Secured Transactions
Sample Final Exam 3
Professor Bradley

Question 1 (50 minutes)

Spatula City, Inc. (SC) is a Delaware corporation. Its principal place of business—a massive retail superstore that sells only spatulas—is in Richmond, Kentucky (which is in Madison County). SC has been having financial problems due to the decline in the use of spatulas over the 80 years or so. SC’s visionary CEO has decided to diversify its business by branching out into the burgeoning ladle and whisk lines of business. To that end, SC has arranged to borrow money from two banks: Calipari Credit Union (CCU) and Stoops National Bank (SNB).

SC’s security agreement with CCU was signed on July 6, 2017. The agreement granted CCU a security interest in “all equipment and inventory, whether currently owned or later acquired,” in order to secure “all obligations, including but not limited to a $100,000 initial loan and all subsequent loans to SC from CCU, including loans of up to $50,000 per month, which will be advanced solely at CCU’s discretion.” CCU also filed a UCC financing statement covering the stated collateral with the Secretary of State of Delaware that same day, July 6. Also on that same day, CCU advanced the $100,000 initial loan to SC. The debtor’s name on the financing statement was simply “Spatula City.”

SC signed a document on July 5 stating: “SNB is hereby authorized to file a financing statement (and any other necessary documents) covering all of SC’s assets.” The debtor’s name on the financing statement was written thus: “Spatula City, Inc.” Immediately, SNB filed a financing statement in the appropriate office(s). Several days later, on July 8, SC’s security agreement with SNB was signed. The agreement granted SNB a security interest in “all the debtor’s assets, whether currently owned or later acquired” in order to secure a 100,000 loan. SNB advanced the $100,000 that same day.

a. When—if ever—did CCU’s security interest attach? When—if ever—did CCU’s security interest become enforceable? (6 minutes)

STUDENT ANSWER

For CCU’s interest to attach, it must be enforceable, according to 9-203(a). To be enforceable according to 9-203(b), value must be given (1-204), the debtor must have rights in the collateral or the power to transfer rights, and either: an authenticated security agreement or the secured creditor must possess the collateral. Attachment occurs when the last of these three requirements is met. For CCU, the security agreement was signed on 7/6/17 and it was a valid security agreement because the description of the collateral was sufficient according to 9-108(a). CCU gave the initial loan of 100K on 7/6/17, so value was given. And lastly, Spatula City had rights in the collateral because it used the loan money to buy inventory. Therefore, attachment occurred on 7/6 and CCU’s interest became enforceable on 7/6.

PROFESSOR COMMENTS

Attachment occurred when the last of 9-203(b) elements—(1) signing security agreement, (2) secured creditor giving value, and (3) debtor having rights in the collateral—occurred. Here, the debtor

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1 As always, these student answers sometimes have mistakes in them but they are designed to show you answers that got all or nearly all of the relevant credit on a given question.
had rights from the start. Security agreement was signed on July 6. Value was given on July 6. Thus attachment occurred on July 6. Enforceability is the same as attachment, 9-203(a).

b. When—if ever—did SNB’s security interest attach? When—if ever—did SNB’s security interest become enforceable? (6 minutes)

STUDENT ANSWER

For SNB’s interest to attach, it must be enforceable, according to 9-203(a). To be enforceable according to 9-203(b), value must be given (1-204), the debtor must have rights in the collateral or the power to transfer rights, and either: an authenticated security agreement or the secured creditor must possess the collateral. Attachment occurs when the last of these three requirements is met. For SNB, value was given on 7/8 when SNB advanced $100K loan to Spatula City. Spatula City had rights in the collateral when it received the funds to purchase inventory. However, the security agreement portion is not met. The security agreement was signed on 7/8, but the description was insufficient, according to 9-108(a). The purpose of the security agreement is to enable interested parties to ID the collateral, and the description of "all the debtor's assets, whether currently owned or later acquired" is too broad. 9-108(c) says that a description of collateral as "all the debtor's assets" does not reasonably identify the collateral. The other way to achieve the third prong is through possession by the secured party of the collateral and that does not happen here either. Therefore, attachment does not occur and the security interest is not enforceable.

PROFESSOR COMMENTS

Attachment occurred when the last of the 9-203(b) elements—(1) signing the security agreement, (2) secured creditor giving value, and (3) debtor having rights in the collateral—occurred. Here, the debtor had rights from the start. Security agreement was signed on July 8, and value was advanced. Thus attachment would have occurred on July 8. Enforceability is the same as attachment, 9-203(a). BUT the security agreement has a description that is “super-generic” in that it attempts to cover “all assets.” This doesn’t “reasonably identify the collateral,” under UCC 9-108(c). For that reason, this security interest never attached and was never enforceable. This is a fairly subtle point, so I gave lots of partial credit here where appropriate.

c. Is it a problem that CCU didn’t have any explicit authorization to file a financing statement, as SNB did? If not, why not? (5 minutes)

STUDENT ANSWER

This is not a problem for CCU because by authenticating a security agreement granting a security interest in the equipment and inventory, CCU is considered to have given authorization to file a financing statement covering that same collateral. 9-509(b).

PROFESSOR COMMENTS

Signing a financing statement is authorization to file a financing statement covering the same collateral. UCC 9-509(b). Nothing wrong here.
d. Leave aside any issues involving fixtures or fixture filings. Is it a problem that CCU filed its financing statement only in Delaware and not in any other states or places? If not, why not? (5 minutes)

STUDENT ANSWER

CCU only filed its financing statement in Delaware, which is where Spatula City, Inc. is incorporated. It seems that CCU is a registered organization that is organized under the law of Delaware, so the company is located in that state, pursuant to 9-307(e) and 9-301(1). As long as the state of Delaware generally requires filing as a condition for obtaining priority (which it almost certainly does), the state of Delaware is the correct place. 9-307(c). If Delaware did not require filing as a condition for obtaining priority, then the secured creditor should file in the District of Columbia. 9-307(c). I would also suggest filing in Kentucky, however, since this is where the principal place of business is. I would rather be safe than sorry, and would rather file in multiple places just in case. Also, the place of filing may change if Spatula City relocates, but because it is incorporated in Delaware, it doesn’t seem to be going anywhere.

PROFESSOR COMMENTS

SC is a registered entity (“Inc.” indicates that, as well as the problem stating it’s a Delaware entity) and is thus considered to be located in the state of organization, Delaware. See UCC 9-307(e); casebook p. 409. Delaware is the proper state for a UCC filing. Nothing wrong here.

e. Is it a problem that SNB filed its financing statement when it did—i.e., before the security agreement was signed and the money advanced? If not, why not? (5 minutes)

STUDENT ANSWER

It is not a problem that SNB filed its financing statement before its security agreement was signed. 9-502(d). Once the filing office actually inputs the financing statement into the system, others will be put on notice of SNB’s security interest. Also, SNB received authorization to file its financing statement in a signed document. 9-509(a)(1). However, attachment must take place before perfection, and because the security agreement was not signed until 7/8, attachment would not occur until then if the other 2 requirements had been satisfied (value given and debtor had rights in the collateral). But as analyzed in part (b), attachment never occurred because the description of the collateral in the security agreement was insufficient.

PROFESSOR COMMENTS

The UCC explicitly says that you can file a financing statement before entering into a security agreement. UCC 9-502(d). Nothing wrong here.

f. Who has priority as between CCU and SNB in SC’s inventory, and why? (11.5 minutes)

STUDENT ANSWER

CCU has priority over SNB. SNB’s interest did not attach due to an invalid description of collateral in the security agreement, therefore perfection also did not occur. 9-308(a). Furthermore, even if attachment had occurred, perfection would not have occurred because the name on the financing statement was seriously misleading, according to standard search logic and IACA and 9-526. The
name on the financing statement is misspelled, and the safe harbor of 9-506(c) would not save this situation. CCU’s attachment occurred (see part a answer) and perfection occurred when the financing statement was properly filed. The name on the financing statement was OK and not seriously misleading. The noise words "Inc." would be ignored, so the financing statement would be OK. Therefore, CCU wins over SNB.

PROFESSOR COMMENTS

CCU would win. The omission of the “Inc.” part of SC’s name doesn’t affect the validity of CCU’s financing statement: The standard search logic is in place and it ignores “ending noise words” like this. See UCC 9-506; casebook p. 307. CCU’s financing statement is valid.

SNB would have won because its financing statement was filed first, on July 5. See 9-322. And I gave partial credit for that answer. However, SNB’s filing was never valid: The name is misspelled in a way that is seriously misleading and will not come up in a standard search. See UCC 9-503 (requiring debtor name as per organic record), 9-506 (name isn’t seriously misleading if standard search logic would find it). Thus SNB was never perfected and never had a properly filed financing statement.

Finally, as noted in a. above, SNB’s security interest never attached because it suffered the problem of being “super-generic,” so that is yet another reason CCU would win.

Here as elsewhere on the exam, I gave partial credit here where appropriate.

g. Assume for this sub-question that CCU’s security interest (as per the security agreement described above) is attached, enforceable, and perfected, all no later than August 1. An unsecured creditor levies on some of PC’s equipment on October 1, 2017, and immediately notifies CCU. CCU nonetheless keeps lending: $50,000 on November 1, 2017, and $50,000 on December 1, 2017. Does CCU have priority over this lien creditor as to any or all of these new obligations? (11.5 minutes)

STUDENT ANSWER

According to 9-323(b), a secured party has priority over a lien creditor regarding future advances if the secured creditor doesn’t have knowledge of the lien. But in this situation, CCU does have knowledge of the lien (since the lien creditor immediately notified CCU of its levy). But even if CCU does have knowledge of the lien, every secured advanced within 45 days of the lien’s creation (which was 10/1) is still given priority to CCU. So the first $50,000 advance by CCU on 11/1 is within this 45 days, so CCU has priority over this advance. Advances made outside the 45 days pursuant to a commitment entered into without knowledge of the lien are also protected. 9-323(b)(2). So even if CCU knew about the levy at the time of advance, but if there was no knowledge of the lien at the time of commitment (which was on July 6 in the security agreement), then the advance is secured. The lien creditor will argue that because CCU knew of the lien and because CCU had discretion to advance funds, that there was no true "commitment" to advance the $50,000 on 12/1. It seems that this is probably the winning argument. Likely CCU will have priority over the first advance, but the lien creditor will probably win on the second advance.

PROFESSOR COMMENTS

This is about future advances, so you apply the test of 9-323(b). (Some thought it was an after-acquired property clause question, and got off track.) Notice was provided on Oct 1, so that is “knowledge,” and starts the 45-day clock running. The Nov. 1 advance is protected because it was less than 45 days later. The Dec. 1 advance is after the 45 days have run. It’s also not an obligatory advance (the problem expressly states that CCU preserved its discretion as to future advances, and while some
people still found it ambiguous, I'm not sure how the clause could be any clearer that it isn’t obligatory. So it fails the test, and the lien creditor wins (has priority) as to the last advance.

The average score on question 1 was high -- 82% (41 points out of 50). Looking in the context of the exam as a whole, I think some people may have spent too much time on it. The student sample answer given above, for instance, was quite long and may have hindered the student from spending appropriate time on the other questions. So my advice is always to keep fairly close to the time indications.
Question 2 (55 minutes)

Add to the facts of the previous question:

All loans with SNB have been paid off, and SC and SNB have amicably parted ways and terminated all of their legal relationships.

CCU remains SC’s primary lender. For this question, please assume that CCU has an enforceable, perfected security interest in SC’s inventory.

Bluegrass Kitchen Supply (BKS) is SC’s primary supplier of whisks, ladles, and spatulas. (SC also has a custom-spatula business that has been doing well of late.) Traditionally, BKS has supplied SC on an unsecured basis, and has received payments roughly every 60 days, per longstanding invoicing and payment practices. But lately, BKS has become nervous. Payments seem to be taking longer to trickle in from SC, and SC’s parking lot isn’t as full as it used to be.

The holiday season is SC’s high point in terms of sales, because ladles, whisks, and spatulas make such great gifts, particularly for children. SC has begun ramping up orders in anticipation. But that makes BKS nervous. BKS wants to control the risk of SC (and/or CCU) leaving BKS unpaid for the large holiday shipments.

BKS thought about requiring SC to make immediate payments for deliveries, or getting CCU to advance funds directly to BKS to fund incoming inventory. But SC’s visionary CEO has already told BKS that won’t work—they can’t spare the cash at this point, although she assures you that they’ll be awash in money by the end of the season. In the meantime, however, she’s open to other ways of protecting you, because, as she put it:

CCU can be sneaky. I’m worried they might pressure my board of directors to fire me and then install a puppet CEO in my place, who will do whatever it takes to help them, regardless of its effect on CS or BKS. For instance, they’ve been known to encourage their debtors to “feed the lien” and then either foreclose on the collateral or encourage a bankruptcy filing. Anyway, I can tell you for sure that CCU will never agree to anything that is good for you or any other creditor.

BKS wants to discuss other options you might have in mind, and what you think might happen in this “feed the lien” scenario. So BKS’ President asks you these questions:

a. What does “feeding the lien” mean, in plain terms? Should we be worried about it? Would a court condone the sort of behavior that the CEO suggests CCU might engage in? (15 minutes)

STUDENT ANSWER

feeding the lien can be described as the practice of advancing more funds to a debtor in hopes that they obtain more valuable collateral, and then the lender can call the loan (upon default), or force the debtor into bankruptcy. The point of this strategy is to increase the value of collateral that the lender can obtain and sell upon default or bankruptcy. This strategy was specifically used in in re M Paolella & Sons. The seller's right of reclamation is subject to the rights of a buyer in the ordinary course of business, or the rights of a good faith purchaser under 2-403.2-702. Thus, an inventory lender is a buyer in the ordinary course of business and can stop reclamation. The Paolella court stated (in regards to feeding the lien) "it seems reasonably clear from the decided cases that a lending institution does not violate a separate duty of good faith by adhering to its agreement with the borrower or by enforcing its legal and contractual rights as a creditor. the duty of good faith imposed upon contracting parties does not compel a lender to surrender rights which it has been hiven by statute or by the terms of the contract." Thus, barring a showing of bad faith, feeding the lien is traditionally allowed. Accordingly, we should certainly be concerned about it. If our case were to proceed to bankruptcy, the creditor need not
behave in good faith, it only needs prior rights to act on. BR 546(c).

There are some equitable remedies available, but it is not safe to bank on them to work. Bankruptcy courts have applied equitable subordination under BR code 510(c). This power allows BR courts to subordinate claims on equitable grounds. To satisfy this, the claimant must have (1) engaged in some type in inequitable conduct; (2) the misconduct must have results in injury to the creditors of the bankrupt or conferred an unfair advantage on the claimant; and (3) equitable subordination of the claim must not be inconsistent with the provision of the BR code.

It should be noted that the hurt seller could claim an unjust enrichment claim against the lender, but this is the least likely outcome to be successful. Really the only way this would work is if the secured creditor initiates or encourages transactions between the debtor and suppliers of goods, and benefits from the goods or services.

If instead of creating a PMSI, BKS perfected in the goods it sells to SC, it could potentially get priority through 9-322(a), which states that a security interest created by a debtor is subordinate to a security interest on the same collateral created by another person if (1) the debtor acquired the collateral subject to the security interest of the other person; (2) the security interest created by the other person was perfected when the debtor acquired the collateral; and (3) there is no period thereafter when the security interest in unperfected.

**PROFESSOR COMMENTS**

Feeding the lien refers to a debtor (often with the explicit or implicit approval or encouragement of the secured creditor) pulling in a lot of collateral (usually inventory) before the secured creditor finally calls a default at an opportune time and swoops in with its position significantly improved from what it might have been. See casebook, p. 587. BKS is extending unsecured credit that will apparently instantly become CCU’s collateral, and it’s the holiday season, and there’s reason to think BKS is in distress. So, yes, for these reasons, this is a serious concern; it’s a classic set-up for feeding the lien. People generally did a good job of describing this.

Would a court condone such behavior? The legal theories that the book offers that might apply are equitable subordination and unjust enrichment. See casebook pp. 588-92.

The CEO says that CCU will install a “puppet” in her place, who will goad the debtor to behave in ways that are good for BKS and no one else. If that happens, BKS might run into trouble for unjust enrichment. But it seems likely that BKS could accomplish its goal without going that far. As the secured creditor did in Paolella, they could let the restocking happen in due course, and then simply monitor the collateral and call the default at an opportune time. The cases in our book suggest that courts generally are willing to let creditors behave in quite sketchy ways as long as they aren’t directly controlling the debtor, either by virtue of an insider relationship or if it otherwise “initiates or encourages the transactions.” See generally Paolella and the Duggan case at the end of Assignment 35 (secured creditor usually in the clear).

If SC is in bankruptcy, there is the possibility of equitable subordination. For this doctrine to help you, you would have to show that CCU met all three of the prongs under s. 510(c) of the Bankruptcy Code. As the casebook notes, the type of conduct this usually catches is fraud, illegality, or breach of fiduciary duties, undercapitalization, or use of the debtor as mere instrumentality or alter ego. If CCU is too involved in the debtor’s affairs the court might even consider it an “insider,” and therefore make this claim much more likely to succeed. But again, as emphasized in the book and in class, usually it’s hard to win these claims against secured creditors.

Whether relief is possible will depend on the degree to which CCU uses the debtor as its puppet. As Paolella demonstrates, CCU’s behavior can be pretty bad before it will be sufficient for BKS to get relief.
I gave a lot of partial credit to those who could explain what feeding the lien was and how it applied to this situation, and to those who identified and discussed the relevant doctrines. There was obviously no one “right answer” here.

b. Why can’t we do what car dealers do, when they sell you a car on credit—i.e., loan you the purchase money to buy the car—and then repossess the car if you don’t pay? If we did that kind of thing—which I don’t know the legal term for—would that make us first in line to repossess the stuff we supply SC with? (10 minutes)

STUDENT ANSWER

What BKS is talking about is a purchase money security interest. What BKS sells is inventory in the hands of SC. Thus, the normal rule of automatic perfection of a PMSI in consumer goods under 9-309 will not work, because the goods are inventory, not consumer goods. 9-324(a) provides for PMSI perfection in goods other than inventory if perfected not later than 20 days after the debtor receives the goods, but again, we are concerned with inventory here.

9-324(b) does provide for protection for an inventory PMSI seller. Under this statute, a perfected PMSI in inventory has priority over a conflicting security interest in the same inventory and also has priority in identifiable cash proceeds of the inventory, if (1) the PMSI is perfected when the debtor receives possession of the inventory; (2) the PMSI party sends an authenticated notification to the holder of the conflicting security interest; (3) the holder of the conflicting security interest receives the notification within 5 years before the debtor receives possession of the inventory; and (4) the notification states that the person sending the notification has or expects to acquire a PMSI in the inventory.

In theory this would give BKS priority over CCU if all of the above terms were complied with. However, it may not be in BKS' best interest because according to the facts, CCU is extremely against giving any creditors a break, especially at CCU's expense. Doing this could provoke CCU to call the loan, cut off funds, or force SC into bankruptcy. This could leave BKS in a worse position than before. There best bet would be to ask for a subordination agreement, although CCU is unlikely to give this to BKS.

If instead of creating a PMSI, BKS perfected in the goods it sells to SC, it could potentially get priority through 9-322(a), which states that a security interest created by a debtor is subordinate to a security interest on the same collateral created by another person if (1) the debtor acquired the collateral subject to the security interest of the other person; (2) the security interest created by the other person was perfected when the debtor acquired the collateral; and (3) there is no period thereafter when the security interest in unperfected.

PROFESSOR COMMENTS

This is a description of a PMSI. You can do this but you will lose to an inventory lender like CCU unless you follow the prescribed steps in 9-324(b). Even if you do that, CCU is likely to call a default or otherwise stop lending to SC. So you might win a battle but you are unlikely to win the war. A lot of people got this.

c. I’ve also heard that if you ship stuff out and it turns out you shipped it to someone who is out of money or declares bankruptcy, you can sometimes get it back. Would that help? (9 minutes)

STUDENT ANSWER
if a buyer receives goods while insolvent, the seller has a right to reclaim them. Any demand of reclamation must be made within 10 days of buyer's receipt of goods. 2-702. The seller's right of reclamation is subject to the rights of a buyer in the ordinary course of business, or the rights of a good faith purchaser under 2-403.2-702. "purchaser" is anyone who takes by purchase, and "purchase" includes taking by "mortgage, pledge, or any other voluntary transaction creating an interest in the property. 1-210(b)(29) and (30). When a creditor acquires a security interest in collateral, the creditor is a purchaser of the collateral and eligible for protection. Additionally, a creditor can purchase through the operation of an after acquired property clause. Thus, an inventory lender is a buyer in the ordinary course of business and can stop reclamation. In Bankruptcy, a seller's demand is only effective if the debtor is actually in bankruptcy, and written demand is made within 45 days of receiving the goods, and not later than 20 days after bankruptcy is filed. BR 546(c).

Thus, this would likely not be a successful strategy against CCU.

PROFESSOR COMMENTS

This is a question about reclamation. Neither in bankruptcy nor out of it are BKS' prospects very good. UCC section 2-702(2) provides a limited right of reclamation against an insolvent buyer, but the reclamation right is subject to the rights of a good-faith purchaser (UCC 2-702(3))…such as a secured creditor like BKS (again see Paolella). Similarly, Bankruptcy Code section 546(c) gives rights to a seller when the buyer enters bankruptcy but those rights are explicitly made subject to holders of security interests. So, unless your “inequity” or “bad faith” argument is extremely strong, again you’re probably out of luck. I gave some partial credit for those who made other reasonable points but didn’t see that this was about reclamation. Again, a lot of folks got this one.

d. What about this great idea: We agree with SC that when we ship them the stuff, it’s not really theirs, it’s still ours, until they have sold it to the end user and paid us for it. Kind of like a consignment shop or an unusual kind of installment contract or something. Would that work?
(10.5 minutes)

STUDENT ANSWER

This will likely not work. Under the UCC, if a transaction is structured as a security interest, but is given another label, it will nevertheless be treated as a security interest. Such a contract is treated as an immediate sale, with the seller retaining a security interest. 2-401(1). "any reservation by the seller of the title in goods shipped or delivered to the buyer is limited in effect to a reservation of a security interest. Id. at (a).

a consignment is an arrangement in which the owner of the goods entrusts the goods to an agent or bailee for sale. the UCC recognizes three types of consignment, and only the first will not be considered a security interest under article 9.

The first consignment, which would not be recognized as a security interest under the UCC, must be (A) a consignment in which the cosignees do business under the name of the cosignor; (B) small consignments under $1,000 in value; (C) consignments by consumersl and (D) any other consignment that does not create a security interest. 9-109(a)(4); 9-102(a)(20). The situation here does not comply with the above requirements, so BKS cannot get a consignment that escapes the treatment of article 9 as a security interest.

Any other type of consignment that does not comply with the above requirements would be treated as a security interest under article 9. 9-109. Specifically, the security interest of a consignor of goods is a PMSI in inventory. 9-103(d). Thus, we are right back where we started, and this strategy will not work.
PROFESSOR COMMENTS

This is a question about whether you can consign the goods or otherwise engage in what courts would consider a “disguised” secured transaction by trying to say that you’re not technically transferring title to SC until they actually sell the inventory and pay you for it. The UCC deals with this in several places. For instance, UCC 9-109(a)(1) makes clear that article 9 applies whatever the form of a security interest and 9-102(a)(20)(D). As far as consignments, this seems unlikely to fall in the one category that would help—that of being a “non-UCC consignment.” Such consignments are with vendors who regularly engage in the consignment business (which SC doesn’t seem to), or when only consumer goods or goods with little value are involved. Those things are probably not applicable here, so there’s not much likelihood of success. It will just be a reservation of a security interest. UCC 9-103(d). This transaction would likely be considered to establish a security interest, and thus CCU would prevail over it. This was a pretty hard part of the question and I gave a lot of partial credit.

e. Sometimes you can use accounts receivable as collateral, right? Would that work here?

STUDENT ANSWER

You can use accounts receivable as collateral. Specifically, accounts are defined in 9-102(a)(29) and specifically include accounts receivable. BKS and SC could agree to execute a security agreement and financing agreement giving BKS a security interest in accounts, but it would be subordinate to CCU to the extent those accounts contained proceeds of inventory collateral. Proceeds are whatever is acquired upon the sale, lease, exchange, or other disposition of collateral. 9-102(a)(64). Proceeds are collateral within this definition, thus the proceeds of proceeds are proceeds. 9-102(a)(12). Even if the security agreement makes no mention of proceeds, a security agreement automatically includes proceeds. 9-315(a)(2); 9-203(f). A security interest continues to encumber proceeds so long as they remain identifiable. 9-315(a)(2). Additionally, proceeds remain perfected as long as (1) a filed financing statement covers the original collateral; (2) the proceeds are collateral in which a security interest could have been perfected by filing in the same office; and (3) the proceeds are not acquired with cash proceeds. 9-315(d)(1). Here, CCU has a security interest in inventory, and to the extent the accounts receivable represent proceeds of the inventory, CCU will automatically be perfected in the accounts, because a security interest in accounts is filed in the same place as the security interest for inventory and equipment. Additionally, the proceeds will receive the priority date of the original filing. 9-322(b)(1). Thus, you will always be primed by CCU, to the extent the accounts represent proceeds from CCU’s collateral.

PROFESSOR COMMENTS

Yes, you can try to get SC to grant you a security interest in the accounts receivable (which generally fall in the UCC category of “accounts”), and you do it by filing a financing statement. However, it won’t mean that you will prevail over CCU. True, CCU does not have a direct interest in SC’s accounts. But the accounts receivable generated from the sale of inventory will likely be proceeds of the inventory that CCU has priority in, and due to the same office rule (this is a “Type 1” change, per the casebook; see also UCC 9-315(d)(1)), CCU will likely retain priority in them. (A number of people remembered that the security interest remained in proceeds but didn’t do the perfection analysis of them.)
Even if you otherwise comply with the provisions to get priority over the inventory financier per section (b) of this problem, your special PMSI priority doesn’t continue in accounts, per 9-324(b) (see also problem 32.9).

The average score on question 2 was 52% (29 points out of 55).
Question 3 (30 minutes)

This question is not intended to incorporate any facts or details from prior questions.

Bluegrass Kitchen Supply’s factory is in Lexington, KY, a lovely town in Fayette County. In order to fund its building of its facility several years ago, BKS took out a large mortgage loan from Mitchell National Bank (MNB). MNB’s mortgage includes the real property, “all improvements thereto, and all fixtures thereon, whether presently existing or coming to exist hereafter.” The mortgage was duly recorded in the Fayette county real property records.

BKS contracted with Cann Construction, which builds custom, high-tech, high-security fences and gates, to help protect its facility. (In the cut-throat kitchen-utensil-manufacturing business, break-ins are frequent, as competitors seek to discover closely held trade secrets.) Cann built a high-tech, heavy-duty fence around the facility by placing the heavy, metal fence into trenches (which stretched several feet underground to prevent intruders from tunneling in), and mounting the large, technology-laden custom fence posts into concrete poured into sizeable pits approximately every ten feet.

Cann completed the work a little over a month ago, but Cann hasn’t been paid yet. It was quite an expensive process, since Cann had to front the cost of both the fence (and related materials) and the labor. Cann thinks that BKS has run into some hard times and is worried that BKS might file bankruptcy or that MNB might take action against BKS, and prejudice Cann’s interests in some way. Cann thinks there might be some improvement or renovation underway (or recently completed) inside the facility but isn’t sure—BKS is very secretive about its facility, as mentioned above. Aside from the information that has been given to you about MNB, no other searches of public records have been conducted.

Cann has come to you for legal counsel. What do you advise? What are the advantages, disadvantages, risks, strategic possibilities, etc., that you see in the different possible approaches here?

STUDENT ANSWER

There are multiple way which Cann could go about approaching the problem of being given a priority interest over the fence which he built on BKS’s land.

1. Cann could have BKS grant a an enforceable S.I. (9-203(a)(b)) in the fixtures which he attached to the land and file a fixture filing covering the fixtures (the high-security fence) in both the Real Estate recording office located in the country which the property is located and in the UCC filing system. It is likely that this fence could be held to be a fixture by the court, and thus qualifying for a fixture filing because it is attached to the property, the fence is adapted to the use of the property (to keep the BKS trade secrets secret), and it is intended by the owner to be a permanently attached to the realty because of the use of the concrete to secure the posts (Cliffs Ridge) This fixture filing made by Cann must include the information listed in 9-502(b)- name of the debtor (Bluegrass Kitchen Supplies), name of the secured party (Cann), indicate the collateral covers fixtures, indicate that it is to be filed in the RE office, and describe the real property and name of record owner. By making this fixture filing according to the states real estate law and UCC 9-502, this would give Cann a perfected interest in money owed to him, and would secure that interest with the fence as collateral. However, this fixture filing would not grant Cann priority over the Construction mortgage filed by MNB's construction mortgage filed in the RE system, which also covers fixtures because the construction mortgage was filed first (9-334(h) and (e)(1)(a). Cann could gain priority of the prior construction mortgage in this situation is by MNB agreeing to subordinate its interest in the fixtures constructed by Cann. OR Cann can argue that the fixtures became fixtures only after completion of the construction and thus Cann's fixture filing in the RE recording office has priority over the construction mortgage under the 9-334(h).
2. It could also be said that Cann has a Mechanic's lien which gained priority from the date of commencement of construction because he contributed to the erection or construction of the building by changing the appearance of use of the building during construction (Skyline Properties) and did not just conduct alterations or repairs after construction (which according to Cann the construction is still occurring but he does not know). In this situation, Can would have priority over all other liens against the property, secured by the entire property, filed after the commencement of construction. However, if the construction mortgage was filed before the commencement, that mortgage would still have priority.

If Cann is wrong and construction had already ended by the time he began to build the fence, he would only be able to file a mechanic's lie in the RE filing office within 90-120 after completion of the work in building the fence. In this situation, he would still not have priority over the construction mortgage filed before the commencement of construction.

PROFESSOR COMMENTS

Cann is currently in big trouble. It is an unsecured creditor behind at least one known lien.

First and foremost, this is plainly a fixture. It passes the Cliff’s Ridge test and the other less formal tests that we discussed in class. As such it will be covered by the existing mortgage that you have been told about.

What to do about it? The two most obvious options are to get a mechanics’ lien or to make a mortgage or fixture filing covering your fences and gates.

Mechanics Lien. See Casebook pp. 546 ff. A mechanics’ lien will be filed in the county real estate recording system. It will cover the entire property. Its priority will date from either the time of filing or the time that construction began; the problem expressly notes that there may be construction going on inside, see Skyline Properties. Probably this is just an alteration or improvement; and even if there is more major construction going on, this work doesn’t seem to “arise” from it. (I gave credit for any good discussion of this part of the problem.) The lien would need to be filed fairly soon, within 90-120 days of the end of construction. Your lien will be junior to any existing mortgages but will otherwise have priority over the fixtures. And you will have the right to remove, vis-à-vis any junior liens or mortgages. Also, you don’t have to have BKS’ consent to file.

Fixture filing. A fixture filing is also a good possibility. It’s made in the real estate recording system. 9-501. It covers only specified fixtures. You will of course need BKS’s consent to give you a security interest and file this. Also, under 9-334(h), a fixture filing will lose to an earlier construction mortgage if there is one. If there’s no construction mortgage, then under 9-334(d), the PMSI fixture filing over this fence would prevail over ordinary mortgages if it had been perfected WITHIN 20 DAYS. But here we are told that it’s been a little over a month, so we’re outside of that window and don’t win. As far as a right to remove, we will only have that if we’re senior, see 9-604(c), which we probably aren’t; or if the debtor has the right to remove vis-à-vis the mortgage holder, which we don’t know.

Mortgage. Some might wonder if these fences are “ordinary building materials” and thus outside the scope of Article 9 altogether. §9-334(b). I don’t think so given the description of them in the problem, although it’s a good question. That’s why I gave plenty of credit for the possibility of a mortgage instead of a fixture filing to secure this interest. The characteristics of the mortgage will largely resemble those of the fixture filing.

Judgment lien. A lot of people said, get a judgment and take collection steps. That is a perfectly legitimate approach, although it’s usually a very slow one and unlikely to really help all that much.

Final note: making a regular UCC filing is also a possibility but not really indicated from the circumstances of the problem. It would get you priority over the unsecureds and the bankruptcy trustee, which is nice. But you still need consent etc., and you don’t beat a lot of the other relevant parties.
The average score on question 3 was 63% (19 points out of 30).
Question 4 (45 minutes)

This question is not intended to incorporate any facts or details from prior questions.

A celebrity chef buys a diamond-encrusted custom spatula from Spatula City with a market value of approximately $90,000, to use at his restaurant when he cooks. Spatula City takes a valid and perfected purchase money security interest in the spatula, securing an obligation of $20,000. The chef had already borrowed money to fund his extravagant lifestyle, so there was an earlier, attached and perfected, non-purchase money security interest on “all spatulas, whether currently owned or hereinafter acquired, and used in the business of [the chef],” in favor of Murray National Bank, securing an obligation of $50,000. The chef has only one unsecured creditor, who is owed, in total, $80,000.

Shortly after the chef purchases the spatula, the unsecured creditor (who is your client) tries to levy on it. The sheriff, writ of execution in hand, heads toward the chef’s home to seize the spatula and prepare to sell it. The expenses with respect to the sheriff’s sale would be $200, and for this problem, you may ignore interest and any other fees (including attorney’s fees) that creditors might try to add to the amounts they are owed.

a. Please assume that all parties at the sale would value the spatula at its market value, and ignore any issues about credit bidding. Please answer the following questions:

• How much would the winning bid be?
• Where would the sales proceeds go?
• Which liens—if any—would be discharged in the sale? (18 minutes)

STUDENT ANSWER

It is important to note that this purchase is not a PMSI in consumer goods, because it is used for the chef at work.

the winning bid would likely not exceed 20,000, because the buyer would take the spatual subject to the senior liens. 9-617(a) the sale discharges from the collateral the lien under which the sale is held and subordinate liens. the proceeds of a sale are applied first to the expense of the sale, and then to payment of subordiante liens in the order of their priority. 9-615(a). the remaining surplus, if any, is given to the debtor. a lien holder is entitled to a jdugment against the debtor for any deficienecy. 9-615(d)(2).

because the two other security interests are senior to the lien, the buyer of the spatula would be stuck with 70,000 of liens attached to it. Although the creditors cannot enforce this debt against the purchaser, if it is not paid, they may repossess the spatual from the purchaser. Effectively forcing the purhcaser to pay off the liens.

the proceeds would be distributed in terms of who is senior between Spatula City and Murray Bank. If the chef only used the proceeds from spatula city to buy the spatula (i.e., it only cost 20,000), then spatula city would be perfected and have prioiuty under 9-324(a). It would be perfected over Murray even though it had a prior security interest in spatulas because of the special PMSI perfection.

However, if some of the funds that Murray advanced were used to purchase the spatula, a different analysis is necessary. In this scenario, Murray would be a PMSI Lender, and Spatula city would be a PMSI seller. In this scenario, 9-324(g)(1) gives the seller's PMSI priority over the cash lenders security interest. Thus, still, Spatula city, as the seller, would have priority over Murray, despite the normal rule of 9-322 that gives priority to the first to file or perfect.

This entire analysis depends on Spatual city having a valid and perfected PMSI, which the facts say it does.
The proceeds would be distributed as follows: 200 for the sale, 19,800 to the lien holder, and zero to the rest. only the client's lien would be discharged, and the rest would have deficiency claims for the amounts they are owed.

This is not realistic however, because spatula and murray will likely bid on this, using their credit to try to make the most of the situation. there is still money to be made for the creditors.

**PROFESSOR COMMENTS**

Note: The spatula is specifically noted as being for use at the chef’s restaurant while he cooks—thus it is not a consumer good. (It is probably “equipment.” UCC 9-102(a)(33).)

1. The spatula should sell for $20,000 at the sale, because the spatula will remain encumbered by both existing security interests, which total $70,000.

2. The first $200 of the sales proceeds go to the sheriff, and the remaining $19,800 to the levying creditor. See generally 9-615. The buyer will have to cut deals with the remaining secured creditors if they want to hold free of the other security interests.

3. Foreclosure sales discharge the lien pursuant to which the sale is being held, and all subordinate liens. UCC 9-617(a). Thus, here, only the lien creditor’s lien will be discharged.

b. **Add this to the facts from a.**: Before the sheriff can actually levy, the chef files for Chapter 7 bankruptcy. It turns out that the chef has no non-exempt assets for the trustee to administer—aside from the spatula. Ignore any fees or expenses related to the bankruptcy, including the trustee’s fees and so on. How much can your client expect to receive in the bankruptcy? (12 minutes)

**STUDENT ANSWER**

the client can potentially get 20,000. The proceeds of the bankruptcy sale will first go to pay secured creditors. Assuming these are the only debts owed, the first money will go to the most senior creditor (spatula city) to pay their debt, the next will go to the next most senior creditor, Murray. They will each get 20,000 and 50,00 respectively. That leaves 20,000 to share pro-rata with other unsecured creditors. assuming no other debts, and no other unsecured creditors, the client can assume it will split the 20,000 pro-rata with itself, which will get it 20,000. this also assumes the spatula is sold for its market value.

**PROFESSOR COMMENTS**

The collateral value exceeds the value of both existing secured claims. Thus, they will both be paid in full and the remainder will be split pro rata among the unsecureds. The first lien is probably that of SC, which is a PMSI and is for $20,000, and that will be paid first. See 9-324(a). Then the second MNB lien will be paid for $50,000, and that will be paid second. There will be $20,000 left over for the unsecureds. As the only unsecured creditor, your client will receive that for his claim.

(Some people got sidetracked by the idea that maybe the spatula wouldn’t receive fair market value in a bankruptcy sale. That’s true to a degree, although unlike foreclosure sales, bankruptcy sales are much more likely to yield FMV. See, e.g., casebook at p. 101-02. Anyway I gave a lot of partial credit if you properly described where the money would go if there were enough of it.)

c. **Add this to the facts from a. and b.**: It turns out that a lawyer who had never taken Secured Transactions was responsible for perfecting SC’s interest in the spatula, and failed to do so. Ignore any fees or expenses related to the bankruptcy, including the trustee’s fees and so on. What will happen next
(in other words, who will likely take legal action to strip SC’s lien off the property, and under what authority)? How much can your client expect to receive in the bankruptcy now? (15 minutes)

STUDENT ANSWER

under 554(a) the bankruptcy trustee is given the rights of a hypothetical lien creditor, and can invalidate any security interests that a lien creditor would win against as of the filing of the bankruptcy case. The proper law is 9-317(a)(2), a lien creditor wins against a secured creditor if the lien creditor attaches before (1) the secured party perfects; or (2) the secured party files a financing statement and complies with one of the 9-203(b) requirements (security agreement, possession, or control). Since SC’s interest is a PMSI, it would have had to have been perfected via a financing statement since the item is not a consumer goods. Thus, because it is unperfected, you can assume that a financing statement was not filed, and thus SC’s claim was not perfected. Thus, the bankruptcy trustee can avoid SC’s interest. Now, the proceeds will go 50,000 to Murray, and 40,000 to the client, assuming that no other creditor’s exist.

Note that I am taking a gamble here and saying that SC's interest goes away instead of just becoming unsecured. I am not super confident about this. If SC only becomes unsecured, then SC and the client will share pro-rata in the funds. in this scenario, the total amount to be distributed is 40,000 and the total debt between the two is 100,000. 40,000/100,000 = .4. .4*20000 = 8,000(SC), and .4*80,000=32,000(Client)

PROFESSOR COMMENTS

What will happen next (in other words, who will likely take legal action to strip SC’s lien off the property, and under what authority)? The trustee will likely strip off the lien under the bankruptcy code’s “strong arm” power, see Bankr Code s. 544. (A number of people answered that MNB would strip it off, or your client. The MNB answer doesn’t make a lot of sense—they are getting paid anyway, so they wouldn’t have a lot of motivation. Your client might be a plausible answer, because they have the motivation and the right to do this under bankruptcy law, although from this course’s materials, the trustee seems clearly to be the “likely” answer here. I gave some partial credit for MNB, and more partial credit for your client.)

How much can your client expect to receive in the bankruptcy now? Now the unsecured claims are $100,000 (the original 80k plus the now-unsecured claim of SC for 20k). There should be $40,000 to pay them. Thus, the unsecured claims will get paid at a rate of 40%. Your client’s claim is for $80,000. So, 40% & 80,000 = $32,000. That’s how much your client can expect to receive in bankruptcy. See, e.g., problems 7.2, 30.3, casebook pp. 117-18. (Incidentally, SC will receive the remaining $8,000.)

The average score on question 4 was 71.7% (32.3 points out of 45). I will note that people who actually seemed to leave sufficient time for the question did quite well on it; several people gave little answer at all, which I suspect was a product not of the question’s difficulty but of insufficient time.