HOT TOPICS FOR BANKERS

UNDER THE UCC

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

2006 LBA BANK COUNSEL CONFERENCE
NEW ORLEANS LOEWS HOTEL
NOVEMBER 16, 2006

Barkley Clark is a nationally recognized expert on the UCC. He was involved in the drafting of Revised Article 9. He advises secured lenders around the country on a whole range of Article 9 compliance issues, and he frequently testifies as an expert witness in state and federal courts. He co-authors, with Barbara Clark, several popular publications including *Clarks' Guide to Electronic Check Collection: Check 21, Image Exchange & Electronic Check Presentment; The Law of Secured Transactions Under the UCC; The Law of Bank Deposits, Collections and Credit Cards*; "Secured Transactions Monthly" and "Bank Deposits and Payments Monthly" newsletters; *Clarks' Check 21 Manual;* and *Compliance Guide to Payment Systems* (with Mark Hargrave). These publications are used by financial institutions and their counsel around the country, and are frequently cited by federal and state courts. Barkley is a partner in the Washington, D.C. office of Stinson Morrison & Hecker LLP, and a member of the Board of Editors of *The Banking Law Journal*, The *UCC Law Journal* and the *Journal of Payment Systems Law*.

I

REPORT CARD ON REVISED ARTICLE 9 AFTER FIVE YEARS

*Transition period, with use of "effective financing statements", has come to an end.

*Retroactive impact of R9.

*Reduction of "enforcement" litigation; growing popularity of strict foreclosure.

*Supergeneric collateral descriptions in financing statements not that popular.

*Biggest benefit: simplified filing/debtor location.

*Filing problems emerge for proprietorship-debtor names and IRS tax liens.

*Cross-border secured transactions and increased Washington DC filings.

*Dragnet clauses, with multiple citings of 9-204, Official Comment 5.

*Free assignability issues loom large.

*Dramatic increase of consensual security interests in deposit accounts leads to ABA model DACA.

*Securitization issues.

*Free transferability of collateral proceeds out of deposit accounts.

II

NINTH CIRCUIT BAP HOLDS THAT PAYMENT INTANGIBLES MAY BE "STRIPPED OUT" OF EQUIPMENT LEASES/CHATTEL PAPER

*The Commercial Money Center case and the use of "stripping" in structured finance: In re Commercial Money Center, Inc., 2006 WL 2505205 (BAP 9th Cir. 8/25/06), rev'g 56 UCC Rep.2d 54, 2005 WL 1365055 (Bankr. S.D. Calif. 2005).

*Bankruptcy court holds that payment streams are "chattel paper" requiring UCC filing or possession in order to perfect.

*9th Circuit BAP sees it otherwise, based on plain language of statutory definitions and pro-securitization policy of Revised Article 9.

*The priority problem under UCC 9-330(b): double financing scenario

*But BAP holds that underlying transactions were secured loans, not sales.

*The issue on remand: did NetBank perfect by possession of the chattel paper after all?

III

GOVERNMENT BORROWERS/ACCOUNT DEBTORS UNDER REVISED ARTICLE 9

*R9 now requires UCC filings for government debtors on collateral such as accounts and equipment/impact on revenue bond issues, to the extent that no state statute covers these matters. UCC 9-109(c)(2).

*18 states have opted out (but not Louisiana).

*In the 18 states exempted from R9, does the exemption apply to the government as the **account debtor** on a receivable? Recent Ohio supreme court case says it does. MP Star Financial, Inc. v. Cleveland State University, 837 NE2d 758, 58 UCC Rep.2d 191 (Ohio 2005).

*Why the Ohio case is wrong

IV

PROBLEMS CAUSED BY FEDERAL TAX LIENS

*Sixth Circuit holds that IRS is exempt from UCC filing requirements regarding debtor names: In re Spearing Tool and Man. Co., Inc., 412 F3d 653 (6th Cir. 2005).

*Exact registered name of debtor was "Spearing Tool and Manufacturing Co." but IRS filing was under name "Spearing Tool & Mfg. Company, Inc."—the name that appeared on the company's tax return.

*Court relies on federal preemption.

*Public policy: IRS as an "involuntary" creditor.

*Due diligence suggestion to avoid getting burned by the IRS: When doing UCC searches for competing liens, obtain debtor's tax returns and search under the name shown on those returns.

*Another IRS bugaboo: under FTLA regulations, taxpayer's "residence" is in state where business has "principal executive office". 26 CFR §301.6323(f)-1. This conflicts with "birth certificate" test under R9. The need to do two searches.

*IRS tax lien vs. security interest in receivables: a hot area of litigation. The 45-day rules and the problem of unripened receivables.

V

THE SUPEREST SUPER-PRIORITY: NON-COLLUSIVE TRANSFEREES FROM A DEPOSIT ACCOUNT

*The impact of UCC 9-332(b): transferee protected unless it is in cahoots with transferor.

*Recent Idaho case: non-collusive transferees prevail even though debtor intended to launder receivables through the deposit account. Keybank, N.A. v. Ruiz Food Products, Inc., 59 UCC Rep.2d 870, 2005 WL 2218441 (D. Ida. 2005).

*Recent 8th Circuit case: ordinary course transferee trumps subordination agreement. GE Capital Corp. v. Union Planters Bank, N.A., 409 F.3d 1049, 58 UCC Rep.2d 46, 2005 WL 1269085 (8th Cir. 2005)(transferee was debtor's depositary bank, whose ordinary course "sweeps" of borrower's DDA trumped prior perfected secured lender and overrode an express agreement by which the prior lender had priority over the depositary bank).

*How this priority rule differs from UCC 9-340, which allows depository bank's right of setoff to trump security interest in proceeds residing in deposit account.

VI

FREE ASSIGNABILITY OF PAYMENT STREAMS UNDER REVISED ARTICLE 9

*Under UCC 9-406 and 9-408, anti-assignment clauses and state laws prohibiting assignments of receivables are invalid. Power to require deflection by the account debtor depends on the nature of the receivable.

*Recent 9th Circuit BAP decision upholding anti-assignment provision in structured settlement contract because it was excluded from R9 as a "tort claim". In re Gallagher, 331 B.R. 895, 57 UCC Rep.2d 762 (9th Cir. BAP (Wash.) 2005). Court totally ignores Official Comment 15 to 9-109. Mercifully, the 9th Circuit BAP decision was vacated and ordered depublished two weeks after it was published.

*Recent decisions protect free assignability of lottery prizes against state statutes that flatly prohibit assignments. Impact of UCC 9-406(f). Lottery winnings as "accounts" under UCC 9-102(a)(2). Possible impact of UCC 9-201 (consumer protection statutes control over conflicting provisions of R9). New lottery (court-order) statutes in many states.

*Recent New Mexico decision upholds anti-assignment clause in structured settlement annuity, viewing the annuity as exempt from Article 9 because it is a (1) "tort claim" and (2) an "insurance claim". Espinosa v. United of Omaha Life Ins. Co., 137 P.3d 1279, 60 UCC Rep.2d 321, 2006 WL 1867251 (N.M. Ct. App. 2006)

*Recent Kansas case prohibits assignment of anticipated real estate commissions based on consumer credit legislation that trumps Revised Article 9 of the UCC. Decision Point, Inc. v. Reece & Nichols Realtors, Inc., 2006 WL 3040636 (Kan. 10/27/06).

VII

PURCHASE MONEY SECURITY INTERESTS IN MOTOR VEHICLES AND THE CHAPTER 13 CRAMDOWN

*New bankruptcy amendments prohibit cramdown for PMSIs on motor vehicles obtained within 910 days prior to debtor's bankruptcy. Bankruptcy Code 1325(a).

*Does the secured creditor have a "purchase money security interest" in the vehicle when the secured transaction finances debt beyond the price of the car? UCC 9-109 and the "transformation rule". Most recent cases say that including other debt doesn't "transform" the PMSI portion for cramdown purposes. In re Johnson, 337 B.R. 269 (Bankr. M.D.N.C. 2006)(loan proceeds covered both purchase price of car and extended service contract); in re Murray, 346 B.R. 237 (Bankr. M.D. Ga. 6/6/06)(same). Contra: In re White, Case No. 06-10095 (Bankr. E.D. La.)(obligations for extended service contracts are not "purchase money obligations" protected by the new Bankruptcy Code amendments); In re Horn, 338 B.R. 110 Bankr. M.D. Ala. 2006)(based on refinancings, debtor's car secured more than the acquisition price, so that none of the debt was PMSI).

*The fighting issue: Can debtor/trustee bifurcate PMSI on motor vehicle into (1) an unsecured claim for amounts loaned for items other than the actual cost of the vehicle and (2) a secured claim for the price of the vehicle itself under 1325?

*The "negative equity" issue. Is the payoff of a negative equity obligation on a trade-in vehicle a protected PMSI? In re Wible, Case No. 06-0017 (Bankr. M.D. Ga. 2006) says yes, while In re Vega, 344 B.R. 616 (Bankr. D. Kan. 2006) says no.

VIII

MARSHALING OF ASSETS

*How R9 incorporates the equitable doctrine of marshaling. UCC 9-610, Comment 5; UCC 1-103.

*The three key elements: (1) two creditors of same debtor, (2) two funds that belong to the debtor, and (3) only one of the creditors has right to resort to both funds.

*Recent case from Kentucky holds that garnishing creditor can't force competing secured lender to go after guarantors of secured debt because suretyship obligation is not a "fund" belonging to the debtor. UPS Capital Business Credit v. C.R. Cable Construction, Inc., 181 S.W.3d 44 (Ky. Ct. App. 2005).

*Junior secured creditor can't sue senior for failure to marshal in absence of a clear court order.

IX

BLOCKBUSTER CALIFORNIA SOCIAL SECURITY DIRECT DEPOSIT/SETOFF CASE

*The problem: bank covers overdrafts (and NSF fees) with direct deposits of social security/veterans benefits that come into the account electronically.

*The social security exemption rule codified at 42 USC §407 prohibits assignments of future benefits, but it doesn't prohibit waiver of the exemption once payment is made.

*California state court case holds that California has broader prohibition against such exercise of setoff, that federal law does not preempt California law on this point, and that the depositor did not waive the broader exemption through language in the BofA deposit agreement. Miller v. Bank of America, Cal. Ct. App. No. 301917 (current appeal from trial court decision against BofA, with potential $1 billion in damages under California consumer protection statute).

*How the California state court case is 180 degrees from a 9th Circuit case on the same point. In Lopez v. Washington Mutual Bank, F.A., 302 F.3d 900 (9th Cir. 2002).

*The three big issues: (1) federal preemption, (2) freedom of contract, and (3) the nature of bank setoff.

X

NEW JERSEY SUPREME COURT REJECTS CLASS ACTION ARBITRATION WAIVERS

*Growing use of arbitration clauses, coupled with class action waivers, to short-circuit consumer class action filings.

*The recent New Jersey case: Muhammad v. County Bank of Rehoboth Beach, 2006 WL 2273448 (N.J. 8/9/06): Class action waiver tied to consumer arbitration clause are procedurally and substantively "unconscionable" under New Jersey law.

*Court supports class arbitration.

*Unconscionable clause was severable.

*How the New Jersey case conflicts with the trend of judicial decisions elsewhere. See, e.g., Iberia Credit Bureau, Inc. v. Cingular Wireless LLC, 379 F.3d 159 (5th Cir. 2004)

*Drafting tip: use favorable choice-of-law provision.

XI

FOUR DRAFTING TIPS FOR DEPOSIT AGREEMENTS

*Do you have a good "cutdown" clause imposing a deadline of 14-30 days for reporting unauthorized debits? Such clauses are okay under UCC 4-406(f). See, e.g., Peak v. Tuscaloosa Commerce Bank, 707 So.2d 59, 36 UCC Rep.2d 1116 (La. Ct. App. 1997)(court upholds 30-day cutdown provision as applied to checks); Regatos v. North Fork Bank, 257 F. Supp.2d 632, 50 UCC Rep.2d 35 (S.D.N.Y. 2003), aff'd by New York Court of Appeals, 2005 WL 2664712 (2005)(court invalidates attempt by bank to reduce the one-year reporting deadline for unauthorized wire transfers (UCC 4A-505) to a lesser period by way of private contract); Zengen, Inc. v. Comerica Bank, 40 Cal. Rptr.3d 666, 59 UCC Rep.2d 151 (Cal. Ct. App. 2006)(California court imposes strict compliance duties on customer notifying bank of unauthorized wire; also a strong case for Article 4A displacement of common law).

*Does your deposit agreement expand your right of charge-back to cover cases where the payor bank's returns are late? A leading Maryland case allows banks to vary the contrary rule of the UCC (4-214) in this way. Lema v. Bank of America, 826 A.2d 504 (Md. 2003).

*Does your deposit agreement have a clause by which the bank's customers consent to the bank's exercise of setoff of social security direct deposits to cover overdrafts and related charges? This type of clause is given a judicial stamp of approval in Lopez v. WAMU, 302 F.3d 900 (9th Cir. 2002).

*Do you disclose your "high-to-low" posting order?

XII

EXPANDING E-PAYMENTS AND THE "CONVERGENCE" ISSUE

*New FRB rule on remotely created checks (effective 7/1/06)

*ACH check conversion: POP and ARC

*ACH conversion of business checks (NACHA rule effective 9/15/06)

*Reg. E amendments on ECK transactions (effective 1/1/07)

*ACH back-office POP check conversion (effective spring 2007)

*Final FRB rules on payroll cards (effective July 1, 2007)

*OCC guidance on gift card disclosures (OCC Bulletin 2006-34, 8/14/06)

*Remote deposit capture

*Electronic or paper—what difference does it make?

- *Unauthorized debits
- *Stopping payment
- *Overdrafts
- *Dispute settlement