

### Question 3 – February 2013 – Selected Answer 1

1. The issue is which secured creditor has the superior interest in various items of collateral. Bank has a security interest in the savings account, and currently owned and after acquired inventory and equipment because (1) the debtor authenticated a security agreement adequately describing the collateral, (2) the debtor had rights in the collateral, and (3) the Bank gave value (the loans). A security agreement can provide for a security interest in after acquired collateral, and it will attach when the debtor acquires the collateral. LoanCo has a security interest in the savings account, and currently owned or after acquired inventory and equipment because (1) the debtor authenticated a security agreement describing the collateral, (2) the debtor had rights in the collateral, and (3) LoanCo gave value (the loan). All of the security agreements involved here adequately describe the collateral because descriptions by class ("all inventory") is a sufficient description.

a. Savings Account - Bank has the superior interest.

Bank has a security interest in the savings account for the reasons stated above. Bank's security interest was perfected (making it good against third parties) because the Bank has control over the account since it is the Bank where the account is located. LoanCo also has a security interest in the savings account, and it was perfected by filing a financing statement which was authorized by the debtor by virtue of Wally signing the security agreement. Between two secured parties, the general rule is the first to file or perfect has priority. Here, Bank never filed a financing statement, but it is perfected by control. A bank with control over a deposit account like a savings account has priority over all other security interests. Thus, Bank has the superior interest.

b. Inventory - LoanCo has the superior interest in inventory. Both Bank and LoanCo have security interests in current and after acquired inventory, for the reasons stated above. Bank never perfected its security interest because its filed financing statement only covered equipment, and it did not take possession of the inventory. LoanCo perfected its security interest by filing a financing statement describing inventory as the collateral. Between an unperfected and a perfected secured creditor, the perfected creditor prevails. Thus, LoanCo has the superior interest in inventory.

c. Widget-making machine - Bank has the superior interest. Both Bank and LoanCo have security interests in current and after acquired equipment, for the reasons stated above. The machine is equipment because it is a durable good used in a business that is not sold or leased and is not quickly consumed. Both Bank and LoanCo's security interest attached at the same time under their after-acquired property clauses, when Wally acquired rights in the machine on October 19. Since perfection cannot occur until attachment has occurred (which cannot occur until the debtor has rights in the collateral), perfection will also occur on the date of attachment if the security interest was previously perfected by filing a financing statement. However, the priority date will relate back to the date the creditors filed a financing statement under the first to perfect or file rule. Bank filed a financing statement covering equipment on Sept. 4, 2011. LoanCo filed a financing statement describing equipment as the collateral on October 30, 2011. Both attached and perfected on October 19. Between two perfected secured creditors, the first to file or perfect prevails, but here they both perfected on the same date. Since Bank was the first to file a financing statement, the Bank has priority.

2. No. The issue is whether a maker of a note has any liability to a subsequent holder who may qualify as a holder in due course when he has personal defenses against the payee. A maker's obligation is to pay the note according to its terms when it was issued. This liability arises from the maker's signature and

promise to pay, and runs to anyone entitled to enforce the note. A holder is a person entitled to enforce. A person becomes a holder by having the note negotiated to him. Order paper is negotiated by transfer of possession of the note plus the holder/payee's indorsement. Since George, the payee, indorsed the note and transferred it to Bank, Bank became a holder and was entitled to enforce the note. Thus, upon presentment to the Maker, Wally, Wally must pay Bank unless it has any defenses against payment. However, if the Bank qualifies as a holder in due course, Wally can only assert real defenses, but not any personal defenses it may have against George. A holder in due course is a holder (Bank is a holder for the reasons stated above) of a negotiable instrument (the facts say it was) who takes the instrument in good faith (honesty in fact and observance of reasonable commercial standards of fair dealing - the bank's good faith is not questioned here) for value (settlement of a preexisting disputed claim is considered value), and the instrument does not bear visible evidence of forgery or alteration or otherwise is so incomplete as to call into question its authenticity. The holder must take without notice that the note was altered or contained an unauthorized signature, was overdue, or of any claims or defenses against enforcement. Bank meets all of these requirements, thus it is a HDC. HDC status is determined at the time of negotiation; no subsequent events can defeat HDC status. Thus, the fact that George told the Bank of Wally's defense against payment a week after the transfer has no effect on Bank's HDC status. Wally must pay Bank \$1000 according to the note unless it has a real defense against George. Wally's defense of failure of consideration (the desk was not worth as much as George said) is a personal defense and cannot be asserted against Bank. Wally's possible defense of duress or coercion is insufficient to qualify as a real defense - to be a real defense, the duress or coercion must be so serious as to make the transaction void, not merely voidable. A misrepresentation about the value of the desk is not sufficient to make the note void. Thus, Wally must pay Bank the entire \$1,000 and cannot deduct anything because Bank is a HDC who takes free of Wally's personal defenses.

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### **Question 3 – February 2013 – Selected Answer 2**

1.) Between Bank and LoanCo - Who has the superior interest in:

a.) The Savings Account - As between Bank and LoanCo, Bank has the superior interest in the savings account. At issue is whether control over the savings account automatically perfects Bank's security interest absent a financing statement. In Texas, to perfect a security interest, a creditor must normally file a financing statement. One of the exceptions is where the creditor maintains possession or control over the collateral. Where the collateral is in a bank account held by the bank with the security interest, the interest is automatically perfected. Thus, even though Bank did not file a financing statement, its interest in the savings account of Wally's Widgets was automatically perfected on August 15th, 2011. LoanCo's interest in the savings account was filed and perfected on October 30th, 2011. First to file or perfect has the superior interest, and since Bank perfected more than two months before LoanCo, Bank has the superior interest in the Savings Account.

b.) Inventory held by Wally Widgets - As between Bank and LoanCo, LoanCo has the superior interest in the inventory held by Wally's Widgets. At issue is whether Bank or LoanCo perfected first. In Texas, to perfect a security interest, a creditor must normally file a financing statement. There are a number of exceptions, but none of them are applicable to the inventory. Bank had a security interest in Wally's inventory as of August 15th, 2011. Bank never perfected its interest. LoanCo obtained an interest in the inventory on October 15th, 2011. It filed a financing statement and perfected its interest on October 30th. LoanCo was first to perfect, and indeed the only one to perfect its interest. A secured creditor with a perfected security interest has a senior interest in the collateral over a creditor who has an

unperfected security interest. Since LoanCo was perfected and Bank was not, LoanCo has the superior interest in the inventory.

c.) The Widget-Making Machine - As between Bank and LoanCo, LoanCo may have a superior interest in the widget making machine. At issue is whether the machine is categorized as "equipment," and whether LoanCo's loan will be treated as a purchase money security interest. In Texas, to perfect a security interest, a creditor must normally file a financing statement. There are a number of exceptions, but none of them are applicable to the widget making machine. The widget making machine is classified as equipment for Wally's Widgets since it is an item that Wally's uses in the ordinary course of business. His business being widgets, a widget making machine clearly fits within the definition of equipment. Wally granted Bank a security interest in all of his equipment then owned or after acquired. Bank took this interest on September 3rd and perfected its interest on September 4th. Bank thus had a perfected security interest in the widget making machine when it was acquired on October 19th. Wally also granted LoanCo an interest in all of his equipment then owned or after acquired on October 15th. LoanCo did not perfect its interest until 11 days after Wally purchased the machine. Where money is given directly for the purchase of particular collateral, it is considered a purchase money security interest (PMSI). If a creditor obtains a PMSI in after-acquired inventory or equipment, they have 20 days from the date of delivery of the collateral in which their interest is automatically perfected. If they fail to perfect within that 20 day window, their interest becomes unperfected. If LoanCo's loan is treated as a PMSI, they will have a superior interest in the collateral, even if Bank perfected its interest first, since a perfected PMSI will have priority over a perfected non-PMSI security interest. If LoanCo's loan is treated as a normal loan, Bank will prevail since Bank perfected first.

2.) Bank v. Wally on the \$1000 Note. If Bank sues Wally to collect on the \$1000 note, Wally does not have any defense on which he will likely prevail. At issue is whether Bank is a Holder in Due Course, and whether George's conduct was sufficient to constitute duress. To qualify as a holder in due course (HDC), Bank must 1) have a negotiable instrument, 2) be a holder, 3) with authenticity of the note not apparently questioned, take 4) for value, 5) in good faith, and 6) notice of any defenses. The instrument is negotiable (stated in the facts), and Bank was a holder (since George indorsed the note), the authenticity of the note is not questioned, and Bank took in good faith. The question is whether Bank paid value and took without notice. Reduced consideration of a past debt is sufficient value to satisfy the holder in due course requirement. And taking without notice only requires that the holder not have notice at the time they obtain the note. Here, the Bank took the \$1000 note in satisfaction of a \$1500 debt, which is sufficient as value paid. Bank also did not have any knowledge of any defenses when it took the note, since George's call to Bank did not take place until a week after George had given them the note. Bank thus meets the requirements to be a Holder in Due Course of the note from Wally. Where a holder is a holder in due course, they are not subject to personal defenses such as failure of consideration or other contracts defenses, but are subject only to the so-called Real Defenses such as fraud-in-the-factum, forgery, authenticity, adjudicated incapacity, infancy, etc... The Real Defense that might apply in this case and that Wally will doubtless assert is duress. Duress requires such force applied to the maker/drawer that the will of the person originally receiving the note is substituted for the will of the maker/drawer. Courts have found many levels of coercion, manipulation and even threats to fall short of the level of force required to successfully assert duress. Such a "gun-to-the-head" level of force is not present in this case. George merely "demanded" that Wally pay George \$1000 for the destroyed desk. This is nowhere near sufficient to constitute duress. Since duress does not apply, and no other real defenses are implicated, Wally does not have any defense on which he can rely, since his other defenses (failure of consideration or unconscionability due to the disparity in value between the desk and the note) are not applicable against a Holder in Due Course.

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### Question 3 – February 2013- Selected Answer 3

#### A. Savings Account

The question of who has a superior interest in the savings accounts turns upon the parties respective rights under Article 9 of the UCC. The only two parties with a potential interest in the savings accounts are Bank and Loan Co. The first question is whether or not the secured parties interests in the savings accounts attached. For a security interest to attach, there must be a security agreement, the secured party must give value, and the debtor must have rights in the collateral. Both Bank and Loan Co had signed security agreements and both gave value. Furthermore, the facts do not indicate that Wally's rights in the collateral were deficient. AS such, both parties' security interests have attached. The next question is whether or not the parties' security interests were perfected. Typically perfection occurs by filing a financing statement. However, deposit accounts are not perfected by the filing of a financing statement. Rather, they are perfected in one of 3 ways: 1. the secured party and the debtor entered into an agreement with the depository bank that the depository bank will follow the directions of the secured creditor; 2. the secured creditor becomes the owner of the deposit account, or 3. the funds are maintained at the secured creditor's bank. Here, the facts indicate that the savings account is maintained at Bank. Furthermore, there is no indication that either of the other two requirements are met for Loan Co. AS such, Bank is the only party with a perfected security interest. As such, Bank has priority over Loan Co. Even if Loan Co had perfected by agreement, the UCC makes clear that being the owner of the account or being the bank at which the debtor maintains the account, has priority.

#### B. Inventory

As with the savings accounts, this question turns on whether Bank or Loan Co have a superior security interest in the inventory. Inventory is defined under Article 9 as things which are sold as part of a business and any works in progress. These come under the category of goods for purposes of Article 9. The first question is attachment. As with the savings accounts, there is no indication that the parties interests did not attach. As such, the question is whether or not the parties are perfected. To perfect in inventory, a secured party must either file a financing statement or have possession. The facts do not make clear whether or not Wally has possession, but it is likely that he does given that it is inventory of his business. Here, Bank did not ever file a financing statement covering the inventory. Therefore, at this time Bank is an unperfected secured creditor. Loan Co., however, did file a financing statement on October 30. AS such, its interest was perfected both as to the currently owned inventory, and the after acquired inventory (this is permissible under Article 9. As such, Loan Co has a superior interest in the inventory. Importantly, a purchase money security interest in consumer goods perfects automatically. However, that does not appear to be the case here. Furthermore, while a purchase money security interest in goods typically has 20 days after receipt of the goods to perfect to retain priority, this does not apply to inventory. Rather, for inventory the secured creditor must file a financing statement prior to the debtor's receipt of the inventory, and must notify the other potential creditors of their interest. This does not appear to be implicated by the facts.

#### C. Widget Making Machine

The Widget Making Machine qualifies as equipment under Article 9. Essentially, anything used in a business that does not qualify as inventory is considered equipment. Here, both Bank and Loan Co have security interests in the widget making machine. Their security agreements provided that they had a security interest in all equipment owned or after acquired. In addition, both parties appear to be perfected. Equipment is perfected by either filing or possession. Bank filed a financing statement

describing the equipment on September 4, 2011. Loan Co thereafter filed a financing statement on October 30, 2011 covering the equipment. Because both parties are perfected, the default rule of first in time first in right would typically cover their respective interest. Here, because Bank was perfected first, they would have the superior interest. However, because Loan Co. loaned Wally the money to purchase the equipment. Loan Co. likely qualifies as an enabling purchase money security interest. As such, Loan Co. gets super-priority as long as they are perfected within 20 days of the acquisition of the goods. Here, Loan Co. perfected 11 days after Wally received the Machine. AS such, Loan Co has first priority with respect to the Machine.

2. This question turns upon whether or not Bank qualifies as a holder in due course. When a party does not qualify as a holder in due course they are subject to personal defenses like inadequacy of consideration, etc. However, a holder in due course is not subject to these defenses. A holder in due course is only subject to real defenses. Real defenses include defects in the formation process (illegality, incapacity, fraud, etc.), as well as fraud in the factum (the party did not know they were signing a promissory note). To qualify as a holder in due course, the instrument in question must be a negotiable instrument. The requirements for a negotiable instrument are: 1. writing, 2. signed by the maker, 3. promise or order to pay, 4. unconditional, 5. fixed amount, 6. of money, 7. no unauthorized promises, 8. on demand or at a definite time, 9. payable to order or bearer. Here, the question makes clear that the promissory note met all of these requirements. In addition, to establish status as a holder in due course, the party must be a holder, who gave value, in good faith, without notice of a defense. To be a holder, the party must be in possession or bearer paper, or order paper specifically indorsed in their favor. The facts make clear that the note was issues to George and George subsequently indorsed it. While the facts do not make clear whether George's indorsement was a specific endorsement or not, it is likely that the note was indorsed in favor of Bank. Even if it were note, Bank would have a right to require George to indorse the note in its favor because it gave value. Second, Bank must have given value. The UCC makes clear that taking a note in exchange for an antecedent debt qualifies as value. Furthermore, given that the Bank took a \$1,000 promissory note in exchange for the \$1,500 antecedent debt, there is likely no argument that the value given was insufficient. Next, Bank must have taken the note in good faith. This means that the Bank must have taken the note with a "white heart" (subjective test) and in observance of reasonable commercial standards (objective test). There is nothing in the facts to indicate that Bank did not meet this test. Finally, Bank must have taken the note without notice of any defenses. Importantly, holder in due course status is determined at the time the party gave value. As such, the subsequent notice from George to the Bank's President that there may have been a defense will not invalidate Bank's holder in due course status. Furthermore, there are no other facts indicating that Bank was on notice of any defense. As such, Bank qualifies as a holder in due course. Because Bank qualifies as a holder in due course, the defense that the desk was only worth have as much will not be good against the Bank, as that is a personal defense. Duress, however, could be a defense, as it could invalidate the formation. However, the facts only indicate that George "felt coerced." This is not sufficient to meet the test for duress. As such, Bank's status as holder in due course likely protects it, and Wally must pay Bank the full amount of the Note.