Bradley Secured Transactions Sample Exam with Answers/Comments

Basic Fact Pattern for Questions 1-3
On January 15, 2007 Big Bank filed a properly completed financing statement in the correct location describing the collateral as all of the “inventory, accounts and equipment” of XYZ Manufacturing Co. On January 21, 2007 XYZ and Big Bank executed a security agreement containing the same description of the collateral and including an after acquired property and future advance clause. Big Bank loaned XYZ $2 million on January 21, 2007. On July 1, 2008, Equipment Sales Co. sold and delivered a Caterpillar Bulldozer to XYZ and the parties entered into a security agreement providing for annual installment payments of the purchase price from Caterpillar to Equipment, and describing the collateral as “Bulldozer.” Equipment Sales filed a properly completed financing statement describing the collateral as a “Bulldozer” in the correct location on July 30, 2008.

Question 1 (15 minutes)
XYZ filed a bankruptcy petition on December 10, 2011. As of that date, what are the priorities to the Bulldozer?

ANSWER/COMMENTS:
Big Bank probably has a valid and perfected security interest in the bulldozer. The description in the security agreement is sufficient, because here, categories such as “equipment” are sufficient in this instance, 9-108(e); the bulldozer seems to be equipment of XYZ, or if not equipment, then inventory, and is included even though it is after-acquired. Big Bank’s security interest was perfected as of January 21, 2007. Big Bank’s financing statement is still valid (not lapsed); although one could argue that the collateral description does not expressly include “after-acquired” inventory, accounts, and equipment (which is required in a security agreement, see 9-204), the better argument is probably that financing statements need not explicitly include after-acquired given that the purpose of the financing statement is just to provide notice to potential other creditors. Thus this is likely a sufficient “indication” of the collateral in a financing statement, including after-acquired collateral of the type specified.
Equipment Sales has a PMSI in the bulldozer, but since it didn’t perfect within 20 days of the debtor obtaining possession of the bulldozer, its s.i. doesn’t prime Big Bank’s prior lien. See 9-324(a). Equipment Sales did, however, perfect in the bulldozer, on July 30, 2008, prior to the bankruptcy (which is when the trustee’s lien is deemed to arise, see Bankr. Code s. 544(a)). The description in Equipment’s security agreement is also sufficient, because as noted descriptions can be by category, and “bulldozer” is even more specific than that. Thus its interest is junior to Big Bank but senior to the bankruptcy trustee.
So here the order is Big Bank—Equipment---trustee.

Question 2 (15 minutes)
Would your answer change if Equipment Sales delivered the Bulldozer to XYZ on July 20, 2008?

1 This exam was originally given in slightly modified form by Professor Frost, but I emphasize that these answers and comments are mine alone and should not be viewed as relevant to his class or to his exams in general.
ANSWER/COMMENTS:
Yes, because the timeline of 9-324(a) runs for 20 days from when the debtor receives possession. If possession began on July 20, then the filing date of July 30 is within the twenty-day window, and thus Equipment’s p.m.s.i. becomes senior to Big Bank’s. Big Bank should still beat out the bankruptcy trustee, per 9-317, as explained in question 1 (because it perfected before the trustee’s lien arose). So here the order is Equipment---Big Bank---trustee.

Question 3 (15 minutes)
It is now April 11, 2012, nothing further has been filed in the relevant secretary of state’s office. Does that change your answer to question 1, above?

ANSWER/COMMENTS:
Big Bank’s financing statement lapsed five years after it was filed, in other words on January 21, 2012. Apparently Big Bank failed to file a continuation statement. Thus it is junior to future lien creditors, and it is retroactively unperfected against any past or future purchasers of the collateral for value. 9-515(c). This has the consequence that Equipment is now senior to Big Bank, due to the retroactive unperfection.

The bankruptcy trustee is in the position of a lien creditor and not a “purchaser of the collateral for value.” See Bankruptcy Code s. 544(a)(1); 1-201(b)(29), (30); 9-102(a)(52). The bankruptcy trustee’s status vis-à-vis collateral is determined as of the bankruptcy petition date (here Dec 10, 2011), and as of that date, Big Bank still defeated a lien creditor, and there is no retroactive unperfection in that regard. Thus the order of the rights as of the petition date is now: Equipment—Big Bank—bankruptcy trustee.

Basic Fact Pattern for Questions 4-6
You have been assigned to work on a $10 million loan that your client, Second Bank, is planning to make to XYZ Manufacturing, Inc., a Kentucky corporation. Second Bank insists on a first priority security interest in all of XYZ’s accounts, inventory, and equipment as a condition of its loan.

Question 4 (20 minutes)
Your search has revealed one financing statement filed by Finance Company on January 15, 2009 with the Secretary of State of Kentucky under the name The XYZ Manufacturing Corporation, which financing statement describes the collateral as “equipment.” The debtor has presented you a letter from Finance Company that states “We claim a security interest in one industrial drill press Model XY354. The current balance on this loan is $6,000.” In light of this letter and the insignificance of the drill press and the amount, you are inclined to ignore this financing statement. Should you?

ANSWER/COMMENTS:
You should absolutely not ignore this!
First, the financing statement will likely be valid despite the incorrect name, because it will show up in an application of the standard search logic, which ignores the word “the” at the beginning of a name and ignores “ending noise words” such as corporation. Since the name, although incorrect, will be sufficient to pull up the relevant filing, Finance Company is protected by the safe harbor of 9-506(c).
Unless you enter into a subordination agreement with Finance Company (which would be honored pursuant to 9-339), you will not have certainty as to the amount of Finance Company’s collateral or the obligation secured by that collateral, and Finance Company will always have the ability to prime you as to XYZ’s equipment by virtue of its filing of a financing statement. 9-322.

For instance, the current security agreement might cover after-acquired collateral (all subsequently acquired drill presses) and future advances (what if Finance Company advances a million dollars the day after this letter?) or non-advances (attorney’s fees, e.g.). You would in such instances be junior as to such new collateral and to the extent of such new advances. See 9-204, 9-322, 9-323.

Moreover, even if its current security agreement doesn’t cover any collateral aside from the one drill press referenced in the letter, and even if it only covers a small-dollar obligation, XYZ and Finance Co. could at any point simply enter a new security agreement that covers such additional collateral and such additional obligations.

Question 5 (20 minutes)
Your due diligence has disclosed that about half of the equipment that XYZ currently owns was purchased 2 years ago by XYZ from Acme Corporation, an Indiana corporation. Does this revelation cause you any concern? If so, what do you need to know and what will you do?

ANSWER/COMMENTS:
Even if Acme reserved for itself a PMSI when it sold the equipment to XYZ, if it didn’t file a financing statement, there’s not a concern because it apparently didn’t file a financing statement. (It is not automatically perfected, 9-309(1), because this isn’t a consumer goods transaction.)

However, there could be a prior lien on the equipment that XYZ did not take free of. You would want to search the UCC records of Indiana (which is where it is located for UCC purposes, 9-307(e)) to see if there are any filings against Acme. Even if this comes up clear, you can’t be sure that there aren’t liens still left over from a prior owner whom you don’t know about, but this is a good first step.

It is possible that even if there were a prior lien, XYZ took free and clear of it as a buyer in the ordinary course, 9-320(a), although this will depend likely on whether Acme is in the business of selling this type of equipment (and note that this will only discharge liens created by Acme, the “debtor’s seller,” not by any prior owner).

In theory, to really nail this down, you might have to request the sale documents from the XYZ—Acme sale, or even the documents showing where Acme’s ownership interest came from.

Question 6 (20 minutes)
Three years ago, XYZ Manufacturing filed an amendment to its Kentucky Articles of Incorporation that changed its name from The XYZ Corporation to XYZ Manufacturing, Inc. Do you need to do an additional search? Why or why not?

ANSWER/COMMENTS:
This is a significant name change; the old financing statement will be seriously misleading, and a search for the new name will not show financing statements under the old name. 9-506. You need to run an additional search in the Kentucky UCC system, because a
security interest perfected by a filing under the old name would still be effective as to collateral acquired by the debtor before, or within four months after, the filed financing statement became seriously misleading. 9-507(c).

Thus, absent a subordination agreement with whatever other secured creditor might have perfected under the old name, you will have a subordinate interest to that old creditor as to that previously acquired collateral.

Basic Fact Pattern on Questions 7-10
On January 15, 2009, Finance Co. entered into an Inventory Lending Agreement with ABC Distributing Company, a distributor of consumer electronics. ABC buys consumer electronics from manufacturers and resells those electronics to retailers. Under the agreement, Finance Co., agreed to lend up to 80% of the value of the inventory, provided that ABC was not in default of the agreement. The Inventory Lending Agreement described the collateral as “now existing and hereafter acquired inventory” and included a future advance clause. Finance Co. filed a properly completed financing statement in the correct location on January 15, 2009. ABC defaulted on the agreement in September, 2011 and filed a bankruptcy petition on February 1, 2012. As of the date of the petition inventory was valued at $5.0 million and Finance Co. is owed $8.0 million. The following transactions and events have since come to light.

Question 7 (20 minutes)
As of the date of the petition, ABC had accounts with a value of $2 million, all of which reflect amounts owed by retailers for the purchase price of consumer electronics. First Bank claims a security interest in those accounts based on a Security Agreement that was executed by ABC on July 1, 2010. That Security Agreement describes the collateral as “now existing and hereafter acquired accounts and proceeds thereof.” First Bank filed a properly completed financing statement (with the same description) in the correct location on July 2, 2010. Who has priority in those accounts as of the bankruptcy petition date, Finance Co. or First Bank?

ANSWER/COMMENTS:
The Inventory Lending Agreement appears to be a valid and enforceable security agreement, in that it appears to be an agreement to secure ABC’s specified present and future obligations with the collateral (i.e., it appears to grant Finance a security interest); its description of the collateral is sufficient pursuant to 9-108(e); and ABC appears to have authenticated it. 9-203(a).

The fact that the Inventory Lending Agreement and financing statement don’t expressly include “accounts” is of no moment. These accounts are proceeds of the inventory because they were acquired upon the disposition of that inventory. 9-102(a)(64)(A). Pursuant to 9-315(d), Finance’s security interest remained perfected because the three conditions of (d)(1) are met (filed financing statement covers the original collateral, inventory and accounts are both perfected by filing in the same office, and they weren’t acquired with cash proceeds). Finance’s financing statement has not lapsed as of the bankruptcy petition date. Thus, Finance has a valid and perfected s.i. in the $2mm of accounts.

First Bank appears also to be perfected in the accounts as well (assuming it advanced value, which isn’t specified here).

Who wins as between First Bank and Finance?
Finance prevails on a very simple ground. It simply relies on the general rule of 9-322(a)(1) that it was the first to file, and that filing date (as to its original collateral) is imputed to be also the filing date as to its proceeds (9-322(b)(1)). See Comment 9 to 9-324, Ex. 2. There is no exception allowing account lenders to prime prior perfected lenders.

Thus, in addition to being senior as to the inventory, Finance Co. should also be senior as to the accounts.

Note that while “consumer electronics” are involved in the underlying transactions, this is not a consumer transaction or a transaction involving consumer goods for UCC purposes, because those terms apply only to goods that are used for personal or household purposes in the hands of the buyer. 9-102(a)(22), (23), (24). That’s not the case here because retailers (as opposed to the end-users, most of whom probably will be the consumers) are buying the goods. In other words, these are not consumer goods in the hands of the relevant buyer.

Also, you might be tempted to say the special rule of 9-324(b) applies here. That rule limits the special status of a PMSI in inventory to certain types of proceeds, notably excluding accounts. Thus, you might think that First Bank, as the apparent account lender, benefits from that exclusion and thus prevails over Finance. And that would be the case if Finance were relying on the priming lien it gets by virtue of its PMSI-in-inventory, see 9-324(b). But in light of its status under 322(a)(1), Finance doesn’t have to appeal to its special status as inventory financier.

Question 8 (20 minutes)

$1.5 million dollars’ worth of the inventory that ABC currently has was acquired on October 1, 2011 in a liquidation sale from Defunct Manufacturing, a now dissolved manufacturing company. The acquisition was conducted by a broker, who made no representations regarding the title of the inventory and the inventory consisted of damaged and discontinued items. It turns out that Defunct Manufacturing had granted a security interest in all of its inventory to Second Bank, which security interest was perfected by a financing statement filed on March 1, 2009. Who has priority in this $1.5 million in inventory, Finance Co. or Second Bank?

ANSWER/COMMENTS:

We have already determined that Finance Co. is perfected.

We aren’t totally sure on the facts as given whether Second Bank is perfected. While the problem implies that (i) there is a security agreement, that (ii) Defunct had rights in the collateral, and that (iii) there was a proper filing of a financing statement, I don’t see a firm indication of whether Second Bank gave value to Defunct. If it didn’t, then, of course, it never actually had a security interest per 9-203, and would therefore certainly not prevail over Finance Co. or anyone else.

Assuming that Second Bank is also perfected in the collateral, the analysis would run as follows:

Second Bank’s priority date is March 1, 2009; that is, it is after Finance Co.’s filing date of January 15, 2009. Does this resolve the difficulty in Finance Co.’s favor, pursuant to 9-322(a)?

The answer is no. This situation implicates the special rules for transferred collateral. 9-325. Pursuant to that section, a continuously perfected security interest in the collateral in the
hands of the transferor prior to the transfer of the collateral primes an earlier security interest in the collateral as against the transferee. 9-325(a). (As the casebook suggests, this makes a lot of sense because if the opposite outcome obtained, how could the transferor’s secured creditor have protected itself against getting primed in this situation?) Thus, again assuming that it is perfected, Second Bank will prevail.

You might wonder if ABC is a buyer in the ordinary course, and thus took free pursuant to 9-320(a), which would have put Second Bank into peril. We look to the definition of buyer in the ordinary course in 1-201(b)(9). It seems possible that, as required by 1-201, Defunct was “in the business of selling goods of that kind.” And the sale was likely in good faith and without violating the rights of another. But let’s get real: a liquidation sale is hardly a good candidate for an “ordinary course” transaction—such a transaction seems by its nature extraordinary. All the more so in that there was expressly no title warranty (although 9-320(a) makes clear that even actual knowledge of a cloud on title isn’t enough per se to disqualify from BIOC status); also, the inventory was of defective and discontinued items, which might not even be sold in any case in the ordinary course. Thus, I think Second Bank isn’t threatened on this score.

**Question 9 (20 minutes)**

On September 1, 2011, ABC sold $250,000 of inventory to Liquidators, Inc. in exchange for a check in that amount. ABC indorsed the check over to its CEO, Arnold B. Comer, and he deposited the check, along with $50,000 of his own money, into a newly created bank account in his own name. Immediately after those deposits, Comer wrote a $200,000 check on the account to Caesar’s Gaming, a casino company, in payment of Comer’s personal gambling debt. Can Finance Co. recover the funds from the account? Can Finance Co. recover any of the $200,000 payment from Caesar’s?

**ANSWER/COMMENTS:**

The check appears to be an instrument that was received as proceeds of Finance’s collateral, the inventory. Comer is not a buyer in ordinary course from his own company under these circumstances; nor is this transfer of an instrument protected by 9-332 (and it would likely be considered “collusive” anyway).

The money deposited into the account in respect of the deposit of the check is also proceeds (proceeds of proceeds are proceeds, under the statute). Thus, the money in Comer’s account after deposit of the check also remains ABC’s collateral as proceeds. 9-203(f).

Finance remained perfected throughout, because first (a) it remained indefinitely perfected in the instrument because a filed financing statement covers the original collateral, it wasn’t acquired with cash proceeds, and the “same office rule” of 9-315(d)(1) applies (note: yes, you can perfect in an instrument by filing, see 9-312(a), even if possession is preferable); and then (b) it remained indefinitely perfected in the money in the deposit account because that was “identifiable cash proceeds,” see 9-315(d)(2).

Comer’s check to Caesar’s probably cannot be recovered, in light of 9-332, despite the sketchy nature of a quick payment for gambling debts, unless there was “collusion” between Comer and Caesar’s, which we have no indication of. Thus we must simply look to the money left in the account. Pursuant to the lowest intermediate balance rule, Comer is deemed to have spent his $50,000 as part of the payment to Caesar’s, and therefore ABC has a perfected security interest in the $100,000, and assuming there are no competing interests (for instance by the depository bank), should be able to recover these funds.
Question 10 (15 minutes)
On September 15, 2011, an unpaid supplier of ABC obtained a judgment lien on $500,000 worth of inventory (which is currently located in the sheriff’s impound facility). On September 30, 2011, Finance Co’s representative made a check of inventory noting to the bank that ABC was out of trust by $500,000. On October 15, 2011, Finance Co. made an advance to ABC in the amount of $100,000. On November 10, Finance Co. loan made an advance to ABC in the amount of $200,000. To what extent does Finance Co have priority over the supplier?

ANSWER/COMMENTS:
Future advances are covered under the security agreement, as is permitted under the UCC, see 9-204(c). Finance will remain senior pursuant to 9-323(b) as to any advance made less than 45 days after the levy, but will be junior as to advances made more than 45 days after the levy, unless there was a commitment to lend or unless Finance lacked knowledge of the lien.

Under the facts here, the October 15 advance will certainly be protected as within the 45-day safe harbor.

The November 10 advance is outside of the 45-day safe harbor. But is it protected anyway? Finance will argue that it didn’t have knowledge of the lien, and that it was under a commitment to lend pursuant to 9-323(b)(2). The supplier might respond that Finance had notice of the levy (which is where the inventory was), because Finance knew as of the end of September that Finance Co. was out of trust and that the inventory was not on premises. But that doesn’t seem successful under our facts: the statute says that it is knowledge of a levy, and not simply knowledge of missing collateral, that triggers subordination of the future advance. We have no indication of knowledge of the levy.

The supplier might also argue that there could not have been an obligation to lend when ABC was so far out of trust, because the obligation only arose when the amount lent was less than 80% of the inventory. Also, ABC was almost certainly in default when it went this far out of trust—so how could the advance be said to be pursuant to obligation?

The default itself is not a sufficient grounds to hold that there wasn’t an “obligation,” unless Finance had actually declared the default and called the loan and thus ended any further obligations of its own. We don’t really know enough to determine this. That said, if the math supports supplier’s argument about the 80% limit being exceeded, then there really might have been no obligation to lend. This won’t matter if Finance can successfully show it lacked knowledge.

Thus, Finance’s position appears fairly strong because it might have lacked knowledge and it might have been under an obligation to lend, but the outcome will depend on further facts.