

The George Washington
University Law School

May 26, 2022

Grading Guides for Past Final Examinations In

SECURED TRANSACTIONS

(Course No. 6280)

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This document contains the grading guides for the Secured Transactions examinations that I gave on these dates:

May 4, 2022
April 19, 2021
April 20, 2020

Please see also the grading guides for my past examinations in Secured Transactions & Commercial Paper (Course No. 6281).

Grading Guide for Final Examination In

SECURED TRANSACTIONS

(Course No. 6280-20; 2 credits)

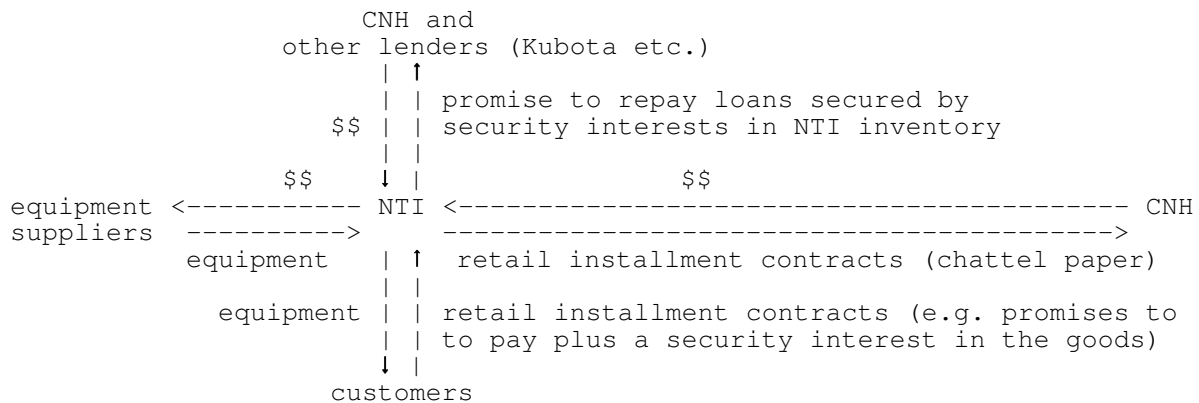
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On the final examination, each problem was worth 20 points and each question within each problem was worth 5 points. I used this guide in awarding points. Answers could receive full points even if they did not address everything in this guide and even if they expressed different conclusions.

Below I have provided various "notes" to help those reviewing this guide to understand the answers provided. I did not expect students to include such notes in their own exam answers.

PROBLEM I.

Note: The diagram below illustrates how I understand the article. CNH and other lenders make loans to NTI so that NTI can buy inventory from equipment suppliers. NTI promises to repay the loans and gives the lenders security interests in this inventory as collateral. NTI sells the goods to customers who sign retail installment contracts promising to pay for them. If these retail installment contracts give NTI a security interest in the goods, the contracts are "chattel paper." See 9-102(a)(110); Textbook at 214-15. NTI then sells at least some of these retail installment contracts to CNH. But NTI sometimes commits fraud either (1) by selling the inventory and not using the proceeds to repay CNH and the other lenders or (2) by selling fake retail installment contracts to CNH.



A. If CNH had a perfected security interest extending to NTI's after-acquired inventory, why would other lenders also agree to finance NTI's inventory purchases?

Even if CNH had a perfected security interest extending to NTI's after-acquired inventory, other lenders might agree to finance NTI's inventory purchases if their security interests would have priority over CNH's security interests. The other lenders' security interests in the after-acquired inventory would have priority if the other lenders complied with the special priority rule for purchase money security interests in inventory in 9-324(b).

Note: A security interest may extend to after-acquired collateral. 9-204(a). The first-to-file-or-perfect rule generally determines the priority of security interests in after-acquired collateral. 9-322(a)(1) & cmt. 5, ex. 4. But the special priority rule for purchase money security interests in 9-324(b) creates an exception to the first-to-file-or-perfect rule.

B. How would CNH's purchase of non-fraudulent retail installment contracts affect CNH's security interests?

CNH's purchase of non-fraudulent retail installment contracts from NTI would have two effects on CNH's security interests. First, assuming that the retail installment contracts give NTI security interests in the goods purchased by NTI's customers, CNH would acquire those security interests by purchasing the retail installment contracts. Second, by purchasing the retail installment contracts, CNH would prevent its security interests in the retail installment contracts (which CNH otherwise could claim only as proceeds) from being subordinated if NTI were to sell the contracts to someone else. 9-102(a)(11) (defining chattel paper); 9-330(a) (special priority rule for buyers of chattel paper); Textbook at 214 (explaining chattel paper transactions).

Note: To understand these effects, follow these five steps: (1) CNH acquires a security interest in the goods when they become part of NTI's inventory. (2) CNH loses the security interest in the goods, under the exception for buyers in the ordinary course, when NTI sells the goods to customers. 9-320(a). (3) NTI acquires a security interest in the goods through their retail installment contracts. (4) CNH at the same time acquires a security interest in the installment contracts as proceeds of the inventory. 9-315(a)(2). (5) When CNH buys the installment contracts, it acquires NTI's security interest in the goods. Textbook at 214.

C. How might NTI's alleged fraudulent actions have affected the rights of the various lenders?

One of the fraudulent actions described in the article is selling inventory secretly and then not using the proceeds to repay the lenders who have a security interest in the proceeds. This fraudulent action is likely a default under the lenders' security agreements. 9-601 cmt. 3 (explaining that the security agreement specifies what is a default). If there is a default, then the lenders would have a right to enforce their security interests by judicial action or self-help. 9-609(b). The lenders also would have an action for breach of contract. 9-601(a).

The other fraudulent action described in the problem is creating fake retail installment sales contracts and then selling them to CNH. This fraudulent action would give CNH the fake installment contracts claims against NTI for breach of contract and fraud. Although CNH might think that it was acquiring rights to payment from the persons whose names were falsely used on the fake installment contract and might think that they were acquiring security interests in goods purportedly bought by these persons, CNH in fact would be acquiring nothing.

D. What steps could the affected lenders have taken to limit or prevent the kinds of fraud alleged?

One step that the lenders could have taken to limit or prevent NTI from secretly selling inventory and not using the proceeds to repay the loans would have been to inspect NTI's premises and accounting records on a regular basis to determine whether any inventory that NTI should have in its possession is in fact in its possession and not missing. Another step that the lenders

could have taken to limit or prevent NTI from creating and selling fake installment contracts would be to contact the named customers before buying the installment contracts to verify that the named customers in fact had made them.

Note: Some answers identified other steps or variations of these steps. The answers received credit so long as they reasonably addressed the kinds of fraud alleged.

PROBLEM II.

A. How could a lender create, perfect, and enforce a security interest in a taxi medallion?

A lender could create a security interest in a medallion by extending credit to the owner of the medallion and entering into an authenticated security agreement that describes the medallion as collateral or taking possession of the medallion. 9-203(b)

Unless a state statute outside the U.C.C. requires perfection by another means, see 9-311, a lender could perfect a security interest in a taxi medallion either by filing a financing statement, 9-310(a), or by taking possession of the medallion, 9-313(a).

If a debtor defaulted in repaying the loan to the lender, the lender could enforce the security interest either by suing the debtor for breach of the loan and security agreements, 9-601(a), or by taking possession of the medallion and disposing of it in a commercially reasonable manner, 9-609(a) (1), (b) (2); 9-610(a).

Notes: In Chicago, lenders do in fact perfect security interest in taxi medallions by filing financing statements. Creating or perfecting a security interest in a taxicab medallion by taking possession would not make much sense because the owner of the medallion needs to display the medallion to operate a taxi.

B. If multiple lenders had security interests in or judgment liens on SG's taxicab medallions, how would their priority be determined?

If no state statute outside the U.C.C. provides otherwise, the first lender either to file or to perfect a security interest in the medallion would have priority over the security interests of other lenders. 9-322(a) (1). But a lender would not have priority over a lien creditor merely by filing first. Such a lender would only have priority over a lien creditor if the lender's security interest actually was perfected at the time that the lien creditor acquired the lien, 9-317(a) (2) (A), or the lender and debtor had formed an authenticated security agreement and the lender had filed a financing statement, 9-317(a) (2) (B).

C. How might the parties have addressed the possible volatility of the price of medallions in their security agreements?

The parties could have directly addressed the volatility in their security agreements by requiring the debtor to pay a specified percentage of the outstanding debt whenever the debt (or a percentage of the debt) exceeds the value of the medallion. The security agreement could then specify that failing to make such a payment is a default. See 9-601 cmt. 3 (explaining that the security agreement specifies what is a default).

Note: For an example of this approach, see the following clauses in the sample security agreement in the textbook at 647-684: 9.1.1 (not paying is a default); 2.1.3 (requiring immediate payments if the debt exceeds

the "borrowing base"); 1.7 (defining the "borrowing base" as percentages of the value of the debtor's account and inventory).

The security agreement could reduce the volatility of the collateral securing their loans by giving lenders a security interest in both taxi medallions and also in less volatile collateral. The security agreement also could reduce the risk of volatility by reducing the period of the loan. For example, the security agreement could require repayment or refinancing every six months on the theory that the price likely will not change much during such a short period.

Note: Good answers discussed some or all of these examples or discussed other examples of ways of addressing the volatility.

D. If a secured party takes possession of a taxi medallion and sells it, what circumstances might prevent the secured party from recovering a deficiency from the sale?

Ordinarily, a secured party is entitled to recover any deficiency from the debtor. 9-615(d)(2). But in class we discussed several situations in which the secured party could not recover a deficiency. First, the secured party could not recover a deficiency if the debtor did not have enough money to pay the deficiency. That possibility seems highly likely here because the medallions have fallen in value and because operating a taxi appears to have become less profitable given the competition from Uber and Lyft. Second, the secured party could not recover the deficiency if the secured party and debtor had agreed to strict foreclosure. 9-620(a). Third, if the sale was not commercially reasonable, the secured party could recover only what the deficiency would be if the sale had been commercially reasonable. 9-626(a)(3)(B). Fourth, if the sale was commercially reasonable, but the secured party (or a related person) purchased the medallion, the secured party could recover only what the deficiency would be if the sale had not been to the secured party or a related party. 9-615(f).

Note: These are only some possibilities. Some answers properly identified others.

PROBLEM III.

Note: Here is how I understand the article: (1) First Security Bank and Legacy National Bank both made loans to Lauren James Enterprises Inc. and both took security interests in Lauren James Enterprises Inc.'s accounts and inventory. (2) Legacy National Bank believes that its security interest had priority over First Security Bank's security interests. (3) Lauren James Enterprises Inc. apparently defaulted on its obligations to Legacy National Bank because the article says that Legacy National Bank sold Lauren James Enterprises Inc.'s inventory to LJ Apparel in a "foreclosure sale." (4) First Security Bank contends that the foreclosure was a sham.

A. How would a court determine whether Legacy National Bank or First Security Bank had priority in Lauren James Enterprises Inc.'s inventory and accounts?

If Legacy National Bank and First Security Bank both had security interests in the inventory and accounts, the first-to-file-or-perfect rule generally would determine which secured party had priority. 9-322(a). But the special priority rule for purchase money security interests would apply if the requirements of 9-324 are met.

B. If Legacy National Bank properly disposed of Lauren James Enterprises Inc.'s inventory and accounts after a default, would all of First Security Bank's rights be extinguished?

If Legacy National Bank had priority, and the sale produced no surplus, then First Security Bank's security interests would be extinguished. The buyer would take the collateral free of First Security Bank's security interest because a secured party's sale of collateral after a default discharges the secured party's security interest and all subordinate security interests. 9-617(a)(2) & (3). The sale, however, would not have extinguished Lauren James Enterprises Inc.'s debt to First Security Bank.

If Legacy National Bank had priority, and the sale produced a surplus, Legacy National Bank would have a duty to return the surplus to the debtor, Lauren James Enterprises Inc. 9-615(d)(1). First Security Bank then would have acquired a security interest in the surplus as proceeds. 9-315(a)(2).

If First Security Bank had priority, Legacy National Bank's sale of the collateral would not have discharged First Security Bank's security interest in the collateral or the proceeds. 9-617(a)(3).

C. How would the parties' rights be different if the disposition of the collateral was a sham as alleged?

If LJ Apparel did not act in good faith, then Legacy National Bank's sham sale of the inventory and accounts to LJ Apparel would not discharge First Security Bank's security interest. 9-617(c)(3).

D. Could First Security Bank have used a letter of credit to provide further security against the fraud alleged?

Yes. For additional security, First Security Bank might have asked Lauren James Enterprises Inc. to obtain a standby letter of credit. The letter of credit would name First Security Bank as the beneficiary. It might require the issuer to pay First Security Bank upon presentation of an affidavit or statement from First Security Bank saying that Lauren James Enterprises is in default in its obligation. With such a letter of credit, First Security Bank would be protected even if its security interests were discharged or subordinated.

Note: Whether any bank would be willing to issue a letter of credit would depend on the financial condition and creditworthiness of Lauren James Enterprises Inc.

PROBLEM IV.

Note: Here is my understanding of the article. The buyer of a house typically needs to borrow money from a bank to pay the seller. As discussed in class, in a typical home mortgage transaction, the bank usually lends the buyer an amount less than the total price of the house (e.g., 90%) and takes a mortgage in the house as security for the loan. The buyer must supply the rest of the price (e.g., 10%); this portion of the purchase price is called a down payment. (The same is true for auto loans, etc. See, e.g., Prob. 3, p. 312.) But the article says that Milo is willing to lend a home buyer 100% of the price of the house if the buyer will give Milo both a mortgage on the house and a security interest in some amount of cryptocurrency. The buyer thus does not need to make a down payment. In addition, the borrower still owns the cryptocurrency; the buyer therefore does not have to sell it and pay capital gains taxes.

A. How might a lender create and perfect a security interest in cryptocurrency?

Cryptocurrency meets the definition of a "general intangible." 9-102(a)(42). A lender could create a security interest in cryptocurrency by lending money to a debtor and entering into a security interest with the

debtor describing the cryptocurrency as the collateral. 9-203(b). Unless a statute outside the UCC provides otherwise, see 9-311(a), the only way to perfect a security interest in a general intangible like cryptocurrency would appear to be filing a financing statement, see 9-310(a).

Note: A secured party could not perfect a security interest in cryptocurrency by possession. Section 9-313(a) authorizes perfection by possession for "negotiable documents, goods, instruments, money, or tangible chattel paper." Cryptocurrency would meet the definition of "money" only if it is adopted by a government as a medium of exchange. 1-201(b)(24). But taking "possession" of an intangible asset is not possible. See 9-313 cmt. 1 (noting that possession is not defined in the UCC). A secured party also could not perfect by taking control. Section 9-314(a) authorizes perfection by control only for "investment property, deposit accounts, letter-of-credit rights, or electronic chattel paper." Cryptocurrency does not meet the definition of any of these terms. It is not an "investment property" because it is not a "security." 9-102(a)(49); 8-102(a)(15).

B. Would you recommend that a security agreement creating a security interest in cryptocurrency require the debtor to disclose the private key to the secured party?

The secured party should insist that the debtor disclose the private key because otherwise the secured party could not use self-help to dispose of the collateral upon a default. To be sure, the debtor might be worried that the secured party would misuse the private key without authorization to sell the cryptocurrency or use it in payment. But debtors must have the same concern any time that they allow a secured party to perfect a security interest in collateral by possession or control. If they want a loan using cryptocurrency as collateral, they need to take this risk.

C. What risks does a lender face in relying on cryptocurrency as collateral and how might Milo be mitigating these risks?

A secured party faces the risk that the debtor might sell or use the cryptocurrency without authorization. Although the secured party's security interest might continue to exist in the cryptocurrency, 9-315(a)(1), the secured party might have no practical way to track down the cryptocurrency after it has been transferred or to enforce the security interest if the private key changes. In addition, the secured party faces the risk that the value of cryptocurrency might drop significantly.

Milo appears to be mitigating these risk by taking a security interest not only in the debtor's cryptocurrency but also in the debtor's home through a home mortgage. A debtor would have little incentive to make an unauthorized transfer of cryptocurrency because that would constitute a default and might justify the seller in foreclosing on the debtor's home.

D. How might the possibility that a secured party has a security interest in cryptocurrency affect the willingness of merchants to take cryptocurrency in payment?

The possibility that a secured party has a security interest in cryptocurrency might make merchants reluctant to take cryptocurrency in payment. Subject to some exceptions, a security interest remains attached to collateral when the collateral is transferred. 9-315(a)(1). Accordingly, if someone pays with cryptocurrency, the cryptocurrency might come with a security interest attached, greatly lessening its value.

In theory, before taking cryptocurrency in payment from a customer, merchants could check whether a secured party has filed a financing statement

in the customer's name that covers the cryptocurrency. But checking financing statements before any sale would be burdensome because it would take time and require human intervention. The merchant would also need to know the debtor's name and location, which seems unrealistic for many internet transactions involving cryptocurrency.

Note: Some answers suggested that merchants might take the cryptocurrency free of the security interest under the special rule for the buyers in the ordinary course in 9-320(a). But 1-201(b)(9) defines "buyer in the ordinary course" to refer only to a "a person that buys goods." The merchants would be selling goods, not buying them, so 9-320(a) would not apply to them.

Grading Guide for Final Examination In

SECURED TRANSACTIONS

(Course No. 6280-20; 2 credits)

Professorial Lecturer Gregory E. Maggs

I used this grading guide in evaluating students' answers to the final examination. Because I did not expect all students to see everything the same way, answers could receive full or partial credit even if they did not address all of the points discussed in the grading guide and even if they expressed conclusions that were different from mine. Each problem was worth 20 points and each question within each problem was worth 5 points.

PROBLEM I.

- A. How could American use money that it expects to earn from selling frequent flier miles to "back" a \$2.5 billion loan from a lender? (Explain the legal requirements and propose specific language for a possible agreement.)**

American and the lender could enter into a security agreement that secures "all existing indebtedness and future advances" with a security interest in "all accounts, now owned or hereafter acquired, arising from the sale of frequent flier miles." See 9-102(a)(2) (defining accounts); 9-108(b)(3) (allowing the description of collateral to use a type of collateral defined in the UCC, such as an "account"); 9-204(a) (providing that a security agreement may create a security interest that attaches to after-acquired property). The security interest should cover both existing debts and future advances because the lender might not advance the entire \$2.5 billion at once. The security agreement also should cover after-acquired accounts because American may not currently have enough outstanding accounts to cover the entire loan. (If existing accounts were worth \$2.5 billion, American would not have to borrow the money; it could just sell the accounts.)

Notes: (1) The security agreement does not need to mention the proceeds from the accounts because the security interest automatically extends to proceeds. 9-315(a)(2). (2) Some answers suggested that American could give the lender a security interest in the frequent flier miles themselves. But that is not possible because frequent flier miles are not something that American Airlines owns like airplanes and other equipment. Instead, the frequent flier miles are commitments that American makes to those to whom the miles are sold. (3) Some answers also suggested that the security agreement should give the lender a security interest in all of American's assets, such as its airplanes. But that possibility is not raised by the problem (and American and its other lenders might not agree to such a provision).

- B. How could a lender guard against the possibility that American might undermine the lender's security by obtaining other loans that are purportedly backed by the same money?**

To protect itself against the possibility that American already has given other creditors security interests in accounts arising from the sale of frequent flier miles, the lender first should check the UCC filing system in the state of American's corporate registration. Creditors who already have filed will have priority under the first-to-file or perfect rule. 9-322(a)(1).

To protect itself against the possibility that American in the future might give security interests to other creditors, the lender should perfect its security interest in American's accounts by filing a financing statement indicating that it has a security interest in American's accounts. 9-504(1). Perfection will preserve the lender's priority over other creditors.

In addition, to avoid disputes about priority, the lender might also include a "negative pledge clause" in the security agreement barring American from encumbering the accounts and their proceeds with additional security interests. See Textbook, p. 166.

C. What steps might a lender take to ensure that American will use money earned from selling frequent flier miles to repay the loan and to obtain a remedy if American improperly diverts the money to other uses?

First, the lender should insist that the security agreement require American to deposit all proceeds of the accounts directly into a separate deposit account over which the lender has control. Although the lender's security interest automatically attaches to the proceeds and automatically has priority for 20 days, cash proceeds lose their priority after 20 days unless they are identifiable or perfected by some other means. 3-315(d)(2) & (3). Depositing the proceeds in a separate deposit account will make them identifiable. Giving the lender control over the deposit account will provide another means of perfection and will make it easy for the lender to seize the money upon a default in repaying the loan.

Second, the lender should insist that the security agreement forbid American from using the proceeds of the accounts (or at least some percentage of the proceeds) for any purpose other than repaying the loan.

Third, the lender should insist that the security agreement require American to transfer the proceeds of the accounts (or at least some percentage of the proceeds) to the lender within specific deadlines.

Fourth, the lender should insist that the security agreement contain an acceleration clause making the entire debt owed due upon an uncured default of the loan agreement or security agreement. That way, upon default, the lender can recover all of the proceeds currently in American's possession.

Note: If American violates these provisions of the security agreement, the default will allow the lender to collect not only the proceeds of the accounts from American but also the amount of the accounts directly from the account debtors. 9-607(a).

D. Suppose a lender is concerned that hard times may continue, causing American to declare bankruptcy and go out of business. What legal and practical advice would you give the lender?

Legal advice: If the lender has perfected its security interest in American's accounts by filing, the lender will have a secured claim in bankruptcy. The Strong Arm Clause of the Bankruptcy Code, 11 U.S.C. § 544(a), does not enable the bankruptcy trustee to defeat perfected security interests.

Practical advice: Accounts arising from the sale of frequent flier miles are a poor form of security if the lender is worried about American going bankrupt. If American goes out of business, American cannot sell any additional frequent flier miles and banks and retailers are unlikely to honor their promises to pay for frequent flier miles they have already agreed to purchase because frequent flier miles will be worthless if American planes are not flying. As a result, the accounts (unlike other possible collateral, such as airplanes or other equipment), may not be worth anything when the lender needs to resort to them. The lender therefore might want to seek additional

forms of collateral to reduce this risk or might want to insist on a higher interest rate to compensate for this risk.

PROBLEM II.

A. What claims might Duncan assert against Ford?

Section 9-625(b) authorizes Duncan to assert claims against Ford for failing to comply with UCC article 9's provisions. Duncan appears to have at least four such claims.

First, Duncan might claim that Ford violated 9-609(a) because Ford did not have a right to repossess the property when she was not in default. She will assert that she was not in default because she and Ford made arrangements regarding the overdue balance.

Second, Duncan might claim that, even if she was in default, Ford violated 9-609(b) (2) by breaching the peace when repossessing the car without judicial process. She will assert that Ford breached the peace by threatening to call the police. A creditor's involvement of law enforcement in the collection of debt without a judicial order constitutes a breach of the peace. See 9-609(b) (2) cmt. 3, ¶4.

Third, Duncan might claim that Ford violated 9-207(a) because Ford did not exercise reasonable care in caring for the collateral. As evidence, she will assert that Ford caused \$3000 of damage to her car.

Fourth, Duncan might claim that Ford violated 9-620(e) by failing to dispose of the collateral in a reasonable manner. She will assert that Ford simply left the vehicle in a lot and lost track of it.

In addition to these claims under UCC article 9, Duncan also might sue Ford for breach of contract. She might claim that Ford violated its implied obligation of good faith by giving her the runaround and insisting that she waive her claims before releasing the vehicle. See 1-203 (imposing an obligation of good faith).

Duncan also might sue Ford for the tort of conversion, as in Williams v. Ford Motor Credit, and possibly other torts. She might claim that Ford wrongfully repossessed the vehicle, wrongfully insisted that she sign a release before returning the vehicle, and wrongfully delayed in returning it after she finished paying for it.

B. If Duncan can show that her rights were violated, can she recover the types of damages that she seeks?

Yes. If Duncan has valid claims against Ford, she can recover damages under 9-625(b) for "any loss caused by a failure to comply" with article 9. This would include the \$3,000 claims for damage to the vehicle, the \$4,000 for vehicle rental costs, and the nearly \$2,000 for the personal property inside the vehicle that was not returned. She will claim that Ford caused all of these losses by wrongfully repossessing the vehicle and by failing to care for the vehicle properly. She will contend that these losses were reasonably foreseeable and easily avoidable.

C. Could Duncan recover other kinds of damages (including punitive damages) under any circumstances?

The problem identifies actual damages that Duncan is claiming. This question therefore asks whether she could recover non-actual damages, such as statutory damages or punitive damages.

Statutory damages: Sections 9-625(e) and (f) establish statutory damages for violations of various sections for which it would be difficult to provide actual damages. Under the facts provided in the article, Duncan does not appear to qualify for these statutory damages. But circumstances might exist in which she could recover statutory damages. For example, Duncan could recover statutory damages if she could show that Ford routinely and improperly failed to explain the deficiency she owed. 9-625(e)(5), 9-616(b)(1).

Punitive damages: Article 9 does not provide for punitive damages. But Duncan might be able to recover punitive damages under state tort law if she has a valid state tort claim for conversion (see above).

Note: Article 9, unlike Article 5, does not provide for the recovery of attorney's fees.

D. What advice could you have given both Ford and Duncan for avoiding the unfortunate situation described here?

Advice to Ford: Ford could have avoided or reduced its liability in several ways, including: (1) by not violating the provisions of article 9 listed above; (2) by using judicial process instead of self-help to repossess the vehicle, see Cla-Mil v. Medallion Funding; and (3) by settling Duncan's claims.

Ford might have avoided violating the provisions of article 9 if it adopted better business practices. The facts indicate several failings. For example, Ford did not communicate with its collection agents, Ford had no clear process for responding to Duncan's reasonable requests, and Ford appears to have lost track of the vehicle.

Although using self-help to repossess vehicles in theory might be less expensive and faster than using judicial process, Ford and its collection agents were unable to follow the rules in using self-help. Ford might do better with judicial process even though it is more expensive and slower.

Once it appeared that Ford had violated article 9 provisions, Ford could have attempted to reduce its liability by settling in two different ways. If Ford wanted to keep the car, it might have proposed strict foreclosure with a release. If Ford did not want to keep the car, it might have suggested a release together with some kind of consideration (such as cash or a reduction of debt). A release of all claims is not enforceable if Ford induces a debtor to sign it by threatening to violate Article 9 provisions if the debtor does not agree. But a release might be enforceable if Ford, for example, offered consideration such as reduction of the debt owed.

Advice to Duncan: First, when Duncan made arrangements with a Ford representative to pay off her overdue balance, she should have asked for written evidence of the agreement. If she had shown such evidence to the repossession agent, the repossession agent might not have taken the car. Second, she should have adamantly refused to allow the repossession agent to take the car because she was not in default. Although the repossession agent was insistent, in many jurisdictions, merely saying "no" is enough to stop a repossession. See Note (1), p. 283. Third, Duncan might have sought legal help and initiated a lawsuit earlier and saved herself considerable effort. Fourth, Duncan should have contacted the press earlier. A newspaper article like the one quoted in the problem might have (and should have) embarrassed Ford sufficiently to cause Ford to correct its mistakes.

PROBLEM III.

A. What additional facts must be ascertained in order to resolve the dispute regarding the removed equipment?

Additional facts are necessary to determine whether there really was a default. If 3CDC in fact breached the contract by failing to use their best effort to obtain the neighboring parcel, then Panino might be excused from paying the rent, and would not be in default. If Panino is not in default, then 3CDC cannot obtain possession of the removed equipment.

Additional facts are necessary to determine whether NL's parents and 3CDC have security interests in the removed equipment. Specifically, it is unclear whether each of them entered into an authenticated security agreement with Panino describing the removed equipment as collateral. Perhaps NL's parents never actually made a security agreement with Panino because the transaction only involved family members. Perhaps a security agreement between 3CDC and Panino does not extend to after-acquired equipment. If only one of the parties has a security interest in the removed equipment, then that party will prevail in the dispute.

On the other hand, if NL's parents and 3CDC each have a security interest in the removed equipment, then additional facts are necessary to determine which of their security interests has priority. NL's parents will have priority if they have a purchase money security interest in the removed equipment and they perfected their security interest within 20 days after Panino acquired the equipment. 9-324(a). We thus need to know when Panino acquired the equipment, the extent to which Panino used the money from NL's parents to buy the equipment, and whether (and if so when) NL's parents filed a financing statement. 3CDC will have priority if 3CDC perfected its security interest and NL's parents did not perfect their purchase money security interest before 20 days after Panino acquired the collateral. We thus also need to know whether (and if so when) 3CDC perfected its security interest. The party with priority will prevail in the dispute.

B. Might strict foreclosure of the kitchen fixtures that were left behind be advantageous to the parties?

Strict foreclosure is a voluntary settlement in which the debtor surrenders the collateral in full or partial satisfaction of the outstanding debt. 9-620(a). (Partial satisfaction is permissible here because Panino is not a consumer. 9-620(g).)

The parties will only agree to strict foreclosure if the settlement is advantageous to each of them. Panino may think that strict foreclosure would be advantageous if it is likely to reduce the size of the deficiency for which Panino would otherwise be liable. For example, suppose that the parties agree that the fixtures are worth \$40,000, but Panino thinks that 3CDC would realize less than that if it repossessed and sold the fixtures. And 3CDC might agree to such an arrangement because a debtor who agrees to strict foreclosure cannot object to what the secured party does with the collateral. For example, 3CDC might not want to dispose of the fixtures but instead might want to leave the fixtures in place and lease them to the next tenant.

C. Did 3CDC need to "file any paperwork to claim any collateral from Panino" before the restaurant was vacated?

The parties could form a security agreement without filing any paperwork with the government or anyone else. A security agreement is simply a contract that provides for a security interest. 9-102(a) (74).

In addition, 3CDC would not need to file any paperwork to enforce a security interest. A secured party may enforce a security interest upon the debtor's default, regardless of whether the security interest is perfected and regardless of whether the secured party's security interest has first priority. See 9-609. To be sure, filing a financing statement may perfect the security interest and thereby establish priority, but filing is not

necessary for enforcement. The security interest's priority or lack of priority will merely determine how the proceeds of the collateral are distributed.

3CDC, however, would have to provide notification to Panino before disposition of the collateral. 9-611. In addition, 3CDC would need to file court papers if 3CDC wanted the assistance of a marshal or sheriff in taking possession of the collateral. Otherwise, a secured party can take possession of collateral without judicial process if the secured party can do so without a breach of peace. 9-609(b)(2). Judicial process might have been necessary in this case if 3CDC did not have a right to enter the restaurant.

D. Might 3CDC be in a better position if the parties had used a letter of credit to ensure payment of the rent?

3CDC might be better off if the parties had used a letter of credit because then 3CDC would be relying on a bank for payment instead of on an insolvent restaurant. In addition, 3CDC would only need to make the documentary presentation required by the letter of credit to obtain payment from a bank. 5-108(a). The documentary presentation could be as simple as an affidavit saying that Panino was in default. 3CDC then would not have to worry about finding, repossessing, and disposing of the collateral. 3CDC also would not have to worry about suing for a deficiency. In addition, because of the independence principle, the bank issuing the letter of credit would have to pay even if Panino asserted a claim or defense against 3CDC. 5-103(d).

That said, a letter of credit might not be a realistic option. A restaurant like Panino might have difficulty finding a bank that would issue a letter of credit in this situation. The bank might worry, justifiably, about being able to obtain reimbursement from Panino after paying the letter of credit, see 5-108(i)(1), if Panino could not even pay its rent.

PROBLEM IV.

A. If Easterday had not declared bankruptcy, how could the bank have responded to Easterday's alleged sale of collateral securing loans without the bank's authorization?

Easterday's sale of the collateral without authorization would almost certainly be a default under the security agreement. Accordingly, the bank would have a claim against Easterday for breach of contract. 9-601(a). The bank also could take possession of any remaining collateral and dispose of it in a commercially reasonable manner, using the proceeds to satisfy Easterday's indebtedness. 9-609; 9-610.

The bank would not lose its security interest in the collateral unless the buyer bought the collateral in the ordinary course. 9-315(a)(1) (continuation of security interest); 9-320(a) (buyer in ordinary course). Easterday appears to be in the business of selling cattle. But unauthorized sales would not have been in the ordinary course if the buyer knew the sales were unauthorized. 1-201(b)(9).

B. How if at all might the bankruptcy proceeding affect Tyson and the bank's claims against Easterday?

The bank will have a secured claim in bankruptcy, to the extent of the value of the collateral, if the bank perfected its security interest. A perfected security interest will have priority over the rights of the bankruptcy trustee. 11 U.S.C. § 544(a).

The bank, however, appears to be alleging that some of the collateral was sold. Accordingly, some part of its claim might be unsecured. To the

extent the claim is unsecured, the bank will recover in bankruptcy on a pro rata basis with the other unsecured creditors. Tyson is likely to be at least partially unsecured because the facts say that some of the collateral is missing.

C. If Easterday and Tyson had signed a security agreement providing Tyson with a security interest in the cattle that Tyson paid to feed, how if it all would that agreement benefit Tyson here?

A security interest can only attach to collateral in which the debtor has an interest. 9-203(b). A security agreement between Easterday and Tyson, therefore, could not provide Tyson with a security interest in non-existent cattle.

But Tyson could have a breach of contract claim against Easterday for breach of the security agreement. 9-601(1). Of course, if Easterday is insolvent, a judgment for damages on such a claim will not be very valuable.

D. What steps might Tyson and the bank have taken to prevent the types of fraud alleged here?

Tyson and the bank should have inspected Easterday's business regularly to ensure that the collateral existed and was in Easterday's possession. Otherwise, they could not count on the collateral as security.

In addition, they should have required Easterday to disclose more about its finances and business model before making initial loans and subsequent advances. Even if a lender has collateral, it should not lend money to a borrower whose operations run at a loss or who is likely to default.

Grading Guide for Take-Home Final Examination In

SECURED TRANSACTIONS

(Course No. 6280-20; 2 credits)

Professorial Lecturer Gregory E. Maggs

PROBLEM I.

(30 points)

A. Why might a lien filing by the IRS have triggered a default on MedCare's Loans with Veritex Community Bank?

The terms of a security agreement specify the circumstances giving rise to a default. See 9-601 cmt. 3; Text, p. 262. Accordingly, a lien filing by the IRS might have triggered a default because Medicare and Veritex agreed in their security agreement that a default occurs when a tax lien arises. Such agreements are common. See, e.g., clauses 7.6 and 9.1.2 of the sample security agreement on pp. 673 & 677.

B. Why might a lien filing by the IRS make additional financing impossible to obtain?

As a practical matter, most lenders would be reluctant to make new loans to Medicare after a lien filing by the IRS because the lien filing suggests that Medicare is having trouble paying its existing debts.

As a legal matter, lenders making new advances could not rely on a security interest to assure repayment after a tax lien filing unless the security interest was a purchase money security interest. A federal tax lien would attach to all of Medicare's existing property and after-acquired property. 26 U.S.C. 6321. The tax lien would have priority except with respect to security interests in existing property that were already perfected and purchase money security interests in after-acquired property. *Id.* 6323(a), (h).

C. Why might entering bankruptcy help Medicare avoid a default with Veritex Community Bank and help Medicare obtain additional financing?

Avoiding a default: When a debtor files for bankruptcy, an automatic stay prevents the attachment of new liens, including a tax lien. Accordingly, if the security agreement between Veritex Community Bank and Medicare provides that the attachment of a lien is a default (see part A above), filing for bankruptcy might prevent a default. (But note: If the security agreement also provides that filing a bankruptcy petition is a default, then filing for bankruptcy would not help. See, e.g., clause 9.1.4 of the sample security agreement on p. 677.)

Obtaining additional financing: In the absence of a tax lien, lenders who already have perfected security interests covering future advances could continue to lend money, and retain their priority, even in bankruptcy. Although the bankruptcy trustee is given the status of a lien creditor, 11 U.S.C. § 544(a)1), a security interest would be "subordinate" only if the security interest is not perfected, 9-317(a)(2)(A), and the collateral is not covered by a security agreement and a filed financing statement, 9-317(a)(2)(B).

D. Under what circumstances would Medicare's bankruptcy filing have the

least effect on Veritex Community Bank?

The bankruptcy filing would not affect Veritex if (a) Veritex has a perfected security interest in all of Medcare's existing and after acquired property; (b) the security interest secures existing indebtedness and future advances; and (c) Veritex has priority under the first-to-file or perfect rule. In such circumstances, Veritex can "clean out [MedCare's] bankruptcy estate without a penny for either unsecured creditors or junior secured creditors." Textbook, p. 146.

PROBLEM II.

(30 points)

A. Does VW Credit have a security interest in motorcycles for which customers have (1) paid the full price and taken delivery; (2) paid the full price but not yet taken delivery; and (3) merely paid a deposit?

(1) No, VW Credit does not have a security interest on motorcycles for which customers have paid the full price and taken delivery. Such customers are buyers in the ordinary course of business. 9-201(b)(9). A buyer in the ordinary course of business takes free of any security interest. 9-320(a).

(2) Yes, VW Credit does have a security interest in motorcycles for which customers have paid the full price but not yet taken delivery. Such customers are not buyers in the ordinary course of business because they have not taken possession of the goods. 9-201(b)(9) ("Only a buyer that takes possession of the goods . . . may be a buyer in ordinary course of business."). Because the exception for buyers in the ordinary course does not apply, the general rule that a security interest continues notwithstanding sale of the collateral preserves VW Credit's security interest. 9-315(a)(1).

(3) Yes, VW Credit does have a security interest. For the reasons stated above, if the customers have just paid a deposit, and not taken possession of the motorcycles, the customers are not buyers in the ordinary course of business. 9-201(b)(9). The security interest continues under 9-315(a)(1).

B. If customers made written contracts in which they promised to pay H.C. for the motorcycles and granted H.C. a security interest in the motorcycles, to what extent should VW Credit rely on these contracts as collateral?

VW should rely on these contracts as collateral only to the extent that H.C. does not sell the contracts. The written contracts and security interests are chattel paper. 9-102(a)(11). VW Credit would have a security interest in this chattel paper because the chattel paper are proceeds of the motorcycles in which VW Credit has a security interest. 9-315(a)(2). But if H.C. sold the chattel paper to another lender, such as a bank, the bank would have priority. 9-330(a).

C. How should VW Credit have perfected its security interests?

VW Credit should have perfected its security interests by filing. 9-310(a). Although making a notation on the certificate of title is ordinarily the only way to perfect a security interest in a vehicle (such as a motorcycle) that is covered by a certificate of title, 9-311(a)(2), this rule does not apply to vehicles while they are in inventory, 9-311(d). Security interest in such vehicles are perfected by filing. 9-310(a).

D. Is there any way that H.C. might grant a lender a security interest in motorcycles merely brought in for repair?

Yes. H.C. is a merchant who deals in motorcycles. The customers who bring motorcycles in for repair entrust their motorcycles to H.C. If a person entrusts goods to a merchant who deals in goods of the kind, the merchant can transfer a property interest in such goods, including a security interest, to someone who acquires the property interest in good faith and for value. 2-403(2). See Problem, p. 52.

PROBLEM III.

(30 points)

A. What will determine which lender has priority in the tractor?

The first-to-file-or-perfect rule will determine who has priority in the tractor. 9-322(a)(1). In most states, the only way to perfect a security interest in a tractor is to make a notation on a certificate of title. 9-311(a)(2). Accordingly, the lender who makes the notation first will have priority. Note: The exception to the first-to-file-or-perfect rule for purchase money security interests in 9-324(a) will not apply to money advanced by AgHeritage Farm Credit Services because the money was not in fact used to purchase the tractor.

B. Why might lenders be willing to lend money for what they think is new equipment without checking whether another lender has already entered a security agreement granting a security interest in it?

A lender who lends money to buy new equipment may take a purchase money security interest in the equipment. 9-103(b). In such a case, even if another lender already has a perfected security interest in all of the debtor's existing and after-acquired collateral, the purchase money security interest will have priority provided that the requirements in 9-324(a) are met. Accordingly, the lender may see no need to check whether another lender already has entered a security agreement covering the new equipment.

C. Do lenders need to know the correct serial number of equipment to obtain or perfect a security interest in it?

Obtaining a security interest in the equipment: No. Lenders merely have to "describe" the collateral in the security agreement to obtain a security interest in it. A description is sufficient if it "reasonably identifies" the collateral. 9-108(a). The drafters of U.C.C. art. 9 specifically rejected a "serial number test." 9-108 cmt. 2 ¶2.

Perfecting a security interest in the equipment: If the equipment is covered by a certificate of title, and the lender is perfecting a security interest by making a notation on the certificate of title, the lender needs to match the serial number on the certificate of title to the serial number of the equipment. Otherwise, the lender risks making a notation on the wrong certificate of title, which would have no effect. But if the lender is perfecting a security interest in the equipment by filing a financing statement, the lender does not need to know the serial number. Filing statements merely have to "indicate" the collateral. 9-502(a)(3). A filing statement can indicate the collateral by describing it specifically, 9-504(1), or with a supergeneric description (such as "all personal property"), 9-504(2).

D. What steps might the lenders have taken to prevent the fraud described in the article?

To prevent the fraud, the lenders should have determined that the equipment actually existed and that no one else had a perfected security interest in it. To determine that equipment actually existed, they should

have asked to see the equipment. To determine whether someone had a perfected security interest in equipment (like tractors) covered by a certificate of title, they should have asked to see the certificate of title. For other kinds of collateral, they should have checked that no one else had possession of the equipment or had filed a financing statement covering the equipment.

PROBLEM IV.

(30 points)

A. Why might BB&T have decided to enter the forbearance agreement instead of immediately enforcing its rights?

In exchange for the promise to forbear, BB&T received additional collateral. BB&T also may have thought that the defendants would be able to pay off more of their debt if they stayed in business.

B. If BB&T provided funds only to F. Toyota, how could BB&T acquire a security interest in C.F.'s personal property?

Section 9-203(b) establishes the requirements for attachment of security interests. One requirement, under 9-203(b)(1), is that "value has been given." The value does not have to have been given to the debtor who supplies the collateral. Indeed, that is why Article 9 distinguishes the "obligor" from the "debtor." Under 9-102(a)(59), an obligor is the person who owes payment (F. Toyota). Under 9-102(a)(28), a debtor is a person having rights in the collateral (C.F.).

C. Did BB&T have to prove that its security interest was perfected and had first priority before enforcing it?

No. Perfection and priority are not required for enforcement. 9-601(1). Perfection is necessary only for establishing priority and protecting a security interest in bankruptcy. Priority determines how collateral is divided among secured parties if it does not suffice to pay all of them in full.

D. How might the rights of the parties be different if the BB&T representatives had ignored the threats and taken possession of the property themselves?

The BB&T representatives only had a right to take possession of the property if they could do so without breach of the peace. 9-609(b)(2) & cmt. 3. Courts disagree about what constitutes a breach of the peace, but what happened here appears to be a breach of the peace given the threats. If they took possession in breach of the peace, they could be liable for actual and statutory damages under 9-625(b)-(e). They might also be liable in tort. Williams v. Ford Motor Credit.