or perfect. And, indeed, that is what the court so ruled. Wawal should also win – at least presumptively – as to collections by Yale. That is because of the difference between a disposition of tangible collateral and a collection of receivables. When a junior secured party

[1] The court should have cited Article 3 for this point, but instead relied on Article 9.

disposes of collateral, any senior security interest remains unaffected and the buyer takes subject to it. *See* § 9-617. Because of that, the senior secured party has no claim to the proceeds of the junior's disposition. *See* § 9-615(a). However, when a junior secured party collects on accounts, the account debtor's obligation is discharged, with the result that the senior's collateral is gone. To compensate for this, the comments to Article 9 make clear that the junior secured party must account to the senior for the amounts collected, unless the junior qualifies for priority as a holder in due course, good faith purchaser of an instrument, or noncollusive transferee of money. *See* §§ 9-330 comment 7, 9-331 comment 5, 9-607 comment 5.

The court did not analyze Yale's potential priority under these rules. Nevertheless, the court rejected Wawal's claim against Yale for conversion because it concluded that Wawal had no right to dominion and control over the debtor's accounts. The court noted that Wawal's agreement with the debtor allowed the debtor to collect its accounts until Wawal declared a default. Accordingly, so the court reasoned, Yale's collection of the accounts prior to that declaration did not amount to a conversion of Wawal's property. Perhaps the court's confusion here emanates from the fact that the tort of conversion originated as an action relating to tangible property, and the language used in old cases seems inapplicable to intangible assets, such as accounts. Yet once Yale collected, the accounts were gone. What more should be necessary to maintain a conversion claim? Error three.

Glimcher Supermall Venture, LLC v. Coleman Co.,
739 N.W.2d 813 (S.D. 2007)

This case is another example of a court reaching the right result for the wrong reason. In the process, the court provides a seriously flawed analysis of the Uniform Fraudulent Transfer Act ("UFTA") that we can only hope others will not follow.

In 1994, Coleman Company, a South Dakota corporation, decided to open a retail outlet in a new mall in Auburn, Washington. To reduce the risk associated with this venture, a new corporation – Black Hills Gold Factory Outlet Store, Inc. – was formed. It had substantially the same shareholders, officers, and directors as Coleman. Black Hills leased space in the mall and purchased jewelry on credit from Coleman.

In 2001, Black Hills ceased operations. It vacated the store 19 months before the end of the lease term. It paid the lessor for the time it was in possession but paid nothing for those additional 19 months. Shortly after it ceased operations, Black Hills transferred all it remaining assets – $45,000 in cash and $225,000 in inventory – to Coleman in satisfaction of a $600,000 debt for unpaid inventory. The lessor sued Black Hills for the remaining rent due and obtained a judgment for $90,000. The lessor then brought a fraudulent transfer action in South Dakota against Coleman. The trial court ruled that the transfers to Coleman were not done with fraudulent intent and were made in exchange for reasonably equivalent value. The lessor appealed to the state supreme court, which reversed on both grounds.

In addressing the claim of actual fraud, the court looked at the badges of fraud listed in section 4(b) of the UFTA, which South Dakota has enacted. It concluded without much difficulty that the transfers were to an insider, were made after the lessor had already threatened legal action, involved substantially all of the debtor's assets, and were done when the debtor was insolvent. To this the court added that the debtor had concealed the transfer, absconded, and removed assets. These additional conclusions are dubious. The court's basis for the concealment point was that the lessor had no knowledge of the transfer and was somewhat misled by the fact that the debtor had in fact paid rent for the one month after it vacated the premises. The court seemed to treat this payment to the plaintiff as an effort to conceal the fact that it was about to make transfers that would make it unable to pay any more. It is odd indeed to suggest that payment of a lawful debt to the plaintiff makes the avoidance action stronger. As to absconding, the court concluded that the debtor's failure to inform the lessor of its plans to abandon the premises qualified as absconding. This misconstrues the term. The debtor did not move to South Dakota by transferring its inventory to Coleman; the debtor ceased operations. This is not the case of an individual who moved to a foreign country – or even a different domestic jurisdiction – to evade capture or make collection more difficult. Ceasing operations is not absconding. The court made essentially the same error with respect to removal and concealment of assets. It treated the transfer to Coleman – which was, after all, a lawful creditor of the debtor – as "removal" of assets.

As a result of this analysis, the court reversed the trial court's ruling on what is essentially a factual question. But it did not stop there. It did not remand for reconsideration, it ruled that the transfer was made with actual intent to hinder, delay, or defraud.

If this were the only disturbing aspect of the court's decision, it would not merit discussion in this column. Of far greater concern is how the court dealt with the lessor's claim of constructive fraud: whether the debtor received reasonably equivalent value for its transfers to Coleman. The UFTA expressly provides that value is given for a transfer if an antecedent debt is satisfied or secured. UFTA § 3(a). *See also* Bankruptcy Code § 548(d)(2)(A) (providing similarly for the purposes of the Bankruptcy Code's fraudulent transfer provision). Because payment of a debt normally reduces the amount of debt on a dollar-for-dollar basis, payment of a lawful debt is always in exchange for reasonably equivalent value. On that facts of this case, in which the debtor transferred assets worth $270,000 in exchange for cancellation of a $600,000 debt, the debtor's receipt of reasonably equivalent value is simply beyond question. Nevertheless, the court ignored the clear mandate of the text and ruled that value must be measured from the perspective of the frustrated creditor, not from the debtor's perspective. Because cancellation of the debt was of no value to the lessor, reasonably equivalent value was not received.

This analysis confuses fraudulent transfers with preferences. The debtor's transfers to Coleman were quite possibly preferential transfers to an insider that could be avoided if the debtor went into bankruptcy within the next year. But creditor equality is basically the province of preference law, not fraudulent transfer law. Although some courts have held that a payment to one creditor can be for the purpose of delaying or defrauding another creditor,[2] such cases are and should be rare. More importantly, such transfers simply cannot be transfers for less than reasonably equivalent value.

Nevertheless, despite the court's very questionable analysis of both fraudulent transfer claims, it may have reached the correct result. The UFTA has, in addition to actions based on actual fraud and lack of reasonably equivalent value, a cause of action for a transfer to an insider. The elements are essentially those of a preference: the transfer must be on account of an antecedent debtor, it must be made while the debtor is insolvent, and the insider must either know or have reason to know that the debtor is insolvent. UFTA § 5(b). The facts of the case seem to satisfy these elements, a point the dissenting justices noted. Unfortunately, the lessor had either not brought a § 5(b) claim or had abandoned it. Consequently, the state supreme court should have affirmed the trial court's judgment.

***In re Zych*,**
2007 WL 4409797 (Minn. Ct. App. 2007)

This case involves a dispute arising from a security interest in cattle and has some truly disconcerting language regarding whether a security interest can attach to a commercial tort claim as proceeds of other collateral.

On April 25, 2005, Zych sold 217 head of cattle through a subsidiary of GFI America for just over $220,000. GFI's payment for the cattle was dishonored due to insufficient funds and shortly thereafter GFI filed for bankruptcy under Chapter 11. Zych brought a claim against GFI's lender, Wachovia, claiming that Wachovia had violated the Packers and Stockyards Act in its treatment of the cattle proceeds from the April 25 transaction. The classification of this claim as a "commercial tort claim" within the meaning of § 9-102(a)(13) was not in dispute.

In Zych's own subsequent Chapter 11 action, Zych's attorneys filed a UCC financing statement declaring their lien on various items of collateral, including any settlement from Zych's claim against Wachovia. Meanwhile, Zych's secured lender, Rabo Agrifinance, claimed that its security interest in the cattle extended to the claim against Wachovia, both as proceeds of the cattle and as a "general intangible" under the parties' security agreement.

Relying upon the language of § 9-108(e) and § 9-204(b)(2), the court ruled that Rabo had no security interest in Zych's claim against Wachovia because: (1) the security agreement did not

---

[2] *See, e.g., In re McGalliard*, 183 B.R. 726 (Bankr. M.D.N.C. 1995) (citing other cases on the point); *In re Fieser*, 248 B.R. 648 (Bankr. M.D. Fla. 1999) (denying discharge to man who, thinking himself fatally ill, borrowed money on credit cards covered by insurance feature and used funds to pay off home mortgage); *First National Bank v. Hooper*, 48 S.W.3d 802 (Tex. Ct. App. 2001) (delivery of deed of trust to unsecured creditor was done with intent to delay, hinder or defraud other creditors; court's review on appeal incorrectly held no reasonably equivalent value was given).

describe the claim with the requisite degree of specificity; and (2) the commercial tort claim did not exist at the time at which the security agreement was perfected. That ruling is undoubtedly correct to the extent that Rabo's interest was asserted as an interest in after-acquired collateral. However, the court also ruled that these provisions prevented Rabo's security interest from attaching to the claim against Wachovia as proceeds. This is patently wrong and confuses the concepts of after-acquired property and proceeds. Moreover, it effectively nullifies the portion of the definition of proceeds in § 9-102(a)(64)(D) that expressly includes claims arising out of the loss of the collateral. Perhaps most important, there is no way for lenders to draft around this problem. The court expressly ruled that Article 9 still applies to commercial tort claims and their proceeds – and implicitly, therefore, lenders cannot hope to acquire a security interest in commercial tort claims under other law – but that the specificity rule of § 9-108(e) and the prohibition on attachment in § 9-204(b) apply even to commercial tort claims as proceeds of other collateral.

Stephen L. Sepinuck
Professor, Gonzaga University School of Law
Chair, U.C.C. Committee
ssepinuck@lawschool.gonzaga.edu

Kristen Adams
Professor, Stetson University College of Law
Chair, Subcommittee on General Provisions & Relations to Other Law
adams@law.stetson.edu