UNIFORM COMMERCIAL CODE COMMITTEE

REPORT PREPARED FOR THE MAY 4, 2012 COUNCIL MEETING

1. **Next Scheduled Meeting of the Committee.**

Next scheduled meeting of the Committee: None scheduled yet.

2. **Council Approval.**

None.

3. **Membership.**

Attached to this report is a memorandum with attachments that I sent to Committee Members on March 23, 2012.

4. **Accomplishments Toward Committee Objectives.**

I will continue to monitor current developments in Michigan law relevant to the UCC and report on those developments to Committee members.

5. **Meetings and Programs.**

Nothing to report at this time. I have previously recommended to the Council the need for a seminar on UCC topics if and when the recent amendments to Articles 1, 7 and 9 are adopted by the Michigan legislature, as they are expected to be.

6. **Publications.**

The Spring, 2012 issue of the Business Law Journal contains the article entitled "Michigan's Emergency Financial Manager Law and Its Impact on Creditors of Municipalities and School Districts" authored by John Gregg and me. In addition, by no later than July 31, 2012, articles on UCC topics must be submitted to Dan Kopka for editing and then publication in the Michigan Business Law Journal. Three individuals have volunteered to submit three separate articles on UCC topics and are coordinating with Dan Kopka at present.

7. **Methods of Monitoring Legislative/Judicial/Administrative Developments and Recommended Action.**

See response to #4 above.

8. Miscellaneous.

Nothing to report at this time.

Respectfully submitted,

Patrick E. Mears, Chairperson

BARNES & THORNBURG LLP

MEMORANDUM

TO: All Members of the UCC Committee

FROM: Patrick E. Mears

DATE: March 23, 2012

To All Members:

I am sending to you with this memorandum a recent decision of the Michigan Court of Appeals captioned *Michigan Basic Property Insurance Association v. Joyce Washington, et al.*, Case No. 299579 (Mich. Ct. App. January 24, 2012) on the issue of a liability of a drawee bank/payor bank under the UCC for honoring a check over a forged endorsement and the impact of a contractual alteration of that liability.

I am also enclosing the recently published Commercial Law Newsletter for Spring 2012 that is jointly issued by the Commercial Finance and UCC Committees of the ABA.

STATE OF MICHIGAN

COURT OF APPEALS

MICHIGAN BASIC PROPERTY INSURANCE ASSOCIATION, Plaintiff-Appellee,	UNPUBLISHED January 24, 2012
v JOYCE WASHINGTON, CLEVELAND POWELL, COUNTRYWIDE HOME LOANS, DIMONTI & ASSOCIATES, and SAN DIEGO NATIONAL BANK, Defendants, and FIFTH THIRD BANK, Defendant/Third-Party-Plaintiff, v NATIONAL CITY BANK, a/k/a PNC BANK NA, Defendant/Third-Party-Defendant-Appellant.	No. 299597 Wayne Circuit Court LC No. 08-107295-CK

Before: GLEICHER, P.J., and CAVANAGH and O'CONNELL, JJ.

PER CURIAM.

This controversy concerns a simple piece of paper, a common check. The question before us is not as simple or straight forward as the piece of paper at its core: Who bears the loss when someone forges an endorsement on a check and wrongfully takes the proceeds? Specifically, we are asked to consider whether defendant Fifth Third Bank is statutorily or contractually liable to its customer, plaintiff Michigan Basic Property Insurance Association (MBP), for honoring a check with forged endorsements and deducting those funds from MBP's account.

We conclude that Fifth Third Bank would be required by the Uniform Commercial Code (UCC) to recredit the check proceeds to its customer's account as it deducted those funds over a

forged endorsement. However, the parties altered their statutory duties by contract. MBP assumed liability for "any improper endorsements by payees." MBP also agreed to review its account statements and notify Fifth Third of any discrepancies or forgeries within 30 days. MBP failed to do so and its breach of the contractual notice requirement, as well as its contractual assumption of risk, precludes its claim to relief. As the trial court granted summary disposition in MBP's favor, we reverse and remand for entry of judgment favoring Fifth Third Bank.[1]

I. CHECK COLLECTION PROCESS

"In the normal functioning of the check collection process," a "drawer" writes a check made payable to a "payee," with the funds ultimately to be deducted from the drawer's checking account. *J Walter Thompson, USA, Inc v First BancoAmericano*, 518 F3d 128, 131 (CA 2, 2008); MCL 440.3103(1)(e). The payee takes the check to his or her bank for cash or deposit. "The payee's bank, which is the first to receive the check, is known as the 'depositary bank.'" *J Walter Thompson*, 518 F3d at 131; MCL 440.4105(b). In a simple transaction, the depositary bank sends the check directly to the drawer's bank for payment. In that situation, the depositary bank is also a "collecting" and "presenting" bank. "A 'collecting bank' . . . handles a check for collection. A 'presenting bank' . . . presents an item for payment." *J Walter Thompson*, 518 F3d at 131; MCL 440.4105(e)-(f). The check is "presented" to the bank that holds the drawer's bank account. That bank is referred to as a "drawee bank" as it "draws" the funds from its customer's account and a "payor bank" as it pays the cash promised in the check. *J Walter Thompson*, 518 F3d at 131; MCL 440.4104(c); MCL 440.4105(c).

II. FACTUAL AND PROCEDURAL BACKGROUND

Plaintiff Michigan Basic Property Insurance Association (MBP) issued a $69,559.06 check jointly payable to its insured, Joyce Washington, *and* two lien holders over her property, Countrywide Home Loans and T & C Federal Credit Union (the "Washington-Countrywide" check).[2] Either Joyce Washington or Cleveland Powell, who acted with Washington's power of attorney, took the check to National City Bank on February 16, 2007. Either Washington or Powell endorsed the check by signing "Countrywide Home Loans," "T & C Credit Union" and "Joyce Washington," interspersed with two additional but illegible signatures. The signatures were all made in the same handwriting. National City accepted the check and deposited the proceeds into an account shared by Washington, Powell and a corporate entity.

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National City presented the check directly to Fifth Third Bank. MBP maintains an account at Fifth Third and wrote the Washington-Countrywide check from its Fifth Third account. Pursuant to a special commercial client account agreement, Fifth Third sent MBP a daily account statement detailing all checks presented for payment against MBP's account. That

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[1] From our review of the record, it appears that MBP's fraud and conversion claims against defendants Joyce Washington and Cleveland Powell remain pending.

[2] The check was part of a larger homeowner's insurance settlement and was made jointly payable due to a mortgage clause in the underlying policy.

statement listed the check number, date presented, amount payable and electronic tracing number of the subject check. Fifth Third expected MBP to review the daily account statement and immediately notify it of any checks that should not be paid. MBP did not object to the presentment of the check so Fifth Third withdrew the funds from MBP's account and transferred $69,559.06 to National City. Fifth Third later sent MBP a February 2007 monthly account statement including the same item description as the daily statement to memorialize that the check had been paid. MBP raised no objection to the monthly statement.

Despite that the subject check was made payable to joint payees, it appears that Washington kept the entirety of the proceeds, and she certainly did not satisfy the lien held by Countrywide Home Loans. Countrywide notified MBP of the lack of payment and, on March 31, 2007, MBP issued a duplicate joint check for $69,559.06 and mailed it directly to Countrywide.

One year later, in March 2008, MBP filed a fraud and conversion suit against Washington and Powell, as well as claims against National City for UCC violations.[3] However, National City owed no direct duty to MBP and the court dismissed the UCC claims. Only then did MBP pursue reimbursement from its own bank, Fifth Third. On May 18, 2009, MBP filed suit against Fifth Third, arguing that the bank's payment of the subject check was "unauthorized" because the forged payee endorsements rendered the check "not properly payable." Fifth Third, in turn, filed a third-party claim against National City, now PNC Bank, for breaching its warranty under the UCC that the check it presented for payment was properly endorsed.

Fifth Third and National City each sought summary dismissal of MBP's reimbursement claim. Fifth Third contended that MBP was not entitled to reimbursement because it failed to use ordinary care and contributed to the forgery by mailing the original check to Washington instead of Countrywide. Fifth Third challenged MBP's failure to review its account statements and timely notify the bank of any discrepancies or forgeries as required by the account terms. National City added that Fifth Third's account contract placed the risk of forged endorsements on the customer, MBP. Fifth Third also sought summary disposition of its third-party claim against National City for presenting a check with forged endorsements for payment in violation of the UCC.

MBP filed a counter motion for summary disposition, seeking reimbursement as a matter of law. MBP contended that Fifth Third violated MCL 440.4401 of the UCC by charging against MBP's account a check that was not "properly payable" due to forged endorsements. MBP defended that it had exercised ordinary care because it was contractually required to mail the Washington-Countrywide check to its insured, and had no reason to suspect that Washington would forge the endorsements of her joint payees. MBP further asserted that it reasonably expected Fifth Third to have a procedure in place to prevent payment on unauthorized checks. MBP insisted that it could not have discovered the forgery from the sparse information provided

[3] MBP also raised several claims against financial institutions related to Countrywide's negotiation of the March 31, 2007 check. Those claims were settled in the trial court and are not at issue in this appeal.

in Fifth Third's daily and monthly account statements and therefore could never provide the notice required by the account terms.

The trial court determined that Fifth Third was liable to reimburse MBP $69,559.06 and that National City was liable to indemnify Fifth Third in the same amount. The court denied Fifth Third's motion to dismiss MBP's claims on various grounds:

> Fifth Third's motion to dismiss [MBP's] claims for reimbursement is denied. MCL 440.3406[1] only bars [MBP's] claims if its failure to exercise ordinary care substantially contributed to an alteration or forgery of the check at issue. [MBP] had a contractual obligation to its insured to issue a check jointly payable to the payees noted on the check at issue. This Court does not find evidence proving that [MBP] failed to exercise ordinary care.
>
> [MBP's] claims are not barred under § 29 of the Rules & Regulations Applicable To All Fifth Third Accounts And Cards ("Rules & Regulations"). Copies of checks are scanned and the original check is destroyed by Fifth Third. These scanned copies are not sent to [MBP]. The daily check report sent to [MBP] only shows which checks were paid not to whom they were paid. [MBP] had no notice that the funds were paid to a forger. The February 2007 account statement did not provide notice of the alleged alteration or forgery either. Due to Fifth Third's institutional practices, [MBP] did not have notice of the forgery so that it could have notified Fifth Third within the 30-day period provided under § 29 of the Rules & Regulations. [MBP] exercised reasonable care in its duties to inspect bank statements under MCL 440.4406.
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> Section 30 of the Rules & Regulations provides that "Customer assumes liability for any improper endorsement by payees." That section, however, does not apply in this instance because forging a payee's name and presenting a check for payment does not constitute an "endorsement" by a *payee*. The language of the contract is clear and unambiguous that [MBP] would be responsible if its payees improperly endorsed the check. MCL 440.1201 defines unauthorized signature and includes the word "forgery." The contract agreement does not use the term "unauthorized signature" but only refers to payee's endorsements. An endorsement was made by [Powell] and [Powell] is not a payee. Countrywide [] never endorsed the check. [Emphasis in original.]
>
> National City is entitled to assert the defenses Fifth Third may have against [MBP]'s claim. However, as noted above, these defenses fail against [MBP].
>
> Fifth Third's motion for summary disposition as to National City is granted. If the check at issue was honored with forged endorsements, then National City breached its presentment warranties to Fifth Third under MCL 440.3417 and 440.4208. As a result, National City would indemnify Fifth Third for any amount Fifth Third is required to re-credit [MBP].

> [MBP] has presented evidence that the check was forged – that is, the endorsement "Countrywide Home Loans" was not made by Countrywide. Fifth Third and National City do not concede that this was a forgery; both banks failed to present any competent evidence to the contrary.[1] Therefore, this court finds that there is no genuine issue of fact that the check was forged. [MBP] is entitled to reimbursement from Fifth Third in the amount of $69,599.06 [sic].
>
> [1] It is somewhat unbelievable that National City accepted a handwritten "Countrywide Home Loans" as the real endorsement of the former largest mortgage company in the country.

After the trial court issued its ruling, Fifth Third assigned its rights and defenses to National City. National City then pursued this appeal.

III. STANDARD OF REVIEW

We review a trial court's decision on a motion for summary disposition de novo. *Coblentz v Novi*, 475 Mich 558, 567; 719 NW2d 73 (2006). A motion under MCR 2.116(C)(8) "tests the legal sufficiency of the claim on the pleadings alone to determine whether the plaintiff has stated a claim on which relief may be granted." *Spiek v Dep't of Transportation*, 456 Mich 331, 337; 572 NW2d 201 (1998).

> "A motion under MCR 2.116(C)(10) tests the factual sufficiency of the complaint." In evaluating such a motion, a court considers the entire record in the light most favorable to the party opposing the motion, including affidavits, pleadings, depositions, admissions, and other evidence submitted by the parties. Where the proffered evidence fails to establish a genuine issue regarding any material fact, the moving party is entitled to judgment as a matter of law. [*Corley v Detroit Bd of Ed*, 470 Mich 274, 278; 681 NW2d 342 (2004) (internal citations omitted).]

Summary disposition is appropriate under MCR 2.116(I)(2) "[i]f it appears to the court that the opposing party, rather than the moving party, is entitled to judgment."

We review underlying issues of statutory interpretation de novo. *Eggleston v Bio-Medical Applications of Detroit, Inc*, 468 Mich 29, 32; 658 NW2d 139 (2003). The goal of statutory interpretation is to discern the intent of the Legislature based on the language of the statute. "If the statutory language is clear and unambiguous, judicial construction is neither required nor permitted, and courts must apply the statute as written." *Rose Hill Ctr, Inc v Holly Twp*, 224 Mich App 28, 32; 568 NW2d 332 (1997). If a statute is ambiguous, however, judicial construction is permitted. *Detroit City Council v Mayor of Detroit*, 283 Mich App 442, 449; 770 NW2d 117 (2009).

We also review underlying issues of contract interpretation de novo. *Citizens Ins Co v Pro-Seal Service Group, Inc*, 477 Mich 75, 80; 730 NW2d 682 (2007). We must apply the plain and unambiguous language of a contract as the document "reflects the parties' intent as a matter of law." *Hasting Mut Ins Co v Safety King Inc*, 286 Mich App 287, 292; 778 NW2d 275 (2009).

IV. ANALYSIS

A. Liability Under the UCC

The current transaction occurred mostly as anticipated under the UCC. MBP, as the "drawer," wrote the subject check from its bank account at the "drawee"/"payor" bank, Fifth Third. Joyce Washington, as a payee on the check, took the instrument to her bank (or had Powell do so with her power of attorney). National City, which served as the "depositary bank," deposited the check proceeds into Washington's account. It then "handle[d] the check for collection" and presented it to Fifth Third for payment.

Upon National City's presentment of the check, Fifth Third was required to quickly decide whether to honor or dishonor it:

> If an item is presented on and received by a payor bank[,] the bank is accountable for the amount of the following:
>
> (a) A demand item other than a documentary draft whether properly payable or not if the bank, in any case where it is not also the depositary bank, retains the item beyond midnight of the banking day of receipt without settling for it or, regardless of whether it is also the depositary bank, does not pay or return the item or send notice of dishonor until after its midnight deadline. [MCL 440.4302(1).]

To make this decision, Fifth Third had to first determine whether the check was "properly payable." A bank may only deduct "properly payable" items from its customer's account and should use due care at the time of presentment to mitigate its losses.

> A bank may charge against the account of a customer an item that is properly payable from that account even though the charge creates an overdraft. An item is properly payable if it is authorized by the customer and is in accordance with any agreement between the customer and bank. [MCL 440.4401(1).]

In the simplest transactions, a single drawer makes a check payable to a single named payee. That payee then signs his or her name to endorse the check and takes the proceeds. The check in this case was not made payable to a single payee, it was made payable to three. "If an instrument is payable to 2 or more persons not alternatively, it is payable to all of them and may be negotiated, discharged, or enforced only by all of them." MCL 440.3110(4). To "negotiate" the check, each joint payee must "endorse" it. MCL 440.3204(1). If a joint payee's endorsement signature is missing or forged, the endorsement is incomplete and the check is not "properly payable." *Pamar Enterprises, Inc v Huntington Banks of Michigan*, 228 Mich App 727, 733; 580 NW2d 11 (1998); *Siecinski v First State Bank of East Detroit*, 209 Mich App 459, 462; 531 NW2d 768 (1995).

The subject check was endorsed in the name of all three named payees: Washington, Countrywide, and T & C. Despite Fifth Third and National City's contrary allegations, there is no *genuine* issue of material fact that at least two of those endorsements were forged by Washington or Powell acting on her behalf. Neither Fifth Third nor National City presented any

evidence rebutting MBP's forgery claim. On the other hand, substantial evidence supported that the mortgage company and credit union endorsements were forged. All three endorsements were made in one script. The check was deposited at National City by a National City customer into the customer's National City account. National City should have known that its customer was not a Countrywide or T & C corporate representative, was not entitled to endorse a check on Countrywide's or T & C's behalf, and certainly had no power to deposit proceeds payable to the corporate Countrywide and T & C into her personal account. The obviously forged endorsements rendered the check not "properly payable" under the UCC. *Pamar*, 228 Mich App at 733; *Siecinski*, 209 Mich App at 462.

As a general rule, a bank that pays funds from a customer's account based on a check with forged endorsements must recredit or reimburse those funds to the customer's account. *Leather Manufacturers' Bank v Merchants' Bank*, 128 US 26, 34; 9 S Ct 3; 32 L Ed 342 (1888) (under the common law); *The Guardian Life Ins Co v Weisman*, 223 F3d 229, 232 (CA 3, 2000) (under the UCC). See also *Morof v United Missouri Bank, Warsaw*, 391 Fed Appx 534, 537 (CA 6, 2010); *Distributor Label Products, Inc v Fleet Nat'l Bank*, 401 NJ Super 345, 349; 950 A2d 939 (2008).[4] MCL 440.3406(1) creates an exception to the bank's duty to reimburse its customer for otherwise not "properly payable item[s]."

> A person whose failure to exercise ordinary care substantially contributes to an alteration of an instrument or to the making of a forged signature on an instrument is precluded from asserting the alteration or the forgery against a person who, in good faith, pays the instrument or takes it for value or for collection.

The bank must show (1) that it acted in "good faith," (2) while the customer's lack of "ordinary care" (3) "substantially contributed to" (4) "the making of a forged signature." "Good faith" is defined by the UCC as "honesty in fact and the observance of reasonable commercial standards of fair dealing." MCL 440.3103(1)(d). In determining whether a bank observed "reasonable commercial standards of fair dealing," we must consider the "fairness of [its] actions, rather than any negligence on its part." *Wachovia Bank, NA v Fed Reserve Bank of Richmond*, 338 F3d 318, 323 (CA 4, 2003). There is no argument or evidence that Fifth Third was unfair in its actions. Accordingly, we proceed as if Fifth Third acted in "good faith" when it paid the Washington-Countrywide check.

The UCC defines the "ordinary care" required of MBP as "observance of reasonable commercial standards, prevailing in the area in which the person is located, with respect to the business in which the person is engaged." MCL 440.3103(1)(g). While we disagree with the trial court's reasoning, we agree with its conclusion that MBP acted with ordinary care and was not precluded from seeking reimbursement under the UCC.

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[4] As most states have adopted the model UCC with only slight stylistic changes, it is useful to review their interpretations and applications of various UCC provisions. See, e.g., *Baker v DEC Int'l*, 458 Mich 247, 255; 580 NW2d 894 (1998); *Power Press Sales Co v MSI Battle Creek Stamping*, 238 Mich App 173, 180; 604 NW2d 772 (1999).

Fifth Third accused MBP of negligently mailing the subject check directly to its insured rather than to the lien holder that was allegedly entitled to the entirety of the proceeds. The trial court accepted as true MBP's assertion that it was contractually bound to mail the check directly to its insured and to include its insured as a joint payee on the check. As MBP failed to present the insurance policy on the record neither the trial court nor this Court could conclude as a matter of law that MBP acted in accordance with its contractual duties. However, Fifth Third presented no evidence that MBP's procedure of mailing jointly payable checks directly to its insured amounted to a "failure to exercise ordinary care." To invoke comparative negligence principles, Fifth Third was required to create a genuine issue of material fact that the prevailing practice in the homeowner's insurance industry is to exclude the insured as a named payee and mail those checks directly to the creditor, rather than the insured, and that such a practice is a reasonable commercial standard. Absent any attempt by Fifth Third to meet its evidentiary burden, the trial court properly denied its motion for summary disposition on the UCC claims.

As an alternate ground for reversal, National City contends that MBP acted negligently by failing to issue a "stop payment" order to void the Washington-Countrywide check.[5] Washington waited five months to deposit the subject check into her National City account. In the meantime, Washington obtained counsel and objected to the inclusion of a joint payee on a $325.00 check for contracting work. For unspecified reasons, MBP subsequently notified Fifth Third to stop payment on the $325.00 check. Washington's counsel also challenged "the inclusion of the T & C Credit Union" as a payee on the Washington-Countrywide check as "a breach of the policy."

MBP conceded in its amended complaint that "[b]etween September 22, 2006 [the date of the insurance settlement] and February 16, 2007, Countrywide . . . frequently inquired regarding the status of payment on the claim as it was [a] loss payee under the policy." MBP has not conceded, and neither Fifth Third nor National City presented any evidence, that MBP should have prejudged Washington as a fraud risk. Rather, there appears a question of fact whether MBP simply believed that Washington's counsel would resolve the conflict with Countrywide before negotiating the check. Accordingly, there would be no reason for MBP to preemptively stop payment on the check. Viewed in the light most favorable to MBP, this evidence is insufficient to support negligence on MBP's part or to warrant judgment as a matter of law.

Fifth Third further challenges the trial court's failure to consider its alternate defense under the UCC—that the check proceeds reached the intended payee.

> [T]he intended-payee defense provides that a drawee bank is not liable to the drawer of a check for an improper payment if (1) the proceeds of the check reach the person the drawer intended to receive them and (2) the drawer suffers no loss proximately caused by the drawee's improper payment. This defense is intended to prevent the unjust enrichment of the drawer. [*Pamar*, 228 Mich App at 737 (internal citations omitted).]

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[5] MCL 440.4403 permits a customer to "stop payment of any item drawn on the costumer's account."

The intended-payee defense does not protect Fifth Third in this case. The proceeds of the original Washington-Countrywide check did not reach their intended payee. The check was specifically made jointly payable to three intended payees. Yet, only one payee received the proceeds. MBP suffered a loss as it was required to issue a second check to pay off Countrywide's insured lien. MBP's loss was proximately caused by Fifth Third's wrongful payment of the check; absent the wrongful payment, MBP would not have been required to issue a second check.

B. Liability Under the Account Contract

While Fifth Third would be liable to reimburse MBP's account under the UCC, the parties' actions are also governed by the account contract entitled "The Rules & Regulations Applicable To All Fifth Third Accounts And Cards."[6] The UCC allows individuals to contractually alter UCC requirements. MCL 440.1102(3); MCL 440.4103(1). The right to alter UCC provisions is necessary due to "the technical complexity of the field of bank collections, the enormous number of items handled by banks, . . . the certainty of changing conditions and the possibility of developing improved methods of collection to speed the process." MCL 440.4103, comment 1. The only limit on the parties' ability to alter UCC requirements is that they "cannot disclaim a bank's responsibility for its lack of good faith or failure to exercise ordinary care or limit the measure of damages for the lack or failure." MCL 440.4013(1). The parties may, however, contractually define the standards of good faith and ordinary care. *Id.*

Of relevance to the current case, the contract between Fifth Third and MBP provides:

> 27. Customer agrees that Bank can disregard any information on an item other than MICR encoded data, amount, signature of drawer and identity of payee.
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> * * *
>
> 29. Customer agrees to carefully examine and reconcile account statements. . . . Customer agrees that Bank will not be liable if Customer fails to exercise ordinary care in examining their statements. Customer will notify Bank of any discrepancy with any item, including, but not limited to, deposits, withdrawals, and checks, within thirty (30) days of the statement mailing or made available to customer date. *Customer will also notify Bank of any forgery or alteration of any item within thirty (30) days of the statement mailing or made available to customer date. If notification is not received, Bank will have no liability for such item(s).* Customer also agrees that Bank will have no liability if the item is forged, altered or counterfeited in such manner that the fraud could not be detected by a reasonable person . . . .

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[6] We note that National City contends on appeal that the Fifth Third contract contains an Ohio choice of law provision. However, National City has never applied Ohio law to this case. In any event, the choice of law provision does not appear in the relevant clause "Applicable to all Accounts"; it appears in a separate clause applicable only to "card agreements."

30. Customer assumes liability for any improper endorsements *by payees.* [Emphasis added.]

The parties' contract reflects the reality that MBP is in the best position to detect fraud on its account and avoid loss. Fifth Third provides daily and monthly statements to MBP from which MBP can detect any abnormal activity. If MBP fails to use ordinary care to review the statements and notify Fifth Third within 30 days of any discrepancy or forgery, the burden of loss is contractually shifted to MBP. The contract also creates a strict assumption of liability by MBP for "any improper endorsements by payees."

Dismissal of MBP's reimbursement claim was required by ¶ 30's strict assumption of liability provision. The trial court erroneously concluded that the contractual provision only applies when a named payee physically places pen to paper to endorse a check. We cannot accept this tenuous interpretation of the Fifth Third account contract. The trial court disregarded that the named payee can improperly endorse a check by granting an agent unfettered license to forge a third-party's signature on the payee's/principal's behalf.

Despite the lack of evidence regarding who actually took the subject check to National City for deposit, the trial court accepted as true that Powell signed the endorsements. The court ruled that, because Powell was not a named payee, ¶ 30 was inapplicable. Even assuming that Powell negotiated the check at National City, we find that the check bore an endorsement by a payee. It is undisputed that Powell was acting under a power of attorney granted by Washington. "Generally, a power of attorney is a written instrument by which a principal authorizes and appoints an agent . . . and delegates to the agent the power to perform acts on behalf of, in place of, and instead of the principal." *Persinger v Holst*, 248 Mich App 499, 530; 639 NE2d 594 (2001). MBP, National City and Fifth Third never asserted that Powell acted beyond the scope of his power of attorney by signing Washington's endorsement on the subject check. Accepting Powell's authority under the power of attorney, his endorsement on behalf of Washington was an endorsement, improper or not, *by a payee*. An endorsement made by an agent or representative on a check serves to bind a principal under the UCC. MCL 440.3401(1) and comment 1. The agent is permitted to sign in his or her own name or that of the principal. MCL 440.3402(1). Therefore, when Powell signed the check with Washington's name, he made an "endorsement[] by [a] payee[]," and MBP assumed strict liability if the endorsement was ultimately "improper."

In addition, MBP's negligence after the Washington-Countrywide check was negotiated precluded relief under the account contract. Even though MBP likely had insufficient information to preemptively stop payment on the subject check, it certainly had enough information *after* the check had been negotiated to alert its bank. MBP failed to "carefully examine and reconcile account statements" as required in the contract and thereby absolved Fifth Third of liability. Fifth Third notified MBP in both the daily and monthly account statements that the original Washington-Countrywide check had been cashed on February 16, 2007. On appeal, MBP asserts, "After the check was presented and honored, Countrywide . . . contacted [MBP] with regard to its interest in the original settlement check and it was discovered that Countrywide did not receive any funds." MBP then mailed a duplicate check directly to Countrywide on March 31, 2007. The record evidence is clear that MBP was aware of some "suspicious" activity within the 30-day notice period. MBP was on notice from the bank statements that the subject check had been negotiated and from Countrywide's subsequent

correspondence that it had not been paid. If MBP required more proof of an account discrepancy, it could have exercised its contractual right to request Fifth Third's electronic copy of the check, which included an image of the endorsements.[7] MBP would thereby discover the obvious forgery made by its insured or Powell acting as her power of attorney. The bank statements provided sufficient information to arouse MBP's suspicions of forgery or other skullduggery and included more information than required under the UCC. See MCL 440.4406(1) (statement must include "item number, amount, and date of payment"). As MBP failed to notify Fifth Third of the discrepancy or forgery until approximately 27 months after the February 2007 statement date, Fifth Third would also have "no liability" under ¶ 29 of the contract.

MBP's challenges to the propriety of these contractual provisions lack merit. While a bank customer's strict assumption of liability for improper endorsements contemplated in ¶ 30 seems severe, it is supportable in the reality of the banking industry. As noted by the Third Circuit Court of Appeals, "it would be a mistake to require drawee banks to review payee indorsements . . . ." *The Guardian Life Ins Co*, 223 F3d at 233. As our population and economy have expanded, "the volume of checks handled daily by banks" has exploded. *Id.* To accommodate the growth while containing costs, banks have necessarily moved to automated systems that cannot review the authenticity or accuracy of payee endorsements. *Id.* Banks instead review a random sampling or an amount-specific selection of checks to gauge the rate of improper endorsements. *Id.* As noted by the Third Circuit:

> "Increasingly banks are little more than high-speed mechanical sorters of checks, and drawers or other parties are in much better positions to prevent losses. In such circumstances we should resist the temptation to put the loss on the more wealthy but less culpable and less capable risk avoider." [*Id.* at 234, quoting 1 White & Summers, Uniform Commercial Code (3d ed, 1988), p 805.]

MBP also implies that Fifth Third's 30-day notice period was too short to be effective. MCL 440.4406(3) requires a bank customer to "exercise reasonable promptness in examining the statement" and to "promptly notify the bank" of an alteration or forgery. Other jurisdictions have resoundingly approved of contractually shortened notice provisions, like the current 30-day period. The general consensus in federal and state courts is that account holders who fail to notify a bank of an account discrepancy within the contractually agreed-upon time period lose

[7] The account contract provides:

> 32. Customer may not, in all cases, get return of their original deposit account documents, including checks (items). Bank may add images of Customer's items to its electronic document storage system. After doing so, Bank may destroy original items. Any copy from that system will be acceptable for all purposes. Customer may obtain a copy of their deposit account items upon request.

See also MCL 440.4406(2) (the bank must maintain legible copies of deposited checks and provide that copy to its customer upon request).

the right to reimbursement. See, e.g., *Graves v Wachovia Bank*, 607 F Supp 2d 1277, 1280 (MD Ala, 2009) (40-day notice period); *Bank of America, NA v Putnal Seed & Grain, Inc*, 965 So2d 300, 301-302 (Fla App, 2007) (60-day notice period); *Parent Teacher Assoc v Manufacturers Hanover Trust Co*, 138 Misc 2d 289, 293; 524 NYS2d 336 (1998) (14-day notice period); *Crescent Women's Medical Group, Inc v Keycorp*, 127 Ohio Misc 2d 93, 95-96; 806 NE2d 201 (2003); *Nat'l Title Ins Corp Agency v First Union Nat'l Bank*, 263 Va 355, 362; 559 SE2d 668 (2002) (60-day notice period); *Borowski v Firstar Bank of Milwaukee, NA*, 217 Wis 2d 565, 574-575; 579 NW2d 247 (1998) (14-day notice period). Fifth Third's designation of a 30-day notice period comports with the UCC's prescribed need for "reasonable promptness" and would find approval in many, if not most, of our sister states.

In summary, the trial court correctly determined that Fifth Third would have been liable to reimburse MBP under the UCC as the bank improperly deducted funds to pay a check bearing obviously forged endorsements. Yet, Fifth Third's statutory liability was eliminated by the parties' contractual agreement that MBP would bear the loss incurred from "improper endorsements by payees" and would provide notice of any discrepancies within 30 days of the relevant account statement. The subject check bore such an improper endorsement and MBP did not provide the required notice, precluding its claim for reimbursement of the $69,559.06 check proceeds. National City's liability on Fifth Third's warranty claim is limited to the "amount paid" on the subject check. As Fifth Third is no longer liable to MBP, National City's duty to indemnify Fifth Third also disappears.

Affirmed in part, reversed in part and remanded for entry of judgment consistent with this opinion. We do not retain jurisdiction.

/s/ Elizabeth L. Gleicher
/s/ Mark J. Cavanagh
/s/ Peter D. O'Connell

Commercial Law Newsletter
Joint Newsletter of the Commercial Finance and Uniform Commercial Code Committees
American Bar Association Business Law Section
March 19, 2012 Spring 2012

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Joint Report from the Chairs

Dear Members:

We are delighted to present you with this edition of the Commercial Law Newsletter featuring the Spotlight Column and three articles concerning recent developments affecting commercial law:

1. In this issue's Spotlight Column, Professors Steve Sepinuck and Kristen Adams highlight five cases as being wrongly decided or incorrectly analyzed, ranging from a case involving the intersection of UCC Articles 2A and 9 to a case involving a battle between a secured creditor and a litigant claiming trademark infringement in accounts generated from goods under the infringing trademark. These cases hail from across the country; certainly no region has a monopoly on getting the UCC wrong.

2. An article by Lisa Schweitzer and Robin Baik of Cleary Gottlieb Steen & Hamilton LLP about a recent Second Circuit decision in *Parmalat Capital Finance Ltd. v. Bank of America Corp.* applying a four-part test to determine whether a district court must abstain from hearing state law claims that are related to a bankruptcy case when those claims can be timely and properly adjudicated in state court.

3. An article by Tom Hemmendinger of Brennan, Recupero, Cascione, Scungio & McAllister, LLP, Kieran Marion of the Uniform Law Commission and R. Wilson Freyermuth of the University of Missouri School of Law on whether a new uniform state law is needed to address the appointment of receivers in the real estate and perhaps other contexts.

4. An update by Carol Tello of Sutherland Asbill & Brennan LLP on the Foreign Account Tax Compliance Act ("FATCA") and newly issued IRS regulations that provide guidance on implementing the reporting and withholding requirements of the Act.

Many thanks go out to the authors of these articles, to our tireless and assiduous editors, Carol Nulty, Christina Rissler, Rebecca Gelfand, Annette Moore and Celeste Pozo, and to our newly established Articles Advisory Board that will help our editors to identify topics and articles for publication in future editions of the Newsletter.

We hope to see you at the ABA Business Law Section's Spring Meeting to be held in Las Vegas from March 22 to 24, 2012. We have an extensive array of CLE programming planned for the meeting, including:

1. UCC/ComFin Joint Committee Meeting. We will launch our joint UCC and ComFin online discussion forum and have a guest presentation on the basics of the futures market, typical collateral arrangement in such markets and new developments in light of MF Global's bankruptcy and the Dodd-Frank legislation.

MARK YOUR CALENDARS

March 28, 2012 – 1:00 p.m. to 2:30 p.m. ET – Special Servicers and Defaulted CMBS Loans. (CLE Webinar) Click **here** for more information.

March 29, 2012 – 9:00 a.m. to 11:45 a.m. ET – Drafting Indemnification and Hold Harmless Provisions. (Live CLE) Click **here** for more information.

March 29, 2012 – 1:00 p.m. to 3:45 p.m. ET – Drafting Confidentiality Provisions and Non-Disclosure Agreements. (Live CLE) Click **here** for more information.

April 3, 2012 – 1:00 p.m. to 2:30 p.m. ET – Pledge Agreements for Partnership and LLC Equity Interests: Crafting Security and Operating Agreements to Protect Lender Interests. (CLE Webinar) Click **here** for more information.

April 4, 2012 – 1:00 p.m. to 2:30 p.m. ET – Equity Interests as Collateral in Commercial Lending. (CLE Webinar) Click **here** for more information.

August 2-7, 2012 – ABA Annual Meeting – Chicago Marriott Downtown in Chicago, Illinois. Save the date!

November 14, 2012 – Commercial Finance Committee and Uniform Commercial Code Committee Joint Meeting – JW Marriott Desert Ridge in Phoenix, Arizona. Save the date!

VIEW CURRENT REPORTS AND DEVELOPMENTS OF THE FOLLOWING COMMITTEES AND TASK FORCES:

COMFIN SUBCOMMITTEES AND TASK FORCES

- Subcommittee on Agricultural and

(Thursday, March 22, 8:00 a.m. to 9:30 a.m.)

2. CLE Program: Ethical Issues in Commercial Transactions. (Thursday, March 22, 10:30 a.m. to 12:30 p.m.)

3. Young Lawyers CLE Program: How to Negotiate a Secured Credit Facility. (Thursday, March 22, 11:30 a.m. to 12:45 p.m.)

4. Secured Creditors Luncheon on Collateral Enforcement Issues. (Thursday, March 22, 12:30 p.m. to 2:30 p.m.)

5. CLE Program: Current State of Syndicated Loan Markets 2012. (Thursday, March 22, 2:30 p.m. to 4:30 p.m.)

6. CLE Program: Let's Play Doctor: Acquisition and Financing of Healthcare Facilities. (Friday, March 23, 8:00 a.m. to 10:00 a.m.)

7. CLE Program: Security Interests in Proceeds of Collateral: The Rules and Recent Development in Case Law and in Bankruptcy. (Friday, March 23, 2:30 p.m. to 4:30 p.m.)

8. CLE Program: Commercial Law Developments. (Saturday, March 24, 8:00 a.m. to 10:00 a.m.)

9. CLE Program: Variation of the UCC by Agreement. (Saturday, March 24, 10:30 a.m. to 12:30 p.m.)

Our subcommittees and task forces also have organized excellent substantive sessions. Many thanks go out to all the chairs and speakers for their tremendous work; their efforts will ensure that we will all have an excellent opportunity at the Spring Meeting to catch up on key developments in commercial law.

Looking forward, the ABA Annual Meeting will take place this year from August 2nd to August 7th in Chicago, Illinois. The joint UCC/ComFin Fall Meeting featuring a day's worth of CLE programming will take place on Wednesday, November 14, in Scottsdale, Arizona.

We look forward to seeing you at these upcoming meetings and encourage you to look out for future webinars we will be hosting and to get involved in our committees. Please do not hesitate to contact either of us with any questions or to find out how to participate more fully.

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Featured Notes

The Permanent Editorial Board for the Uniform Commercial Code has published draft commentaries for public comment:

1. A Comment on Limited Liability Partnerships under the Choice of Law Rules of Article 9, which will clarify that the proposed 2010 UCC Article 9 Amendments were not intended to imply a change in the "registered organization" status of limited liability partnerships organized under the Uniform Partnership Act (1997) and similar LLP statutes and that these entities are not "registered organizations" for purposes of UCC Section 9-102(a). Click **here** for a copy of the commentary. Comments are due by **April 2, 2012.**

2. A Comment on the Application of UCC Sections 9-406 and 9-408 to Transfers of

- Agri-Business Financing
- Subcommittee on Aircraft Financing
- Subcommittee on Creditors' Rights
- Subcommittee on Cross-Border and Trade Financing
- Subcommittee on Intellectual Property Financing
- Subcommittee on Lender Liability
- Subcommittee on Loan Documentation
- Subcommittee on Loan Workouts
- Subcommittee on Maritime Financing
- Subcommittee on Real Estate Financing
- Subcommittee on Secured Lending
- Subcommittee on Syndications and Lender Relations
- ADR Task Force
- Model Intercreditor Agreement Task Force
- Surveys of State Commercial Laws

UCC SUBCOMMITTEES

- Subcommittee on Annual Survey
- Subcommittee on Article 7
- Subcommittee on Commercial Law Newsletter
- Subcommittee on General Provisions and Relations to Other Law
- Subcommittee on International Commercial Law
- Subcommittee on Investment Securities
- Subcommittee on Leasing
- Subcommittee on Letters of Credit
- Subcommittee on Membership
- Subcommittee on Payments
- Subcommittee on Sale of Goods
- Subcommittee on Secured Transactions

COMFIN AND UCC JOINT TASK FORCES

- Commercial Finance Terms Joint Task Force
- Deposit Account Control Agreements Joint Task Force
- Filing Office Operations and Search Logic Joint Task Force
- Legislative Enactment of Article 9
- Model IP Security Agreement Joint Task Force
- Survey of State Guaranty Laws

Interest in Unincorporated Business Organizations, which will analyze the extent to which UCC Sections 9-406 and 9-408 override transfer restrictions in limited liability partnerships, limited liability corporations and other similar entities and will address favorably concerns over the ability of parties to such agreements to "pick their partners". Click **here** for a copy of the commentary. Comments are due by **April 2, 2012.**

3. A Comment on the NY Court of Appeal's decision in *Highland Capital*, which will highlight that the *Highland Capital* decision was incorrectly decided and will point to the applicability of articles of the UCC beyond Article 9 (as to which a 2010 Amended Comment has been proposed) that "UCC Sections 8-102(a)(13) and 8-102(a)(15) should be interpreted so that an obligation of an issuer that fulfills other criteria for being classified as a 'security,' but is not in bearer form and with respect to which there exist no books maintained for the purpose of registration of transfer, is not a 'security'." Click **here** for a copy of the commentary. Comments are due by **April 2, 2012.**

Also for those of you looking for good pro bono/volunteer opportunities, the ABA Business Law Section and Junior Achievement are partnering to promote youth financial literacy. Business lawyers often witness firsthand the high cost of ignorance about personal finances. Volunteer yourself and your firm to provide personal finance instruction to high school students within the Junior Achievement program. Check **here** for more information about the Section's efforts.

Featured Articles

SECOND CIRCUIT HOLDS DISTRICT COURT MUST MANDATORILY ABSTAIN FROM DECIDING PARMALAT STATE COURT ACTION RELATED TO U.S. ANCILLARY BANKRUPTCY PROCEEDING

By Lisa Schweitzer and Robin Baik,
Cleary Gottlieb Steen & Hamilton LLP

Under 28 U.S.C. § 1334(c)(2), a district court must abstain from hearing state law claims that are related to a bankruptcy case when those claims can be timely adjudicated in state court. In *Parmalat Capital Finance Ltd. v. Bank of America Corp.*, Nos. 09-4302-cv (L) et al., 2012 WL 539957 (2d Cir. Feb. 21, 2012) (to be published in F.3d), the United States Court of Appeals for the Second Circuit (the "Second Circuit") ruled that certain state court actions brought by Parmalat (as defined below) affiliates or their representatives against their former auditor Grant Thornton should be transferred back and remanded to the Illinois court based on the Second Circuit's application of a four-factor test governing mandatory abstention it adopted in a prior appeal in the same case.

The Facts

Plaintiff-appellant Dr. Bondi ("Bondi") represented Parmalat Finanziaria, S.p.A. ("Parmalat") in Italian bankruptcy proceedings commenced in 2003 as its extraordinary commissioner under Italian law. Plaintiff-appellant Parmalat Capital Finance Limited ("PCFL") is a Grand Caymans-based corporate subsidiary of Parmalat. PCFL is in liquidation in the Cayman Islands.

In 2004, Bondi and PCFL commenced separate ancillary U.S. bankruptcy proceedings under former 11 U.S.C. § 304 (the predecessor to chapter 15 of the Bankruptcy Code) in the U.S. Bankruptcy Court for the Southern District of New York (the "Southern District of New York") in order to enjoin litigation against PCFL and

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If so, submit an article for possible publication in a future issue of the Commercial Law Newsletter. Publishing an article with the Commercial Law Newsletter is a great way to get involved with the UCC Committee and the ComFin Committee. Articles can survey the law nationally or locally, discuss particular UCC or Commercial Finance issues, or examine a specific case or statute. If you are interested in submitting an

Parmalat in the United States. Prior to the commencement of the § 304 proceedings, purchasers of Parmalat's debt and equity securities had filed securities fraud class action lawsuits in the United States against Parmalat and various banks and auditing firms that had allegedly participated in the fraud, including the Appellees Grant Thornton International, Inc., Grant Thornton International Ltd. and Grant Thornton LLP (collectively, "Grant Thornton"), who had been auditors for Parmalat and PCFL. The Bankruptcy Court enjoined the actions as against the debtors and the class action plaintiffs subsequently dropped Parmalat from the class action lawsuits.

In 2004 and 2005, Bondi and PCFL separately filed suits in Illinois state court against Grant Thornton, alleging claims arising under Illinois state law including professional malpractice, fraud, negligent misrepresentation, and unlawful civil conspiracy.[1] Grant Thornton removed these cases in separate proceedings to the United States District Court for the Northern District of Illinois on the basis of 28 U.S.C. §§ 1334(b) and 1452, arguing that removal of each case was proper because the case was "related to" Parmalat and PCFL's respective § 304 proceedings pending in the Southern District of New York. Appellants moved to remand the cases to Illinois state court, arguing that the district court was required to abstain from hearing the cases pursuant to the mandatory abstention provided under 28 U.S.C. § 1334(c)(2). The Appellants' motions were denied, the cases were transferred to and consolidated in the Southern District of New York, and their claims were dismissed. Bondi and PCFL appealed to the Second Circuit.

In a 2011 decision, the Second Circuit vacated the district court's decision not to abstain under § 1334(c)(2), and articulated a four-factor test to determine whether a case can be "timely adjudicated" by state courts for purposes of § 1334(c)(2), including: "(1) the backlog of the state court's calendar relative to the federal court's calendar; (2) the complexity of the issues presented and the respective expertise of each forum; (3) the status of the title 11 bankruptcy proceeding to which the state law claims are related; and (4) whether the state court proceeding would prolong the administration or liquidation of the estate." *Parmalat Capital Fin. Ltd. v. Bank of Am. Corp.*, 639 F.3d 572, 580 (2d Cir. 2011) (citing *In re Georgou*, 157 B.R. 847, 851 (N.D. Ill. 1993)). The Second Circuit remanded the cases for the district court to determine whether the cases could be "timely adjudicated" in Illinois state court as analyzed under the four-factor test. On remand, the district court again concluded that mandatory abstention did not apply. The Appellants renewed their appeals to the Second Circuit seeking mandatory abstention.

The Decision

The Second Circuit analyzed each of the four factors *de novo*, and concluded that the cases can be "timely adjudicated" by Illinois state court for purposes of mandatory abstention under § 1334(c)(2).

1. Backlog of the state court's calendar relative to the federal court's calendar

With regard to the first factor, the "backlog of the state court's calendar relative to the federal court's calendar," the Second Circuit agreed with the district court that on balance this factor weighed against abstention but emphasized that this factor is not dispositive. The Second Circuit noted that the district court was familiar with the case having overseen discovery and accordingly an Illinois court that was new to the case may be somewhat slower in ruling on the pending summary judgment motion. However, the Second Circuit concluded that a mere delay of a few months, where there was no evidence of general backlog in the Illinois courts, was insufficient alone to not abstain.

2. Complexity of the issues presented and the respective expertise of each forum

The Second Circuit concluded that the second factor, "the complexity of the issues presented and the respective expertise of each forum," favors abstention. In particular, the Second Circuit focused on the assertion of an *in pari delicto* defense, the nature and scope of which remained unsettled under Illinois law. The Second Circuit was not moved by arguments that the district court was better equipped to adjudicate these cases due to its familiarity with the underlying facts, instead emphasizing that the focus is

article, please contact one of the following Commercial Law Newsletter Editors **Annette C. Moore, Carol Nulty Doody, Celeste Pozo, Christina B. Rissler, or Rebecca Gelfand.**

the complexity of the specific legal issues presented.

3. Status of the title 11 bankruptcy proceeding to which the state law claims are related

The "status of the title 11 bankruptcy proceeding to which the state law claims are related" also was found to favor abstention. Since the pending U.S. bankruptcy case was an ancillary proceeding rather than a full chapter 11 case, the Second Circuit found no evidence showing the adjudication of the cases would have an effect on the § 304 ancillary proceedings. Accordingly, the federal interest in "related-to" jurisdiction was not implicated in a remand of the cases.

4. Whether the state court proceeding would prolong the administration or liquidation of the estate

The Second Circuit similarly concluded that the fourth factor, "whether the state court proceeding would prolong the administration or liquidation of the estate," weighed in favor of abstention given that Parmalat's ability to pay creditors under its approved Concordat in its Italian bankruptcy proceedings did not depend on the resolution of the U.S. litigations. The Second Circuit clarified that this factor considers the effect on the bankruptcy estate (here, the subject of the Italian and Cayman proceedings), not merely the pending U.S. ancillary bankruptcy proceedings. The Court also rejected the Appellees' argument that remand of the cases to the state court would harm creditors by increasing the cost of litigation, noting that the inquiry focuses not on whether abstention increases the ultimate payout to the creditors, but on whether it unduly prolongs the administration of the estate.

Based on the four-factor test, the Second Circuit determined that mandatory abstention under § 1334(c)(2) was warranted in these cases. While recognizing that some additional time will be expended by remanding these cases, the Second Circuit concluded that such a delay does not outweigh the substantial factors that call for abstention, namely the complexity of the state law issues, the deference owed to state courts with respect to state law matters, and the minimal effect of the state cases on the federal bankruptcy action and on the administration of the underlying estates. The Second Circuit did comment that the cases are "unusual cases" in that Grant Thornton had asserted third party contribution claims against Parmalat in securities fraud class actions also pending in the District Court for the Southern District of New York, and that Parmalat and its representatives could have asserted claims against Grant Thornton in that pending litigation. However, the ability to bring such claims in federal court should not weigh upon the abstention analysis where the debtor in fact chose to avail itself of the state court and the defendants had waived this argument against abstention by failing to raise it earlier.[2]

Implications

The *Parmalat* decision is noteworthy in that it provides a roadmap of how to approach weighing the various factors previously espoused by the Second Circuit to consider whether abstention is mandatory in favor of state court litigation. According to the decision, the four-factor test is meant to guide courts in reaching the balance between, on the one hand, creating a federal forum for purely state law cases which, due to delay, might impinge upon the federal interest in the administration of a bankruptcy estate, and, on the other, ensuring that purely state law cases remain in state courts when they would not significantly affect that federal interest. In answering the mixed question of fact and law, the four factors ultimately are interrelated and may carry different weight depending on, among other things, the time and resources available to the relevant courts at times, the key issues in adjudging the state law questions, the nature and status of the underlying bankruptcy proceedings, and the level of impact the state court proceeding will have to the administration or liquidation of the estates. Of note, the fact that the related U.S. bankruptcy cases were mere ancillary proceedings and the foreign proceedings were both in end stages and likely materially unaffected by the U.S. litigations was significant to the Second Circuit and may prove to be a basis for distinguishing other state cases that are related to pending bankruptcy cases and thus removed to federal court.

FATCA PROPOSED REGULATIONS CONFIRM REVOLVING CREDIT FACILITIES COVERED BY "GRANDFATHER" PROVISION

By Carol Tello, Sutherland Asbill & Brennan LLP

On February 8, 2012, the Internal Revenue Service (the "IRS") issued detailed proposed regulations providing operational guidance to financial institutions and withholding agents currently taking steps to implement the reporting and withholding requirements established under the new chapter 4 (sections 1471-1474) of the Internal Revenue Code (the "Code"), commonly referred to as the Foreign Account Tax Compliance Act ("FATCA"). *See* **REG-121647-10.** In those proposed regulations was the positive answer to the question of whether a revolving credit facility would qualify for relief under the "grandfather" provision, which is discussed below.

Under the new chapter 4 provisions, a withholding agent will be required to withhold U.S. tax of 30 percent on each payment of interest (but not principal) made to a foreign lender that does not enter into an agreement with the IRS to identify and report account information on U.S. owned accounts. A foreign lender that enters into such an agreement has the status of a "Participating FFI" and, as such, will not be subject to 30 percent withholding if it provides a certificate to the U.S. withholding agent that it is a "Participating FFI." The fact that a foreign lender receives interest under a credit agreement for its own account (and not on behalf of an account holder) does not relieve a foreign lender from being subject to chapter 4.

One issue of concern to the commercial lending community was whether revolving credit facilities are covered by the so-called "grandfather" rule that excepts from withholding payments made under an obligation that was in existence on March 18, 2012, an issue discussed in the article, *The New FATCA Tax Withholding Rules — Practical Considerations For Drafting Credit Agreements*, which appeared in the **Fall 2010** issue of the Commercial Law Newsletter. The grandfather provision is a statutory rule designed to permit an orderly transition to the imposition of the identification, reporting, and 30 percent withholding rules imposed under FATCA. Although preliminary guidance under Notice 2010-60 issued by the IRS would have appeared to apply to revolving credit facilities, no explicit provision provided such a rule. The proposed regulations, however, explicitly provide that a revolving credit facility is covered under the grandfather rule. *See* Prop. Treas. Reg. §1.1471-2(b). Even better, the grandfather rule has been extended by regulation to cover obligations existing on January 1, 2013. Thus, any lending agreement entered into as late as December 31, 2012 will be covered by the grandfather rule. This means that no withholding should occur on payments made under a lending agreement entered into on or before December 31, 2012. However, compliance with the other FATCA provisions is required, including the provision by a foreign lender of a Form W-8BEN that provides the foreign lender's FATCA status. Revised Forms W-8BEN will be issued by the IRS that will permit a foreign lender to check a box to identify the foreign lender's FATCA status to a U.S. borrower.

The grandfather provision will cease to apply, however, if there is a "material modification" to a lending agreement as that "material modification" will be treated as a newly issued obligation as of the date of the modification. Presumably, this means that a "material modification" executed prior to January 1, 2013 will qualify for the grandfather provision while a "material modification" that occurs on or after January 1, 2013 will not so qualify.

For debt obligations, the term "material modification" is defined under existing regulations under section 1001 of the Code. Generally, a "material modification" means: (i) changes in yield; (ii) changes in the timing of payments; (iii) changes in the obligor or debt collateral; (iv) changes from debt to equity and from recourse to nonrecourse classification; and (v) changes involving financial and accounting covenants.

In addition to obligations that qualify for the "grandfather" provision, the proposed regulations provide for a group of financial institutions that will not be subject to withholding as those financial institutions pose a low risk of FATCA-avoidance, so-called "deemed-compliant" FFIs. Deemed-compliant FFIs are divided into two sub-categories: registered and certified.

Two types of registered "deemed-compliant" FFIs are of interest to the commercial lending community. Significantly, small local banks that only solicit customers from within their country of residence (or, for a local bank located in the European Union, only to customers within the European Union) and other requirements. Such a local bank will have to register with the IRS every three years and certify that it complies with the applicable requirements. Although a deemed-compliant local bank will not be subject to FATCA withholding, it will have to conduct account identification procedures required of a participating FFI. A local FFI will identify itself to a withholding agent by providing a Form W-8BEN with a claim of local bank FATCA status.

Another category of a registered "deemed-compliant" FFI is a non-reporting FFI, which is a member of a participating FFI affiliated group. A non-reporting FFI, sometimes referred to as "ring-fenced," will either close any U.S. accounts or transfer them to an affiliate that is a participating FFI. As with the local FFI, a non-reporting FFI must perform account identification procedures and provide a Form W-8BEN to a withholding agent that identifies its FATCA status.

An FFI that is a certified deemed-compliant FFI does not have to register with the IRS as does a registered deemed-compliant FFI. However, it must certify itself with each withholding agent by providing certain documentation to each withholding agent.

One category of deemed-compliant certified FFI is the non-registering local bank which must be licensed and operated as a bank (within the Code meaning of a bank) that is engaged primarily in the business of making loans and taking deposits from unrelated retail customers solely in its country of incorporation. Such a non-registering bank must have no more than $175 million in assets and so is similar to a local savings and loan bank in the United States. Because of the limitations imposed on such a certified deemed-compliant FFI, it likely would not be making cross-border loans.

Because the LSTA Model Lending Agreement has already incorporated FATCA provisions, it is likely that most borrowers and lenders have adapted to the new FATCA world. However, changes could be made to the proposed regulations, so attention should be provided to the final regulations when they are issued. The Department of the Treasury is predicting that final FATCA regulations will be issued in late summer. Stay tuned!

UNIFORM LAW COMMISSION'S STUDY COMMITTEE ON REAL ESTATE RECEIVERSHIPS: PROJECT UPDATE AND REQUEST FOR COMMENTS

By Thomas S. Hemmendinger, Brennan, Recupero, Cascione, Scungio & McAllister, LLP, Kieran Marion, Uniform Law Commission and R. Wilson Freyermuth, University of Missouri School of Law

For centuries, English chancery courts used receivership as an equitable remedy to protect creditors.[3] This practice carried over to the United States.[4] Within Constitutional limits, receivership continues as an alternative to chapter 7 or 11 bankruptcy proceedings.[5]

Traditionally, mortgage lenders have sought the appointment of a receiver pending foreclosure for one or more reasons, including:

- The foreclosure process under local law takes a substantial period of time, and the lender seeks a receiver to collect rents pending the foreclosure sale.
- The property is subject to waste, deterioration, or some other immediate physical harm that threatens to reduce the value of the property.
- The property may have environmental contamination.
- The collateral includes personal property, and the mortgagee wants to use judicial foreclosure as conclusive evidence that the sale was done in a commercially reasonable manner.

A number of states have enacted statutes dealing with receivers, but there is little comprehensive state statutory guidance regarding the appointment and powers of receivers.

In 2011 the Uniform Law Commission (ULC) established a Study Committee to review whether a Uniform Act on the appointment and powers of real estate receivers would be appropriate and well-accepted by the States. The Study Committee has identified a comprehensive list of issues on receivership that any ULC Drafting Committee should consider and address in a Uniform Act, should the ULC appoint a Drafting Committee.

The Study Committee seeks the views of stakeholders, including the relevant Sections of the American Bar Association. To that end, this article summarizes the seven broad groups of issues that the Study Committee has identified. The Study Committee's full report is available **here**.

1. <u>Scope of a Uniform Act</u>.

One of the first issues is whether any potential Uniform Act should focus narrowly on receivership of mortgaged real estate, or instead apply more broadly to other types of receivership. Courts have appointed receivers for broader purposes, such as the liquidation of insolvent business entities for the benefit of creditors generally, and the operation of non-insolvent business entities where owners are at an impasse.

Either way, for a number of reasons, the Study Committee believes any Uniform Act should be limited to collateral other than the mortgagor's primary residence. Implementing such a limit on scope requires consideration of a number of issues, such as:

- Whether the applicability of the Uniform Act should be limited by the number of dwelling units at the property.
- If not, the effect of the receivership on the owner-occupied dwelling unit.
- Whether the Uniform Act should apply to second and/or third homes and the like.
- How the Uniform Act should address primarily commercial property on which the mortgagor may reside, such as a farm or ranch.

If a receiver is appointed to take custody of property, one would expect the receiver to collect rents and perform certain landlord duties. However, questions might arise regarding the extent of the property over which the receiver would take custody. For example:

- Whether, and if so how, a Uniform Act should address real estate-related interests such as un-severed oil, gas and mineral interests, water rights, and fixtures.

- How to address personal property, such as equipment, furnishings, inventory, and intangible property (such as licenses, permits and variances, development rights), and executory contracts such as leases and franchise agreements.

- How to address mortgagor-owned business operations located on the property.

The Study Committee is also considering whether a Uniform Act should specify the exclusive rules on receiverships, or merely supplement the courts' general equity jurisdiction and power.

2. Appointment of a Receiver.

The Study Committee is of the view that any Uniform Act should provide a comprehensive list of grounds that would justify the appointment of a receiver, and clarify the extent to which any individual ground is necessary as a condition precedent to appointment of a receiver.

Various state laws differ on the grounds for obtaining a real estate receiver. Some courts consider a number of factors in deciding whether to appoint a receiver.[6] Other courts will not appoint a receiver unless the petitioner shows waste or impairment of its collateral.[7] A few courts go even further, requiring proof of the mortgagor's insolvency as a condition precedent to receivership.[8]

Historically, receivership is a discretionary remedy. In response to this principle, modern commercial mortgages often provide for the mortgagor's consent to the appointment of a receiver after default, without regard to whether statutory or equitable grounds exist for appointing a receiver. The effect of such clauses varies among the states. Therefore, the Study Committee believes that any Uniform Act should clarify whether such a clause entitles the mortgagee to a receiver as a matter of right, or only subject to the court's discretion.

Any Uniform Act should also address the extent to which parties other than a mortgage lender may seek appointment of a receiver. Possible candidates include: (1) the mortgagor; (2) unsecured creditors; (3) officers, directors, managers or holders of equity interests in the mortgagor; (4) tenants of the mortgaged property; (5) judgment creditors; (6) attaching creditors; (7) mechanics lien claimants; (8) co-owners or others with an interest in the real estate; (9) spouses in a divorce or support proceeding; or (10) public officials.

3. Qualifications for Receivers.

Some jurisdictions require appointment of an independent third party as receiver. In some instances, however, courts have appointed the mortgagee as a receiver.[9]

Other issues relating to qualifications for serving include: (1) whether the receiver must be an individual, or can be an entity; (2) whether the receiver must possess particular professional qualifications (such as attorney, accountant, or real estate professional); and (3) whether the receiver must post a surety bond, and if so how the court should set the amount.

4. Powers of Receivers.

Most existing state receivership statutes do not comprehensively specify the receiver's powers. In the typical case, the order appointing the receiver establishes the scope of the receiver's powers. Under this approach, a receiver could not exercise any powers not expressly granted by the receivership order. One solution might be for a Uniform Act to provide a comprehensive list of "default" powers that a receiver could exercise after appointment unless the receivership order expressly withheld any such power.

One of the most important issues on receiver's powers is the power to sell the mortgaged real estate. Federal law authorizes receivers to sell mortgaged property.[10] However, existing state law is unclear whether a receiver can sell the property, either subject to the existing mortgage or free and clear of the mortgage and subordinate liens, as in a foreclosure sale. Some state statutes authorize receivers to sell property, but in the absence of a statute, some courts do not permit receivers to sell property.

The Study Committee recommends that any Uniform Act should address these issues:

- A receiver's power to sell the mortgaged real estate.

- Whether the receiver can sell the property free and clear of liens and encumbrances, with the same attaching to the proceeds of sale.

- If a receiver can sell free and clear of liens, whether the receiver can sell over the objection of secured creditors.

- How the receiver may conduct such a sale and what procedures should govern such sales.

- The rights of secured creditors to credit bid.

- Whether the court or the market should determine the value of the secured claims.

The Study Committee believes that any Uniform Act should clearly establish the receiver's authority to manage the property, to collect rents (consistent with the provisions of the Uniform Assignment of Rents Act), to compel turnover of property, and to pay expenses incurred in the management or operation of the property. An Act should also address the receiver's authority to engage agents to perform his/her duties.

Other issues on the powers of a receiver include:

- Whether the receiver may improve the mortgaged real estate, or is limited to mere preservation of the existing real estate.

- Whether the receiver may borrow funds as needed for the maintenance, renovation, or completion of a real estate project, and if so on what terms.

- Whether the receiver may reject existing leases or executory contracts, and if so with what consequences.

- Whether the receiver may assume and assign existing leases or executory contracts; and, if so, how to deal with contractual provisions or other laws that prohibit assignment.

- Whether the receiver may enter into new leases or executory contracts, and if so based on what standards.

- The extent to which the receiver may commence, prosecute, defend, and settle legal proceedings relating to the mortgaged real estate.

- The receiver's employment of professionals (such as attorneys, accountants, brokers).

- Whether a Uniform Act should provide a "model" form receivership order.

5. Procedural and Related Issues.

The Study Committee has identified a number of procedural issues that any Uniform Act might address:

- The process for appointing receivers, including provisions for *ex parte* appointment.

- The stay of creditor or other actions against receivership property.

- The receiver's procedural and ministerial duties, including notice and reporting requirements.

- Avoidance powers.

- Claims procedure and distribution.

- Compensation of receivers.

- Terminating receivership proceedings or discharging the receiver.

6. The Receiver's Legal Status.

Under existing state laws, the receiver has certain fiduciary duties to creditors, and is also an officer of the court. In bankruptcy cases, a party in interest must obtain court permission to sue the trustee.[11] Whether or not this is an appropriate mechanism for state court receivers, any Uniform Act should deal with the extent, if any, to which a receiver is immune from suit for actions or omissions while

serving as receiver.

7. Relationship with Other Law.

Any receivership statute must take into account other laws, including:

- *Equity.*
- *Real Property Law.*
- *Other Uniform Acts* – including the Uniform Commercial Code, the Uniform Assignment of Rents Act, the Uniform Fraudulent Transfer Act, and the Model Marketable Title Act.
- *Regulatory Laws.*
- *Federal Law* – including the Bankruptcy Code and the federal receivership statute.

We welcome your advice and comment. If you are interested in discussing the project or meeting, please contact Thomas Hemmendinger, Kieran Marion or R. Wilson Freyermuth at the email address provided below.

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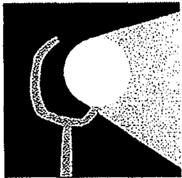
UCC Spotlight

By Stephen L. Sepinuck and Kristen Adams



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

Lyon Financial Services, Inc. v. Jude's Medical Center, Ltd. 2011 WL 6029195 (N.D. Ill. 2011)

This case highlights – or at least should have highlighted – some important differences between Articles 2A and 9.

Simplified slightly, the facts are as follows. Lyon Financial Services, Inc. leased two pieces of equipment to Jude's Medical Center, Ltd. The leases required payments over sixty months, totaling $276,000 and $133,000, respectively. A few years later, Jude defaulted. Lyon repossessed the equipment and sold the items for $2,500 and $10,600. Lyon then pursued Jude's CEO, Abboud, who had guaranteed the obligations under both leases.

Abboud defended on the basis that Lyon had not conducted the sales in a commercially reasonable manner, and claimed that factual issues about the commercial reasonableness of the sales were a basis for denying Lyon's motion for summary judgment. Abboud also claimed that the leases had created security interests and were therefore governed by Article 9.

The court first dealt with whether the transactions were leases or sales with a retained security interest. Looking at the safe harbor in § 1-203(b), the court noted that the leases could not be terminated by the lessee but that no evidence was presented that any of the four characteristics identified in § 1-203(b) were present. Therefore, the court concluded, the transactions were true leases and Article 2A governed.

The court's conclusion on this issue was probably correct but its analysis was flawed. If the safe harbor rule of § 1-203(b) is

not met, the analysis is supposed to revert to subsection (a), which requires courts to examine all the facts and circumstances. *See, e.g., In re Pillowtex, Inc.*, 349 F.3d 711, 717-20 (3d Cir. 2003); *In re Grubbs Constr. Co.*, 319 B.R. 698 (Bankr. M.D. Fla. 2005); *Coleman v. DaimlerChrysler Servs. of N. Am., LLC*, 623 S.E.2d 189 (Ga. Ct. App. 2005). Under that analysis, the transaction might nevertheless be a sale with a retained security interest. For example, a lease with an option to buy at the end for non-nominal consideration might be a sale if the lessee's only real economic choice was to exercise the option. This might be true if all of the lessee's business equipment were subject to the lease and the lessee would have to find alternative goods or go out of business if it failed to exercise the option. It might also be true if the costs incurred and damage likely to be caused in their removing and returning the goods were less than the option price.

Moving to the resales, the court first dealt with Abboud's claim that he was not provided with adequate advance notification. On this point, the court observed that Abboud had failed to identify any requirement of notification after default under a lease, as opposed to a security agreement. Nevertheless, drawing from § 2-706, the court assumed that notification was required. In doing so, the court repeated the Minnesota Court of Appeals' error in *Deutz-Allis Credit Corp. v. Jensen*, 458 N.W.2d 163, 166 (Minn. Ct. App. 1990), which it cited. The court then found that Lyon had given adequate notification. As to the commercial reasonableness of the sales, the court ruled that, given the low prices realized, this was a factual issue preventing summary judgment.

The court's analysis on both notification and commercial reasonableness was flawed. Given the court's conclusion that the transactions were leases, not sales with a retained security interest, Lyon was under no obligation to provide notification of the subsequent sales or to conduct the sales in a commercially reasonable manner. Nothing in Article 2A imposes these requirements and that omission is not an oversight. In fact, § 2A-502 states that, "[e]xcept as otherwise provided in this Article or the lease agreement, the lessor or lessee in default under the lease agreement is not entitled to notice of default or notice of enforcement from the other party to the lease agreement," and its commentary makes it clear that this is a distinction between Articles 2A and 9. Furthermore, § 2A-527(2) includes a specific reference to "commercial reasonableness" in the context of disposition by a new lease agreement, but the portions of § 2A-527 relating to disposition by sale do not include such a reference, and none should be implied. That is because, unlike a seller's right to resale damages under Article 2 or a secured party's right to a deficiency under Article 9, a lessor's damages are unaffected by the resale price. The lessor is instead entitled to: (i) the past rent due, plus; (ii) the present value of future rent for the remaining lease term minus the present value of market rent for the remaining lease term. §§ 2A-527(3), 2A-528(1). Had the court recognized and considered the irrelevance of the sale price to the measure of damages, it might have understood that notification and commercial reasonableness of the sale were not required, and granted Lyon's motion for summary judgment.

Algonquin Power Income Fund v. Christine Falls of New York, Inc., 2011 WL 6178802 (N.D.N.Y. 2011)

This case involves attachment of a security interest to a commercial tort claim and its proceeds. The court correctly analyzed the first issue, properly concluding that the security interest did not attach to the *claim*. However, the court grievously erred on the second issue when it ruled that the security interest did not attach to the *proceeds of the claim*.

In 1988, Trafalgar Power, Inc. and its affiliates ("Trafalgar") acquired secured financing from Aetna Insurance Co., which later assigned its interest to Algonquin Power Income Fund ("Algonquin"). The following year, Trafalgar sued the engineers that had designed some of Trafalgar's power plants for miscalculations that resulted in an estimate of energy production that was far larger than the completed power plants were able to attain. In 1999, a jury awarded Trafalgar $7.6 million on its claim. Trafalgar assigned its interest in the judgment to an affiliate and in 2000 Algonquin sued them both, claiming a prior security interest in the judgment. In 2001, the judgment was paid and put in escrow pending resolution of the dispute about which party was entitled to the funds. A few months later, Trafalgar filed for bankruptcy protection. The bankruptcy court ruled in favor of Trafalgar and Algonquin appealed.

The district court first concluded that a malpractice action was not assignable under Connecticut law. It also concluded that, even though the security agreement described the collateral to include "any interest in any kind of property or asset, whether real, personal or mixed, and whether tangible or intangible," that language was insufficiently particular to include the malpractice claim. Both of these conclusions seem sound.

Although the court had no need to, and thus did not, examine revised Article 9, the result under current law would be no different. Revised Article 9 has two important limitations on the grant of a security interest in a commercial tort claim. First, the generic term "commercial tort claim" is not an adequate description, and the even more general language in Algonquin's security agreement would similarly be inadequate. *See* § 9-108(e)(1); *Beane v. Beane*, 2011 WL 223167 (D.N.H. 2011) (generic references in the security agreement to "accounts and other rights to payment" and "payment intangibles" were insufficient to create a valid security interest in commercial tort claims); *Conley v. Pub. Safety Grp., Inc.*, 771 N.W.2d 653 (Iowa Ct. App. 2009) (generic reference in the security agreement to "proceeds from any lawsuit due or pending" was insufficient to create a valid security interest in commercial tort claims). Second, no security interest can attach to a commercial tort claim under an after-acquired property clause. *See* § 9-204(b)(2); *In re Am. Cartage, Inc.*, 656 F.3d 82 (1st Cir. 2011); *Waltrip v. Kimberlin*, 79 Cal. Rptr. 3d 460 (Ct. App. 2008). For each of these reasons, Algonquin's security interest would not attach to Trafalgar's tort *claim*, which apparently arose after the security agreement was executed.

The court then turned to Algonquin's argument that, even if its security interest did not attach to the malpractice *claim*, its security interest did attach when the claim was "transformed to a judgment, bond claim, contract claim, and interest in an escrow

account," types of collateral that its security agreement did cover. The court rejected this argument out of hand. Quoting the bankruptcy court, it stated that "[i]f the security agreement does not expressly grant a security interest in the underlying tort claim or its proceeds, no subsequent transformation will magically result in an automatic attachment of those proceeds." It even repeated the reference to "magic," as if Algonquin's argument was somehow fanciful. But it was not Algonquin's argument that was fanciful, it was the court's understanding of secured transactions and Article 9.

Property transforms from one classification to another all the time. Thus, for example, a debtor may sell inventory to generate accounts. A security interest in the debtor's existing and after-acquired accounts will not cover the inventory, but will attach automatically to any proceeds of inventory that fall under the definition of accounts. Similarly, a security interest in a bank account will extend to any funds subsequently deposited into the bank account, regardless of what kind of property the debtor liquidated to generate the funds. In other words, as the debtor's property transforms, it may shift from non-collateral to collateral. Even a simple change in use – such as when inventory is taken off the shelf and used as equipment – may cause a security interest to attach (or de-attach). It is not clear why the court had so much difficulty accepting this simple concept.

In re Miller, 2012 WL 32664 (Bankr. C.D. Ill. 2012)

This case shows why states need to enact the 2010 amendments to Article 9. Unfortunately, it does so at the expense of a secured party that quite arguably did nothing wrong.

The facts of the case are quite simple. The secured party filed a financing statement identifying one of the married debtors as "Bennie A. Miller." This was the name the debtor had used much of his life and which appeared on his driver's license, social security card, tax returns, and the deed to his residence. Seven months after the debtors filed a chapter 13 bankruptcy petition, they sought to avoid the secured party's lien. The bankruptcy court ruled for the debtors, concluding that the filing was ineffective to perfect because the debtor's legal name was the name on his birth certificate, "Ben Miller," and a search under that name did not reveal the filing. In making this ruling, the court rejected the argument that the debtor might have two acceptable names, such that a filing against either would be sufficient to perfect.

This is the only known decision to invalidate a filing that identified the debtor by the name used on the debtor's driver's license. Certainly numerous cases have refused to treat as effective a filing against the debtor's nickname, but none of those cases involved a name that actually appeared on the debtor's driver's license. *See In re Larsen*, 2010 WL 909138 (Bankr. S.D. Iowa 2010) ("Mike D. Larsen" instead of "Michael D. Larsen"); *In re Jones*, 2006 WL 3590097 (Bankr. D. Kan. 2006) ("Chris Jones" instead "Christopher Gary Jones"); *In re Borden*, 353 B.R. 886 (Bankr. D. Neb. 2006) ("Mike Borden" instead of "Michael R. Borden"), *aff'd*, 2007 WL 2407032 (D. Neb. 2007); *In re Berry*, 2006 WL 2795507 (Bankr. D. Kan.), *opinion supplemented*, 2006 WL 3499682 (Bankr. D. Kan. 2006) ("Mike" instead of "Michael"); *In re Kinderknecht*, 308 B.R. 71 (B.A.P. 10th Cir. 2004) ("Terry J. Kinderknecht" instead of "Terrance Joseph Kinderknecht"). Indeed, in *Borden*, the court rejected the use of a nickname in part because that was not the name that appeared on his birth certificate, driver's license, real estate deeds, bank accounts, tax returns, and bankruptcy petition. 353 B.R at 887.

The flaws in the *Miller* court's analysis were twofold: (i) in requiring the debtor's "legal" name on the financing statement; and (ii) even if the debtor's legal name were necessary, equating the name on debtor's birth certificate with the debtor's legal name. Nowhere in its text or comments does Article 9 use the phrase "legal name." Instead, § 9-502 requires the name of the debtor, § 9-503(a)(4)(A) supplements that marginally by indicating the name of an individual should be the "individual . . . name," and § 9-506(c) indicates that if a search under the debtor's "correct name" yields the filing, then the filing is not seriously misleading. In short, Article 9 requires the debtor's *correct* individual name, not the debtor's *legal* name. Even if the legal name were required, there is no reason to assume, as the court blithely did, that the birth certificate name is the legal name of an adult who goes by something different. Although the *Kinderknecht*, *Borden*, and *Pankratz Implement* decisions, all of which the court cited, referred to the debtor's "legal name," none of those cases equated "legal name" with the name on the debtor's birth certificate. In fact, none of these cases purported to define the term at all. In most states, an individual's legal name can be anything the debtor regularly uses for non-fraudulent purposes. *See* Darrell W. Pierce, *The Revised Article 9 Filing System: Did It Meet Its Objectives?*, 44 UCC L.J. 1, 12-13 (2011).

So, what is an individual debtor's *correct* name? A strong argument can be made that, under current law, the debtor's correct name is the name that the debtor uses and by which the debtor is generally known, particularly by creditors. *See Peoples Bank v. Bryan Bros. Cattle Co.*, 504 F.3d 549 (5th Cir. 2007) ("Louie Dickerson" instead of "Brooks L. Dickerson" was effective because the debtor held himself out to the community as Louie Dickerson and frequently used his nickname in business affairs); *cf.* 1 BARKLEY CLARK & BARBARA CLARK, THE LAW OF SECURED TRANSACTIONS ¶ 2.09[1][d] (3d ed. 2011) (suggesting that in most cases the name on the debtor's driver's license, bankruptcy petition, or social security card is the best evidence of the debtor's "legal" name and only in cases of conflict among those documents should the name on the debtor's birth certificate be used). After all, the UCC is intended to facilitate commercial transactions, not frustrate them. *See* § 1-103(a). Given that few debtors carry around their birth certificate, it would be a hassle for secured parties to require that the debtor exhibit that document before completing a financing statement. Moreover, it is far easier for searchers to search under the name the debtor uses than by the name on a piece of paper that few ever see.

Admittedly, this standard lacks certainty and can be quite problematic when the debtor goes by more than one name. However, in *Miller*, the debtor was known by only one first name – "Bennie" – and that name appeared on his state-issued driver's license and all his contemporary financials. Only his birth certificate, which was of course quite old in comparison, indicated a different first name. Therefore, "Bennie" was his *correct* name, even if not his *legal* name.

Fortunately, the 2010 amendments will add clarity on this point and change the result. Under either version of § 9-503 offered for states to enact – Alternative A or Alternative B – a filing that identifies an individual debtor by the name on the debtor's driver's license will be effective, provided the license is current and is issued by the state in which the debtor is located.

Commercial Capital Bank v. House, 2012 WL 220214 (W.D. La. 2012)

In this priority dispute between two secured parties, the court reached the correct result but its analysis was unnecessarily complicated. The case also illustrates a common practice that secured parties needlessly follow.

The facts of the case are essentially as follows. In 1997, 1999, and 2009, the debtor borrowed funds from Farm Service Agency ("FSA"). Each debt was secured by the debtor's farming equipment. FSA filed a proper financing statement for each transaction, each time on the date the loan was made or a few days before. It also filed timely continuation statements for the first financing statement. In 2011, the debtors paid off the first and second loans but they remained obligated on the third loan, for approximately $428,000.

In 2005, the debtors borrowed approximately $500,000 from Commercial Capital Bank ("CCB"). Fifteen months later, the debtors granted CCB a security interest in their equipment. CCB perfected that security interest by filing a proper financing statement. In 2011, CCB brought an action against FSA, raising numerous arguments why FSA's perfection had lapsed.

The court ruled in favor of FSA. Citing § 9-322(a), it stated that priority between secured parties is based on "the date of perfection." The court then concluded that, even though the debtors had paid off the first loan, because the security agreement for that transaction covered future advances, the security interest created in that transaction secured the third loan. Hence the date of FSA's perfection for priority purposes was the date of the first loan.

The decision is correct but the fact that the security agreement covered future advances is immaterial. Priority among perfected secured parties is not, as the court indicated, based on the first to *perfect*, but the first to *file or perfect*, as long as there is no period thereafter when there is neither filing nor perfection. *See* § 9-322(a)(1). Thus, as long as the third loan was in fact secured – whether pursuant to a future-advances clause in one of the previous security agreements or pursuant to a new security agreement – priority would be based on the date of the first filing. Secured creditors such as FSA routinely file new financing statements for each transaction but, provided the financing statements cover the same collateral, there is no reason to do so. Financing statements identify the debtor, the collateral, and the secured party, not a particular loan or transaction. There is absolutely no need for a second, duplicative filing, provided the first is properly continued.

Variety Wholesalers, Inc. v. Prime Apparel, LLC, 2011 WL 6036084 (N.C. Ct. App. 2011)

This decision should be very distressing for lenders with a security interest in accounts generated from trademarked goods.

The dispute in the case began with the sale of trademarked apparel by Prime Apparel, Inc. to one of its wholesale customers. Quick Response Marketing, Inc. ("QRMI") claimed that it owned the trademark and instructed the customer to make payment to QRMI. The customer brought an interpleader action seeking a ruling on who was entitled to the payment and it deposited $235,000 with the court. CIT Group Commercial Services, Inc. ("CIT") intervened, claiming a perfected security interest in Prime's accounts and entitlement to the funds.

The trial court ruled for QRMI and CIT appealed. CIT argued that even if Prime had violated QRMI's trademark rights, QRMI had merely an unsecured claim for infringement, which would be subordinate to CIT's security interest in the account. In a very brief opinion, the appellate court affirmed. Its entire analysis consisted of the following syllogism:

(1) Prime's violation of QRMI's trademark meant that Prime had no right to the goods sold, nor any money generated from the sale of those goods.

(2) Prime therefore had no right in the account receivable to pass on to CIT.

(3) Thus, CIT had no security interest in the interpleader funds.

This analysis is simply wrong. The Lanham Act makes a trademark violator liable to the trademark owner, *see* 15 U.S.C. § 1125(a), but does not make all proceeds of the trademarked goods the property of the trademark owner. Nor should it, given that the damages for the trademark violation may have little relationship to the total sales price of the goods. Moreover, nothing in the Lanham Act imposes a constructive trust on all proceeds received for the trademarked goods. While a constructive trust *might* be an

equitable remedy available to the trademark owner in some instances, it is a remedy that does not normally override the property rights of a third party. In other words, while a constructive trust can be used to obtain priority over *unsecured* creditors, it does not allow for priority over *secured* creditors. *See* RESTATEMENT (THIRD) OF THE RESTITUTION AND UNJUST ENRICHMENT § 55 cmt. d (2011).

This unfortunate decision puts a wrinkle in accounts financing that cannot readily be smoothed over. The court ruled that the debtor lacked property rights in the infringing goods and their proceeds, and there is nothing that a lender could put in the security agreement to alter that conclusion. So, if this decision holds up, accounts financiers will need to include trademark issues in their due diligence.

Of course, accounts financiers should probably already be concerned about the debtor's trademark infringement. After all, a trademark owner might have the right to impound the goods, particularly if the infringer's buyer intends to resell them. This would prevent new accounts from being generated. Moreover, a debtor who sold infringing goods that the buyer could not resell would no doubt be violating the warranty of title. *See* § 2-312(3). In such a case, the buyer would have a defense to payment of the purchase price, *see* § 9-404(a)(1), rendering the account rather poor collateral.

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Compiled by Commercial Law Newsletter Co-Editors Annette C. Moore, Carol Nulty Doody, Celeste Pozo, Christina Rissler and Rebecca Gelfand

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5. Pace University's database of the United Nations Convention on Contracts for the International Sale of Goods and International Commercial Law Database can be accessed at **http://cisgw3.law.pace.edu**
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7. The International Association of Commercial Administrators (IACA) maintains links to state model administrative rules (MARS) and contact information for state level UCC administrators. This information can be accessed at **http://www.iaca.org**
8. The Uniform Law Commissioners maintains information regarding legislative reports and information regarding upcoming meetings, including the Joint Review Committee for Uniform Commercial Code Article 9. You can access this information at **http://www.nccusl.org/Committee.aspx?title=Commercial Code Article 9**
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ENDNOTES:

[1] Bondi filed a similar suit in New Jersey state court against Citigroup, Inc. ("Citigroup"), and PCFL filed another lawsuit in North Carolina state court against Bank of America Corp. ("Bank of America"). Bondi's suit against Citigroup remained in New Jersey state court while PCFL's North Carolina suit was removed to the Southern District of New York. With respect to PCFL's North Carolina suit, the district court granted summary judgment to Bank of America, which was affirmed by the Second Circuit. *See* Parmalat *Capital Fin. Ltd. v. Bank of Am. Corp.*, 412 F. App'x 325 (2d Cir. 2011) (summary order). Also, after the Italian bankruptcy court approved the plan of reorganization (the "Concordato"), plaintiffs in the securities fraud class action litigation and Grant Thornton were allowed to file claims against Parmalat. The securities class actions were eventually settled.

[2] Under 28 U.S.C. § 1452(b), the appropriate court to remand a case to state court is the "court to which [the state law] claim or cause of action [was] removed." Because these cases were originally removed from Illinois state court to the District Court for the Northern District of Illinois, which were then transferred to the District Court for the Southern District of New York, the Second Circuit stated in a footnote that the district court, on remand, should transfer the cases to the District Court for the Northern District of Illinois, "which can then remand the actions to Illinois state court." *Parmalat*, 2012 WL 539957, at *7 n.5.

[3] 1 RALPH E. CLARK, THE LAW AND PRACTICE OF RECEIVERS § 4 (3d ed. 1959).

[4] *See, e.g.*, *Petrovics v. King Holdings, Inc.*, 188 A. 514, 515 (R.I. 1936) ("[To] conserve the assets of the corporation and preserve its property for those interested therein, equity has inherent jurisdiction, independent of statute, to appoint a receiver.").

[5] *See, e.g.*, *Gilchrist v. GE Capital Corp. (In re Spartan Int'l, Inc.)*, 262 F.3d 295 (4th Cir. 2001); *In re Newport Offshore Ltd.*, 219 B.R. 341 (Bankr. D.R.I. 1998); *Cambio v. G-7 Corp.*, No. 96-0705, 1998 WL 1472896 (R.I. Super. Ct. Feb. 11, 1998).

[6] *See, e.g.*, *Fleet Bus. Credit, L.L.C. v. Wings Rests., Inc.*, 291 B.R. 550 (N.D. Okla. 2003).

[7] *ANJ Future Invs., Inc. v. Alter*, 756 So. 2d 153 (Fla. Dist. Ct. App. 2000).

[8] *Mut. Benefit Life Ins. Co. v. Frantz Klodt & Son, Inc.*, 237 N.W.2d 350 (Minn. 1975).

[9] *See, e.g.*, *First Interstate Bank of Lea Cnty. v. Heritage Square, Ltd.*, 833 P.2d 240 (N.M. 1992).

[10] 28 U.S.C. §§ 2001 et seq.

[11] *Barton v. Barbour*, 104 U.S. 126, 129 (1881).