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# **BANKS AGAINST SECURED PARTIES TO THE VICTOR GO THE SPOILS**

Janet A. Flaccus\*

## **INTRODUCTION**

Priority fights among creditors are a common part of a failed business. In the past, priority fights were largely ignored by the statutes of the day. This changed with the drafting of Article Nine of the Uniform Commercial Code ("U.C.C."). As Grant Gilmore, a principal draftsman of Article Nine said:

[m]ost of the pre-Code security statutes ignored priority problems, leaving them to be solved, as they arose, by the courts on whatever principles occurred to the judges. The statutory tradition of sweeping all priority problems under the rug no doubt, stems from the nineteenth-century chattel mortgage acts, which were, designedly, fragmentary affairs.<sup>1</sup>

In contrast, Article Nine was designed to tackle priority problems head on. Yet, despite the draftsmen's industrious attempt to address all priority problems, the priority battle between banks claiming an interest not created under Article Nine and secured parties has split the courts. The priority fight between a bank, as a secured party, and another secured party is not at issue here because it is squarely handled by Article Nine. The focus of this paper is the priority dispute between a bank with secured lines of credit and a secured party with proceeds which pass through the bank.

There are several ways a bank can pay off a loan other than by enforcing an Article Nine security interest or a mortgage. First, a bank can set-off a loan obligation with an account a debtor maintains with the bank. Second, the bank may set up a blocked account whereby accounts receivable are paid into a blocked account which is solely in the bank's control. Last, a debtor might authorize the withdrawal of money from one of his accounts, or pay the bank by check or wire transfer. If the money taken by the bank constitutes the proceeds of an Article Nine secured party, there is a priority fight. The extent

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<sup>1</sup> GRANT GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY 653 (Boston, Little Brown 1965).

that Article Nine controls this priority fight is an issue on which courts do not agree.

The lack of guidance in Article Nine is explained by the fact that Article Nine itself excludes, at least, the creation of, set-off rights.<sup>2</sup> The locked box and blocked account of current asset-based lending practices of banks was not a practice used by banks in the 1940's and 1950's when Article Nine was created. The only place in Article Nine that addresses the priority of a non-Article Nine claim of a bank against a secured party is section 9-306 which addresses proceeds in insolvency-proceedings.<sup>3</sup> In this section, a bank's right to set-off against money in a bank account is given priority over a secured party's claim to the account as proceeds. The bank's priority in a given insolvency proceeding cannot easily be compared to other situations. This is because a secured party in insolvency gains the right to all proceeds that the debtor receives within ten days of the initiation of insolvency proceedings, regardless of whether the secured party can prove that the bank account actually contained any proceeds at all. Outside of insolvency proceedings, the secured party must prove that proceeds are still in the account.<sup>4</sup>

The approaches that courts have adopted to resolve the issues inherent in a priority fight with a bank vary in response to a bank's actions. In other words, case law turns on whether the bank is 1) setting off a loan against the debtor's savings or checking account, or receiving a check in which it can claim holder in due course rights; or 2) taking the money directly from the debtor's customers pursuant to a locked box or blocked account arrangement contractually created by the debtor and the bank.

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<sup>2</sup> U.C.C. §9-104 (i)(1990). Section 9-104 is the section in Article Nine that excludes various transactions from Article Nine. The exclusion of section 9-104 states "[t]his act does not apply to any right of set-off". What this exclusion covers is not clear and has divided the courts as discussed in Part I *infra*.

<sup>3</sup> U.C.C. § 9-306(4) (1990).

<sup>4</sup> This is because U.C.C. section 9-306(2) (1990) requires the proceeds to be identifiable in order for the secured party to have an interest in the proceeds at all. Granted most courts allow the secured party to use tracing principles in order to identify the proceeds in a commingled bank account. *C.O. Funk & Sons, Inc. v. Sullivan Equipment, Inc.*, 431 N.E.2d 370 (Ill. 1982). The most common tracing rule is "the lowest intermediate balance rule". The rule works as follows: Assume that the account has \$5,000 in it when the proceeds in the amount of \$1,000 are deposited in the account so that the account now has \$6,000. Next, the debtor takes out of the account \$4,000 leaving now only \$2,000. The tracing rule of the lowest intermediate balance allows the proceeds to remain in the account until the balance is withdrawn. If the debtor had withdrawn \$5,500 instead of \$4,000 as above, and then deposited \$7,000, the identifiable proceeds interest in the account is only \$500 because this was the lowest intermediate balance. The proceeds interest does not increase when more money is deposited.

This article explores whether priority rules should depend on the bank's actions. Thus, the focal point of the discussion will revolve around a single case which well represents the problem at issue in this paper.

In *Orix Credit Alliance Inc., v. Sovran Bank*<sup>5</sup>, the secured party, Orix, represented itself as a purchase-money secured party because it had provided the money that enabled the debtor, A.E. Finley and Associates, to buy a crane that the debtor then leased as part of its ordinary course of business.<sup>6</sup> Orix had a perfected security interest in the crane. Sovran Bank ("Sovran"), the defendant in the case is involved because "Finley maintained both a lending and depository relationship with Sovran. Specifically, Sovran provided Finley with a revolving line of credit and three bank accounts."<sup>7</sup> Sovran also had a security interest in now and after acquired inventory, and had a contractual arrangement with the debtor providing that accounts receivable would be deposited in a special account at Sovran, called a cash management account. The money in this account was available only to Sovran for the purpose of paying off the loans that Finley owed. Finley could write checks on a different account, but such checks would be honored by Sovran only if it released money into the debtor's account pursuant to a line of credit.

When the debtor bought the crane with Orix's money, Orix sent a letter to the bank asking the bank to agree to subordinate any lien it had on the crane to Orix's lien. This request was necessary because although Orix ordinarily, as a purchase money secured party, would have had priority over the bank's after-acquired security interest in the inventory, Orix apparently did not comply with the requirements of section 9-312(3) in order to achieve such priority. As a result, Sovran had a prior security interest in the debtor's inventory.<sup>8</sup> A subordination agreement was signed by the debtor's loan officer,

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<sup>5</sup> *Orix Credit Alliance, Inc. v. Sovran Bank*, 4 F.3d 1262 (4th Cir. 1993) (Interestingly, Justice Powell, retired Justice from the U. S. Supreme Court, was sitting by designation and was one of two judges in the majority).

<sup>6</sup> *Id.* at 1264.

<sup>7</sup> *Id.* at 1264.

<sup>8</sup> *Id.* at 1273-74 (Ervin, C.J., dissenting) (stating that a material question of fact was whether the subordination agreement applied to proceeds. He points out that if Orix did not have priority under the subordination agreement the bank should win. He notes that Orix did not perfect its security interest in the crane until after the crane was received by the debtor. Thus, Orix failed to comply with section 9-312(3)(a). The debtor entered into a lease with a third party before the crane was purchased. Orix's money was needed to buy the crane which was then delivered directly to the lessee who received the crane before Orix perfected its security interest. Judge Ervin was not troubled by the fact that the crane was delivered to the lessee directly, and not the debtor, despite the fact that section 9-312(3)(a) says "the debtor receives possession". Judge Ervin cites several other sections of Article Nine which broaden debtor rights to include nondebtors. The problem with this approach is that debtor is defined in section 9-105(1)(d) to include

Elspeth McClelland, and returned to Orix.

Approximately one year later, when the debtor was in default on its loans, Sovran and the debtor agreed to raise money by a sale of some of the debtor's leased equipment. One piece to be sold was Orix's crane. Orix agreed with the debtor to allow the sale of its crane on the condition that the remainder of its loan on the crane would be paid off with the sale proceeds. The crane and other equipment were sold to a buyer who wire transferred \$565,000 to the cash management account controlled by Sovran. It used this money to pay off

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someone other than the debtor when the debtor does not own the collateral. This does not help broaden the word debtor in this case. The reason for the section 9-312(3)(a) requirement that the security interest be perfected before the debtor receives possession of the collateral is the notice requirement. Under section 9-312(3)(c) notice must be given to holders of conflicting security interests before the debtor receives possession of the collateral. The secured parties entitled to notice are the ones who recorded before the purchase money party did. This elaborate structure was designed to protect the inventory financier who might otherwise lend more money to the debtor on evidence that the debtor had more inventory which was actually already encumbered. U.C.C. section 9-312 cmt.3. Given this purpose, there is a better approach to the fixing of the date by which the purchase money secured party must be perfected when the debtor is not getting possession of the collateral. The inventory financier is not going to rely on the lessee getting possession. They are more likely going to rely on when the inventory is carried on the debtor's books. Under this approach, it is not clear if Orix was perfected in time.

Judge Ervin has a second reason why pursuant to Article Nine the bank had priority if the subordination agreement is not controlling. Section 9-312(3) only gives the purchase money secured party priority in the collateral if it was "cash proceeds received on or before the delivery of the inventory to a buyer". Judge Ervin points out that the buyer of the crane was the lessee. The lessee structured the sale as a sale/lease-back so that a lender actually purchased the crane from the debtor. However, the crane never left the lessee's possession so Judge Ervin concludes that Orix could never have received the proceeds before the buyer received possession. Since the lender was the buyer, the judge concluded that the lender had constructive possession when it entered into the sale/lease-back arrangement with the lessee which occurred before the lessee paid the debtor for the crane.

Comment 3 to section 9-312 states that the interest in proceeds for a purchase money security interest in inventory is limited in order to exclude from the the purchase money priority accounts receivable and chattel paper proceeds that later may generate cash proceeds. The priority fight with these parties is to be covered, according to Comment 3, by section 9-312(5) which gives priority to the party who was the first to file.

Here the fight over the proceeds was not against an accounts or chattel paper financier, but merely the inventory financier. Therefore, the court should have considered giving priority to Orix the purchase money party over the inventory financier's after-acquired property proceeds interest. After all, priority over the inventory financier's after-acquired property interest is what section 9-312(3) is all about. Instead, Judge Ervin misconstrued the law and gave priority to the bank. Under Judge Ervin's analysis, a purchase money party always loses to the inventory financier if the collateral is sold to a lessee after the lessee has received possession of the collateral under the lease. Just because the facts are a little different from the typical inventory sale, is no reason to change the priority given to the purchase-money party. The priority for accounts and chattel paper proceeds of inventory is different because these are common sources of collateral. If a direct interest in accounts or chattel paper lost to a proceeds claimant, the accounts and chattel paper would no longer be good sources of collateral.

loans the debtor owed. Meanwhile, the debtor wrote a check to Orix to pay for the crane. Sovran refused to pay the check because doing so would have put the debtor \$2,206 over the debtor's credit limit.<sup>9</sup> This was due to the fact that the debtor had \$30,740 worth of additional checks that were presented for payment on that day as well. The credit limit had been imposed on the debtor by McClelland, the debtor's loan officer, even though the credit committee at the bank had authorized a higher credit limit under which the payment to Orix would have cleared. (Interestingly, McClelland was the person who agreed to Orix's subordination agreement one year earlier.) Upon the refusal of payment on the check, Orix sued Sovran claiming a proceeds interest. The district court granted summary judgment to the bank which was upheld on appeal, albeit with a dissent, from the Fourth Circuit.<sup>10</sup>

This Article begins in Part I by exploring the priority rules the courts have developed when a bank is asserting a set-off right to the secured party's proceeds. In Part II the holder in due course rules are briefly discussed. These rules are relatively clear since they are derived from statute. The proper place for the *Orix* case is in Part III since the bank did not set-off against the funds, nor was the bank a holder in due course. The *Orix* court used, instead, the "ordinary course of business" exception in Comment 3 to the U.C.C., section 9-306. This exception, according to the First, Fourth, and Seventh Circuits, allows the bank to take free of Orix's claim.<sup>11</sup> Part IV analyzes these rules and suggests a unified way of analyzing the priority fight which does not depart substantially from the current jurisprudence and yet gives priority to Orix over the bank.

## **PART I THE BANK'S SET-OFF RIGHTS AGAINST THE SECURED PARTY'S PROCEEDS**

Courts are divided into two on the issue of priority fights between the bank setting-off against a debtor's account and a secured creditor claiming a proceeds interest in the money. To commence, all courts must address the question: what is excluded under U.C.C. section 9-104(i). This section says "[t]his article does not apply to any right of set-off"

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<sup>9</sup> *Id.* at 1265 n.3.

<sup>10</sup> *Id.* at 1263-64.

<sup>11</sup> *Orix Credit Alliance, Inc.*, 4 F.3d 1262; *Harley-Davidson Motor Co. Inc. v. Bank of New England-Old Colony, N.A.*, 897 F.2d 611 (1st Cir. 1990); *J.I. Case Credit Corp. v. First Nat'l Bank of Madison County*, 991 F.2d 1272 (7th Cir. 1993).

This section obviously excludes some aspects of set-offs from Article Nine. One group of courts, constituting the majority view, say that section 9-104(i) only excludes the creation of set-offs from Article Nine but not the priority questions of who wins between the bank performing a set-off and a secured party.<sup>12</sup> The minority group concludes that section 9-104(i) excludes all questions, in any way, concerning a set-off, including priority questions, from the rules in Article Nine.<sup>13</sup> The group ignoring Article Nine relies on common law rules of set-off to determine priority. This common law body is also divided into two opinions.

On the question of the coverage of section 9-104(i), both sides have valid arguments. The majority view, that section 9-104(i) does not exclude the priority rule from Article Nine, is supported by a statement of the principle draftsman of Article Nine, Grant Gilmore.<sup>14</sup> His reasoning as to why section 9-104(i) came into the Code is supported by the Code's drafting history.

The cases on the majority side of the issue rely heavily on Grant Gilmore's statement on why section 9-104(i) was added to the Code. Gilmore states:

[t]his exclusion is an apt example of the absurdities which result when draftsmen attempt to appease critics by putting into a statute something that is not in any sense wicked but is hopelessly irrelevant. Of course a right of set-off is not a security interest and has never been confused with one: the statute might as appropriately exclude fan dancing. A bank's right of set-off against a depositor's account is loosely referred to as a "banker's lien", but the "lien" usage has

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<sup>12</sup> Valley Nat'l Bank of Arizona v. Cotton Growers Hail Ins. Inc., 747 P.2d 1225, 1229-30 (Ariz. 1st Ct. App. 1987) (involving a set-off by an insurance company rather than a bank); Insley Mfg. Corp. v. Draper Bank & Trust, 717 P.2d 1341, 1344-47 (Utah 1986) (this case is one of the best reasoned opinions on this issue); Southeastern Financial Corp. v. Nat'l Bank of Detroit, 377 N.W.2d 900,901 (Mich. Ct. App. 1985); Griffin v. Continental Am. Life Ins. Co., 722 F.2d 671, 673-74 (11th Cir. 1984) (applying Georgia law handed down by the Georgia Supreme Court from a certified question coming from the Eleventh Circuit. Like the *Cotton Growers Hail Ins.* case, this case involved a set-off by an insurance company); Coachman Indus., Inc. v. Security Trust & Sav. Bank of Shenandoah, 329 N.W.2d 648, 650 (Iowa 1983); Citizens Nat'l Bank of Whitley Co. v. Mid-States Dev. Co., Inc., 380 N.E.2d 1243, 1247-1248 (Ind. Ct. App. 1978) (this case is the most widely cited case for this issue); Ass'n Discount Corp. v. Fidelity Union Trust Co., 268 A.2d 330, 332 (N.J. Super. Ct. Law Div. 1970).

<sup>13</sup> Bank of Crystal Springs v. First Nat'l Bank of Jackson, 427 So. 2d 968, 971 (Miss. 1983); State Bank of Rose Creek v. First State Bank of Austin, 320 N.W. 2d 723, 725-26 (Minn. 1982); First Nat'l Bank of Grand Prairie v. Lone Star Life Ins. Co., 529 S.W. 2d 1097 (Tex. 1975) (remarkable for its brevity).

<sup>14</sup> GILMORE, *supra* note 1, at 315-16.

never led anyone to think that the bank held a security interest in the bank account. Banking groups were, however, concerned lest someone, someday, might think that a bank's right of set-off, because it was called a lien, was a security interest. Hence the exclusion, which does no harm except to the dignity and self-respect of the draftsmen.<sup>15</sup>

The drafting history of Article Nine shows that the language now in section 9-104(i) was added in the 1957 Official Code.<sup>16</sup> The changes that were made between the 1952 Official Code and the 1957 Official Code were to appease the New York Law Revision Commission's review and report on the Code for the New York legislature.<sup>17</sup> During the hearings before the Commission, Mr. Russo, counsel for Chase National Bank, testifying on behalf of the New York Clearing House, stated that bankers were worried that their Banker's lien or set-off would be considered a security interest under Article Nine and require obtaining a security agreement and filing a financing statement to obtain a right to money in the debtor's bank account.<sup>18</sup> Mr. Russo testified that such an event would necessitate the reconsideration of the bank's loan policies, implying that fewer people would get credit. In response to Mr. Russo's comments, Grant Gilmore stated:

[a]nother example of, I think, a useful point is this...whether a bank's so-called lien or set-off might be thought to be included within the Code's definition of security interest. Now, of course, there was no intention whatever that such an interest should be included. If on consideration it is thought that the query has merit, I suggest that once

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<sup>15</sup> *Id.*

<sup>16</sup> The 1952 the original Official Uniform Commercial Code had six types of transactions taken out of the Code by section 9-104. In the 1957 first revision of the Official Uniform Commercial Code five more types of transactions were added to the list of exclusions in section 9-104. Included in these five additions was the language now found in section 9-104(i).

<sup>17</sup> In reaction to the hearings and pending report by the New York Law Revision Commission, the Editorial Board reactivated and appointed sub-committees for each article to consider the criticisms. With cooperation of the Revision Commission, a new draft, the 1957 Official Uniform Commercial Code, was ready within a few months of the publication of the Commission's report to be recommended to the American Law Institute and the National Conference of Commissioners on Uniform State Laws. Herbert F. Goodrich, *Chairman Editorial Board, Foreword* to UNIFORM COMMERCIAL CODE, (The American Law Institute & National Conference of Commissioners on Uniform State Laws eds., 1958).

<sup>18</sup> STATE OF NEW YORK LAW REVISION COMMISSION REPORT, 2 HEARINGS ON THE UNIFORM COMMERCIAL CODE, 117-18 (photo reprint 1980)(1954).



again the solution is entirely simple. A bank that has a banker's lien and set-off should be clearly excluded by a simple phrase<sup>19</sup>

The cases on the minority side of the issue do not address the issue of the intention of the draftsmen in a satisfactory fashion. Instead, they rely on Peter Coogan, William E. Hogan, Detlev F. Vagts and Julian B. McDonnell's assessment of the situation in their treatise on Article nine.<sup>20</sup> However, these authors do not present evidence that the intention of the draftsmen was other than that represented by Professor Gilmore.<sup>21</sup>

One argument is that certain sections in section 9-104 expressly take their reference out of the exclusion of the priority rule and section 9-104(i) does not. For example, the exclusion of mechanic liens in section 9-104(c) and the exclusion of transfers of interests in land in section 9-104(j) both make reference to the Code sections that cover the priority rule between a fight between these interests and a perfected secured party. The courts and commentators argue that since section 9-104 expressly keeps the priority rule in Article Nine for some exclusions, a failure to expressly do so in section 9-104(i) means a total exclusion.

There is, however, a distinction between these sections and the set-off exclusion in section 9-104(i). Article Nine addresses priority fights regarding mechanic's liens and land transfers in the sections that specifically address

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<sup>19</sup> *Id.* at 164. It is interesting to note that at the 1954 hearings before the New York Law Revision Commission, Professor Gilmore seemed most willing to add language to the Code to address the Bankers' set-off concern, whereas in 1965 in his book, Gilmore ridicules the reason for adding the language in section 9-104(i). Professor Gilmore's conciliatory remarks at the hearings may have been due in part to remarks he made the previous day at the hearings describing the memorandum read by Mr. Russo and others as representatives of the New York Clearing House Subcommittee. Professor Gilmore said that "[t]he memoranda read this morning on behalf of the New York Clearing House...were so riddled with mistakes, inaccuracies, misreadings and misconstructions as to be largely untrustworthy and as to throw grave doubt on the professional competence in this field of those who prepared the memoranda....These are harsh words, deliberately chosen, which I shall be prepared to document before you gentlemen tomorrow." *Id.* at 151.

<sup>20</sup> PETER F. COOGAN, ET AL., SECURED TRANSACTIONS UNDER THE UNIFORM COMMERCIAL CODE §3.15[2] (Matthew Bender & Co., Inc, 1990).

<sup>21</sup> These authors do not raise many arguments against relying on Grant Gilmore's explanation on why section 9-104(i) was added to the Code other than to say that section 9-104(i) does not say that only creation issues were excluded and that the banker's concern with Article Nine probably covered ultimate priority not just creation problems. *See supra* notes 14-16. The drafting history suggests that the banker's concern, at least that which was expressed at the hearings, concerns the creation of a right of set-off and not their priority vis-a-vis a security interest.

these problems. In contrast, the priority rule in Article Nine for set-offs, outside of insolvency, is in the general priority rule, section 9-102.

Even more persuasive is the exclusion of landlord liens in section 9-104(b) which, like the exclusion of set-offs, is an exclusion with no reference to priority. Most courts conclude that the priority fight between the landlord and the secured party is covered by common law principles, not Article Nine.<sup>22</sup> It is interesting to note, that these common-law principles look very much like Article Nine. They give priority to the lien that was created first in time.

The landlord lien exclusion in section 9-104(b) was added as one of the original six exclusions when the first official Code was promulgated in 1952. Combined with the landlord lien exclusion in section 9-104(b) was an exclusion of any lien on real estate. The U.C.C. Comments indicate that the draftsmen considered this exclusion to be self-explanatory. In the official Code of 1957 the exclusion for liens on real estate was separated from landlord's liens. When real estate liens were separated from landlord liens and put in section 9-104(j), language was added that reserves in Article Nine the fixtures priority problem that is addressed in section 9-313.

This drafting history can be seen as supporting a conclusion that the exclusion of the landlord lien from Article Nine was meant to be a total exclusion. The drafting history to the set-off exclusion, however, suggests just the opposite.

The main argument against the above mentioned arguments, based on other sections of 9-104, is that if subsection (i) was intended to take all set-off questions out of Article Nine, why does Article Nine address the priority between the two competing parties in insolvency proceedings, as written in section 9-306(4). If the drafters of Article Nine had intended a full exclusion then they should have put in the language "except as provided in insolvency proceedings in section 9-306(4)". Given that they did not, it is probable that the language in section 9-104(i) was added in 1957, for the reasons offered by Grant Gilmore, and that priority rules were not intended to be excluded by the

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<sup>22</sup> *Kuemmerle v. United New Mexico Bank*, 831 P.2d 976 (N.M. 1992) (the secured party wins under the common law rule of first in time, first in right and benefits from the court's erroneous view of when the security interest attached for purposes of perfection. Although the debtor did not have rights in the collateral yet, the court held the security interest attached when the security agreement was signed.); *First State Bank of Maple Park v. DeKalb Bank*, 530 N.E. 2d 544 (Ill. 2nd App. Ct. 1988) (the secured party wins under the common law); *Ex-Cell-O Corp. v. Lincor Properties of Ariz.*, 762 P.2d 594 (Ariz. Ct. App. 1988) (again, the secured party wins under the common law since its interest had attached before the goods were brought into the leasehold).

section 9-104(i) language despite the fact that section 9-104 does this for other interests.

Once a court takes a position on the question of what is excluded under section 9-104(i), the next question to be addressed is what priority rule will control the fight either under the Code or the common law. If the court follows the majority position, then the priority rule is in Article Nine. A drawback is that the only express priority rule for the secured party/bank set-off fight applies in insolvency proceedings.

This forces the courts to the general priority rule set out in section 9-201 which says: “[e]xcept as otherwise provided by this Act a security agreement is effective according to its terms between the parties, against purchasers of the collateral and against creditors.” Under this section, the secured party always beats the bank’s set-off. The courts on the majority side of the issue have so held.<sup>23</sup>

This language has been in the Code since the first official Code in 1952. The relevant comment has not changed. The issue of whether the language “is effective” means merely that the security agreement remains attached to the collateral even if it is in the hands of a purchaser or other creditor. It could mean this, but still neglect to address priority. The Comment to section 9-201, however, suggests that it covers priority as well. It discusses examples of Code rules which fit into the “except as otherwise provided by this Act” phrase, and therefore control over the rule set forth in section 9-201. Sections mentioned in the Comment include sections such as section 9-307 that allow a buyer in the ordinary course of business to take free of a perfected security interest. If the Comment had just discussed section 9-307 this would be consistent with construing the rule in section 9-201 as limited to attachment and not priority.

The Comment also discusses sections like section 9-301 and section 9-312 which subordinate secured parties to buyers and other creditors as part of priority fights. This suggests that section 9-201 is also a priority rule that

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<sup>23</sup> *Insley Mfg. Corp. v. Draper Bank & Trust*, 717 P.2d 1341, 1347 Utah 1986); *Southeastern Financial Corp. v. Nat'l Bank of Detroit*, 377 N.W.2d 900, 901-02 (Mich. Ct. App. 1985); *Citizens Nat'l Bank of Whitley County v. Mid-States Dev. Co., Inc.*, 380 N.E.2d 1243, 1248 (Ind. Ct. App. 1978); *Coachman Indus., Inc., v. Security Trust & Sav. Bank of Shenandoah*, 329 N.W.2d 648, 650 (Iowa 1983) (not basing priority on section 9-201, instead finding priority for the secured party in section 9-306 by implication that if the bank wins in insolvency proceedings in section 9-306(4) then the secured party wins outside of insolvency proceedings. Section 9-201 is a stronger basis for the priority rule than section 9-306).

controls unless the Code otherwise specifies, which it does not outside of insolvency proceedings.

The cases that conclude that all issues are excluded from Article Nine take their authority from the common law which pre-dates Article Nine's adoption. These cases follow one of two rules called: "the legal rule" and "the equitable rule" respectively. "The legal rule" is followed by a clear majority of states. It allows a bank to keep money taken by a set-off unless the bank had knowledge or sufficient notice to put it on inquiry that the money belonged to someone other than the debtor.<sup>24</sup>

"The equitable rule" is quite different. In jurisdictions with "the legal rule" a bank usually wins in a priority fight. Just the opposite occurs in jurisdictions with "the equitable rule". This is because under "the equitable rule" a bank can not set-off against funds that are not the debtor's unless the bank has acted in detrimental reliance on the deposit, or in some other way, established it had the equities to the money. In other words, even if a bank did not have a scintilla of information that the money belonged to someone else, it would still not be able to set-off unless it had acted in reliance.

It is difficult to see how a bank performing a set-off would detrimentally rely. Normally a bank detrimentally relies on a set-off when it releases collateral or makes a loan in reliance on a set-off. If a bank, after setting off, made another loan to the debtor which it would not have done in the absence of the set-off, the bank should have priority over a competing secured party under "the equitable rule". However, it is difficult to imagine that a bank, which has been forced to set-off in order to satisfy an outstanding indebtedness, would agree to lend yet more funds to such an unreliable borrower.

It is interesting to note that two of the three jurisdictions expressly holding that section 9-104(i) takes all issues of set-off outside of Article Nine have adopted "the equitable rule" under which the secured party is likely to win.<sup>25</sup> Even though these jurisdictions depart from the majority, which follows the priority rule borrowed from Article Nine, the result in both cases is that the

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<sup>24</sup> Cherokee Carpet Mills, Inc. v. Northern Bank and Trust Co., 561 S.W.2d 310, 313 (Ark. 1978); State Highway Comm'n of Mo. v. Thelnor, Inc., 543 S.W.2d 229, 233 (Mo. 2nd Ct. App. 1976); Emile v. Bright, 203 So.2d 328, 329 (Fla. 4th DCA. 1967); Westerly Community Credit Union, v. Indus. Nat'l Bank of Providence, 240 A.2d 586, 590-91 (R.I. 1968).

<sup>25</sup> National Indem. Co. v. Spring Branch State Bank, 348 S.W.2d 528 (Tex. 1961) (allowing an insurance company to retrieve money it had taken in a set-off against an insurance agent's account); Agard v. Peoples' Nat'l Bank of Shakopee, 211 N.W. 825, 827 (Minn. 1927) (bank set-off against money in a real estate agent's account collected for someone else by the agent).

secured party is likely to win over the setting-off bank. Compare this rule with the next rule in which a bank is not setting off against the debtor's bank account but receiving a check as a holder in due course.

What would have happened to Orix's fight with Sovran Bank, if the bank had set-off against the debtor's account? In almost all jurisdictions Orix would have won whether the court took the priority rule out of Article Nine, or not. Even in a jurisdiction that would apply common law to the priority issue and include "the legal rule" and not "the equitable rule", Orix still would have probably had priority. In the *Orix* opinion, the Fourth Circuit assumed that the bank had knowledge of Orix's claim to the money.<sup>26</sup> Even in this type of jurisdiction, Orix's claim would win as long as the bank had notice of the claim.

## **Part II THE BANK'S RIGHTS AS A HOLDER IN DUE COURSE OF A CHECK THAT CONSTITUTES THE SECURED PARTY'S PROCEEDS.**

The holder in due course rules across the country are fairly consistent since the test for a holder in due course ("HDC") is defined in Article Three of the Commercial Code.<sup>27</sup> Since there have been few non-uniform amendments to the definition of a holder in due course (HDC), the cases are not entirely consistent. There are several requirements to becoming an HDC.

First, a bank must be a holder of the instrument. This requires that the bank be a holder of the check. A person can become a holder through several different means. Since checks are not bearer instruments, a bank can become a holder of the check if it is issued to the bank by the drawer, or if it is negotiated to the bank.<sup>28</sup> Typically, a check used to pay off a loan will be a check written by the borrower to the bank. In this case, a bank would be in possession of the check and would be the person to whom the check is payable. This makes the bank a holder of the check.<sup>29</sup>

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<sup>26</sup> *Orix Credit Alliance, Inc. v. Sovran Bank*, 4 F.3d 1262, 1266 n.7 (1993) (reviewing court takes the facts most favorably in light of Orix's complaint since the District Court had given summary judgment to the bank).

<sup>27</sup> U.C.C. §3-302(a) (1990).

<sup>28</sup> U.C.C. §3-201 (1990) Negotiation takes place by delivery alone if the check has become bearer paper by an indorsement in blank. If the check has not become bearer paper, then negotiation occurs when the check is delivered with the required endorsement.

<sup>29</sup> U.C.C. §1-201(20) (1990).

The next requirement to becoming an HDC is that a bank must give value. Value is defined to cover the taking of an instrument in total or partial payment of a pre-existing indebtedness.<sup>30</sup> If a bank uses a check to pay off a debtor's loan in part or in full, then it has given value.

Next, a bank must take the check without notice of several different events.<sup>31</sup> The only type of notice that will typically come up in a fight with a secured party is that a bank took without notice of the claim to proceeds by the secured party.<sup>32</sup>

Notice is defined as having knowledge of, or reason to know of, the claim from all the surrounding facts and circumstances known to the bank at the time the bank performs all other requisites to be a HDC. If the bank has reason to know under the surrounding circumstances, the bank is considered to have notice of the claim of the secured party and cannot be a HDC.

Not all courts are in agreement regarding what constitutes the notice portion of the HDC test. Some jurisdictions follow cases suggesting that only knowledge by the alleged HDC will defeat HDC status.<sup>33</sup> Two states, until recently, had statutes that defined notice within Article Three differently.<sup>34</sup> Virginia and New York defined notice in general to mean knowledge or bad

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<sup>30</sup> U.C.C. §3-303(a)(3) (1990).

<sup>31</sup> U.C.C. §3-302(a)(2) (1990) The other types of notice that destroy HDC status are: (1) notice that the instrument is overdue or has been dishonored, or that there is an uncured default in payment of another instrument that has been issued as part of the same series; (2) notice of an unauthorized signature or that the check has been altered; and (3) notice of any defenses to the instrument or right of recoupment).

<sup>32</sup> U.C.C. §3-306 (1990) The official comment states that claim to the instrument includes a claim to a lien which would cover the claim of the secured party which has a perfected security interest in the check because it is cash proceeds. However, the proceeds must be identifiable. See §9-306(3)(b) (1990).

<sup>33</sup> *Hartford Accident & Indem. Co. v. American Express Co.*, 542 N.E.2d 1090, 1093-96 (1989); *Citizens Nat'l Bank of Englewood v. Fort Lee Sav. & Loan Assoc.*, 213 A.2d 315, 318 (N.J. Super. Ct. Law Div. 1965) In *Gen. Inv. Corp. v. Angelini*, 278 A.2d 193, the New Jersey Supreme Court applied a duty to investigate in a consumer home construction finance case but they did not admit to doing so. They said that the lender who knew that the note payments were to begin 60 days after completion of the home improvement work and could be calculated that this meant that the work would be completed in 10 days, should have inquired whether the work had been actually completed. The court limited its holding to consumer finance cases. *Id.* at 200; *Lawton v. Walker*, 343 S.E.2d 335, 338 (Va. 1986); *Grinzinski v. First Fin. Centers, Inc.*, 1994 WL 107289 (Ohio Ct. App. 2 Dist. 1994) (an unpublished opinion subject to Rule 2 of the Ohio Supreme Court which imposes restrictions and limitations on the use of unpublished opinions.) Like New Jersey, Ohio has consumer finance cases reading obligations to inquire into the good faith prong of the HDC inquiry. *Arcanum Nat'l Bank v. Hessler*, 433 N.E. 2d 204, 209-11 (Ohio. 1982).

<sup>34</sup> N.Y. U.C.C. Law §3-304 (McKinney 1991); Va. Code Ann. §8.3-304(7) (Michie 1991) (repealed 1992).

faith. Bad faith in Article Three was defined as honesty in fact,<sup>35</sup> which the Virginia courts adopted for the bad faith part of the HDC notice requirement.<sup>36</sup> New Jersey and Ohio also have case law adopting this same test, but their legislatures have yet to enact any such statutory law.<sup>37</sup> However, Virginia, New Jersey and Ohio have recently adopted the new version of Article Three.<sup>38</sup> In this version of Article Three, a separate general definition of notice within Article Three, which Virginia and New York had originally, and New York still has, is not given. Therefore, the general definition of notice has to arise from the general purpose definition section of the Uniform Commercial Code, section 1-201, which is incorporated into Article Three by section 3-103(d). Section 1-201 adopts the reason to know standard. Thus the vast majority of jurisdictions make it clear that reason to know will suffice to defeat HDC status.

A case illustrative of this point is *Valley Bank v. Monarch Investment Industries Co.*<sup>39</sup> In *Valley Bank*, a thief sold a stolen backhoe to a consumer who wrote a personal check made out to Monarch Investment Co., ostensibly the thief's employer. The thief took the check to the purchaser's bank and asked the bank to replace the check with a cashier's check by telling the bank that his employer, Monarch, did not like to take personal checks. The bank issued the cashier's check without ever contacting Monarch Investment to verify the information given by the thief. The thief gave the cashier's check to Monarch Coins, which also did business as Monarch Investment, to buy gold.<sup>40</sup> Monarch claimed to be an HDC of the cashier's check.

Monarch called the bank. The testimony about what was said in this phone conversation is very important because it illustrates part of the HDC test. The bank agent said that she made it clear to Monarch that the cashier's check was from the purchasers of a backhoe and was to be used to pay for it. The court said that if this had been the only testimony at trial, then Monarch would have had reason to know that the cashier's check could only be used for the purchase of a backhoe, and not coins. However, a Monarch employee testified

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<sup>35</sup> U.C.C. §1-201(19) The new version of Article Three now defines good faith within Article Three. This definition includes "the observance of reasonable commercial standards of fair dealing". There is also now a definition of ordinary care. See U.C.C. §3-103(4),(7) (1990).

<sup>36</sup> *Lawton*, 343 S.E. 2d at 337-38.

<sup>37</sup> *Grinzinski*, 1994 WL 107289 at \*1; *Citizens Nat'l Bank of Englewood*, 213 A.2d at 318.

<sup>38</sup> 1995 N.J. Sess. Law Serv. Ch.28 section1 (West); Ohio Rev. Code Ann. §1303.01-.70 (Anderson 1994 Supp.); Va. Code Ann. §8.3A-101-605 (Michie 1994 Cum. Supp.).

<sup>39</sup> *Valley Bank v. Monarch Inv. Co.*, 800 P.2d 634 (Idaho 1990).

<sup>40</sup> *Id.* at 635-36.

that the phone conversation with the bank only included a question by the bank regarding whether Monarch was calling about the payment for the backhoe, to which Monarch responded that they were calling about the payment for coins and then nothing more was said on this topic. There was agreement however, that the bank told Monarch that the cashier's check had been issued that morning, that the signatures on the cashier's check was authorized and that the bank had no notice that the check was stolen.<sup>41</sup> The court concluded that because of the conflicting evidence there was evidence to support the magistrate's verdict for Monarch.<sup>42</sup>

The Uniform Commercial Code does not define "reason to know", other than to say it is determined from all circumstances and facts known at the time. The Restatement (Second) of Contracts discusses reason to know as "different from knowledge and should have known."<sup>43</sup> It defines "knowledge" as conscious awareness of the fact, and "should have known" as requiring a reasonable duty to acquire more information once a person knows sufficient facts to arouse suspicion. According to the Restatement, a person has reason to know a fact when he has information from which an inference can be drawn that the fact exists.<sup>44</sup> This comports with the requirement in the Code that reason to know is to be drawn from the facts and circumstances known by the purported HDC at the time.

A slightly different definition of reason to know is defined by the Restatement (Second) of Agency.<sup>45</sup> In addition to the inference that can be drawn from the facts, this definition adds that a person has reason to know of a fact if "there is such a substantial chance of [the claim or defense's] existence that, ... exercising reasonable care with reference to the matter in question, ... [the HDC's] action would be predicated upon the assumption of its possible existence."<sup>46</sup> In addition, if the possible HDC has superior intelligence, then the question is whether a reasonable person with this superior intelligence would infer the claim or defense from the facts at hand.<sup>47</sup> In the HDC context, this definition has been adopted by at least one court.<sup>48</sup>

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<sup>41</sup> *Id.* at 636.

<sup>42</sup> *Id.* at 639.

<sup>43</sup> Restatement (Second) of Contracts §19 cmt. b (1979).

<sup>44</sup> *Id.*

<sup>45</sup> Restatement (Second) of Agency, §9, cmt. d (1958).

<sup>46</sup> *Id.*

<sup>47</sup> *Id.*

<sup>48</sup> E.L. Von Gohren v. Pacific Nat'l Bank of Wash., 505 P.2d 467, 472 (Wash. App. 1973).



What would have been the result of *Orix* if the bank had received a check from the debtor paying off the loan with Orix's proceeds? If the bank had claimed HDC status would it have had notice of Orix's claim to the money? As a financial institution, the bank would be in a superior position to understand the financing aspects of the debtor's business. The bank had several facts available to it at the time.

First, the bank knew of Orix's security interest in the crane. This was more than merely seeing Orix's financing statement. Recall that the previous year, Elspeth McClelland, the debtor's loan officer, signed a letter to Orix agreeing on behalf of the bank to subordinate its interest in the crane to Orix's purchase money security interest.<sup>49</sup> One year later, the debtor was in default on the bank's loans and the bank declared default on the debtor's loans on September 4, 1991. On September 11, 1991, the debtor and the bank discussed the debtor's financial position in light of his default. The wire transfer of the proceeds from the sale of the crane was made by the buyer on September 20, 1991. It is not stated in the opinion, but it is highly likely that the debtor discussed with McClelland his financial plan of selling off leased equipment, including Orix's crane. Even if Orix was not identified in the discussion, given the fact that McClelland had signed the subordination agreement and was the one most likely to have had the discussion with the debtor on September 11, 1991, she had reason to know that money resulting from the sale of the crane would be claimed by Orix. Also, it is irrelevant that McClelland may not have been consciously aware that the money was coming from Orix's crane. She had facts that would raise the inference that the money was from the sale of Orix's crane. She did not need to gather more information. Under the reason to know standard, consciousness of the fact need not be shown since that is the definition of knowledge, not notice. It is notice of a claim to the money that precludes a bank from being an HDC.

The importance of the "ordinary course of business" rule from a bank's perspective is that knowledge is irrelevant under this test and no other. A bank wins even if it knows or has reason to know that money belongs to another and although under the set-off rules and HDC rules this knowledge would defeat the rights of the bank.

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<sup>49</sup> *Orix Credit Alliance, Inc. v. Sovran Bank*, 4 F.3d 1263, 1264. (4th Cir. 1993).

**Part III BANK'S RIGHTS IN TAKING THE SECURED PARTY'S PROCEEDS IN THE ORDINARY COURSE OF THEIR BUSINESS**

The Fourth Circuit, in *Orix*, does nothing novel in applying the “ordinary course of business” rule. Comment 2(c) to section 9-306, the proceeds section, states:

[w]here cash proceeds are covered into the debtor's checking account and paid out in the operation of the debtor's business, recipients of the funds of course take free of any claim which the secured party may have in them as proceeds. What has been said relates to payments and transfers in ordinary course. The law of fraudulent conveyances would no doubt in appropriate cases, support recovery of proceeds by a secured party from a transferee out of ordinary course or otherwise in collusion with the debtor to defraud the secured party.<sup>50</sup>

Several circuit courts of appeal have interpreted this comment to allow a bank to keep the money even if it knew the money was the secured party's proceeds.<sup>51</sup> This rule is clearly different from any set-off rule or the HDC rule, wherein knowledge would defeat a bank's interest. The question remains, just how do the facts of these cases justify such a divergent rule. The First and Seventh Circuits conclude that the bank will be forced to give back the funds only if it acted improperly, defined here as fraudulent or collusive conduct.<sup>52</sup> The question is whether the courts are applying this Comment correctly given the facts in the cases. It is submitted here that they are not.

The facts fall into three basic patterns. The first pattern is the one found in cases such as *Orix*. In these cases, the third party makes payment directly to the bank. In the second pattern, the debtor, or someone on his behalf, authorizes the bank to take money out of the debtor's bank account. The third pattern is a variant of the second, but instead of authorization to take money

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<sup>50</sup> U.C.C. §9-306 cmt. 2(c) (1990).

<sup>51</sup> *Orix Credit Alliance, Inc.*, 4 F.3d 1263; *J.I. Case Credit Corp., v. First Nat'l Bank of Madison County*, 991 F.2d 1272 (7th Cir. 1993); *Harley-Davidson Motor Co., Inc. v. Bank of New England-Old Colony*, 897 F.2d 611, 619 (1st Cir. 1990).

<sup>52</sup> *J.I. Case Credit Corp.*, 991 F.2d at 1277; (stating that collusion is involved when the bank knows that the payment of the money is in violation of the secured party's rights.); *Harley-Davidson Motor Co., Inc.*, 897 F.2d at 622-23.

out of an account, the debtor or someone acting for the debtor, pays the bank by writing a check to the bank.

The first pattern is illustrated by the *Orix* case and *General Electric Co. Lighting Business Group v. Halmar Distributors, Inc.*<sup>53</sup> In *Orix* the third party made a wire transfer to the bank's blocked account. The debtor had no access to this account; only the bank could reach the money. In *General Electric Lighting*, the third party sent its check to a lock box. The court said that the lock box was in control of the bank and thus the debtor never had any interest in the money.<sup>54</sup> The bank in *General Electric Lighting* took the checks out of the lock box, which was a post office box, and endorsed the checks over to itself.<sup>55</sup> The bank's purpose was to gain control of the money to be applied against its debt because the checks were made payable to the debtor.

The second pattern is illustrated by *Tuloka Affiliates Inc. v. Security State Bank*<sup>56</sup>. In *Tuloka*, the debtor owned two businesses, one which sold mobile homes and the other which sold recreational vehicles. The bank and the finance company may not have known of one another's interest because the bank financed the recreational vehicle business and the finance company financed the mobile home business. Also, the bank's security interest was unperfected. And, the two companies were located in two different states. Problems developed when the finance company, notified by the debtor of a mobile home sale, sent a draft to be paid on the recreational vehicle company's bank account instead of the mobile home business account. This

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<sup>53</sup> *General Elec. Co. Lighting Bus. Group v. Halmar Distrib.*, 116 B.R. 328 (Bankr. D. Mass. 1990).

<sup>54</sup> *Id.* at 332-34. The bankruptcy court does not rely exclusively on Comment 2(c) to rule in favor of the bank. The court said that the debtor never "received" the proceeds when the checks were sent to the lock box. Since section 9-306(2) gives a security interest only in identifiable proceeds "received by the debtor", the court concluded that the secured party had no interest in the funds at all and, therefore, there was no priority fight. The court bases its conclusion on the fact that the third parties sent their checks to a lock box from which the bank collected the third party checks. Lock box arrangements are services the bank provides much like bookkeeping services for its customers. The bank picks up the checks by going to the lockbox several times per day. The lock box is in the post office. The third parties make the check out to the debtor and send it to the post office box address. It is hard to imagine that these checks are never received by the debtor. Under the court's reasoning, any debtor who used the services of the bank in picking up and processing its checks would destroy the proceeds interest of the inventory financier. The fact that the bank probably had in this case additional contractual agreements with the debtor allowing them to take the checks collected from the post office box and use the checks to pay off the debtor's loan should not change the conclusion of whether the debtor received the money when the checks were addressed to it and sent to its post office box.

<sup>55</sup> *Id.* at 331.

<sup>56</sup> *Tuloka Affiliates, Inc. v. Security State Bank*, 627 P.2d 816 (Kan. 1981).

mistake probably occurred because the finance company was doing business with the recreational vehicle business as its debtor. The money from the sale had gone into the mobile home account.<sup>57</sup>

Shortly thereafter, the bank learned that the debtor had sold some recreational vehicles in violation of the bank's security agreement. When they called the debtor and told him of this violation, the debtor authorized the bank to take money out of the mobile home company's account. However, the bank could not have set-off against this account since their lending arrangement was with the recreational vehicle business not the mobile home business.<sup>58</sup>

Moreover, the authorization by the debtor arguably may have been under duress. When the debtor had previously sold recreational vehicles in violation of the bank's agreement, the bank had informed the debtor that they would "press charges" the next time vehicles were sold without the bank's consent. Consequently, the debtor may have agreed to the taking of the home company's money under the pressure of, at the very least motivated by, previously made threats.<sup>59</sup> The bank refused to pay the finance company's draft on the recreational vehicle company's account and raided the money in the mobile-home account which constituted finance company proceeds. The court allowed the bank to keep the funds.<sup>60</sup>

The third pattern is perhaps the most consistent with the "ordinary course of business". This is where a check is sent by the debtor to the bank. In this situation, the bank would be protected from the secured party's claim if the bank were an HDC. If the bank had notice of the claim of the secured party, which would preclude them from being a HDC, it is questionable that they would be able to claim the money under the "ordinary course of business" exception. By comparing the facts in *J.I. Case Credit Corp v. First National Bank of Madison County*<sup>61</sup> and the facts in *Harley-Davidson Motor Co., Inc., v. Bank of New England-Old Colony*<sup>62</sup> this issue is further explored.

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<sup>57</sup> *Id.* at 817.

<sup>58</sup> *Id.* at 823 (Prager, J., dissenting).

<sup>59</sup> *Id.* It would surprise most people if the bank had not made the same threat now that the debtor was violating the bank's security agreement for the second time. This was not in the opinion, but it is highly likely that the debtor was authorizing the bank's grab under pressure of an immediate pressing of criminal charges if the debtor refused to allow the taking of the money from the other business's account.

<sup>60</sup> *Id.* at 820.

<sup>61</sup> *J.I. Case Credit Corp. v. First Nat'l Bank of Madison County*, 991 F.2d 1272 (7th Cir. 1993).

<sup>62</sup> *Harley-Davidson Motor Co., Inc. v. Bank of New England-Old Colony*, 897 F.2d 611 (1st Cir. 1990).

In the *J.I. Case Credit Corp.* case, the debtor sold agricultural equipment and used cars. The bank was aware that J.I. Case held a security interest in the agricultural equipment. In the five months in question, the debtor sent checks to the bank totaling \$603,000. Whereas, in the previous two years he had averaged payments of \$4,000 and \$10,000 per month respectively. Although the bank knew that the debtor was in financial trouble and believed that payment on the debtor's loans was doubtful, the court notes that the bank was in no way influenced by these payments. The district court held that the bank was not a HDC and did not take the money in the "ordinary course of business".<sup>63</sup> The Seventh Circuit reversed not reaching the HDC argument.<sup>64</sup> The Seventh Circuit noted that the district court inappropriately used a "should have known" standard instead of an "actual knowledge" standard.<sup>65</sup> However, the court did not discuss the rationale behind the "actual knowledge" standard which is at minimum the applicable standard for the HDC discussion.

As this paper has illustrated, there is no standard for the "ordinary course of business" rule since knowledge that the money is the secured party's does not defeat the bank's right to the money. The *J.I. Case Credit Corp.* court held that the bank will not take money in the "ordinary course of business" if it acts with knowledge or reckless disregard that the payment to the bank is in violation of the secured party's security agreement.<sup>66</sup> Thus, even if the bank knew that the money was J.I. Case's proceeds, the bank would be able to keep it.

In *J.I. Case Credit Corp.*, at least, the bank had a credible argument that it did not have reason to know that the checks included J.I. Case's proceeds. This would allow the bank to keep the money in spite of the claim of J.I. Case because they would be a HDC. Note that this result is under the HDC "reason to know" test, not the test the court uses which is knowledge or reckless disregard that the payment is a violation of the security agreement.

In the *Harley-Davidson* case the bank was a junior secured party to the debtor's new and used motorcycles. It knew that Harley-Davidson held a senior security interest in the cycles.<sup>67</sup> The bank however required the debtor to give it the title documents to the cycles. When one of the cycles was sold

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<sup>63</sup> *J.I. Case Credit Corp.*, 991 F.2d at 1273-74.

<sup>64</sup> *Id.* at 1279-80.

<sup>65</sup> *Id.* at 1277-78.

<sup>66</sup> *Id.* at 1279-80.

<sup>67</sup> *Harley-Davidson Motor Co, Inc.*, 897 F.2d at 613-14.

the debtor had to pay the bank in order to procure these title documents.<sup>68</sup> As a junior secured party to the cycles, the bank knew or should have known, that its interest in the money it was receiving was from the sale of cycles was junior to Harley-Davidson's interest and that in taking the money it was in violation of Harley-Davidson's security agreement.

Unlike the Seventh Circuit, the First Circuit does not discuss knowledge at all. Rather the inquiry is whether the bank acted improperly or fraudulently.<sup>69</sup> The court further limits the question of improper behavior to the new motor cycles that were not financed by the bank. Consequently, the court summarily concludes that the bank acted properly in taking the money.

The court ignores the fact that Harley-Davidson was the senior secured party to the used cycles as well. Since the bank, financed the purchase of the old cycles, it could have obtained priority over Harley-Davidson by going through the steps outlined in section 9-312(3); something it did not do.<sup>70</sup> The section 9-312(3) requirements are in place to protect the previously filed party. The careful balancing in this section purports to provide protection to the prior inventory financier, but the court actually gives priority to the subsequent secured party. Not surprisingly, the court does not even mention section 9-312(3). Instead, by using the "ordinary course of business" exception, the court avoids the Article Nine analysis that would defeat the bank's claim to the money and instead adopts a rule which allows each party priority to the cycles that it financed.

Unlike the *J.I. Case Credit Corp.* case, the bank in *Harley-Davidson* could not be an HDC of the checks because it knew the money belonged to Harley-Davidson. Arguably, the bank even knew that the payment to them was in violation of Harley-Davidson's security agreement thereby defeating their right to the money under the Seventh Circuit's standard in *J.I. Case Credit Corp.* Nonetheless, the bank won, at least as to the money from the used cycles.<sup>71</sup> As to the money from the sale of new cycles, the court remanded the case for a factual determination of whether the bank acted improperly and to determine what constitutes improper behavior.

Not all courts are doing such an injustice to the rules of Article Nine. The Eighth Circuit in *Barber-Greene Co. v. National City Bank of Minneapolis*<sup>72</sup>

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<sup>68</sup> *Id.* at 614.

<sup>69</sup> *Id.* at 622.

<sup>70</sup> *Id.* at 616-17.

<sup>71</sup> *Id.* at 622-23.

<sup>72</sup> *Barber-Greene Co. v. Nat'l City Bank of Minneapolis*, 816 F.2d 1267 (8th Cir. 1987).

faced a situation like the *Orix and General Electric Co. Lighting Business Group v. Hamlar Distributors* cases. In these cases the accounts receivables were paid directly into an account controlled by the bank. When the bank took money that was proceeds of a party that had priority under Article Nine, it argued that it took the money in the ordinary course of their business arrangement with the debtor. The Eighth Circuit held that this was not an ordinary course arrangement. The court said that, at the very least, ordinary course presupposed an account over which the debtor had control in deciding who to pay.<sup>73</sup> In *Farmers and Merchants National Bank, Fairview v. Sooner Cooperative, Inc.*,<sup>74</sup> the Oklahoma Supreme Court held that the bank's knowledge of the contents of a financing statement filed by the secured party with priority precluded the bank from taking the money in the ordinary course. The court reached this conclusion despite the fact that the debtor sent the bank a check that the debtor had written on an account containing proceeds.<sup>75</sup>

Are the First, Fourth, and Seventh Circuits correct in their holdings that the ordinary course of business transfer can ignore priority rules in Article Nine and holder in due course rules in Article Three? Is Comment 2(c) to section 9-312 controlling at all? If the answer to these questions is no, what rule should govern the priority fight between the secured party and the common law rights of the bank? These are the questions addressed in Part IV.

#### PART IV WHO SHOULD BE ENTITLED TO THE SPOILS?

Perhaps Comment 2(c) to section 9-312 should be ignored. After all, as a Comment, unless it is enacted into law, it is no more than persuasive authority. It is certainly less controlling than Article Nine statutory language. Is Comment 2(c) inconsistent with Article Nine and if so, should it be disregarded? To answer this question an analysis of Article Nine is needed.

Article Nine has several general priority rules as set out in section 9-312 which establishes a hierarchy of priority unless a specific rule provide an exception to this general hierarchy. The first creditor to file or perfect its interest in the collateral wins under the general priority rule.<sup>76</sup> Section 9-312 applies not only to the priority ordering as to the original collateral but also

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<sup>73</sup> *Id.* at 1272-73.

<sup>74</sup> *Farmers and Merchants Nat'l Bank, Fairview v. Sooner Cooperative, Inc.*, 766 P.2d 325 (Okla. 1988).

<sup>75</sup> *Id.* at 326.

<sup>76</sup> U.C.C. §9-312(5) (1990).

the proceeds of that collateral.<sup>77</sup> Unless a specific rule provides a controlling exception, the creditor with priority as to the original collateral will have priority as to the proceeds of that collateral. This raises the question of what specific rules control are exceptions from this general rule.

The first specific rule applies to the collateral and proceeds of a purchase money security interest in inventory and is included in section 9-312 along with the general rules.<sup>78</sup> This rule gives priority to the purchase money inventory secured party even over previously filed or perfected parties if certain steps are taken.<sup>79</sup> However, they are given priority in the proceeds of inventory only as to cash proceeds received by the debtor on or before the date the inventory is delivered to the buyer.<sup>80</sup> A purchase money secured party in collateral other than inventory has no such limitation and is given priority over previously filed parties both as to the collateral and the proceeds.<sup>81</sup> The specific rule limiting the proceed's rights of an inventory financier only limits the priority as to proceeds of a purchase money party who does not have priority under sections 9-312(5),(6) because they were not the first to file or perfect. If they have priority because they were the first to file or perfect, then the limitation in section 9-312(3) does not apply, and they do not even need section 9-312(3) to win as to the original collateral or its proceeds.

What proceeds then, would be excluded under this rule in section 9-312(3)? Some illustrations should be helpful. First, note that accounts, chattel paper, instruments and goods are not cash proceeds.<sup>82</sup> Assume that creditor #1 has the first filed security interest in the debtor's now owned and

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<sup>77</sup> U.C.C. §9-312(6) (1990) This statutory section says that the filing or perfection date of the original collateral is to be the filing or perfection date for purposes of perfection as to the proceeds. This controls most questions of priority of the proceeds because the general rule for priority is the first to file or perfect. §9-312(5).

<sup>78</sup> U.C.C. §9-312(3) (1990).

<sup>79</sup> The steps the purchase money secured party with an interest in inventory must take in order to get priority include: 1) perfecting before the debtor gets possession of the collateral; 2) giving written notice to all other secured parties who had filed as to the same collateral before the purchase money party filed; 3) stating in the notice that the purchase money party was going to take a security interest in specifically described (by item or type) inventory; and 4) making sure that the previously filed secured parties receive the notice sometime within five years before the debtor receives possession of the inventory. The last requirement necessitates an explanation. This allows the purchase money party, who is going to make several sales to the debtor, to give notice to a particular creditor only once every five years. But the notice before the first sale must be received by the competing secured party before the debtor receives possession of the inventory.

<sup>80</sup> U.C.C. §9-312(3) (1990).

<sup>81</sup> U.C.C. §9-312(4) (1990).

<sup>82</sup> U.C.C. §9-306(1) (1990).



after acquired inventory. Creditor #2 has a purchase money security interest in a boat sold to the debtor dealer. Creditor #2 filed after Creditor #1 but because creditor #2 is a purchase money party they have priority over #1 as to the particular boat. If that boat is sold to a buyer in the ordinary course of the debtor's business, creditors #1 and 2 are going to fight over the proceeds. If the proceeds are cash and a trade-in vehicle, #1 wins as to the trade-in since it is not cash proceeds, and #2 will win as to the cash assuming the debtor received the cash on or before the buyer received possession of the car.

Now assume that creditor #3 comes into the picture and files even earlier than did #1 but takes a security interest in the debtor's accounts receivable now and after-acquired. Now, when the buyer purchases the car, the buyer pays with a trade-in and an unsecured promise to pay the remaining balance over the next year, i.e., an account receivable. Creditor #1 wins as to the trade-in and #2 is second. Creditor #3 has no interest since his only interest is in accounts. But who wins as to the accounts? Since the account is not cash proceeds, creditor #3 wins as to the account because he was the first creditor to file or perfect. Number 1 comes next as the next creditor to file and the purchase money party comes in last. If Creditor #3 had been the last to file then #1 would have won as to the account because he was the first to file. Observe the extent to which the general first to file or perfect rule controlled most of the above described priority fights.

Specific rules are also contained in sections 9-308 and 9-309 which cover chattel paper, instruments and documents. Taking section 9-308 first, it changes the general rules discussed above if the proceeds paid by the buyer of the boat is in the form of chattel paper instead of an account. Assume as above that #1 filed first but #2 as a purchase money party has first priority as to the particular boat. Now #3 takes a security interest in the debtor's now owned and after-acquired chattel paper and was the last to file. Assume that when the buyer bought the boat, they signed a note evidencing their promise to pay over the next year and a security agreement to secure that promise. This is chattel paper.<sup>83</sup>

Who wins as to the chattel paper proceed? Creditor #3 probably wins even though he was the last to file. But he will win only if he gave new value and took possession of the paper in the ordinary course of his business.<sup>84</sup> It does not matter whether he knew about Creditors #1 and #2's interest before he took his interest in the chattel paper since the proceeds are proceeds of

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<sup>83</sup> U.C.C. §9-308 (1990).

<sup>84</sup> U.C.C. §9-308(b) (1990).

inventory and controlled by section 9-308(b). The only way for the inventory financier to have priority over the chattel paper financier is for the inventory financier to take a direct interest in the chattel paper and file or perfect first; or take possession of the chattel paper so that no other party can meet the standards of section 9-308.<sup>85</sup>

The Code even has rules covering the fight between the inventory financier and the accounts or chattel paper financier when the buyer returns the boat to the dealer or the dealer repossesses the boat from a defaulting buyer.<sup>86</sup> Subsection 9-306(5) applies to the returned boat the priorities set out among the parties when the proceeds were the account or chattel paper. The account or chattel paper is worthless, so the creditors are now interested in their claim to the returned boat. If the proceeds before return were chattel paper, then, the chattel paper financier beats the inventory financier if the chattel paper financier had priority under section 9-308. The accounts receivable financier does not fare as well. Recall that unlike the chattel paper financier, the accounts financier beats the inventory financier, whose interest in the account is only a proceeds interest, only if the accounts financier was the first to file or perfect. This is the rule for the returned or repossessed boat. The accounts financier wins only if they were the first to file and had priority in the account.

Negotiable instruments and negotiable documents are covered by the specific rule in section 9-309. In this section, Article Nine conforms with the HDC rules in Article Three and the holder to whom negotiable documents of title are duly negotiated rules in Article Seven. This section also covers purchasers of securities in conjunction with Article Eight but these rules will be ignored here since securities are not normally proceeds. The only issue that Article Nine adds by way of section 9-309 to the rules set forth in the other Articles is the fact that the previous party's filed financing statement does not constitute notice to defeat the rights of the subsequent holder.

The rules for a holder to whom a negotiable document has been duly negotiated are very similar to the HDC rules.<sup>87</sup> The holder of the document must be a "holder" which is accomplished by endorsement and delivery of

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<sup>85</sup> Note that the inventory financier that takes this route to protect itself, in the case the after acquired property clause fails to protect it, will want to mark the chattel paper with a statement of the financier's interest. This is because another buyer or lender who does not know of the financier's interest, and who gives new value and takes possession of the chattel paper, will beat the financier's interest in the chattel paper under section 9-308(a).

<sup>86</sup> U.C.C. §9-306(5) (1990).

<sup>87</sup> U.C.C. §7-501 (1990).

order documents and delivery alone of bearer documents.<sup>88</sup> For “due negotiation” the holder must take the document in the ordinary course, in good faith and without notice of any defenses or claims just like a holder in due course of a negotiable instrument.<sup>89</sup> If a negotiable instrument, (i.e., a note, a check, or a negotiable document of title, such as a negotiable warehouse receipt), is given to the debtor as payment for some piece of collateral then the collateral financier will likely lose to a subsequent holder.

Article Nine has a limited group of property categories.<sup>90</sup> The priority rules concerning the proceeds of inventory are exhaustive and cover each type of collateral. However, this does not mean that Article Nine leaves nothing for the courts to fill in. Grant Gilmour stated in his book, which was published in 1965, that the draftsmen had to leave some fights out of Article Nine. Specifically, he mentions the relation between financing banks and sureties.<sup>91</sup> Yet, especially after the 1972 amendments, Article Nine covers most issues.

In considering the above discussed priority rules, keep in mind that in every one of the ordinary course of business cases that allowed the bank to keep the money, the bank had either a junior security interest in the inventory that generated the proceeds or no security interest at all.<sup>92</sup> Article Nine

<sup>88</sup> *Id.* at §7-501(1), (2) (1990).

<sup>89</sup> *Id.* at §7-501(4). Holders to whom negotiable documents have been duly negotiated do not always beat previously perfected parties. Section 7-503 protects a prior secured party with an interest in the goods or represented by the negotiable document, but only if the debtor had no actual or apparent authority to sell, ship or store the goods and the secured party did not acquiesce in the procurement by the debtor of the document. This is not easily shown, however. Section 7-503 comment 1 states: “acquiescence’... does not require active consent under subsection (1)(b) and knowledge of the likelihood of storage or shipment with no objection or effort to control it is sufficient to defeat his rights as against one who takes by ‘due’ negotiation of a negotiable document.”

<sup>90</sup> The types of goods covered in section 9-109 are inventory, farm products, consumer goods, and equipment. Then there are the tangible intangibles which include instruments, documents and chattel paper. Last are the intangible intangibles which include accounts receivables and general intangibles. Both the for tangible and intangible property the Code provides a catch-all section. Equipment is the catch-all section for tangible property and general intangibles fills that function for intangible property.

<sup>91</sup> GILMORE, *supra* note 1, at 656.

<sup>92</sup> *Orix Credit Alliance Inc. v. Sovran Bank*, 4 F.3d 1262, 1274 (Sovran Bank was arguably junior because of the subordination agreement not because of the priority rules in Article Nine. But as a purchase money secured party, Orix could have obtained Article Nine priority.); *Harley-Davidson Motor Co., Inc. v. Bank of New England-Old Colony*, 897 F.2d 611, 613 (1st Cir. 1990); *General Elec. Co. Lighting Bus. Group v. Halmar Distrib.*, 116 B.R. 328, 330 (Bankr. D. Mass. 1990). (holding the bank had a junior security interest in the specific inventory). *J.I. Case Credit Corp. v. First Nat’l Bank of Madison County*, 991 F.2d 1272, 1273 (7th Cir. 1993); *Tuloka Affiliates, Inc. v. Security State Bank*, 627 P.2d 816, 817 (Kan. 1981). (holding the bank’s security interest was in other inventory not in the inventory that created the proceeds.)

relegates this fight to the general rule of first to file or perfect. By using the ordinary course of business rule, the courts allowed a creditor that Article Nine places in a junior position to nonetheless win. In *Orix*, the court went as far to ignore a subordination agreement between the bank and the secured creditor.

The secured parties who are given priority over previously filed or perfected parties are few and far between. Chattel paper financiers are such a group, but only if they have given new value and take possession of the paper. These steps entail considerable policing of the debtor. As to the proceeds of property other than inventory, the chattel paper financier wins only if in addition to the requirements of new value and possession it takes without notice of the prior secured party's interest.

Holders in due course and holders to whom negotiable documents of title have been duly negotiated also take priority over a previously filed secured party. However, to be a HDC or a holder of a duly negotiated document, the creditor must take without notice of the claim of the secured party.

There is only one other category of creditor which which defeats a previously filed and perfected party, which has not yet been discussed. This category consists of buyers. Buyers are an especially interesting group since the "ordinary course of business" cases analogize not only to buyers in general, but to the most protected buyer in the entire Code: the buyer in the ordinary course of business. This analogy is especially clear in the Seventh Circuit case, *J.I. Case Credit Corp.*. In this case, it was pursuant to the buyer in the "ordinary course of business" rules, that the court drew its test for knowledge.<sup>93</sup> The buyer in the ordinary course must take without knowledge that the transfer is in violation of the secured party's interest. It matters not that the buyer knows that a secured party has a security interest in the item being purchased.

It is not easy to qualify as a buyer in the "ordinary course of business." First, these special buyers must be buying from someone in the business of selling the item bought.<sup>94</sup> Second, the buyer in the ordinary course must also give new value. Most importantly, payment in partial or total satisfaction of

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<sup>93</sup> *J.I. Case Credit Corp.*, 991 F.2d at 1278-80.

<sup>94</sup> U.C.C. §1-201(9) (1990). These other requirements include: good faith, and an ordinary course purchase. Excluded in addition to payments on antecedent debts, are pawnbrokers transactions and sales in bulk.

a preexisting indebtedness precludes a person from being a buyer in the ordinary course.<sup>95</sup>

Clearly banks in the ordinary course cases cannot fit within the definition of buyer in the ordinary course. First, they are not buyers; buyers must be exchanging cash or other property for the property purchased.<sup>96</sup> Throughout common law jurisprudence, buyers have received greater protection than creditors. Second, a bank does not give new value. In taking the money they are paying off pre-existing loans. Thus, for two very important reasons banks cannot qualify as buyers in the ordinary course. Why the Seventh Circuit is analogizing to these rules is perplexing.

Nor do all buyers, in fact, win under Article Nine. In addition to buyers in the ordinary course of business there are consumer buyers, namely buyers who are buying from another consumer.<sup>97</sup> These buyers beat a previously perfected secured party, but only if the buyer does not have knowledge of the secured party's claim to the property. More importantly, even consumer buyers do not win if the secured party has perfected by filing a financing statement before the sale. Incidentally, most of the banks in the ordinary course cases had knowledge of the secured party's claim.

The catch all category of buyers, i.e., buyers who do not fit in the other two categories, allows the buyer priority only if the secured party is unperfected.<sup>98</sup> The banks would have all won in the ordinary course cases if the secured party had not perfected its interest in the inventory. Every competing creditor and buyer beats the *unperfected* Article Nine secured party.<sup>99</sup> All the secured parties in the ordinary course cases had filed and were perfected.

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<sup>95</sup> U.C.C. §1-201(9) (1990).

<sup>96</sup> *Id.*

<sup>97</sup> U.C.C. §9-307(2) (1990).

<sup>98</sup> U.C.C. §9-301(1)(c) (1990). A colleague and I have debated for years whether the section 9-301 buyer of goods takes free of the secured party's unperfected interest or only takes priority. This is probably more of an academic question, but one can imagine a purchase of something for a price below its fair market value. Who is entitled to the value above the price paid by the buyer? If the buyer took free of the security interest, then the buyer gets to keep the value. If, however, the buyer only takes with priority then the secured party who is junior could force the sale of the property and capture the value above and beyond the purchase price. Section 9-307 says that the buyer takes free of the security interest. However, section 9-301 says that the unperfected secured party is subordinate to the parties listed in that section, which include buyers who do not get the protection of section 9-307 like buyers in bulk. An even more interesting question is who gets property value increase after the sale, not caused by the buyer's efforts, if the buyer only gets priority.

<sup>99</sup> *Id.*

Consequently, the only type of buyer who could have beaten the secured parties in the ordinary course cases is the ordinary course of business buyer.

Nor can the banks analogize their position to that of the chattel paper financier. To achieve priority, the financier must give new value just as did the buyer in the ordinary course. The only two groups of people who beat previously filed and perfected secured parties must give new value in order to win and must satisfy other requirements. None of the banks who won in the ordinary course cases gave new value in exchange for the payment.<sup>100</sup> The bottom line is that in Article Nine, no one beats a previously filed and perfected secured party if that person has knowledge of the secured party's interest in the property except: 1) a buyer in the ordinary course; and 2) chattel paper financiers when they are fighting with an inventory financier's proceeds interest.<sup>101</sup>

Both these types of people have special reasons why they are given this exalted position. Our economy would cease to function efficiently if every time a person made a purchase they had to check the U.C.C. filing records to ensure that no one held a valid security interest. Most buyers would not have the vaguest idea where to look. If they did look, and found out that they did not take free, they would not buy the item. Buyers in the ordinary course even take free of a previously filed federal tax lien and very few parties beat the I.R.S..<sup>102</sup>

Chattel-paper financiers are given an exalted position because the Article Nine draftsmen decided that the debtor should be able to use chattel paper proceeds of inventory for additional financing.<sup>103</sup> Originally the priority of the chattel paper buyer who beats the inventory financier was placed in section 9-306. The Comment to section 9-306 in the first Official Code of 1952 noted that this rule was needed to keep inventory financiers from monopolizing all forms of property of the debtor.<sup>104</sup> Moreover, this was the law before the

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<sup>100</sup> In the Eighth Circuit case, *Barber-Greene Co. v. Nat'l City Bank of Minneapolis* 816 F.2d 1267, 1272, (8th Cir. 1987), the creditor argued that after the proceeds money was deposited in the collateral account and used to pay off the bank's loans, the bank reloaned the money to the debtor and the debtor drew on this line of credit and spent the money. This did not change the Eighth Circuit's decision that the payment of proceeds into the collateral account was not in the ordinary course and therefore the bank had to pay the money to the secured party.

<sup>101</sup> If the proceeds are from collateral other than inventory, then knowledge of the prior security interest will preclude the chattel paper financier from taking priority in the chattel paper. U.C.C. §9-308(a) (1990).

<sup>102</sup> I.R.C. §6323(b)(3) (1988).

<sup>103</sup> U.C.C. §9-306 cmt.2(c) (1952).

<sup>104</sup> U.C.C. §9-306(4), cmt. 2(c) (1952).

Code was enacted.<sup>105</sup> If the inventory financier were able to have priority as to the chattel paper, then fewer debtors would be able to use this valuable property as collateral for a loan. The inventory financier can still beat the chattel paper financier but it must take special action to do so.<sup>106</sup>

Why should a bank that has a junior security interest in the debtor's inventory, or no consensual interest at all, be given priority over the senior security interest simply because a wire transfer of the proceeds was sent to the bank, or a check was sent by the account debtor to a lock box that the bank endorsed over to itself in order to pay off the debtor's loans at the bank? Why should a check drawn by the debtor on its bank account and sent to the bank be sufficient to elevate the junior creditor over the senior creditor? If the bank, in taking the check, is a HDC then Article Nine recognizes the long established rule that allows the HDC to take free of claims and defenses. But to be an HDC the bank must be without notice of the secured party's claim.

The First Circuit, in *Harley-Davidson*, provided a rationale in support of giving the bank priority despite knowledge of the claim of the senior Article Nine claimant. The court reasoned that the ordinary course test must be broad or else ordinary suppliers like the sellers of gas, electricity, tables or chairs would be forced to return the money to the inventory financier.<sup>107</sup>

Is the bank in *Harley-Davidson* like a supplier of electricity? Recall the bank in that case had a junior interest in the used motorcycles that were part of the debtor's inventory. Because the bank obtained the title documents for the cycles, the bank could require payment each time a cycle was sold. As a junior inventory financier, the bank knew about the senior secured party's interest in the same cycles. Suppose the electricity supplier for some reason knows that the money that has been sent to it belongs to the inventory financier. Should the electricity supplier be able to keep the money? It is submitted that neither the bank nor such an electricity supplier should be able to keep the money. What most suppliers of gas, electricity, tables and chairs have in common is the lack of information about the debtor's finances. Take for an example employees of the debtor. The secured party could not claim checks paid out to the workers even if the checks were purely proceeds. But would the same rule apply to the company comptroller who knows that his paycheck constitutes the secured party's proceeds?

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<sup>105</sup> GILMORE, *supra* note 1, at 728.

<sup>106</sup> See *supra* text accompanying note 83.

<sup>107</sup> *Harley-Davidson Motor Co., Inc. v. Bank of New England-Old Colony*, 897 F.2d 611, 622 (1st Cir. 1990).

It is submitted here that it should not. What then does Comment 2(c) to section 9-306 add to the other rules in Article Nine? It fills the gap among the rules regarding the transfer of non-negotiable items. But the rule should not be any broader than the HDC rules. At least, the rule should not allow someone to knowingly take someone else's money no matter who they are. There is no policy that raises them to the level of the buyer in ordinary course or chattel paper financier.

The history to Comment 2(c) in section 9-306 suggests that the drafters of Article Nine did not intend the comment to elevate a junior inventory secured party over the senior. The 1950 "Proposed Final Draft" was the first official American Law Institute document to have Article Nine with comments.<sup>108</sup> Comment 2(c) in section 9-306 discusses the fact that a note purchased by a HDC would defeat the secured lender's interest.<sup>109</sup> This comment also refers to section 9-307 the buyers in ordinary course section and section 9-308 the chattel paper section, as well as as other sections defining when someone could defeat a proceeds interest. The current language in Comment 2(c) dealing with transfers in the ordinary course first appeared in 1952 in the first Official Code.<sup>110</sup> This comment starts out by discussing sections 9-307, 9-308 and 9-309 as examples of people who take priority as to proceeds and 9-306(4) which covered chattel paper that was proceeds of inventory (this section was later moved into 9-308(b) where it has remained in the current Code).

In the next paragraph, the comment is concerned with secured parties who might lose because they allow the debtor to keep possession of the proceeds. It first discusses the types of proceeds that are covered in sections 9-307, 9-308, and 9-309. Comment 3 then talks about cash proceeds deposited in a bank account and paid out in the ordinary course of the debtor's business. When proceeds are deposited in a bank account and paid out, a check that is drawn on the account is still a check. Comment 2(c) may be a mere illustration of how the HDC rules would operate to protect the taker of the check in order to provide a warning to inventory financiers who leave proceeds with debtors.

The 1958 Official Code moved the Comment's discussion of section 9-307, 9-308 and 9-309 to Comment 3 where the discussion no longer refers to proceeds.<sup>111</sup> Now these sections are discussed in reference to a transfer of the

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<sup>108</sup> U.C.C. Article Nine (Proposed Final Draft 1950).

<sup>109</sup> U.C.C. §9-306 cmt. 2(c) (Proposed Final Draft 1950).

<sup>110</sup> U.C.C. §9-306 cmt. 2(c) (1952).

<sup>111</sup> U.C.C. §9-306 cmt. 3 (1958).



collateral itself. Left in subsection 2(c), alone, is the language about the transfers in the ordinary course.<sup>112</sup> This structure remains today.<sup>113</sup> Given its history, the most logical interpretation of 2(c) is just as an illustration of how the proceeds could disappear if left in the debtor's hands. If this is the Code's interpretation then it means no more than the HDC rules and cannot be expanded to justify any of the ordinary course cases.

More persuasive than the history of the U.C.C. is PEB's Commentary No.7 issued March 10, 1990. Three of the ordinary course cases cited herein were decided after Commentary No.7 had been issued but none of these courts mention the Commentary.<sup>114</sup>

The PEB Commentaries were and are issued pursuant to a resolution passed by the American Law Institute and the National Conference of Commissioners on Uniform State Laws.<sup>115</sup> They were and are created by the Permanent Editorial Board of the National Conference of Commissioners on Uniform State Laws. All but one of these Commentaries make changes to the Code's comments.<sup>116</sup> Members of the Permanent Editorial Board are listed in each group of PEB Commentaries.

Commentary No. 7 discusses cash and check proceeds sent by an account debtor directly to a creditor who has a junior interest in the chattel paper, accounts or general intangibles. To this extent the problem addressed in the Commentary is it very similar to the ordinary course cases. The only difference is that the commentary is talking about proceeds from chattel paper,

<sup>112</sup> U.C.C. §9-306 cmt.2(c) (1958).

<sup>113</sup> U.C.C. §9-306 cmt.2(c) (1990).

<sup>114</sup> *Orix Credit Alliance Inc. v. Sovran Bank*, 4 F.3d 1262 (4th Cir. 1993); *J.I. Case Credit Corp. v. First Nat'l Bank of Madison County*, 991 F.2d 1272 (7th Cir. 1993); *General Elec. Co. Lighting Bus. Group v. Halmar Distrib. (In Re Halmar Distrib.)*, 116 B.R. 328 (Bankr. D.Mass. 1990).

<sup>115</sup> The full resolution states:

[a] PEB Commentary should come within one or more of the following specific purposes, which should be made apparent at the inception of the Commentary: (1) to resolve an ambiguity in the UCC by restating more clearly what the PEB considers to be the legal rule; (2) to state a preferred resolution of an issue on which judicial opinion or scholarly writing diverges; (3) to elaborate on the application of the UCC where the statute and/or the Official Comment leaves doubt as to inclusion or exclusion of, or application to, particular circumstances or transactions; (4) consistent with UCC section 1-201(2)(b), to apply the principles of the UCC to new or changed circumstances; (5) to clarify or elaborate upon the operation of the UCC as it relates to other statutes (such as the Bankruptcy Code and various federal and state consumer protection statutes) and general principles of law and equity pursuant to UCC section 1-103; or (6) to otherwise improve the operation of the UCC.

<sup>116</sup> All the PEB Commentaries with the exception of Commentary No. 13 make changes or additions to the current Code comments. Commentary 13 does however add a paragraph to the Prefatory Note to Article 4A.

accounts, and general intangibles not inventory. The Commentary is concerned with the question of whether the senior secured party can get the money back from the junior creditor. The Commentary states that the result depends on whether the payment is made by way of a check or cash. If the account debtor sends a check, then the holder in due course rules apply.<sup>117</sup> The bank was a recipient of a check in *J.I. Case Credit Corp. and General Electric Co. Lighting Business Group*. Neither court adopts the HDC test.

The commentary notes that even if the bank is not an HDC, the bank might win under section 9-308 which also covers the transfer of instruments in addition to the transfer of chattel paper. None of the above cases would qualify for section 9-308 priority because in order to qualify for section 9-308 relief, the bank must have given new value for the check. If the check represents inventory proceeds then the bank can win even if it has notice of the senior party's interest, but new value and possession of the check are keys for success under 9-308.

For a cash payment from the account debtor, the Commentary adopts the common law rule of restitution. It notes that the Code, unlike the treatment of payment with a check, does not specifically address the right of the junior secured party to keep cash. It concludes that the rules must be interpreted according to the common law, which incorporated into the Code through section 1-103.<sup>118</sup> It starts with the general rule that the senior secured party can get restitution of the amount. It then lists the circumstances under which the junior party can keep the cash. These requirements include taking the cash for value, not new value, in good faith, and without knowledge or reason to know of the senior party's interest in the chattel paper, instruments, or general intangibles which are generating the cash proceeds payment. Note that the knowledge requirement is the same as the Code's definition of notice. Also, note that it is not notice that the cash is proceeds but notice of the senior's interest in the original collateral that generated the proceeds. The junior secured party must take the cash without notice of the senior party's interest just as does the HDC.

In the cases covered by Commentary 7, the junior secured party may not know of the senior's interest since these contests arise when the debtor assigns

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<sup>117</sup> U.C.C. PEB Commentary No. 7 (1990)

<sup>118</sup> U.C.C. §1-103 (1990) This section brings common law rules into the Code when the Code does not specifically address the problem. Listed as examples are "the law merchant and the law relative to capacity to contract, principal and agent, estoppel, fraud, coercion, mistake, bankruptcy, or other validating or invalidating cause ..."

an interest in the same collateral to two different parties. In all of the ordinary course cases, however, the bank had reason to know of the senior party's claim to the original collateral.

The Commentary cites in support of its discussion of the common law rules: Restatement of Restitution section 126 comment f and illustration 8 and the Restatement 2d of Contracts section 342(b) comment e and illustration 3. Comment f of the Restatement of Restitution states that a bona fide purchaser has no duty of restitution. Illustration 8 is an example of a bona fide purchaser. The key in that illustration is that the second assignee had no reason to know about the first assignment. Section 342(b) of the Restatement Second of Contracts also uses the knowledge or reason to know standard.

Comment f of the Restatement of Restitution makes reference to the bona fide purchaser rules in sections 172 through 176. Restatement of Restitution section 172 defines when there has been a bona fide purchase. It requires that the claimant give value and take without notice. Interestingly, notice is defined by the Restatement of Restitution section 174 as when the claimant knows the facts or should have known the facts. Of course should have known requires an inquiry for more information once a reasonable claimant would have acquired enough information to make the matter questionable.<sup>119</sup> This definition in section 174 excludes holders in due course. No doubt this is because the holder in due course rules referred to in the Restatement of Restitution are that the taker take in good faith and without knowledge.<sup>120</sup> PEB Commentary No. 7 uses instead, reason to know, and this is the same standard that is required of an HDC under the U.C.C.

The Commentary makes it clear that the constructive notice provided by a filed financing statement does not satisfy reason to know. This is also part of section 9-309 which covers negotiable instruments and documents. In all of the ordinary course cases the bank knew of the secured party's interest and knew that the secured party had the senior position with respect to all or a part of the inventory. In *Orix* and *Harley-Davidson* the bank knew that the money in the wire transfer and check were the senior creditor's proceeds. No case involved constructive notice and constructive notice would never satisfy the reason to know test.

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<sup>119</sup> Restatement of Restitution §174 cmt.a. (1937).

<sup>120</sup> Restatement of Restitution §174 cmt.c. (1937) The Restatement of Restitution was promulgated in 1937 when the Uniform Negotiable Instruments Law was in place in many jurisdictions. The holder in due course rules of today require not only good faith and no knowledge but also no reason to know.

The Commentary also makes reference to Comment 2(c) in section 9-306 under the “cf” signal. The “cf” signal means that the cited authority constitutes a proposition different from the main proposition but sufficiently analogous to lend support.<sup>121</sup>

To which type of interest are the banks in the ordinary course cases most closely analogous? Are they more like the junior secured party discussed in Commentary No.7 or they more like a buyer in the ordinary course of business? The bank’s position has no similarity with the buyer in the ordinary course other than the transfer in the ordinary course. They have many similarities to the junior secured creditors in Commentary No.7. The courts have turned for analogy to the buyer in the ordinary course rule. This was the wrong choice. After all, the banks are junior secured parties to the debtor’s inventory or not secured at all. In *Orix* and *General Electric Co Lighting* the bank received the money not from the debtor, but from the third party who was obligated to pay just like the third party in the Commentary. Arguably the wire transfer in *Orix* is like cash, and in *General Electric Co. Lighting* the account debtor sent a check. It is submitted here that the Commentary No.7 rules should apply in all of these cases. If payment is by check then the bank must meet the HDC standard to win. If cash is used, then the banks must take the cash in good faith and without notice of the senior creditor’s security interest in the collateral that generated the proceed.

If these are the rules applied, not the rule in Comment 2(c), the result will be more analogous to the set-off rules at common law. Recall that under even “the legal rule”, the bank cannot win if it has knowledge or reason to know of the other party’s interest. Moreover, in most of the ordinary course cases, the senior creditor has the equities. In *Orix*, the court made note of the fact that Orix did nothing to protect its interest once it consented to the sale of the crane. Orix did, however, obtain the agreement of the debtor to pay off the loan with part of the money.<sup>122</sup> The court should have focused on the fact that the bank had agreed to subordinate its interest to Orix’s interest. Orix may well have been relying on that subordination agreement in not taking action to insure that the third party buyer sent the money directly to Orix. It is possible that, but for the subordination promise, Orix would never have lent the money to the debtor to buy the crane in the first place. Orix was a purchase money party. No other creditor receives the protection accorded to

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<sup>121</sup> EDITORS OF THE COLUMBIA LAW REVIEW ASSOCIATION ET AL., THE BLUEBOOK A UNIFORM SYSTEM OF CITATION Rule 1.2 (15th Ed. 1991).

<sup>122</sup> *Orix Credit Alliance, Inc. v. Sovran Bank*, 4 F.3d 1262, 1264 (4th Cir. 1993).

a purchase money party.<sup>123</sup> As Grant Gilmore said: “[t]he closest thing to invulnerability is a purchase-money loan on the security of goods over which the debtor has no power [of] disposition...”. This was the position of Orix. Without their loan, the debtor would never have had the crane and the bank would never have had the proceeds from the sale of the crane. All of the equities in that case were on the side of Orix not the bank.

### CONCLUSION

The “ordinary course of business” rule, as the First Fourth, and Seventh Circuits have applied it, allows a party to avoid Article Nine’s carefully laid-out rules. There is no policy to justify such a deviation, and in fact, policy supports an application of the rules in Article Nine. None of the Courts provides any reasoning which stands up to scrutiny to justify their application of the ordinary course of business test. If the courts had applied the correct analysis such absurd results, as the one in *Orix*, would not have occurred. Applying the reason to know test makes the rules more consistent no matter whether the bank is setting off, acting as a HDC or taking money out of a blocked account. The different actions of the bank should not justify a complete ignoring of the bank’s knowledge. This application of the ordinary course rules should not be followed.

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<sup>123</sup>GILMORE, *supra* note 1, at 653.