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COMMERCIAL LAW OUTLINE

SECURED TRANSACTIONS

CREDITOR'S REMEDIES

Creditor – anyone owed a legal obligation that can be reduced to a money judgment.
Debtor – owes that obligation

- **Unsecured vs. Secured**
  - Secured creditor means they have contracted with the debtor for the secured status or been granted it by a statute.
    - Secured creditors usually come about through consensual liens.
  - Unsecured creditors are *general creditors* or *ordinary creditors*
  - An unsecured creditor cannot repossess property of a debtor, or he can be sued for conversion of chattle (tort) and be tried for larceny. (self-help remedies are illegal)
    - He can try to create a lien against the debtor's property.
    - Judicial liens take a long time. Involuntary Lien (See Handout)
    - When a sheriff seizes the property, then the judicial lien attaches. The Sheriff will sell off the property and pay off the lien.
    - Judicial liens can be attached to real estate and personal property.
  - Judgment creditor – an unsecured creditor that has obtained a court judgment to establish liability.
  - Account receivable – a creditor's right to receive payment from a debtor.
  - Mechanic's Lien – if someone is in possession of your property due to service rendered, they have a lien (and the right to hold onto that property) until you pay up – example of statutory lien.
  - Lien – a charge against an interest in property to secure payment of a debt or performance or obligation
    - it is a relationship between particular property (the collateral) and a particular debt or obligation.
    - 3 Types of Liens:
      - security interest (contractual lien)
      - statutory lien (unconsensual)
      - judicial lien (unconsensual)
- **Security and Foreclosure**
  - Foreclosure – the process by which a creditor can compel the application of the value of the collateral for payment of the debt.
    - Foreclose and taking possession are different.
    - UCC 9-609 gives the secured party the right to take possession of the property right away on default . – easiest way is to file for replevin.

            - This directs the sheriff to take possession of the property and give it to the plaintiff.
    - Security Interest – the most common type of lien.
        - This encompasses any lien created by contract between debtor and creditor.
        - It is a right in property that is contingent on nonpayment of a debt.
    - In judicial foreclosure, the end comes about with the sheriff seizing the property and sells it off to pay the lien
    - Article 9 Reposession, 9-609
        - Self-Help repossession is the most powerful type of repossession; only available to secured creditors
        - Article 9 does not define "Breach of the Peace"
        - There are 2 broad factors to consider in any breach of the peace situation: *(Cottom Factors & Salisbury Factors)*
            - Potential for immediate violence
                - Less potential for violence at night
            - Nature of the premises
                - Is it commercial property or residential property?
                - There is a heightened expectation of privacy at our homes, and judges uphold this
                - A demand to vacate a 3rd party's land must elevate above a simple request in order to qualify as a Breach of the Peace (at least on commercial property) – if it does elevate the creditor can come back and try again.
    - Foreclosure
            - Why get possession pending foreclosure?
                - The debtor has little incentive to maintain the property
                - The time between the right to foreclose accrues and the final step may have substantial economic value.
                - Depresses resale price by not allowing potential purchasers to view it
        - Strict Foreclosure, 9-620
            - partial satisfaction – the debtor receives credit again the debt in some amount but continues to owe the remainder.
            - After a default, the debtor can consent to the secured party retaining collateral in full or in partial satisfaction of the debt. – basically, the creditor keeps the collateral in exchange for some or all of the debt.
                - This requires the debtor's consent
                - Silence is consider consent after 20 days of notification – must receive a notice of objection
                - Oral objection is not sufficient.
                - This right to consent is subject to 3 Conditions:
                    - No objections from others holding a lien

- If the collateral is consumer goods, the debtor can only consent (written or in silence) after repossession
- Strict foreclosure is not permitted if the debtor has paid 60% of the cash price of a consumer good purchased on credit.

- You also have to get consent from certain people:
  - The debtor
  - The people you notified under 9-62a1 – people who have an interest in that property.
  - If you don't get permission from everyone, then you have to sell the property and use the proceeds to pay off your lien.

- Foreclosure Sales, 9-610
  - Requirements of a Foreclosure Sale – 9-610(a), (b)
    - It must be commercial reasonable (directed at getting a good price for the collateral)
    - You must give prior notice to the debtor– 9-611(b),(c)
      - A good faith purchaser at a UCC sale can buy with confidence that it will not lose its bargain because the sale is set aside.
    - Warranties must be issued
  - The reasonable fees and attorney fees must included in the security agreement in order to collect them during a sale or in deficiency.
  - Potential Injuries to the Debtor in the Sale
    - The debtor may forfeit all or some of the equity her has in the collateral
    - An insufficient sale price causes the entry of a deficiency judgment that is larger than appropriate.
  - Problems with Article 9 Sales
    - Failure to Sell the Collateral
      - No specific provision that the creditor must sell the collateral – can just keep it.
      - No time limit, but waiting can limit the deficiency amount if the sale was commercially reasonable.
    - Requirement of Notice of Sale
      - Failure to notify does not invalidate the sale, but can reduce the deficiency
      - Wide latitude to the creditor
    - Commercial Reasonable Sale
      - Deliberately vague so the secured party can brings it knowledge and creativity to the sale

in a reasonable way – different types of collateral.

- Commercial reasonableness – every aspect of the sale
    - 9-627 creates a safe harbor provision
    - there are several factors courts look at:
        - look at commercial reality – time of sale, advertising (you have to get the right amount and the right kind of people to participate in the sale), price (price itself is a product of the sale, not an aspect of the sale. A low price can indicate a problem in the process of the sale, but a low price alone is not enough to make the sale unreasonable)
        - requires expert testimony to establish

- Self-Help Repossession
    - A creditor with an Article 9 security interest in tangible, personal property can bypass the courts and use self-help- 9-609
        - Unsecured creditor cannot do this – see above.
        - This is also only allowed without a breach of the peace—9-609(b)(2)
            - *Salisbury Livestock v. Colorado Central CU* says there are two factors: "potential for immediate violence" and nature of the premises intruded upon
            - does not require confrontation – but requires more than trespass.
        - Can't endanger other property; private property is easier than commercial property. Sneakiness and misrepresentation is ok.

<u>CREATION OF SECURITY INTERESTS</u>

- **Formalities for Attachment of Security Interests**
    - A security interest is the right to apply the value of the collateral to the holder's debt. (therefore the value of the security interest can be no greater than the value of the collateral covered by it.
    - The creation of a security interest takes only 1 sentence to create a consensual lien. "I agree to have a lien attached to this property."
    - Secured transactions have two descriptions of the collateral: one in the security agreement and one in the financing statement that is filed in the public records.
    - 3 Formalities: (9-203) – "no magic words" create an interest
        - there is a security agreement describing the collateral, or the secured party has possession of the collateral.
            - 3 Types:

        - written (usually signed)
        - oral
        - in some other tangible medium (called a record, like in a computer)
      - Requirements for a **Security Agreement:**
        - Description of the collateral
        - A description of the obligation secured
        - Provisions defining default that specify the rights of the secured creditor on default. "granting language"
        - It must be signed by the debtor.
      - You could also consider the "Composite Document Rule" – look at the transaction as a whole.
        - Majority rule = so long as the documents express some internal connection with each other, they may be read together for purposes of including the collateral under the security agreement umbrella.
      - Reasons for Requiring Separate Security Agreements:
        - **See page 838**
    - value must have been given
      - value is broadly defined so that it is almost always met. 1-201(44) – even includes past consideration.
      - doesn't even say who must give value, although we assume the creditor.
    - the debtor must have rights in the collateral.
      - Cannot grant a security interest in someone else's property.
    - **When these requirements are met the security interest attaches to the collateral and becomes enforceable against the debtor.**
  - To get priority over other secured parties who have a security interest, a creditor must **perfect the interest** by having the debtor authenticate a financing statement and file the statement in the public records.
  - <u>Field warehousing</u> – a method for taking possession of collateral while still allowing debtors to use it, as most debtors use the collateral to make money in order to repay the debt.
- **Security Agreements**
  - the rules governing security agreements are similar to contract law (binds 3rd parties too)
  - Types of collateral :
    - Accounts
    - Equipment
    - Inventory
    - Instruments
    - Consumer goods
    - General intangibles
    - When these terms are used, they are given their Article 9 meaning instead of their common meaning, even when this is contrary to the parties' intentions.

- Adhesion contract: a standardized contract prepared entirely by one party to the transaction for the acceptance for the other.
- the security agreement must "reasonably identify" the collateral.
  - Would a reasonable party need to further inquire as to what collateral is being referenced?
- After-acquired property – property that a debtor acquires after the security interest is created.
  - majority view = no express language is required to describe after-acquired property. When talking about thing like accounts and inventory that is constantly turning over and changing it wouldn't make sense. *Stoumbos v. Kilimnik*
  - the typical use allows the security interest to "float" on collateral. – The specific components of the collateral are constantly changing but the whole value remains stable in identity and value. – "cycically depleted"
  - After-acquired property clauses allow for long-term financing relationships --- often called *floating liens*
- Future advance – a future obligation will come to existence as the result of an additional extension of credit by the secured creditor. 9-204(c)

- **Proceeds, Products, and Value Tracing Concepts**
  - Value tracing concepts – terms of art that indicate that in certain kinds of transformations of the collateral, the security interest should follow in prescribed ways. --- most often employed concepts are: proceeds, products, rents, profits, and offspring.
  - Proceeds – defined in 9-102(a)(64)
    - a security interest will follow through some transformations but not others.
    - If the debtor sells the collateral, the security interest attaches to the price paid, no matter what form the price is, like an account or cash.
    - If the debtor rents or leases the property, then the interest attaches to the rents received.
  - Even if the security agreement expressly prohibits the sale of the collateral, the debtor has the power to transfer ownership to a buyer (9-401)
    - This breaches the agreement and could be a crime
    - The result is that the secured part has not authorized has not authorized to be free of the security interest and the buyer now owns that collateral, subject to the interest. – continues in the collateral and its proceeds
    - Think of the BLOB example.
  - A security interest encumbers proceeds only as longer as they remain indentifiable.
    - Commingling – collateral is put together in one mass with identical non-collateral and no one can separate them. (grain mill)

        - Identifiabilty – the law may provide a rule that arbitrarily designates a particular part of the mass as the collateral. (this is tracing)
        - 9-**315(b)** – lowest intermediate balance rule – the amount of the secured creditor's collateral remaining in a bank account is equal to the lowest balance of all funds in the account between the time the collateral was deposited to the account and the time applied.
            - This does not apply to deposit accounts, as they cannot be attached in consumer situations
    - Value-tracing vs. non-value tracing
        - Non-valuing tracing involves after-acquired property, replacements, additions, and substitutions.

DEFAULT: THE GATEWAY TO REMEDIES

- **Default**
    - creditors only have access to remedies when debtors are in "default" – the debtors failure to pay then debt when it is due or otherwise perform the agreement between the debtor and the creditor
        - If creditors try to act before a debtor is in default, they act wrongly and are liable for any damages they do.
    - Creditors want default defined broadly (security agreements almost always define it expansively because creditors are more concerned about default at the beginning and they have a greater bargaining position)
        - Debtors wants default defined narrowly
        - Both sides want it defined precisely
        - Most defaults are acted upon when debtors fail to repay the money in time. (this is fixed at the time of contract)
- **When is payment due?**
    - Installment loan – if the parties arrange for the debtor to repay the loan in a series of payments (car loans and real estate payments)
        - Absent a contract provision, each installment is treated as a separate obligation
        - A creditor can only sue for installments missed, not ones coming up.
        - An acceleration clause allows you to get around that rule, by allowing the creditor to sue for the entire amount of the loan in 1 sum
            - Practical effect is that it eliminates debtor's ability to cure its default
            - *Insecurity clause* – creditor can only accelerate if he has the good faith belief that the ability to repay the loan is impaired.
    - Single payment loans – all the money is repaid on a specific day. – these are often renewable, with the understanding that if the debtor' financial

circumstances remain satisfactory, the bank will renew the loan without requiring payment. This is called *rolling the note* or a *rollover*
    - The bank has no legal obligation to roll a note.
  - Loan on demand – the debtor must repay the money when the bank demands it. (calling the loan).
  - Line of credit – the bank lends money up to a fixed amount (the line limit) as the debtor needs it. – most of the time, the debtor "borrows" the money just by writing a check from its account. – other times the bank makes all the payments as instructed by the borrower.
- Once a debtor is in default, a secured creditor has several remedies that fall into two basic categories:
  - Judicial remedies
    - Like foreclosure and replevin
    - These are slow but safe in the fact you won't be liable for inflicted damages.
    - Replevin is a more intermediate course. In replevin, the secured creditor can move for an order granting it temporary possession of the collateral.
  - Self-help remedies
    - Repossession without judicial assistance
    - Refusal to make further advances.
  - The creditor's choice is often based on the assessment of the likelihood that the debtor will resist and the debtor's defenses and the manner those defenses will be determined in each remedial procedure.

PERFECTION

- **Priority**
  - We think usually think of priority as an attribute of a lien – priority can exist among creditors who do not have liens.
    - Debentures – unsecured bonds ... publically held companies issue these to raise capital.
  - Liens rank priority in the order they were created.
  - Perfecting the Lien – taking whatever steps are necessary to put any other prospective lender on notice of the lien's existence.
    - the dates and times of perfection establish the order or liens.
    - **Auto perfection = 9-311**
    - **Example: file financing statement with name and address of lienholder and pay the fee – recorded within 10 days.**
    - For a judicial lien creditor, in order to perfect all they need to do is levy the execution order.
  - The filing system is the principle means used to communicate the existence of a lien from one creditor to any potential creditors
    - Article 9 security interests use financing statements – also called UCC-1 (the form number)
    - Each county has an office for real estate and fixture filing.
    - The type of collateral often determines which office you file in.

        - To search the filing systems, some offices do it for you, sometimes you do, or you hire a service company.
    - Where do I search?
        - Look in the appropriate office under the type of collateral
        - Or in the department of motor vehicles for cars.
        - Local county filing office for inventory and accounts
            - There is an exception when autos are the inventory.
        - secretary of state's office for equipment, trademarks
- **Filing System**
    - Filing System Consists of 4 subsystems
        - the filed records
        - adding new records
        - searching the records
        - removing obsolete records
    - When a financing statement is filed it receives a <u>file number</u> – also called a <u>book and page number</u>
    - 9-519(c) requires the office index financing statements according the name of the debtor
        - typically also includes the debtors address
        - also includes the file number
        - it may also included the name and address of the creditor, date of filing, and a description of the collateral.
    - <u>The basket</u> **--** the name of the unindexed records that have not been filed yet.
- **Names on Financing Statements**
    - 9-506 – "A financing statement substantially complying with the requirements is effective even if it includes minor errors or omission, unless the errors or omissions make the financing statement seriously misleading."
        - <u>9-503 safe harbor</u> – a financing statement sufficiently provides the name of a registered entity only if it provides the name of the debtor indicated on the public record of the debtor's jurisdiction of origin
    - "individual names refers to human beings
        - black letter law says a person's name is the name by which he is generally known
        - however, there may be no single version of a debtor's name that is "correct"
        - a financing statement should be filled in the full, formal name of the debtor as well as the shorter versions by which he is more commonly known.
    - Corporate name
        - Corporations can only be formed by obtaining a *charter* or *certificate of incorporation* from the secretary of state

        - A searcher can discover the precise spelling of a corporate name of the true name of a corporation by examining the certificate of incorporation.
        - The name must show that the entity is a corporation
        - No state will permit a the formation of two corporations with the same or confusingly similar names.
    - Limited Partnerships
        - Formed in the same way as a corporation
        - <u>Trade name</u> – <u>fictitious name</u> – the name under which a person or entity conducts business that is not its legal name.
    - Nothing in Article 9 requires the creditor to search for prior filings – if you don't you may get an unpleasant surprise when trying to foreclose.
    - Filings can be considered ineffective (and defeat lien priority) if a search under the correct name would not have retrieved the filing.
- **Financing Statements: Other Information**
    - 9-502 lists the financing statement requirements:
        - name of the debtor
        - name of the secured creditor
        - indication of the collateral covered (this can be optional)
        - mailing address of the secured creditor 9-516(b)4
        - mail address of the debtor 9-516(b)(5)(a)
        - an indication if the debtor is an individual or a corporation 9-516(b)(5)(b)
        - .... if the debtor is an organization .... the type of organization
        - debtor's jurisdiction of organization
        - the debtor's organizational number.
    - Even if the information is clearly inaccurate, the filing officer must accept it – just makes sure all the blanks are filled in
        - If the officer accidentally accepts a filing that lacks the above information, it is still effective.
        - It MUST have items 1-3 or it is not effective.
        - Use Reasonable Reliance Test from 9-338
    - If an officer wrongfully rejects a filing, it will be stamped with the date and time, and still serves to perfect the lien.
        - Purchasers are more protected from inaccurate filings than lien creditors
    - If there is uncertainty whether a title is encumbered by a lien, it is callec <u>clouded</u> – getting all the information is called <u>clearing the title</u>
    - A person may only file a financing statement if the debtor gives permission – getting the debtor to auntheticate (sign) a security agreement counts as this.
        - If the person filing the financing statement is not authorized, then the filing is ineffective.
- **Exceptions**
    - 3 Other ways for a creditor to perfect a lien:
        - taking possession of the collateral – 9-310(b)(6) and 9-313

        - possession is mandatory for money
        - works for: negotiable documents, goods, instruments, money, or tangible chattel paper.
        - **Possession-give-notice theory** – filing is redundant
        - Possession is not merely an observable fact, but depends on legal rights
    - automatic perfection by operation of law for certain collateral
        - <u>purchase-money security interest</u> – 9-103(b)(1) – arises in 2 situations:
            - promising to pay for something with a note that grants security interest in that item.
            - A third party pays for the item and gains a security interest in the collateral.
        - Automatically perfected only in consumer goods – everything else requires filing
        - Consumer goods are – good that are used or bought for use primarily for personal, family, or household reasons. – it is not the nature of the goods but the use that defines them.
    - giving notice to or through some person who controls the collateral
        - stocks require control

- **Article 9 Termination and Release**
    - If the debtor has paid and the secured party is not required by law to lend more money (by contract), a debtor can demand the creditor file a *termination statement* within 20 days. 9-513(c)
        - *Termination statement* – when it is filed, the financing statement to which it is related is no longer effective.
        - If the secured party fails to do so, it is liable for damages and a civil penalty of $500. 9-625(b) (e)(4)
        - The collateral is released by amending the financing statement 9-512(a)
            - Not required on partial payment except through contract
    - A termination statement must:
        - Identify by number the initial filing statement.
        - Indicate that the financing statement is no longer effective.
    - Errors or omissions in a termination statement are subject to the "seriously misleading" standard
    - Unless the secured party takes affirmative action (by filing a *continuation statement*) then financing statement lapses in a *self-clearing system.*
        - Financing statements are good for 5 years.
        - Continuation statement must occur within the last 6 months of those 5 years. 9-515(a)
        - 1 year after a statement lapses then the officer can remove and destroy it. 9-522(a)

- When the statement is allowed to lapse it "unperfects a security interest"
  - 9-515 – this is retroactive.

- **Change in Name, Identify and Use**
  - Changes in the Debtor's Name
    - 9-507(c) – even though a change in a debtor's name makes a filed financing statement seriously, it is still effective with regard to:
      - collateral owned by the debtor at the time of the name change
      - collateral acquired by the debtor in the 4 months after the change.
      - Anything after that, and the filing is not perfected
  - Changes Affecting the Description of the Collateral
    - 2 kinds of changes:
      - there is a change in circumstance over the collateral – like it used to be inventory and is now equipment. 9-507(b)
        - even though this makes it seriously misleading, the financing statement is still effective
      - the collateral changes into something else – like lumber being used to build a deck.
        - 9-507(b) excuses the misdescription, but requires a new filing for that new thing.
  - Conversion of the collateral into proceeds
    - **** I need to do the proceeds dance:
      - Is it proceeds under 9-102(64), is it identifiable 9-315(a)(2)
    - Barter transactions – 9-315(d)(1)
      - *Elephant rule* – applies only in barter transactions. Even though the collateral description is wrong, there is no need for a new filing. – maintains perfection.
        - **must explore how the debtor came to own the elephant**
      - if the new item requires filing in a different office, you must refile in the correct office.
    - Collateral to Cash to Noncash Proceeds
      - Debtor exchanges original collateral for cash and then buys something else.
      - The secured creditor's interest follows to the new item, provided it can trace the value.
      - If it requires refilling, the secured creditor has 20 days after the debtor's receipt of the new property, or the interest is no continuous.
        - A change in the description requires refilling – no *elephant rule*
    - Collateral to Cash Proceeds

- There is perpetual perfection in identifiable cash proceeds.

- **Relocation of Debtor or Collateral**

---- Relocation of the Debtor

- 9-301(1) – states the general rule regarding the correct state in which to file a financing statement.
    - When a debtor is located in a state, the local law of the state governs perfection of a non-possessory security interest.
- <u>registered organization</u> – an organization that is organized solely under the laws of one state and they must maintain a record showing that organization. – 9-102(a)(70).
    - if they apply for organization in another state, it effectively creates a new corporation with the same name, not a second charter for the same organization.
    - A registered organization is located in the state it is organized in.
    - Allows the proper place for filing and search to be determined solely from the public record
        - <u>Debtor based filing</u> – filing is in the jurisidiction where the corporate debtor has its headquarters
        - <u>incorporation based filing</u> – filing at the corporate debtor's place of incorporation.
- 9-307(b)(2) – if an organization is not incorporated, then it is located at its place of business. – "a place where a debtor conducts its affairs." .. also chief executive office if it has more than one location.
    - 9-307(b) is problematic in 3 ways:
        - Filing against mobile goods and intangible property
        - Locating corporations for purposes of diversity jurisdiction in federal court
        - Determining proper venue for corporate bankruptcies.
    - In response courts developed the *nerve center test*: the organization is located in the place from which is managed, regardless the location of its operations.
- 9-501 -- a fixture filing must be made in the office designated for the filing or recording of a mortgage on the real property
    - the purpose of this rule is to keep all filing against real property or the fixtures attached to it in the same records of the county where the land is located.
    - this keeps all the filings for the same real property in the same place.

--- Relocation of the Debtor

- <u>Principle residence</u> in a state requires that the debtor sometimes be physically present in the state – this is ultimately a matter of the debtor's intention.
    - 9-316 -- When an individual changes his or her state of principal residence, the secured creditor who filed in the original state has 4 months to file in the destination state.

        - If the SC does not, then the security interest becomes unperfected.
    - Two strategies for organizations to change states:
        - merger
        - sale of assests.
        - Merger is easy to follow for secured creditors, but sale of assets could go unnoticed.

PRIORITY

priority – to say that one creditor has *priority* over another means that if the value of the collateral is sufficient to pay only one of them, the law requires that value to be paid to the one who has priority.
-- this only comes into play when there is more than one interest in a piece of property.

- **Priority in Foreclosure**
    - Two basic principles govern the timing of the enforcement of competing liens against the same collateral:
        1. absent an agreement to the contrary – any lien holder may foreclose while the debtor is in default to the lien holder.
        2. no lien holder is compelled to foreclose
            a. each has the option to extend the debtor's time to pay or forebear from exercising its remedy.
    - The holder of virtually any type of lien may foreclose but the procedure for doing so varies with the type of lien.
    - A prior lien holder cannot enforce the debt on the purchaser of property at a foreclosure sale, but he can enforce the lien against that property.
        - If the purchaser or someone else doesn't pay the debt, the holder of the lien can foreclose on the property again.
    - The proceeds of a sale are first applied to the expenses of the sale and then to the payment of the lien under which the lien was held, and then pays the holders of subordinate liens in order of priority.
        - The debtor gets anything left over.
        - Unsecured creditors don't get anything – they have to levy on the surplus that is left with the debtor.
    - judicial sales are on of the few places where caveat emptor still applies.

COMPETITIONS FOR COLLATERAL

- **How Creditors Become Lien Creditors**
    - Lien creditor – an unsecured creditor who won a judgment against the debtor, obtained a writ of execution, and then obtained a lien by levying on specific property of the debtor.
        - UCC 9-102(a)(52) defines the term more broadly, including "a creditor who has acquired a lien on the property involved by attachment, levy or the like.
    - How does an unsecured creditor obtain lien creditor status???

- Attachment – a legal process in which the plaintiff in litigation obtains a writ and delivers it to a sheriff, marshal, or other law enforcement officer, who then levies on property of the debtor.
  - in some jurisdictions it is synonymous with *execution*
  - in most jurisdictions, an attachment occurs before judgment is entered, and execution is an attachment occurs after
- garnishment – the process by which a judgment creditor in most states reaches debts owing from a third party to the debtor or property of the debtor that is in the hands of a third party.
- Recordation of a judgement for money damages – creates and perfects a lien on real property owned by the debtor within the county.

- **Priority Among Lien Creditors**
  - the rules are normally found in state statutes – They are setup in a first-come first-serve basis.
  - the first creditor to take the legally designated crucial step has the first lien, and so forth.
  - The laws generally award a lien priority as one of four dates:
    1. *Date of Levy* – the date on which the sheriff took possession of particular property (either physical or symbolic, depending on the state)
    2. *Date of delivery of writ* – the date on which the writs of execution are delivered to the sheriff for service.
    3. *Date of Service of a writ or garnishment* – the delivery by the sheriff to the garnishee – a bank or an employer
    4. *Date of recordation of judgment* – the date the judgment is delivered to the filling or recording officer.
  - The officer receiving the writs shall indorse every writ of execution at the time which he received it.
- **Priority Between Lien Creditors and Secured Creditors**
  - Priority depends on whether the lien creditor becomes a lien creditor before the secured creditor does either of two things:
    - 1) perfects it security interest or
    - 2) files a financing statement and complies with 9-203(b)(3).
      - A security interest is perfected only after it has attached and the applicable steps required for perfection complete
  - The lien creditor's priority date is the date he becomes a lien creditor.
    - Majority Rule: an execution creditor becomes a lien creditor at the time of the levy
    - Minority Rule: an execution creditor becomes a lien creditor upon the delivery of the writ by the sheriff.
  - As long as a valid security agreement and financing statement exists, the secured party has priority
    - Gives the secured party time to search.
  - every bankruptcy filing immediately gives the trustee the rights of an ideal lien creditor that levied at the moment of the filing of the petition.
- **Priority Between Lien Creditors and Mortgage Creditors**

    - This is governed by real estate law, which normally gives priority to the first lien created.
- **Purchase-Money Priority**
    - The fundamental principle underlying the system of priority among liens is that liens rank in the order in which they public.
    - When a second-in-time interest takes precedence over an earlier interest the cognoscenti describe the second secured creditor as "priming" the first.
        - This occurs with *purchase-money security interests* (PMSI's). – they are an exception to the fundamental principle of first in time is first in right.
        - If the PMSI attaches first, the holder of the PMSI has a 20 day grace period in which it can perfect and thereby defeat a lien that came into existence between the dates of attachment and perfection of the PMSI.
            - the reason for the grace period is to facilitate sales of personal property on secured credit.
- <u>Lien Creditors vs Secured Creditors</u> **– Priority of Future Advances: Personal Property**
    - 9-323(b) gives future advances priority over an intervening lien, provided the initial creditor making the advance does not have knowledge of the new lien.
        - allows a secured creditor to conduct one search at the time it begins lending relations with the debtor and to make future advance without a fear of creditors whom the secured creditor as no knowledge of.
    - 2 other exceptions:
        - every secured advance made within 45 days after the levy is given priority over the levy, even if the secured creditor knows about the levy.
        - 9-323(b)(2) – every advance made "pursuant to commitment entered into without knowledge of the lien" is given priority.
- **Priorities of NonAdvances: Personal Property**
    - A debtor's obligation to pay a secured party's interest, attorney fees, and costs on the prior lien have priority over lien creditors.
- **Secured Creditors vs. Secured Creditors**
    - 9-322 governs prority among security interests.
    - Between the holders of two security interests in the same collateral, the first to file or perfect has priority.
        - This is true so long as the holder remains continuously filed or perfected.
        - This is done to protect the filing system, because a secured party could file a financing statement before either lending or agreeing to lend and then search the filing at its leisure --- this justifies the first to file rule, instead of first to file or perfect as under 9-322.
    - 9-325 sets out an exception to this rule

        - security interests perfected against a transferee are underneath those perfected against the transferor.

Priority of Future Advances

- As long as the secured creditor's financing statement "covers the collateral" all advances made by the secured creditor to the debtor have priority as of the filing of the financing statement.
    - 9-204(c) says that security agreement must include future advance clause. .... in 2nd agreement in this case – financing statement does not require it.
- Only the financing statement need be on file, and rarely mentions the existence of future advance clauses in the security agreement.
    - means it makes less sense than under real estate law.
    - It does relieve the lender from the necessity to file and search in conjunction with each advance.
- Who would take a secondary interest in a system where the first interest can increase without limit?
    1. lenders who do not understand the future-advance rule
    2. creditors who hope to benefit from their second interest but do not advance funds in reliance on it
    3. lenders who protect themselves against future advances by contract with the holder of the first interest.

Priority in After-Acquired Property

- Against other Article 9 secured creditors, the after-acquired lender's priority dates from the time of its filing.
    - it has the same priority with respect to after-acquired property as it does with original collateral.
- 9-325 – Priority of Transferee.

Priority of Purchase-Money Security Interests

- 9-324 – a purchase-money security interest in collateral other than inventory has priority over a conflicting security interest in the same collateral if the purchase-money security interest is perfect not later than 20 days after the debtor receives possession of the collateral.
- the purchase-money lender has acquired a relationship with the collateral before the after-acquired lender does.
- it allows companies to:
    - 1) do away with the need for a straw man, making business more efficient.
    - 2) allows a company to sell and deliver collateral immediately without having to check the public record, which is more efficient for business.
    - it also protects debtors from having initial secured parties from overreaching and grabbing everything. (KEATING DISAGREES WITH THIS)

- although generally, any easing on filers makes things more difficult for searchers.
- more than one creditor can have a valid purchase-money security interest in the same collateral.
  - 9-324 the seller's purchase-money interest takes priority over a cash-lender's purchase-money interest.
- The 20 day grace period does not apply when the property sold will be used as inventory by the buyer.
  - need to accommodate inventory financing.
- 9-324 permits purchase-money priority in inventory only on these conditions:
  - the PM financier must perfect no later than the time the debtor receives possession of the collateral
  - the PM financier must give advance notice to the inventory lender that it expects to acquire a PMSI in inventory
    - to give this notice the PM must search the filing system, send notice to the names and addresses of all secured parties it finds by certified mail.
    - This expires after 5 years.

<u>Purchase-Money Priority in Proceeds</u>

- PM priority under 9-324 extends to "collateral or its proceeds"
  - the exception found in 9-324 is that PM status in inventory flows only into chattel paper, instruments and cash proceeds.
  - this is also further limited by 9-327 and 9-330, which protect purchasers of the chattel paper or instruments and secured parties with control of the deposit account into which cash proceeds are deposited.
    - PMSI priority for software 9-324(f)
    - Accounts are normal process
  - the exception helps to facilitate accounting financing.

<u>Priority in Commingled Collateral</u>

- *Commingled collateral* – collateral mixed with other property, like cash into an account that contains other funds that are not proceeds. Or corn mixing.
- Two situations:
  1. the identity of the collateral is lost by commingling as the collateral becomes part of a product or mass.
     a. the security interest continues in the product or mass.
  2. *accession* – where the identity is not lost, like in a replacement part.
- If more than one security interest attaches to a product or mass as a result of commingling, the interests rank equally and share in the proportion that the cost of each party's contribution bears to the total cost of the product or mass.

- **Buyers Against Secured Creditors**
    - 9-401 – Security does not interfere with the free alienability of property.
        - The secured party's expectation of value in its interest is still maintained.
    - Buyers of Real Property
        - Priority is solved generally by first in time – if the mortgage was created before the debtor sold the property, then the buy takes possession subject to the mortgage.
        - A recording statute may reserve this result and vice versa.
            - A person who buys in good faith without notice of an unrecorded mortgage may take it free under such a statute.
        - All purchasers of real property are expected to search the public record and are deemed to have notice (*constructive notice*)
            - No exceptions are recognized
        - Types of Recording Statutes:
            - Race statute – first to file regardless of notice.
            - Notice-Race Statute – first to file with notice of competing liens
            - Notice – if a person buys before a mortgage is recorded, but is recorded before that person records the purchase.
    - Buyers of Personal Property
        - If you see "chattal paper, deposit accounts, or intrumentalities" then go to 9-330.
        - 9-201 and 9-315(a) outlines the personal property rule
            - "a security agreement is effective against subsequent purchasers." – a security interest continues in collateral notwithstanding a sale.
        - Authorized disposition exception – 9-315(a)(2) – the security interest does not continue in the collateral if the secured party authorized the sale free of the security interest.
            - The authorization need not be express
            - Where a secured creditor knew the debtor was selling collateral in violation of the security agreement and did nothing waives the provisions an authorizes the sale.
        - Buyers of personal property are not expected to search the public records for most kinds of personal property.
        - A buyer in the ordinary course of business can take free of a security interest created by its seller. – defined in 9-210(9)
            - Buyer in ordinary course of business – only occurs when buying something from a person in the business of selling goods of that kind. (ordinary refers to the *seller's* business, not the buyer's)
            - 9-320(a) – protects a buyer even when he knows of the security interest.
            - The buyer must take possession of the goods or have the right to recover the goods from the seller

        - 9-320(e) rejects this notion is the collateral is in the possession of the secured party
      - It does not take free of a security interest created by the seller's predecessor in title.
      - Receiving goods in exchange for relief of a previous debt does not make a person a buyer.
    - <u>Farm products Exception</u> – 9-320(a) – affords no protection to those who buy farm products, but the Federal Food Security Act provides parallel protection.
    - <u>Consumer to Consumer Exception</u> – 9-320(b) – requires that the goods be held for personal, family, or household purposes of the seller prior to the cale, and the buyer also use the goods for the same reasons after the sale.
      - This is also protected from automatic perfection PMSI in consumer goods

NEGOTIABLE INSTRUMENTS

Two broad classes of transactions:

1) typical sales transaction
2) credit transactions

Any functioning payment system must address several problems:

1. must provide a way for a party that is obligated to make a payment establish some sort of claim against a 3rd party that will ultimately pay.
2. the transaction payor must be able to transfer the claim to the party entitled to payment (payee).
3. The seller must be able to obtain payment from the third party.
4. all systems must respond to the likelihood of mistake and wrongdoing and determine what to do about any losses that occur.

- **The Basic Checking Relationship and the Bank's Right to Pay Checks**
  - for a payment system to be available, the person that wants to make a payment must establish a claim against the 3rd party that actually will pay the seller.
    - i.e. in the checking system the transaction payor establishes that claim by opening a checking account.
  - Negotiable instruments are governed by Article 3 of the UCC.
    - however, principles of negotiability have little to do with the day-to-day functioning of the checking system.
  - When is it Proper for the Bank to Pay?
    - UCC 4-401(a) –proper to charge a customer's account for any "item that is properly payable" ... which means the customer has authorized the payment
      - the most common way to accomplish this is by writing a check.
    - if the payee presents the check to the customer's bank, it is proper for the payor bank to honor the check.
    - when a customer writes a check to a particular payee, it authorizes payment to that payee and to parties that acquire that check from the payee
      - does not authorize payment to thieves who do not properly acquire the check.
    - *Overdraft* – most common problem is when customer authorizes payment by writing a check, but the account does not have enough funds to cover the check.
      - the payor bank is free to pay the check or dishonor it, as the bank wishes.
      - If the person received no benefit from the transaction, they are not liable for the $$ - 4-401(b)

        - banks are entitled to charge whatever they want for overdraft privilege, but there is also a notion of "Unconscionability".
            - However, unconscionability could only succeed is the customer could show they were deprived of a meaningful choice of banks they could do business with (unfair competition).
    - 4-303(b) – banks can pay items in any order
    - *Stopping Payment* – another problem to the bank's right to pay a check. The customer changes its mind after it has written a check and decides that it no longer wants the payor to pay the payee.
        - this decision does not become final at the time the customer issues the stop payment request.
        - A check ceases to be properly payable if the customer gives the bank **timely and adequate notice of the customer's desire.**
        - 3 major considerations limit the practicality of stop payments:
            1. the customer must act promptly to exercise his right. 4-403(a) says it is only valid if "received at a time and in a manner that affords the bank a reasonable opportunity to act on it before any final action by the bank with respect to the item."
            2. the duration of the stop payment. 4-403(b) says a stop-payment order is only valid for 6 months. A savvy holder of a stopped check could hold it for 6 months and then cash it.
            3. the underlying obligation for which the check was written. The payee has two rights to payment: 1) the right to enforce the check and 2) the right to pursue the check writer on the underlying transaction. (sue on his drawer's liability)
    - Rights of a Payee -- 3-310
        - purpose is to enhance the likelihood the payee will be paid once and just once.
        - Two critical Rules:
            1. to prevent the payee from obtaining double payment by collecting on the check and the underlying transaction, the UCC suspends the payee's right to pursue the customer on the underlying transaction when the payee accepts the customer's checks.
            2. to ensure the payee is not prejudiced by its willing to accept the check the UCC provides that the suspension ends if the check is dishonored.
- Remedies for Improper Payment
    - Common Problems:

            1. the customer did not write the check
            2. the payment was made after a forged endorsement
            3. the bank failed to comply with a valid stop payment order
        - the bank must return any fees it charged with the dishonored check and pay any damages to the customer that are proximately caused by the dishonor – UCC 4-402(b)
        - <u>subrogation</u> – the bank steps into the shoes of the payee, advocated that position and refuses to recredit the payor's account in order to avoid anyone getting double payment. ** prevent unjust enrichment.
- **When Are Funds Available for Payment?**
    - when an account has sufficient funds to cover a transaction, the bank has an affirmative obligation to pay the item.
        - (This obligation runs only to the customer not to the payee)
    - 2 Questions to determine when funds are available:
        1. When is the determination made?
        2. What is the balance in the account at that time?
    - The statute basically says that when the bank evaluates the check is when the determination is made.
        - (maximizes the bank's flexibility and minimizes logistical difficulty.
        - 4-402(c) – the bank is free to determine whether the account has sufficient funds at any time between the item is received by the payor bank and the time that the payor bank returns the item.
        - no more than 1 determination need to be made.
    - 4-215(e) grants the depository bank unfettered discretion to protect itself by permitting the bank to limit the customer's access to funds deposited by check until the depository bank can determine whether the check will be honored
        - called putting a hold on a check
    - Bank does not have to honor checks older than 6 months, but it may do so, its actions are good faith regarding reasonable commercial standards.

- **Wrongful Dishonor: What Happens If the Bank Refuses to Pay**
    - <u>*Wrongful dishonor*</u> – when a bank violates its agreement with its customer by failing to pay a check that it was obligated to pay.
    - UCC 4-402(b) – customer is entitled to all the damages proximately caused by the wrongful dishonor.

- **Bank's Obligation to the Payee**
    - <u>Payee</u> – any person entitled to enforce an instrument -- 3-301
        - in ordinary check transaction, the payee has no rights against the payor bank.
        - 3-408 – the check itself does not operate as an assignment of funds.

        - The drawee is not liable on the instrument until the drawee accepts it.
        - If a payee is concerned about the payor bank not paying, it can protect itself in several ways:
            - Refuse to accept an ordinary check – *certified checks*
            - ask for a check drawn on the bank itself – *cashier's check* or a *teller's check*
    - Payee has 2 different ways to pursue collection
        - Obtaining payment directly from the power bank (unusual)
            - 4-301(a) – cash the check at the teller window. This payment is final
            - The payee has an account at the same bank as the drawer.
                - ❖ bank produces as "on-us" item and gives the depositor a "provisional settlement" for the item on the day it is received.
                - ❖ The payor bank has until its *midnight deadline* (midnight of the next banking day) to honor or dishonor the check – 4-104(a)(10); 4-301(a),(b)
                - ❖ If the bank dishonors, then the payee is left with the check itself and the right to obtain payment from the purchaser on the underlying obligation
        - Obtain payment indirectly through an intermediary (depositing the check in a bank).
            - <u>Payee/Customer to Depository Bank</u>
                - ❖ Customer deposits check into its account: 1) an agency relationship is created. 2) the depository bank gives a "provisional settlement"
                - ❖ The bank accepts a responsibility to act as the customer's agent in trying to get payment from the payor bank – it now becomes a *collecting bank*
            - <u>Depository Bank to Payor Bank</u>
                - ❖ 4-202 – as long as it minds its obligation to ordinary care, the depository bank can collect from the payor bank anyway it wants to. 4-204.
                - ❖ One of the most prominent options is clearance through the Federal Reserve. ... use the MICR line. PAGE 356.
                - ❖ Clearinghouses – multilateral arrangements – efficient in clearing local checks and **nets** out each bank check on a daily basis. PAGE 352
                - ❖ ***Bilateral Agreements*** – a pair of banks have a relationship and provide for a direct-send clearing of checks .... the large bank is the correspondent of the smaller bank.
    - **Bank Deadline Requirements –** PAGE 359.

The checking system includes a detailed, two-tiered framework to deal with losses.

- 1st Tier – framework that distributes losses based on generalized assumptions about the relative abilities of the parties to prevent certain types of losses
    - 1st Major Theory – Indorsement Liability
        - the basic role of indorsement is to provide a simple method for transferring checks.
        - The indorsement itself needs to be nothing more than a signature by the person selling the check.
            - This is a “blank” indorsement under Article 3
            - It has the legal effect of making the check “bearer paper” so that any party that subsequently is in possession of the check would be entitled to enforce it. 3-205(b)
            - If the indorser wants to make the check payable to a particular person, it needs to add a statement identifying that person above the signature.
            - This is a “special indorsement” and makes the check “order paper’
            - The indorser can make the check payable for “deposit only” or “for collection” which are “restrictive indorsements” 3-206
        - Indorsement carries with it a form of liability that shifts the loss that arises when a payor bank refuses to pay a check. UCC 3-415.
            - Indorsing a check makes an implied contract with subsequent parties that acquire the check, obligating the indorser to pay the check if the payor bank dishonors it.
        - The UCC includes two rules that protect the indorser from liability on stale obligations:
            - 1. the indorsers liability is conditioned on the check being deposited or presented within 30 days of the indorsement.
                - If the transferee does not present the check within 30 days of the indorsement, the indorser has no liability.
            - 2. UCC 3-415(c) requires any person seeking to enforce a claim of liability on an indorsement to give prompt notice of dishonor to the indorser.
                - If the person giving the notice is a collecting bank, it must give the notice y midnight of the banking day after it learns of the dishonor.
        - <u>NonPayment</u> – these losses are relatively common because of two elements in the checking system
            - 1. The payee’s inability to know when it takes a check whether the payor bank will honor it
            - 2. The relatively long delay between the time that the payee accepts the check and the time the payee finds out whether the check will be honored.
        - <u>Forged Signatures</u>

- The checking system relies on a low-tech authorization system – pieces of paper with written signatures – leaving it susceptible. Credit cards and debit cards have also increased security, making checks more attractive to people who practice frauds.
- Who is responsible?
  - The thief – this is hard to enforce as the thieves rarely leave a forwarding address where we can track them down.
  - If someone is negligent it justifies a departure from the basic rule set.
  - Problem 1 – the check is a complete forgery and is not even signed by the purported drawer. (ex. Thief steals checkbook or copies a valid check)
    - The allocation of losses depends on whether the payor bank:
      - Is duped into paying the check
      - The payor bank bears the loss if it fails to notice the forgery and honors the check – the check was not properly payable from the account or the purported drawer and the payor bank had no right to authorize the check. UCC 4-401(a)
      - 2 statutory exceptions:
        - UCC 3-418(a)(ii) – the payor bank can seek recovery from the person to whom benefit payment was made, but only if it was done in bad faith. This is not common as it is hard to show bad faith.
        - UCC 4-208 -- Payor bank can claim an earlier party in the chain of collection breached a presentment of warranty.
        - This requires knowledge and not mere notice.
      - Notices the forgery and dishonors the check.
  - 2nd Major Theory – Warranty Liability.
- 2nd tier – consists of several situation specific exceptions to the general 1st tier theories

*** no one can be the holder of a stolen check after it is stolen.

- holders are people entitled to enforce the instrument, so payor banks can never be a holder. They accept checks (acceptor) but are also not indorsers.

Transferring a check – the issuer is never a transferor. A transferor is someone who voluntarily transfers a check.

4-401(a) The Properly Payable Rule (these are no longer authorized)

1. forged drawer's signature
2. forged payee's endorsement
3. altered instrument
4. stale check 4-404
5. overdraft 4-401(a); 4-402(a)
6. stop payment order 4-403
7. post-date notice 4-401(c)

RISK OF LOSS IN THE CHECKING SYSTEM

Negligence:

Negligence is the basic theme of all the special provisions
- if one of the innocent parties was negligent in a way that contributed substantially to the loss, it makes sense to place the loss on that party than on an innocent party that was not negligent.

- 3-406 does not provide a general right to challenge negligence – it provides a defense only when the negligence leads to a "forged signature"
    - for example there is no relief under 3-406 if a thief, who is not the payee indorses the check in the thief's name rather than the payee's name.
- The UCC also imposes a general duty of ordinary care on banks in processing and payig checks.
    - In defining "ordinary care" the UCC is deferential to general banking usage.
    - Basically, the bank established a prima facie case of ordinary care if it can establish that tis activities conform to general banking usage. 4-103.
    - Read this as "the practices you use and those practices have to be reasonable when compared to the industry."
    - The UCC trusts that the market will eventually force banks to develop cost-effective procedures for preventing loss.

Bank Statements:

The bank statement rule rests on the general intuition that customer can stop extended forgery schemes by the simple expedient of promptly reviewing their bank statements.

- When a drawer fails to discover a forgery evident from its monthly bank statement, the UCC normally transfers ensuing losses from the payor bank to the drawer by precluding the drawer from challenging the payor bank's decision to honor future checks by the same forger. UCC 4-406.

- The rules rests on the underlying norm that it is appropriate to cast losses on customers unless they take seriously their obligation to review their bank statements promptly and thouroughly.
    - Draft Withdrawl Agreement???? Page 388 in the case.

<u>Theft By Employees</u>
The most common case for applying this rule occurs when an employee forges the employer's endorsement on a check payable to the employer.

- The ordinary negligence rule or the bank-statement rule would place the loss on the employer.
- BUT when the loss is caused by a responsible employee, the UCC 3-405 places the loss on the employer as well, even if the aforementioned rules do not apply.

<u>Imposters</u>
This rule deals with checks procured by imposters or payable to fictitious persons.

- 3-404(a) says the loss should be allocated to the person that was victimized by the fraud.

NEGOTIABILITY – NEGOTIABLE INSTRUMENTS

<u>Negotiability and Liquidity</u>

<u>Liquidity</u> – the ease with which an asset can be sold at a price that reflects the asset's economic value.

- The lack of a market makes a sale difficult because it forces a prospective seller to expend considerable effort to locate a buyer and educate the buyer about the value of the asset.

a negotiable instrument is the oldest device for enhancing liquidity in modern commerce.

1. they offer an east way for verifying a party's power to transfer an enforceable interest in the instrument
2. there is a defense-stripping rule that makes a negotiable instrument more valuable in the hands of a purchasers than it was in the hands of the payee that sold it.
    - a purchaser that becomes a "holder in due course" takes the instrument free from all personal defenses.

\- a negotiable instrument must be a <u>writing</u> that is an <u>obligation to pay money</u> that is <u>signed</u>. It is a piece of paper (a physical writing) that evidences the payment obligation.

<u>Drawer or Issuer</u> – the party that directs payment (the payor bank most of the time)

<u>Remitter</u> – the person who caused the draft to be issued.

<u>Drawee</u> – the person on whom the draft is drawn (the payee bank most of the time)

Negotiable Instrument: 3-104 sets out 7 requirements

- the obligation must be a written promise or order
  - it also must be signed.
  - A promise is a direct commitment to pay – an instrument that contains a promise is a “note” and the person making the promise is a “maker”
  - An order is an instruction by one person (drawer) directing some other party (drawee) to pay. – an instrument containing an order is called a “draft”
    - Drafts include checks, a cashier’s check, and teller’s checks.
- the obligation must be unconditional
  - there can be no conditions like “valid if ...”
  - a negotiable instrument must have its terms of payment evident on its face and cannot reference or incorporate other documents – this is too cumbersome for the system.
  - There are 2 exceptions to this rule in 3-106(b)
    - A note references other writings that describe the rights related to the collateral and to the payee’s remedies upon default.
    - Where payment is limited to resort to a particular fund or source. (like a non-recourse real-estate note)
- the obligation must requirement payment of money
  - this includes both domestic and foreign money
- the amount of the obligation must be fixed
  - interest can be fixed or variable.
- the obligation must be payable to bearer or order
  - This is achieved in 2 ways:
    - It can say “payable to bearer” on it
    - If it otherwise indicates that the person in possession of the promise or order is entitled to payment
  - The second type of bearer paper is paper that is not payable to any particular identifiable person. 3-109(a).
  - Order paper is made in two ways:
    - The document states that it is payable to the order of an identified person. “Pay to the order of Matt”
    - It can say that it is payable to an identified person or order. “Pay to Matt or order.”
- the obligation must be payable on demand or at a definite time
- the obligation must not contain any extraneous undertakings by the issuer.
  - Forbids the inclusion of a promise calling fro something other than the payment of money. – the “courier without luggage” requirement.

An instrument in Article 3 literally means a negotiable instrument.

Problem 39.1

Requirements to be a Negotiable instrument:

1. Is it a signed writing? Yes

2. Is there a promise to pay a sum of money or an order to a third party to pay? Yes
3. Is the promise unconditional? (3-106)

TRANSFER AND ENFORCEMENT OF NEGOTIABLE INSTRUMENTS

One of the advantages of negotiable instruments is the ease with which an owner of the negotiable instrument can transfer clean and verifiable title.

- requires just delivery and a signature.
- enhances liquidity

Negotiation and Status as a Holder

Holder – a person in possession of an instrument and has a right to enforce it.

Negotiation – any transfer of possession involuntary or not by a person other than the original issuer that causes the transferee to become a holder.

** no person can be a holder without possession
** if the instrument is bearer paper, then any person in possession is a holder, regardless of that person's claim to ownership (a thief would be a holder)

** order paper must always be payable to some particular, identified person.
- this person is the only one who can be a holder.
- order paper only has a holder when the person in possession and the identified person matchup

-- a holder transferring an instrument can use two different types of indorsements to make the purchaser the holder of the instrument.

1. special indorsement – identifies a person to whom the instrument is to be paid.
2. blank endorsement – any indorsement made by a holder that does not indicate an identified person

two other kinds of endorsements:

1. restrictive indorsement – purports to limit the indorsee's ability to deal with the instrument. **(Article 3 invalidates almost all of these) – exceptions are "for collection only" and "for deposit only"**
2. anomalous indorsement – made by a person that was not the holder at the time of the indorsement. – **Article 3 uses these for accommodation**

presentment – a demand for payment made by a person entitled to enforce an instrument.

Liability on an Instrument
- generally, no party is liable on an instrument unless it has signed the instrument.
  -- for this signature includes any name, word, or mark made with an intention to authenticate a writing.

-- also an exception over agency laws.

Article 3 includes a series of 4 separate rules to cover each of thecapacities in which a party can sign an instrument

1. liability is absolute – a party that issues a note is directly and unconditionally liable on that instrument.
2. liability of a drawee – there is no liability for the drawee when the draft when it is issued, but when he accepts the draft (by signing it) he becomes directly liable on that draft.
3. drawer liability – conditioned on dishonor and discharged when the bank accepts the draft
4. indorser liability – conditioned on dishonor and discharged when the bank accepts the draft.

<u>UCC 3-310</u> sets out the rules governing the relation between liability on the instrument and liability on the underlying obligation.
-- divided into 2 classes:

1. near-cash instruments
    a. certified checks, cashier's checks, and tellers checks
        i. cashier's checks and teller's checks are checks on which the bank is the drawer.
    b. all these are instruments on which a bank has incurred liability.
2. ordinary instruments

HOLDER IN DUE COURSE

- **Requirements**
    - the holder in due course is a specially favored type of transferee that is immune from most defenses that an issuer of the instrument can raise
    - The HIDC must obtain the instrument through the process of negotiation so that it becomes a holder
    - It must take the instrument for value – 3-302(a)(2)(i) and 3-303(a)
        - 1-204(4) – any consideration sufficient to support a simple contract
        - includes ordinary payment and release of a preexisting claim against the seller. 3-303(a)(3)
        - promise of future performance counts as consideration but not value until it is performed. 3-303(a)(1)
    - Take the instrument in good faith – 3-302(a)(2)(ii)
        - Requires honesty in fact and the observance of reasonable commercial standards of fair dealing.
        - Common breach is when there is such a "close connection" between the purchaser and the seller of the note that there has been no cognizable sale at all.
    - Take the instrument without notice of certain problems with the instrument. – 3-302(a)(2)(iii – vi)

        - A person cannot be a HIDC if they know there is a problem with the instrument.
        - This includes actual knowledge and reason to know of the fact based on the circumstances 1-202(a)(3)
        - It is not enough to prove that the holder generally had notice of something wrong – the maker must prove notice of one of the 4 problems listed in 3-302(a)(2)
            - The instrument is overdue,has been dishonored, or is in default
                - Demand instruments = overude is not paid on the day after the demand is made
                - Check = overdue 90 days after their date
                - Payable at a definite time = overdue upon any failure to make a scheduled payment
            - It is a forgery or an alteration
            - A 3rd party claims to own all or part of the instrument
            - One of the obligors has a defense or claim that would limit or bar the enforcement of the instrument by the original payee.
- **Rights of a Holder in Due Course**
    - Immune from all defenses to payment except 4 Real Defenses:
        - Infancy – a holder in due course cannot enforce an instrument issued by a money that has no capacity to bind itself to a simple contract – 3-305(a)(1)(i)
        - Duress, Legal Capacity, & Illegality – cannot enforce if the underlying transaction in which the instrument was issued occurs under circumstances that would make the original obligation void. – 3-305(a)(1)(ii)
        - Fraud – cannot enforce when there is fraud that induced issuance of the instrument with neither knowledge nor reasonable opportunity to learn of its character or essential terms. – 3-305(a)(1)(iii)
        - Discharge of the Obligor In Insolvency Proceedings – a discharge of liability under Federal bankruptcy l;aws bars enforcement of that same liability.
- **Payment and Discharge**
    - 3-302(b) – a holder in due course is not precluded by notice of payment or discharge
    - any whole or partial discharge is effective against a person take takes with notice of the discharge.
        - A discharge is not binding on a holder in due course that took without notice of the discharge
- **Transferees without Holder-In-Due-Course Status**
    - 2 rules make the position of the purchaser without HIDC status better than the purchaser of a nonnegotiable obligation
        - a purchaser of order paper cannot become a holder of the instrument unless it obtains indorsement from the previous holder.

            - 3-203(c) protects that purchaser by obligating the seller to provide the indorsement upon request
            - <u>Shelter Rule</u> – implements the basic property principle that a purchaser or property obtains all of the rights that its seller had in the purchased property.

<u>CREDIT ENHANCEMENT</u>

- **The Role of Guaranties**
    - If the lender thinks the borrower is financially unsound, the lender may insist on a great deal of compensation for deferral to offset the risk of nonpayment.
    - <u>Principal obligor</u> -- The party who owes the money directly
    - <u>Lender</u> – the person to whom the money is owed. (also the oblige)
    - <u>Guarantor</u> – someone who agrees to provide a backup source of payment for the lender that the lender could obtain payment from if the principal obligor coul not pay. The guarantor then becomes a surety or secondary obligor.
        - This is as simple as a co-signer in a car loan.
        - The laws establishing the legal relations arising from a guaranty are called the laws of suretyship.
- **Rights of the Creditor Against the Guarantor**
        - The guarantor is liable to pay the obligation in question immediately upon default of the principle obligor.
            - In fact the lender can go after the guarantor first
            - If the guarantor is setup as a "guarantor of collections" then the lender cannot pursue the guarantor unless : --- this is rarely done.
                - He cannot locate and serve the principal
                - The principal is insolvent
                - The lender is unsuccessful in obtaining payment even after it obtains a judgment against the principle 3-419(d)
- **Rights of the Guarantor Against the Principle**
    - <u>Performance</u>
        - The right of performance (or exoneration) allows the guarantor to sue the principal in order to force the principal to perform the guaranteed obligation.
        - Rarely used because if the principle could perform, then it would have repaid the lender in the first place.
    - <u>Reimbursement</u>
        - Allows guarantor to recover any funds that he pays to the lender.
    - <u>Subrogation</u>
        - Allows a guarantor to recover payment by stepping into the shoes of the creditor and asserting against the principal all the rights the creditor could have asserted. – equiable assignment
        - Right of "pro-tanto" subrogation might hinder the creditor's attempt to collect from the principal.
            - This is barred common-law.
- **Rights of the Guarantor Against the Creditor**
    - <u>Impairment of Collateral</u>

- Guarantor can use this as a defense, in that the lender's mistake made it impossible or more difficult for them to actually collect from the principle.

- <u>Extensions</u>
  - The lender grants the principle an extension of time to pay.
  - Guarantor can argue that isn't fair.
  - Law allows guarantor to discharge his guaranty to the extent that he can prove the extension decreased the lender's ability to recover from the principle.