Secured Transactions
Washington and Lee University Law School
Tricia A. Hoefling
Spring 2014

Syllabus

Office Hours are Wednesdays from 11:30-1 and by appointment.

Page references are to RUSCH & SEPINUCK, PROBLEMS AND MATERIALS ON SECURED TRANSACTIONS (2D ED. 2010). The assignment includes problems within the designated pages, unless specifically indicated. Please carefully read the sections of the Uniform Commercial Code and the Bankruptcy Code referenced in the assignment.

Week 1: Introduction to Secured Transactions

Pages 1-7, 14-25, and 30-42 (omitting all Problems in these pages). Pay close attention to pages 30-42.

Bankruptcy Overview

Attachment- Introduction and Security Agreements

Pages 43-63 (omitting Problems 2-2, 2-3, and 2-4 Part A).

In addition: Problem 2-21, Part D, page 101

Attachment—Composite Document Doctrine and After-Acquired Property

Pages 63-74.

Week 2: Attachment—Proceeds

Pages 74-81 (omitting Problem 2-9 Parts B and C).

Attachment—Additional Collateral Description Issues, and Value

Pages 81-92 (omitting Problem 2-12 Parts A and B; and Problem 2-14).

Attachment—Rights in Collateral and Automatic Attachment

Pages 92-98; 102-105 (omitting Problems 2-15 and 2-17).

Week 3: Scope of Article 9

Pages 105-124.
Effect of Bankruptcy on Attachment

Pages 124-131.

Perfection—Overview and Parties’ Names

Pages 217-228.


Problem 4-3, p. 229, Parts A-E.

**Week 4:** Perfection—Additional Content of Financing Statements

Pages 228-234.

Problem 4-3, Parts F & G.

Perfection-- Transmitting Utilities


Pages 234-247.

Omit Part B of Problem 4-5.

**Week 5:** Perfection by Possession or Control, and Automatic Perfection

Pages 247-262.

Merely read Problems 4-12 and 4-16.

Perfection: Gathering Information about Your Clients' Collateral (Perfection Certificates and UCC Searches)

**Week 6:** Perfection: Choice of Law Issues

Pages 263-267

Perfection: Post-Closing Changes

Pages 268-301 (omit Problem 4-28)

Review of Attachment and Perfection

Priority—Basic Rules, and Secured Party v. Lien Creditor
Pages 303-322
Omit Problem 5-4 and 5-12

**Week 7:** Priority—Secured Party v. Lien Creditor Continued; Secured Party v. Secured Party

Pages 323-349.
Omit Problem 5-20.

**Week 8:** Priority—Secured Party v. Sellers and Buyers

Pages 350-377.
Omit Part B, page 353.
Omit Parts B and C of Problem 5-47, and Problem 5-49.

**Week 9:** Priority—Secured Party v. Purchasers of Collateral Other than Goods

Pages 379-390.
Omit Problem 5-54.

Fixtures

Pages 395-405.

**Week 10:** Federal Tax Liens

Pages 442-451.
Omit Part D of Problem 6-14.

Bankruptcy

Reread pages 30-33 and 38-39. Pages 451-460

**Week 11:** Bankruptcy, continued.

Pages 462-468.

Enforcement
Pages 133-155.
Week 12: Enforcement, continued.

Pages 142-180

Omit Part B of Problem 3-10.

Week 13: Enforcement

Pages 184-192, including Problem 3-21 and pages 206-214.

Review.

If time permits, we may cover Marshaling and Securitization, based on the materials below. Regardless, you should read the materials, especially the Schwarcz article on securitization.

(I) Enforcement—Marshaling

Pages 203-205.


(II) Securitization

Major’s Furniture Mart, Inc. v. Castle Credit Corp., 602 F.2d 538 (3d Cir. 1979), attachment page 1.

This appeal requires us to answer the question: “When is a sale not a sale, but rather a secured loan?” The district court held that despite the form of their Agreement, which purported to be, and hence was characterized as, a sale of accounts receivable, the parties’ transactions did not constitute sales. No facts are in dispute, and the issue presented on this appeal is purely a legal issue involving the interpretation of relevant sections of the Uniform Commercial Code as enacted in Pennsylvania, §§ 1-101 et seq. and their proper application to the undisputed facts presented here.

The district court granted plaintiff Major’s motion for summary judgment. Castle Credit Corporation appeals from that order. We affirm.

I

Major’s is engaged in the retail sale of furniture. Castle is in the business of financing furniture dealers such as Major’s. Count I of Major’s amended complaint alleged that Major’s and Castle had entered into an Agreement dated June 18, 1973 for the financing of Major’s accounts receivable; that a large number of transactions pursuant to the Agreement took place between June 1973 and May 1975; that in March and October 1975 Castle declared Major’s in default under the Agreement; and that from and after June 1973 Castle was in possession of monies which constituted a surplus over the accounts receivable transferred under the Agreement. Among other relief sought, Major’s asked for an accounting of the surplus and all sums received by Castle since June 1, 1976 which had been collected from the Major’s accounts receivable transferred under the Agreement.

The provisions of the June 18, 1973 Agreement which are relevant to our discussion provide: that Major’s shall from time to time “sell” accounts receivable to Castle, and that all accounts so “sold” shall be with full recourse against Major’s. Major’s was required to warrant that each account receivable was based upon a written order or contract fully performed by Major’s. Castle in its sole discretion could refuse to “purchase” any account. The amount paid by Castle to Major’s on any particular account was the unpaid face amount of the account exclusive of interest less a fifteen percent “discount” and less another ten percent of the unpaid face amount as a reserve against bad debts.

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3 The parties do not dispute that their rights are governed by the law of Pennsylvania. The Pennsylvania Uniform Commercial Code, and in particular § 9-105, classifies the accounts receivable which are the subject of the agreement as “chattel paper.”

4 According to Major’s brief, the “face amount” of its customers’ installment payment agreements included (1) the retail cost of the furniture purchased (amount financed), (2) the total amount of interest
Under the Agreement the reserve was to be held by Castle without interest and was to indemnify Castle against a customer's failure to pay the full amount of the account (which included interest and insurance premiums), as well as any other charges or losses sustained by Castle for any reason.

In addition, Major's was required to "repurchase" any account "sold" to Castle which was in default for more than 60 days. In such case Major's was obligated to pay to Castle an amount equal to the balance due by the customer on said Account plus any other expenses incurred by CASTLE as a result of such default or breach of warranty, less a rebate of interest on the account under the "Rule of the 78's". **7

Thus essentially, Major's was obligated to repurchase a defaulted account not for the discounted amount paid to it by Castle, but for a "repurchase" price based on the balance due by the customer, plus any costs incurred by Castle upon default.

As an example, applying the Agreement to a typical case, Major's in its brief on appeal summarized an account transaction of one of its customers (William Jones) as follows:

A customer [Jones] of Major's (later designated Account No. 15,915) purchased furniture from Major's worth $1700.00 (or more).* He executed an installment payment agreement with Major's in the total face amount of $2549.88, including interest and insurance costs. ** ** Using this piece of chattel paper, ** ** Major's engaged in a financing transaction with Castle under the Agreement. ** ** Major's delivered the Jones' chattel paper with a $2549.88 face amount of [sic; to?] Castle together with an assignment of rights. Shortly thereafter, Castle delivered to Major's payable by the customer over the life of the customer's installment payment agreement, and (3) insurance charges.

** The 15% "discount" was subsequently increased unilaterally by Castle to 18% and thereafter was adjusted monthly to reflect changes in the prime rate.

** It becomes apparent from a review of the record that the amount which Castle actually paid to Major's on each account transferred was the unpaid face amount exclusive of interest and exclusive of insurance premiums less 28% (18% “discount” and 10% reserve).

In its brief on appeal, Castle sets out the following summary of the transactions that took place over the relevant period. It appears that the face amount of the accounts which were “sold” by Major's to Castle was $439,832.08, to which finance charges totaling $116,350.46 and insurance charges totalling $42,304.03 were added, bringing the total amount “purchased” by Castle to $598,486.57. For these “purchases” Castle paid Major's $316,107. Exclusive of any surplus as determined by the district court Castle has retained $528,176.13 which it has received as a result of customer collections and repurchases by Major's. Collection costs were found by the district court to be $1,627.81.

** The Rule of 78 is “the predominant method used to determine refunds of unearned finance charges upon prepayment of consumer debts.” Hunt, James H., *The Rule of 78: Hidden Penalty for Prepayment in Consumer Credit Transactions*, 55 B.U.L.Rev. 331, 332 (1975). That article points out that the Rule of 78 allocates a disproportionately large portion of finance charges to the early months of a credit transaction which produces a hidden penalty for prepayment, although the extent of the penalty diminishes as the term of the debt nears expiration.

** **
cash in the amount of $1224.00. The difference between this cash amount and the full face of the chattel paper in the amount of $2549.88, consisted of the following costs and deductions by Castle:

1. $180.00 discount credited to a “reserve” account of Major’s.
2. $300.06 “discount” (actually a prepaid interest charge).
3. $30.85 for life insurance premium.
4. $77.77 for accident and health insurance premium.
5. $152.99 for property insurance premium.
6. $588.27 interest charged to Jones on the $1700 face of the note.

Thus, as to the Jones’ account, Castle received and proceeded to collect a piece of chattel paper with a collectible face value of $2549.88. Major’s received $1224.00 in cash.

* Some transactions involved cash downpayment to Major’s, but this is not at issue in the law suit.

As we understand the Agreement, if Jones in the above example defaulted without having made any payments on account, the very least Major’s would have been obliged to pay on repurchase would be $1,700 even though Major’s had received only $1,224 in cash on transfer of the account and had been credited with a reserve of $180. The repurchase price was either charged fully to reserve or, as provided in the Agreement, 50% to reserve and 50% by cash payment from Major’s. In the event of bankruptcy, default under the agreement or discontinuation of business, Major’s was required to repurchase all outstanding accounts immediately. Finally, the Agreement provided that the law of Pennsylvania would govern and that the Agreement could not be modified except in writing signed by all the parties. (Apparently, no objection has ever been made to Castle’s unilateral modification of the discount rate. That issue is not before us.)

Under the Agreement, over 600 accounts were transferred to Castle by Major’s of which 73 became delinquent and subject to repurchase by Major’s. On March 21, 1975, Castle notified Major’s that Major’s was in default in failing to repurchase delinquent accounts. Apparently to remedy the default, Major’s deposited an additional $10,000 into the reserve. After June 30, 1975, Major’s discontinued transferring accounts to Castle. On October 7, 1975 Castle again declared Major’s in default.

Major’s action against Castle alleged that the transaction by which Major’s transferred its accounts to Castle constituted a financing of accounts receivable and that Castle had

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8 This “deposit” was effected through the mechanism of a promissory note to Castle dated April 25, 1975 in the amount of $40,000, of which $10,000 was credited to reserve.
collected a surplus of monies to which Major’s was entitled. We are thus faced with the question which we posed at the outset of this opinion: did the June 18, 1973 Agreement create a secured interest in the accounts, or did the transaction constitute a true sale of the accounts? The district court, contrary to Castle’s contention, refused to construe the Agreement as one giving rise to the sales of accounts receivable. Rather, it interpreted the Agreement as creating a security interest in the accounts which accordingly was subject to all the provisions of Article 9 of the U.C.C. It thereupon entered its order of June 13, 1977 granting Major’s motion for summary judgment and denying Castle’s motion for summary judgment. This order was ultimately incorporated into the court’s final judgment entered May 5, 1978 which specified the amount of surplus owed by Castle to Major’s. It was from this final judgment that Castle appealed.

Castle on appeal argues (1) that the express language of the Agreement indicates that it was an agreement for the sale of accounts and (2) that the parties’ course of performance and course of dealing compel an interpretation of the Agreement as one for the sale of accounts. Castle also asserts that the district court erred in “reforming” the Agreement and in concluding that the transaction was a loan. In substance these contentions do no more than reflect Castle’s overall position that the Agreement was for an absolute sale of accounts.

II

Our analysis starts with Article 9 of the Uniform Commercial Code which encompasses both sales of accounts and secured interests in accounts. Thus, the Pennsylvania counterpart of the Code “applies * * * (a) to any transaction (regardless of its form) which is intended to create a security interest in * * * accounts * * * ; and also (b) to any sale of accounts * * *” § 9-102. The official comments to that section make it evident that Article 9 is to govern all transactions in accounts. Comment 2 indicates that, because “[c]ommercial financing on the basis of accounts * * * is often so conducted that the distinction between a security transfer and a sale is blurred,” that “sales” as well as transactions “intended to create a security interest” are subject to the provisions of Article 9. Moreover, a “security interest” is defined under the Act as “any interest of a buyer of accounts.” § 1-201(37). Thus even an outright buyer of accounts, such as Castle claims to be, by definition has a “security interest” in the accounts which it purchases.

Article 9 of the Pennsylvania Code is subdivided into five parts. Our examination of Parts 1-4, §§ 9-101 to 9-410, reveals no distinction drawn between a sale and a security interest which is relevant to the issue on this appeal. However, the distinction between an outright sale and a transaction intended to create a security interest becomes highly significant with respect to certain provisions found in Part 5 of Article 9. That part pertains to default under a “security agreement.”

The default section relevant here, which distinguishes between the consequences that follow on default when the transaction secures an indebtedness rather than a sale, provides:

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10 A “security agreement” is “an agreement which creates or provides for a security interest.” § 9-105(1)(h).
A secured party who by agreement is entitled to charge back uncollected collateral or otherwise to full or limited recourse against the debtor and who undertakes to collect from the account debtors or obligors must proceed in a commercially reasonable manner and may deduct his reasonable expenses of realization from the collections. *If the security agreement secures an indebtedness, the secured party must account to the debtor for any surplus,* and unless otherwise agreed, the debtor is liable for any deficiency. But, *if the underlying transaction was a sale of accounts, contract rights, or chattel paper, the debtor is entitled to any surplus or is liable for any deficiency only if the security agreement so provides.*

§ 9-502(2) (emphasis added).

Thus, if the accounts were transferred to Castle *to secure Major’s indebtedness,* Castle was obligated to account for and pay over the surplus proceeds to Major’s under § 9-502(2), as a debtor’s (Major’s) right to surplus in such a case cannot be waived even by an express agreement. § 9-501(3)(a). On the other hand, if a *sale of accounts* had been effected, then Castle was entitled to all proceeds received from all accounts because the June 18, 1973 Agreement does not provide otherwise.

However, while the Code instructs us as to the consequences that ensue as a result of the determination of “secured indebtedness” as contrasted with “sale,” the Code does not provide assistance in distinguishing between the character of such transactions. This determination, as to whether a particular assignment constitutes a sale or a transfer for security, is left to the courts for decision. § 9-502, Comment 4. It is to that task that we now turn.

III

Castle contends that because the June 18, 1973 Agreement expressly refers only to “sales” and “purchases” that the parties intended a true “sale” of accounts and not a security transfer. However, it has been held in Pennsylvania, as it has elsewhere, that

“Courts will not be controlled by the nomenclature the parties apply to their relationship”: *Kelter, Tr. v. American Bankers’ Finance Co.,* 306 Pa. 483, 492. In *Smith-Faris Company v. Jameson Memorial Hospital Association,* 313 Pa. 254, 260, 169 A. 233, 235, it was said: “Neither the form of a contract nor the name given it by the parties controls its interpretation. In determining the real character of a contract courts will always look to its purpose, rather than to the name given it by the parties.* * * The proper construction of a contract is not dependent upon any name given it by the parties, or upon any one provision, but upon the entire body of the contract and its legal effect as a whole.” 6 R.C.L., p. 836 § 226.”


It thus became the district court’s task, as it is now ours, to examine the record developed by the parties in order to determine whether the transactions in question in fact constitute true sales or security interests.
In normal course the examination of the parties' business activities, objectives and relationship are matters best left to trial and the factfinder after evidence has been presented. Here, however, the proceeding developed somewhat differently. Both parties moved for summary judgment as to Count I—the one count which concerns the character of the transaction. Castle submitted an affidavit which incorporated various pleadings and an interrogatory answered by Major's. When questioned by the court at a hearing held on June 13, 1977 to the following effect

* * * are you in accord and agreement that, as to Count I, that I have before me all of the facts which not only have been adduced to date but could possibly be adduced, whether there be further discovery or whether they be adduced at trial itself so that as a matter of law I have before me all the facts upon which I can make a decision upon the cross-motions for summary judgment which have been submitted by you on Count I. Yes or no.

both Castle and Major's agreed that no other facts were needed. Not content with this representation, the court again inquired:

Is there anything that you believe that could be further adduced by way of live testimony at a trial itself that would shed any additional factual light on this motion or are you satisfied that as a matter of law I have before me all that I need to decide the motions with respect to Count I?

Both parties again answered that there was nothing further in the way of evidence that they desired to produce, or that the court required in order to make its determination.

Accordingly, the district court judge having been assured, and then reassured, that only the matters then in the record before him were to be considered, and that there were no other facts that bore upon the issue, undertook to answer the question at issue on this appeal: i.e., was the transaction a sale or a secured interest? We too are therefore remitted to the same record: the Agreement and those documents on which the district court relied. Our examination of that record and the legal principles pertinent to that issue satisfies us that the district court did not err.

IV

The comments to § 9-502(2) (and in particular Comment 4) make clear to us that the presence of recourse in a sale agreement without more will not automatically convert a sale into a security interest. Hence, one of Major's arguments which is predicated on such a per se principle attracts us no more than it attracted the district court. The Code comments however are consistent with and reflect the views expressed by courts and commentators that “[t]he determination of whether a particular assignment constitutes a (true) sale or a transfer for security is left to the courts.” 12A P.S. § 9-502, Comment 4. The question for the court then is whether the nature of the recourse, and the true nature of the transaction, are such that the legal rights and economic consequences of the agreement bear a greater similarity to a financing transaction or to a sale.
In *In re Joseph Kanner Hat Co., Inc.*, 482 F.2d 937 (2d Cir. 1973), Kanner having obtained a loan of $25,000 from a bank executed an assignment to the bank of $25,000 which was due Kanner from the Norwalk Redevelopment Agency and represented compensable moving expense. The assignment reads “That Joseph Kanner Hat Company, Inc. * * * in consideration of the sum of $25,000.00 * * * does hereby sell, assign and transfer * * * any and all sums of money due and owing * * * the said assignor by * * * the Norwalk Redevelopment Agency * * *.” 482 F.2d at 938 n.4. The bank contended that the assignment constituted a transfer of an absolute right to collect whatever monies were due Kanner from the Redevelopment Agency. Kanner’s trustee in bankruptcy claimed that the transaction created no more than a security interest under the Connecticut Commercial Code, that the security interest had not been perfected by filing, and that the trustee’s interest was entitled to priority over the bank’s. The Second Circuit, looking to the true nature of the transaction, did not consider itself restricted by the form of words used by the parties. Noting that the bank regarded and treated the assignment as a method of payment of a loan, the court held that despite the “absolute assignment” of the entire claim, the transaction was no more than an assignment for security.

In *Kelter v. American Bankers’ Finance Co.*, 306 Pa. 483, 160 A. 127 (1932), the Integrity Construction Company, a general contractor, had borrowed money from American Bankers’ Finance Company. The money was loaned to Integrity in exchange for the transfer of contracts made between independent home owners and Integrity. The contracts of the property owners were “sold, assigned and transferred” by Integrity to American Bankers’ by a writing which, among other things, specified that Integrity had completed the work required, and that Integrity guaranteed that all the monies due under the contracts would be promptly paid. Ultimately, Integrity was adjudicated a bankrupt and the trustee of Integrity’s estate obtained an order restraining American Bankers’ from collecting or applying to its use any of the funds becoming due on the contracts which Integrity had transferred to it. Recognizing that the central question was whether the transaction between Integrity and American Bankers’ constituted a sale of the contracts or merely loans secured by the assignments, the court reviewed the course of dealings between the parties and, in holding in favor of the bankruptcy trustee that the transactions were no more than loans secured by the collateral of the assigned contracts, stated:

It is true that the letters exchanged (which constitute the contracts) speak of “money advanced” and they provide for “finance charges” on the money advanced and for “searches” made in the lender’s interest. On profitable contracts a balance was paid by the so-called “buyer” of the contract to the alleged “seller.” We cannot reconcile the payment of interest and finance charges, nor of the buyer’s expenses in “searches” with the idea that the contractor had sold his contract to the banker. The parties may call this what they please. It is in fact nothing but a loan upon the collateral of the assigned contract.

In cases of this kind it is more important what parties actually do than what they say they do.

160 A. at 130.

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Hence it appears that in each of the cases cited, despite the express language of the agreements, the respective courts examined the parties’ practices, objectives, business activities and relationships and determined whether the transaction was a sale or a secured loan only after analysis of the evidence as to the true nature of the transaction. We noted earlier that here the parties, satisfied that there was nothing other than the Agreement and documents bearing on their relationship, submitted to the court’s determination on an agreed record. The district court thereupon reviewed the Agreement and the documents as they reflected the conduct of the parties to determine whether Castle treated the transactions as sales or transfers of a security interest. In referring to the extremely relevant factor of “recourse”\footnote{Gilmore, in commenting on the Code’s decision to leave the distinction between a security transfer and a sale to the courts, would place almost controlling significance on the one factor of recourse. He states: If there is no right of charge-back or recourse with respect to uncollectible accounts and no right to claim for a deficiency, then the transaction should be held to be a sale, entirely outside the scope of Part 5. If there is a right to charge back uncollectible accounts (a right, as § 9-502 puts it, of “full or limited recourse”) or a right to claim a deficiency, then the transaction should be held to be for security and thus subject to Part 5 as well as the other Parts of the Article.} and to the risks allocated, the district court found:

In the instant case the allocation of risks heavily favors Major’s claim to be considered as an assignor with an interest in the collectibility of its accounts. It appears that Castle required Major’s to retain all conceivable risks of uncollectibility of these accounts. It required warranties that retail account debtors—e. g., Major’s customers—meet the criteria set forth by Castle, that Major’s perform the credit check to verify that these criteria were satisfied, and that Major’s warrant that the accounts were fully enforceable legally and were “fully and timely collectible.” It also imposed an obligation to indemnify Castle out of a reserve account for losses resulting from a customer’s failure to pay, or for any breach of warranty, and an obligation to repurchase any account after the customer was in default for more than 60 days. Castle only assumed the risk that the assignor itself would be unable to fulfill its obligations. Guaranties of quality alone, or even guarantees of collectibility alone, might be consistent with a true sale, but Castle attempted to shift all risks to Major’s, and incur none of the risks or obligations of ownership. It strains credulity to believe that this is the type of situation, referred to in Comment 4, in which “there may be a true sale of accounts * * * although recourse exists.” When we turn to the conduct of the parties to seek support for this contention, we find instead that Castle, in fact, treated these transactions as a transfer of a security interest.

449 F. Supp. at 543.

\footnote{II Gilmore, Security Interests in Personal Property, § 44.4 at 1230. Here, of course, the Agreement provided Castle with full recourse against Major’s.}
Moreover, in looking to the conduct of the parties, the district court found one of the more significant documents to be an August 31, 1973 letter written by Irving Canter, President of Castle Credit, to Major’s. As the district court characterized it, and as we agree:

This letter, in effect, announces the imposition of a floating interest rate on loans under a line of credit of $80,000 per month, based upon the fluctuating prime interest rate. The key portion of the letter states:

Accordingly, your volume for the month of September cannot exceed $80,000. Any business above that amount will have to be paid for in October. I think you’ll agree that your quota is quite liberal. The surcharge for the month of September will be 3% of the principal amount financed which is based upon a 9-1/2% prime rate. On October 1, and for each month thereafter, the surcharge will be adjusted, based upon the prime rate in effect at that time as it relates to a 6-1/2% base rate. * * *

This unilateral change in the terms of the Agreement makes it obvious that Castle treated the transaction as a line of credit to Major’s—i.e., a loan situation. Were this a true sale, as Castle now argues, it would not have been able to impose these new conditions by fiat. Such changes in a sales contract would have modified the price term of the agreement, which could only be done by a writing signed by all the parties.

449 F. Supp. at 543.

It is apparent to us that on this record none of the risks present in a true sale is present here. Nor has the custom of the parties or their relationship, as found by the district court, given rise to more than a debtor/creditor relationship in which Major’s’ debt was secured by a transfer of Major’s’ customer accounts to Castle, thereby bringing the transaction within the ambit of § 9-502. To the extent that the district court determined that a surplus existed, Castle was obligated to account to Major’s for that surplus and Major’s’ right to the surplus could not be waived, § 9-502(2). Accordingly, we hold that on this record the district court did not err in determining that the true nature of the transaction between Major’s and Castle was a secured loan, not a sale.

V

Castle also contends that even if its transactions with Major’s are construed to be secured transfers rather than sales, the district court nevertheless incorrectly calculated the amount of surplus due Major’s, and improperly set off a $15,000 obligation claimed by Castle. We have carefully reviewed the record and the district court’s judgment13 in light of its

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13 Part V of the district court’s opinion, “Judgment,” recites the details of the transactions resulting in a surplus in favor of Major’s of $66,197.38 as follows:

I. COLLATERAL HELD BY CASTLE

Item 1. Total Accounts Receivable $596,901.88
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<td>2</td>
<td>Uncollected Accounts Rec.</td>
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</tr>
<tr>
<td>A</td>
<td>Net Value of Collateral</td>
<td>$526,591.44</td>
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II. MAJOR’S OBLIGATIONS TO CASTLE

<table>
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<th>Item</th>
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<tbody>
<tr>
<td>3</td>
<td>Payments by Castle</td>
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<tr>
<td>4</td>
<td>Deductions</td>
<td>77,957.35</td>
</tr>
<tr>
<td>5</td>
<td>Charges to Reserve</td>
<td>22,972.28</td>
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<tr>
<td>6</td>
<td>Insurance</td>
<td>42,304.03</td>
</tr>
<tr>
<td>7</td>
<td>Collection Costs</td>
<td>1,627.81</td>
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<td>B</td>
<td>Total Obligations</td>
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III. ACCOUNTING OF SURPLUS

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IV. COUNTERCLAIM

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<td>Loan and Costs</td>
<td>15,000.00</td>
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<tr>
<td>9</td>
<td>“Flipped” accounts</td>
<td>4,386.93</td>
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<tr>
<td>10</td>
<td>Collections</td>
<td>555.00</td>
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<tr>
<td>C</td>
<td>Net</td>
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V. MISCELLANEOUS OBLIGATIONS TO MAJOR’S

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<th>Amount</th>
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<td>Loan</td>
<td>10,000.00</td>
</tr>
<tr>
<td>12</td>
<td>Insurance Overcharge</td>
<td>632.90</td>
</tr>
<tr>
<td>D</td>
<td>Total</td>
<td>10,632.90</td>
</tr>
<tr>
<td></td>
<td>Total owing to Major’s (Line A &amp; Line D)</td>
<td>537,224.34</td>
</tr>
<tr>
<td></td>
<td>Total owing to Castle (Line B &amp; Line C)</td>
<td>$471,026.96</td>
</tr>
<tr>
<td></td>
<td></td>
<td>$66,197.38</td>
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Amount of Judgment $66,197.38

449 F. Supp. at 547.

The final order reflecting that judgment and the manner in which collections and payments were to ensue was dated May 1, 1978 and entered May 5, 1978. It reads:

AND Now, this 1st day of May, 1978, upon full consideration of the entire record, including the cross-motions for summary judgment on Count I, the briefs, reply briefs and affidavits in support thereof, the briefs, reply briefs, affidavits, and letters with respect to a final account, the matters raised at oral argument held on December 20, 1977, and our Order entered June 13, 1977, it is hereby ORDERED that:

1. Judgment is entered herein in favor of Major’s Furniture Mart, Inc. and against defendant Castle Credit Corporation in the amount of $66,197.38;
analysis. We are satisfied that the district court correctly dealt with all of Castle’s contentions and did not err in its conclusions.

VI

The judgment of the district court will be affirmed.

2. Castle Credit Corporation shall continue to collect any and all outstanding amounts owing from account debtors in the numbered accounts listed in the 17 page accounting filed in this docket and in the list attached to the August 1975 Loan Agreement between the parties and shall do so in a commercially reasonable manner;

3. The total proceeds from these collections from and after August 1, 1977, shall be deposited in a separate interest bearing escrow account of Castle Credit Corporation and the total accumulated amount in such account, together with interest thereon, less the reasonable costs of collection, shall be paid over to Major’s Furniture Mart, Inc. by check made payable to Major’s Furniture Mart, Inc. and delivered c/o Robert W. Maris, Esquire, 2600 The Fidelity Building, Philadelphia, Pa., 19109, on or before June 30, 1978, and upon the final day of each successive 90 day period thereafter so long as there shall continue to be any proceeds from said accounts receivable; and

3. (sic) Castle Credit Corporation shall also make a reasonable effort to ascertain what, if any, amounts have been collected on those accounts, referred to in counsels’ letter of April 28, 1978, as being held for collection, with a face value of $5,899.44, and pay over to Major’s Furniture Mart any amounts which Castle has actually collected on these accounts, less the reasonable costs of collection.
The recent revisions of Article 9 of the Uniform Commercial Code (“UCC”) are expected to have a significant impact on securitization—a type of financing that is perhaps the most rapidly growing segment of the U.S. credit markets and increasingly a major part of foreign credit markets. In its current form, Article 9 governs the sale of only certain types of assets that are involved in securitization transactions. Revised Article 9 attempts to broaden its coverage to virtually all securitized assets. I analyze how it does that and what it means for Article 9 to apply to these transactions * * *.

Introduction

Asset securitization is “by far the most rapidly growing segment of the U.S. credit markets”¹ and increasingly is becoming a major part of foreign credit markets. In a typical securitization, a company (usually referred to as the “originator”) sells rights in income-producing or financial assets—such as accounts, instruments, lease rentals, franchise and license fees, and other intangible rights to payment—to a special purpose vehicle (“SPV”). The SPV, in turn, issues securities to capital market investors and uses the proceeds of the issuance to pay for the assets. The investors, who are repaid from collections of the assets, buy the securities based on their assessment of the value of the assets. Because the SPV (and no longer the originator) owns the assets, their investment decision often can be made without concern for the originator’s financial condition. Thus, viable companies that otherwise cannot obtain financing because of a weakened financial condition now can do so. Even companies that otherwise could obtain financing now will be able to obtain lower-cost capital market financing.

What does Article 9 of the Uniform Commercial Code have to do with securitization? In its current form, Article 9, which generally addresses only secured transactions, nonetheless governs the sale of certain types of financial assets—accounts and chattel paper—that are commonly involved in securitization transactions. The rationale for including sales of these assets in Article 9 was that “commercial financing on the basis of accounts and chattel paper is often so conducted that the distinction between a security transfer and a sale is blurred, and a sale of such property is therefore covered * * * whether intended for security or not.”² This same rationale, and the significant minimization of transaction costs that the rule achieves,³ holds equally true today.

² Current UCC § 9-102 cmt. 2.
³ Transaction costs are minimized for several reasons. Parties do not have to make the difficult determination of whether each transfer is a secured transaction or a sale. Also, filing for both types of transfers will forestall litigation attempting to second-guess that determination if the debtor eventually
What has changed today, however, is that, increasingly, many other types of financial assets are sold as part of commercial financing transactions. Whereas factoring was the only significant form of commercial financing to involve sales of financial assets (accounts and chattel paper) when the UCC originally was adopted, securitization—which involves the sale of a whole range of financial assets—has now become significant. Yet, Article 9 had not been amended to take securitization into account. Revised Article 9 is a bold and largely successful attempt to remedy that omission and to adapt the law governing secured transactions to the realities of modern commercial and financial transactions. It accomplishes these goals in several ways.

I. Revised Article 9 Brings the Sale of Most Types of Financial Assets Within Its Scope

As a threshold matter, Revised Article 9 brings within its scope the sale not only of accounts and chattel paper, as under current law, but also of “payment intangibles” and “promissory notes.”12 Significantly for securitization, the definition of an account is expanded from current law to include not only credit card receivables13 and health-care-insurance receivables14 but also any “right to payment * * * for property that has been or is to be * * * licensed, assigned, or otherwise disposed of,”15 thereby covering license and franchise fee receivables. Moreover, the term payment intangible is broadly defined as “a general intangible under which the account debtor’s principal obligation is a monetary obligation.”16 This definition appears intended to cover financial assets that are not already covered by the terms account, chattel paper, and promissory notes. For example, loan participations and commercial loans not evidenced by instruments would be payment intangibles.

Accordingly, Revised Article 9 will apply to securitization transactions so long as the financial assets being sold consist of accounts (including credit card, health-care-insurance, license, and franchise fee receivables), chattel paper, promissory notes, or payment intangibles. I will refer to these types of financial assets as “covered financial assets.” The reader should note, however, that in some securitization transactions, financial assets are not goes bankrupt. Finally, pre-UCC sales of accounts had to be perfected under the common law procedures of the state where the seller was located. Different states had different rules and some required the account debtors to be notified of the sale. Notification of numerous account debtors always would be costly and often would be impractical, creating uncertainty in the latter case as to the buyer’s ownership rights in the accounts and sometimes discouraging the sale altogether. Inclusion of sales of accounts and chattel paper in Article 9 circumvents those common law requirements.

12 See Revised § 9-109(a)(3), the successor provision to Current UCC § 9-102(1)(b) (defining scope).
13 See Revised § 9-102(a)(2)(vii) (including within the definition of an “account” rights to payment arising out of the use of a credit or charge card).
14 Revised § 9-102(a)(2) provides that “the term [account] includes health-care-insurance receivables,” a term itself defined in Revised § 9-102(a)(46) to mean “an interest in or claim under a policy of insurance which is a right to payment of a monetary obligation for health-care goods or services provided.” In that connection, Article 9’s traditional insurance exclusion no longer will exclude “an assignment by * * * a health-care provider of a health-care-insurance receivable.” Revised § 9-109(d)(8).
15 Revised § 9-102(a)(2)(i).
16 Revised § 9-102(a)(61). The term general intangible is defined in Revised § 9-102(a)(42).
sold but are merely transferred as security. Revised Article 9 then will apply, as does Current Article 9, to virtually any financial asset so transferred.\(^\text{19}\)

The remainder of this article discusses what it means for Article 9 to apply to the securitization of financial assets. Most significantly, all sales of covered financial assets will be perfected, and the priority of the SPV as against creditors or a trustee in bankruptcy of the originator will be governed, by the rules of Article 9. Establishing clear and pragmatic rules for perfection and priority of the transfer of covered financial assets will minimize transaction costs for the reasons previously explained in the context of transferring accounts and chattel paper: parties to the securitization transaction will not have to make the difficult determination of whether each transfer of a covered financial asset is a secured transaction or a sale; filing for both types of transfers will forestall litigation attempting to second-guess that determination if the originator in the securitization transaction eventually goes bankrupt; and sales of covered financial assets no longer will have to be perfected under state common law procedures that often are costly and impractical.

But Revised Article 9 will apply to securitization in a myriad of other ways. In this article, I focus on the more significant impacts most likely to be encountered in a typical securitization transaction, such as mitigating the effect of commingling proceeds of financial assets and promoting assignability of financial assets, notwithstanding contractual restrictions to the contrary. ** * * *

Of course, the fact that Revised Article 9 will apply to the sale of covered financial assets does not mean that Article 9 applies to those sales for all purposes. In interpreting Oklahoma’s enactment of Current Article 9, the Tenth Circuit Court of Appeals previously had concluded that Article 9’s application to the sale of accounts—characterizing the buyer of accounts as a “secured party,” the seller as a “debtor,” and the sold accounts as “collateral”—means that accounts cannot be sold under Oklahoma law.\(^\text{24}\) Although that decision was much criticized,\(^\text{25}\) and the Permanent Editorial Board of the UCC issued a commentary stating that the case was incorrect\(^\text{26}\) and also amended comment 2 to Current section 9-102 to clarify interpretation,\(^\text{27}\) those actions have not generally been approved by legislatures or courts and

\(^{19}\) See Revised § 9-109(a)(1) (providing that Revised Article 9 applies to any “transaction, regardless of its form, that creates a security interest in personal property or fixtures by contract”). Subsections (c) and (d) of § 9-109 contain certain exclusions from Revised Article 9, few of which relate to securitization transactions. And even though Revised Article 9 does not apply to security interests in (non-fixture) real property, it does apply to security interests in obligations secured by real property, such as mortgage loans. See Revised § 9-109(b).

\(^{24}\) Octagon Gas Systems, Inc. v. Rimmer, 995 F.2d 948 (10th Cir. 1993).


\(^{26}\) See PEB Commentary No. 14, Transfer of Accounts or Chattel Paper (1994) (referring to the Octagon decision as “erroneous” and noting that “to the extent the [Octagon] court relied on Article 9 in reaching its determination, this Commentary adopts a contrary position”).

\(^{27}\) PEB Commentary No. 14 amended Comment 2 to Current § 9-102 to read in part as follows:
do not necessarily have the force of law. Revised Article 9, once approved by legislatures, is intended to drive the final nail into the Octagon coffin by providing not only that the question "whether a debtor’s rights in collateral may be voluntarily or involuntarily transferred is governed by law other than this article [9]," but also that a “debtor that has sold an account, chattel paper, payment intangible, or promissory note does not retain a legal or equitable interest in the collateral sold.” The latter point attempts to address the “rarified” argument that Octagon was correctly decided because certain limited property interests may remain with the originator after the sale of financial assets.

II. Revised Article 9 Establishes Clear and Pragmatic Rules for Perfection and Priority

Two of the essential goals of a commercial law statute are clarity and simplicity of implementation. In the context of the commercial law rules for perfection and priority, Revised Article 9 furthers both of these goals.

A. Perfection

Perfection refers to the protection of a transferee’s interest in transferred assets from creditors of the transferor and from the transferor’s trustee in bankruptcy. Under Current Article 9, perfection is generally achieved by filing financing statements in jurisdictions where the debtor (originator) or the collateral is located. The problem, however, is that it is often unclear where the debtor and the collateral are located and, in the latter case, the location may well change.

Revised Article 9 addresses this problem in two ways: by making the location of the debtor—as opposed to the location of the collateral—determine the jurisdiction whose law governs perfection in most cases; and by clarifying where a debtor is deemed to be located. The former point is less critical to securitization, which involves intangibles, than to other

Neither § 9-102 nor any other provision of Article 9 is intended to prevent the transfer of ownership of accounts or chattel paper. The determination of whether a particular transfer of accounts or chattel paper constitutes a sale or a transfer for security purposes (such as in connection with a loan) is not governed by Article 9. * * * The use of terminology such as * * * “collateral” to include accounts or chattel paper that have been sold is intended solely as a drafting technique * * * and is not relevant to the sale or secured transaction determination.

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29 Revised § 9-401.
30 Revised § 9-318(a).
31 See David Gray Carlson, The Rotten Foundations of Securitization, 39 Wm. & Mary L. Rev. 1055, 1059-61 (1998) (characterizing this argument as rarified). Revised §§ 9-207(d) and 9-601(g) address the same point by providing that the secured party as a buyer of accounts, chattel paper, payment intangibles, or promissory notes generally owes no duty to the debtor regarding the collateral. There is, however, a potential ambiguity in the language of Revised § 9-318(a). By stating that “a debtor that has sold an account, chattel paper, payment intangible, or promissory note does not retain a legal or equitable interest in the collateral sold,” it invites a court to find that when the debtor is in fact shown to have retained a legal or equitable interest, there is no sale under state law. Perhaps Revised § 9-318 or its comments should be amended to clarify that is not the intention.

36 See Revised §§ 9-301(1), 9-305(c).
37 See Revised § 9-307.
forms of secured financing where the assets are tangible items that can be moved around. But the latter point is quite significant to securitization. Section 9-307 of Revised Article 9 changes the rule of Current section 9-103(3) to provide that registered organizations, such as corporations, organized under the law of a particular state are deemed to be located in that state. ***

Revised Article 9 also brings a measure of pragmatism to the securitization of payment obligations evidenced by instruments. Under current law, a security interest in instruments can only be perfected by taking possession of the instrument. That may be impractical, however, where (as is common) a securitization transaction involves the transfer of large pools of instruments. The revision solves that problem by allowing a security interest in instruments to be perfected by filing. ***

One of the major controversies that arose during the Article 9 revision effort was how to perfect the sale of payment intangibles. Bankers were concerned that a perfection requirement of filing financing statements would subject them to costly new procedures when selling loan participations, a form of payment intangible.46 A somewhat practical solution was reached to mitigate this concern: the sale of payment intangibles would be deemed to be automatically perfected, without the need to file financing statements.47 This solution, however, is imperfect. Buyers of payment intangibles cannot search filing records to determine whether those intangibles previously have been sold to others. Thus, an SPV in a securitization transaction cannot ascertain the priority (discussed below) of the SPV’s ownership rights, other than by relying on representations of the originator. Originators that are insufficiently capitalized to back up their representations therefore may find it difficult to securitize payment intangibles.

B. Priority

Priority refers to the ranking of multiple claims against a transferred asset. In a securitization context, it means that “the SPVs and investors’ claims against the transferred financial assets are superior [in ranking] to any third-party claims,” including that of the originator’s trustee in bankruptcy. Under Current Article 9, priority is generally accorded to

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46 Parties to the Article 9 revision process found it difficult to differentiate loan participations, which are typically undivided interests in loans, from other types of payment intangibles. In the debate over this issue, I argued:

Few banks * * * comply with [the pre-UCC] common law requirements [for sales of loan participations], which may involve obligor notification or “policing.” * * * If a bank does not comply, then its failure to file financing statements under Article 9, if it applied to sales of loan participations, would put it in no worse position than at present. Banks would take the insolvency risk of the selling bank, as they likely do now.

Nonetheless, the political heat of the controversy overwhelmed rational inquiry. For a history of this controversy and its solution, see Paul M. Shupack, Making Revised Article 9 Safe for Securitizations: A Brief History, 73 Am. Bankr. L.J. 167 (1999).

47 See Revised §§ 9-309(3), 9-310(b)(2).
the first secured creditor to file or perfect, under a rule usually referred to as “first in time, first in right.” Revised Article 9 continues that rule.

There is, however, one exception under Current Article 9 to first in time, first in right. A holder of a purchase money security interest (“PMSI”) generally takes priority over an earlier perfected security interest in the same collateral. That exception, however, would create a significant problem for securitization and other forms of accounts receivable financing: because accounts are the proceeds of inventory, it would mean that a later perfected inventory financier with a PMSI would take priority over an earlier perfected SPV or accounts financier. To ensure that the PMSI exception does not discourage accounts receivable financing, Current Article 9 has a special rule that favors accounts receivable financiers, including SPVs that purchase accounts, over purchase money financiers of inventory. Revised Article 9 continues that special rule.

III. Revised Article 9 Mitigates the Effect of Commingling of Proceeds

Commingling refers to the mixing of proceeds of collateral with assets of the originator. Under Current Article 9, in an “insolvency proceeding” (such as bankruptcy), the secured party or SPV’s interest in cash proceeds will be lost if the cash is commingled with other funds of the originator, except to the extent that an artificial formula preserves the security interest. However, this rule is unfair to secured parties because it can arbitrarily limit the amount of a perfected security interest in commingled cash proceeds and it allows an originator contemplating bankruptcy, in what has become a commonplace legal strategy for debtors, to intentionally commingle proceeds of a perfected security interest in advance of filing a bankruptcy petition in order to use the formula to defeat the perfected interest.

Revised Article 9 will remedy that unfairness. Rejecting the artificial formula, it returns to the common law principles of “tracing,” under which a perfected security interest will continue in traceable cash proceeds of the original collateral. This would permit common law tracing rules such as the “lowest intermediate balance rule,” in which it is presumed that funds remaining in an account after withdrawal by the debtor include the proceeds of collateral (or, put another way, that withdrawals from a deposit account following the deposit of proceeds are first made from non-proceeds).

Revised Article 9 also expands the definition of proceeds, which currently includes only what “is received upon the sale, exchange, collection or other disposition of collateral or proceeds.” This relatively narrow definition had created confusion, for example, as to whether

53 Current UCC § 9-312(3), which governs a PMSI in inventory, fails to give the PMSI priority over a conflicting security interest in accounts generated by such inventory. See also Comment 3.
54 See Revised § 9-324(b).
56 Current UCC § 9-306(4)(d)(ii) sets forth that formula.
58 See Revised § 9-315(a)(2), (b)(2) (permitting the secured party to identify the proceeds “by a method of tracing, including application of equitable principles, that is permitted under law other than this article [9]”).
dividends of stock are proceeds. Under the expanded definition, stock dividends clearly would be included.62

This expanded definition of proceeds can have major significance for securitization. Increasingly, the financial assets used in securitization transactions represent rights to payment that arise in the future (“future assets”). If, however, the originator goes bankrupt after the securitization transaction is entered into, section 552(a) of the Federal Bankruptcy Code may cut off the SPV’s interest in future assets. While section 552(b)(1) generally would preserve the SPV’s interest in future assets, that interest is only preserved to the extent that the future assets constitute “proceeds, product, offspring, or profit[]” of the SPV’s prepetition assets. In this connection, courts interpret the term “proceeds” by reference to the UCC definition. Thus, Revised Article 9’s expanded definition of proceeds will expand the universe of future assets that can be sold to SPVs without the fear of the SPVs’ interest in those assets being cut off in the event of the originator’s bankruptcy.

IV. Revised Article 9 Promotes Assignability Notwithstanding Contractual Restriction

Parties to contracts sometimes restrict the assignment of rights and obligations thereunder. These restrictions are often referred to as “anti-assignment clauses.” In a securitization transaction, the parties to that contract are the originator and a third party obligated on the financial asset. Because the focus is on the originator’s transfer of its rights in the financial asset to an SPV, we need only examine the obligor’s ability to restrict that transfer.

Current Article 9 nullifies anti-assignment clauses that prohibit “assignment of an account or * * * creation of a security interest in a general intangible for money due or to become due.”68 The rationale given is that the nullification of anti-assignment clauses “is widely recognized in the cases and * * * corresponds to current business practices.”69 An implicit rationale, however, might be that the obligor on the account or general intangible is not prejudiced by its assignment, whereas enforcing the anti-assignment clause would impair the free alienability of property rights.

Revised Article 9 clarifies the rule of Current Article 9. First, the revision eliminates any argument that a transfer of financial assets in violation of an invalidated anti-assignment clause nonetheless constitutes a breach as between the obligor and the originator.72 Second, the revision treats anti-assignment clauses in payment intangibles and promissory notes differently depending on whether the transfer in question is a sale or merely a transfer for security. Anti-assignment clauses would be ineffective in both cases from preventing

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62 See Revised § 9-102(a)(64) (defining proceeds to include not only “whatever is acquired upon the sale, lease, license, exchange, or other disposition of collateral,” but also (among other things) “whatever is collected on, or distributed on account of, collateral,” and “rights arising out of collateral”). * * *
68 Current UCC § 9-318(4).
69 Comment 4 to Current § 9-318. * * *
72 See Revised §§ 9-406(d)(2), 9-408(a)(2) (providing that a transfer in violation of an anti-assignment clause does not constitute a default).
perfection of the transfer of the right to payment, but they would be upheld to prevent an originator from selling its underlying business relationship. Thus, if the originator is a bank which has made a loan to a borrower, the bank could sell a participation in that loan—a loan participation being a payment intangible—to an SPV or other third party and could perfect that sale notwithstanding an anti-assignment clause in the underlying loan agreement; but the bank could not alter the underlying debtor-creditor relationship with its borrower. The buyer of the loan participation therefore would have no direct collection rights against the borrower.

V. Revised Article 9 Clarifies the Effect of a Negative Pledge Covenant

A negative pledge covenant is an agreement by a debtor in favor of a third party (typically, a creditor) in which the debtor agrees not to grant a security interest in or otherwise encumber its assets. In a securitization context, originators often make negative pledge covenants in favor of SPVs regarding transferred and to-be-transferred financial assets. If, of course, those financial assets already have been sold to the SPV and the originator retains no interest therein, the originator would have no power to grant a security interest and a negative pledge covenant then would be superfluous. But it is sometimes unclear whether the financial assets have been sold; and originators often do retain interests, such as interests in financial assets not yet sold, or undivided interests in financial assets that have been sold, or rights to surplus collections. In those cases, negative pledge covenants may be important.

Current Article 9 is unclear as to the enforceability of a negative pledge covenant. Revised Article 9 offers clarity by providing that while negative pledge covenants cannot restrict alienability, a transfer of financial assets in breach of a negative pledge covenant nonetheless constitutes a default by the originator. That default could entitle the SPV to exercise remedies against the originator and might also allow the SPV to sue the transferee, if it knew or should have known of the breached covenant, for tortious interference with contract.

Conclusion

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See Revised §§ 9-406(d), 9-408(a)-(b).

Revised § 9-408(d) effectively provides that, in the case of sales of payment intangibles or promissory notes and in the case of any transfer of a health-care-insurance receivable, anti-assignment clauses are ineffective to thwart perfection of the sale or other transfer but may be effective for all other purposes.

Current § 9-311 provides that “the debtor’s rights in collateral may be voluntarily or involuntarily transferred * * * notwithstanding a provision in the security agreement prohibiting any transfer or making the transfer constitute a default.” It is uncertain whether this means that negative pledge covenants are unenforceable or merely that negative pledge covenants cannot restrict the transfer but the transfer nonetheless constitutes a breach of the covenant.

Revised § 9-401(b) provides that “an agreement between the debtor and secured party which prohibits a transfer of the debtor’s rights in collateral or makes the transfer a default does not prevent the transfer from taking effect.” Comment 5 explains that if, in violation of a negative pledge covenant, the debtor “purports to grant a security interest in the same collateral to another secured party[,] subsection (b) validates [the] creation of the subsequent (prohibited) security interest. * * * However, * * subsection (b) does not provide that the [negative pledge covenant] itself is ‘ineffective.’ Consequently, the debtor’s breach may create a default.”
The revision of Article 9 does much to bring the commercial law setting for securitization into the twenty-first century by embracing a broader range of financial assets, setting clear and pragmatic rules for perfection and priority of their transfer, clarifying inadvertent legal ambiguities, and reducing unnecessary transaction costs.
**SUPPLEMENTARY PROBLEM**

Dave Thomas opened a restaurant that he operated as a sole proprietorship. He named it “Cindy’s,” after his daughter. Dave applied to Commercial Bank for a $10,000 loan to be used to buy a new deep-fat fryer for the restaurant. The Bank approved the loan and, on May 15th, Dave signed a security agreement and a financing statement granting Commercial Bank a security interest in the new fryer. Dave bought the fryer that afternoon, using the loan proceeds.

On the morning of May 17th, Dave filed a bankruptcy petition. The Bank did not file its financing statement until that afternoon.

A. Can Dave’s bankruptcy trustee avoid Commercial Bank’s security interest in the fryer? Did the Bank violate the automatic stay by filing its financing statement after commencement of the bankruptcy case?

B. Would your answers change if the loan proceeds had not been used to buy the new fryer, and Commercial Bank had simply taken a security interest in all of the equipment that the debtor already owned?

C. Would your answers change if Commercial Bank’s filing had occurred in the morning and the bankruptcy petition had not been filed until that afternoon?

See §§ 362(b)(3), 544(a), and 546(b).
IN RE ROBERT E. DERECKTOR OF RHODE ISLAND, INC.


ARTHUR N. VOTOLATO, United States Bankruptcy Judge.

Robert E. Derecktor of Rhode Island, Inc., which for approximately 13 years had conducted a ship building and repair facility in Portsmouth, Rhode Island, filed a Chapter 11 petition on January 3, 1992. Since the filing the Debtor has operated in varying but limited fashion, and is presently in the final stages of total liquidation, with no future operations contemplated.

Before us is the Rhode Island Port Authority’s Motion for Adequate Protection, wherein it asks this Court to order marshaling as to Federal Deposit Insurance Corporation’s (FDIC) interest in the Debtor’s assets. Several unsecured creditors oppose the relief sought by the Port Authority on the ground that to allow marshaling would diminish or wipe out any dividend they might otherwise receive. At the November 24, 1992 hearing on the motion, no evidence was presented, and although the oral arguments focused on the question of marshaling, several additional issues have been raised in the written submissions.

FACTS

The relevant facts, as they appear below, are not in dispute: On April 13, 1979, the Port Authority loaned Derecktor $6,500,000 for the acquisition of facilities and equipment to be used in its ship building and repair business. As collateral for the loan the Port Authority retained a security interest in all of Derecktor’s then owned and after acquired fixtures, furniture, furnishings, equipment, machinery, inventory, and other tangible personal property. As of February 15, 1992, the Debtor owed $4,975,000 to the Port Authority on the original obligation.

On October 23, 1987, to purchase a 20,000 ton floating dry dock (Dry Dock III), Derecktor borrowed $6.5 Million from, and executed a purchase money security mortgage to Bank of New England-Old Colony. As additional collateral, Derecktor granted the bank a security interest in all of its presently owned and after acquired machinery, docks, equipment, inventory, personal property, and general intangibles. As of February 6, 1992, approximately $5.8 Million was due on this loan.

On December 21, 1988, Bank of New England loaned Derecktor $2,500,000 more, and received a security interest in Debtor’s accounts, contracts, contract rights, inventory, and equipment. This security interest also covered the balance due on the original $6.5 Million loan. As of February 6, 1992, approximately $1.2 Million remained due on the December 1988 loan. When Bank of New England was deemed insolvent, FDIC became its successor-in-interest, entitling it to payment under Derecktor’s obligations to Bank of New England.

As is evident, both FDIC and the Port Authority have a security interest in some of the same collateral, namely the equipment, inventory, machinery, and Dry Dock III. FDIC has the
senior secured position on Dry Dock III, and it has the only security interest in the Debtor’s intangibles, accounts, contracts, and contract rights. The Debtor’s major assets include: (1) Dry Dock III; (2) an assignable tug boat contract (the Assignment); (3) a claim against Insurance Company of North America (INA Settlement); and (4) equipment, machinery, and inventory. The parties have agreed to liquidate the assets in the most efficient manner, and to defer the resolution of the marshaling issue pending the disposition of the assets.

Dry Dock III, the first asset liquidated, was sold in July, 1992 for $6.6 Million. The Tug Assignment and the INA Settlement were both approved on September 25, 1992, producing approximately $2.1 Million from the Assignment, and $650,000 from the INA Settlement. The equipment, machinery, and inventory were sold in January, 1993, and proceeds were approximately $1.0 Million.

In the normal course, i.e. without marshaling, because Dry Dock III was the first asset liquidated, FDIC would apply the entire $6.6 Million against its $7.0 Million secured claim. The balance of its claim would then be satisfied from the proceeds of the Tug Assignment, and thereafter the funds remaining from the Assignment and INA Settlement would be used to pay junior secured creditors, and finally unsecured creditors. Again, without marshaling, the Port Authority’s security interest would extend only (after the Dry Dock III proceeds go to FDIC) to the equipment, machinery, and inventory and therefore, it would recover, at best, $1.0 Million of its $5.0 Million claim. Through marshaling however, the Port Authority can realize the benefit of its second secured position on Day Dock III, with FDIC looking first to the INA Settlement and the Assignment for payment, and thereafter to Dry Dock III, leaving a surplus for junior lienors.

DISCUSSION

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The remainder of the present dispute concerns the propriety of applying the doctrine of marshaling to the facts before us. Marshaling is an equitable doctrine which “rests upon the principle that a creditor having two funds to satisfy his debt may not, by his application of them to his demand, defeat another creditor, who may resort to only one of the funds.” Sowell v. Federal Reserve Bank, 268 U.S. 449, 457 (1925). The purpose of the doctrine is to “prevent the arbitrary action of a senior lienor from destroying the rights of a junior lienor or a creditor having less security.” Meyer v. United States, 375 U.S. 233, 237 (1963). Equity requires the senior creditor to look first to property which cannot be reached by the junior creditor, but only if the senior creditor or third parties are not prejudiced. In re Beacon Distribs., Inc., 441 F.2d 547, 548 (1st Cir. 1971); Meyer at 237. A bankruptcy court has the authority under its equity jurisdiction to order the marshaling of funds. Canal Nat’l Bank v. Larry’s Equip. Serv., Inc. (In re Larry’s Equip. Serv.), 23 B.R. 132, 133 (Bankr. D. Me. 1982).

To apply the marshaling doctrine, three elements must be present: (1) the existence of two creditors of the Debtor; (2) the existence of two funds owned by the Debtor; and (3) the ability of one creditor to satisfy its claim from either or both of the funds, while the other creditor can only look to one of the funds. Exchange Bank v. South Carolina Nat’l Bank (In re Dig It, Inc.), 129 B.R. 65, 67 (Bankr. D.S.C. 1991); Peoples Bank v. The Computer Room, Inc. (In re The Computer Room), 24 B.R. 732, 734 (Bankr. N.D. Ala. 1982).
The instant controversy falls squarely within these requirements: (1) FDIC and the Port Authority are two creditors of the Debtor; (2) there are (more than) two funds of the Debtor available for these creditors, i.e., sale proceeds from Dry Dock III, the Assignment, the INA Settlement, and the equipment, machinery, and inventory; and (3) FDIC can satisfy its claim from all of the Debtor’s funds, while the Port Authority can only look to Dry Dock III and the equipment, machinery, and inventory for payment.

The unsecured creditors object to the application of the doctrine on the ground of prejudice, in that marshaling will give the Port Authority more security than it originally bargained for. The FDIC’s claim is roughly $7.0 Million, which would be almost entirely satisfied from the proceeds of the Dry Dock III sale. If FDIC were paid these proceeds, the Port Authority’s recovery on its $5.0 Million claim would be limited to approximately $1.0 Million from the sale of the equipment and machinery, and the balance of its claim would be rendered unsecured. However, if FDIC is required to look first to the proceeds from the Assignment and the INA Settlement before looking to Dry Dock III, the Port Authority will receive an additional $2.0 Million on its secured claim. While it is clear that marshaling in this manner will deplete the fund otherwise available to unsecured creditors, we do not find such a result to constitute legal prejudice, in the marshaling context.

The history and intended purpose of the doctrine, as well as a review of the more recent cases addressing the issue, supports this conclusion. Historically, marshaling has been applied for the benefit of the junior secured creditor by preserving its collateral through a court established order of distribution of secured assets. This is accomplished by requiring the, senior secured creditor to look first to its single interest collateral, i.e., property that the junior secured creditor cannot reach, before looking to the shared collateral to satisfy its claim, and this of course invariably results in a diminution of the funds available for unsecured creditors. If we were to accept the unsecured creditors’ argument regarding prejudice, the doctrine of marshaling would rarely, if ever, be utilized in bankruptcy because its application almost always results in diminished assets for the unsecured creditors.

In support of their position, the unsecured creditors rely on In re Center Wholesale, Inc., 759 F.2d 1440 (9th Cir. 1985), and Berman v. Green (In re Jack Green’s Fashions for Men- Big & Tall, Inc.), 597 F.2d 130 (8th Cir. 1979). Both cases, however, have been criticized as improperly extending the traditional scope of the marshaling doctrine. See Chittenden Trust Co. v. Sebert Lumber Co. (In re Vermont Toy Works), 82 B.R. 258, 315-16 (Bankr. D. Vt. 1987), rev’d on other grounds, 135 B.R. 762 (D. Vt. 1991) (and cases cited therein); Note, Marshaling Assets in Bankruptcy: Recent innovations in the Doctrine, 6 Cardozo L. Rev. 671, 687-88 (1985); Western Farm Credit Bank v. Teresi (In Re Teresi), 134 B.R. 392, 397 n.1 (Bankr. E.D. Cal. 1991).

The Court in Jack Green’s Fashions for Men- Big & Tall, Inc., allowed the trustee in bankruptcy, as a hypothetical lien creditor, to marshal the Debtor’s assets for the benefit of unsecured creditors. Similarly, the Court in Center Wholesale, allowed a debtor-in-possession, as hypothetical lien creditor, to block a request for marshaling that caused “injustice” to the estate. As much as we may empathize with the adverse impact caused to the unsecured creditors here, we are now unwilling to follow the above cases, and feel compelled to adhere to
the view that requires marshaling in favor of a junior secured creditor (here, the Rhode Island Port Authority).

The Port Authority bargained for security on its loan, whereas the unsecured creditors did not, and this allows the junior secured creditor to realize the benefit of its bargain. The caveat against causing harm or prejudice to others applies only to parties having equity equal to the party seeking to invoke marshaling. As the Supreme Court in Meyer stated,

[Marshaling] deals with the rights of all who have an interest in the property involved and is applied only when it can be equitably fashioned as to all of the parties. Thus, state courts have refused to apply it . . . where the rights of third parties having equal equity would be prejudiced.

Meyer at 237 (citations omitted). Here, the parties do not stand on equal footing—the Port Authority’s rights as a secured creditor are legally superior to those of the unsecured creditors, and accordingly the “prejudice” argument does not apply in this instance.

Finally, Paramax argues that marshaling at this juncture is inappropriate because other assets of the Debtor may be uncovered, such as recovery on the guarantees of the Debtor’s parent and its principal shareholder. Without speculating as to the merits of these potential assets, we find that such guarantees do not meet the “two funds” requirement of marshaling. Therefore, the potential realization of such funds will not affect our decision today.

Accordingly, based upon all of the foregoing, the Port Authority’s Motion for Adequate Protection, requesting FDIC to marshal its interest in Debtor’s assets, is GRANTED. * * *
Fredrick and Leona Janke appeal from the decision of the district court for Stanton County denying their motion for marshaling of assets after the district court had entered a decree of foreclosure. We affirm the judgment as modified in accordance with this opinion.

***

FACTS

The facts of this case are essentially undisputed. In 1969, the appellee Jack A. Chace purchased 280 acres of real estate and assumed a note and mortgage to appellee The Federal Land Bank of Omaha, now Farm Credit Bank of Omaha. On June 19, 1980, he sold 2-½ acres of this tract to his son, appellee James R. Chace, subject to Farm Credit Bank’s mortgage. James Chace was married to plaintiff’s daughter, Diana, and they borrowed $69,037.86 from Fredrick and Leona Janke to build a house on the 2-½ acres and executed a mortgage to the Jankes to secure repayment of the loan. Farm Credit Bank of Omaha held a first mortgage on the entire 280 acres, with Jack Chace as its debtor, and the Jankes held a second mortgage on the 2-½ acres, with James and Diana Chace as their debtors.

James and Diana Chace defaulted on the note to the Jankes, and the Jankes foreclosed against James Chace, which was interrupted by his filing a chapter 7 bankruptcy. The Jankes obtained relief from the bankruptcy stay and obtained a decree of foreclosure. Diana Chace was not made a party to the foreclosure action.

On December 6, 1989, a foreclosure decree was entered in favor of the Jankes in the amount of $116,419.41 on their note and mortgage, and it was declared a valid second mortgage on the 2-½ acres of real estate owned by James Chace. Farm Credit Bank was found to hold a first mortgage position on the 2-½ acres described in the foreclosure decree, as well as on the 227-½ acres owned by Jack Chace. The first mortgage position held by Farm Credit Bank totaled $19,416.18. The evidence established the 227-½ acres [sic] owned by Jack Chace were valued at $178,345.

After entry of the decree of foreclosure on December 6, 1989, the Jankes requested the court to marshal the assets. The district court entered an order on February 2, 1990, denying the Jankes’ application for marshaling of the assets.

If the assets were marshaled, the Jankes’ second mortgage on the 2-½ acres would become, in effect, a first mortgage. If the assets were marshaled, the proceeds from the foreclosure sale would be paid to the Jankes. Without marshaling, the first $19,416.18 of sale
proceeds would be applied to the debt of Jack Chace to Farm Credit Bank, with the remainder, if any, being paid to the Jankes.

The Jankes assert the district court erred in finding that the defendant Jack Chace had standing to oppose Jankes’ application for marshaling, in failing to give proper effect to the stipulation between Farm Credit Bank and the Jankes, and in denying Jankes’ application for marshaling. We discuss only the third assignment of error.

At the time the Jankes loaned money to their daughter, Diana, and son-in-law, James Chace, and took a note on the 2-½ acres, the first mortgage to Farm Credit Bank which secured the debt of Jack Chace was of record. What the Jankes sought to do in this case was subordinate the mortgage of Farm Credit Bank with respect to the proceeds from this foreclosure action, even though the Farm Credit Bank mortgage was of record at the time of their loan.

The root of the matter is what to do with the $19,416.18 debt that is owed by Jack Chace to Farm Credit Bank. It is clear that courts of equity may apply the doctrine of marshaling of assets in proper cases. Under the doctrine of marshaling of assets, if a senior lienor has a lien that extends to and covers two funds or potential funds and if the junior lienor has recourse to only one of those funds to satisfy the debt due him, the senior lienor may be required to exhaust the funds that are exclusively available to him before proceeding against the fund that is also available to the junior lienor.

In the present case, Farm Credit Bank has two tracts of land as security for the debt owed by Jack Chace. The Jankes have security only on the 2-½ acres which is owned by James Chace. The debt of Jack Chace of $19,416.18 is secured by land valued at $178,345. However, the prerequisite for the application of the doctrine of marshaling of assets is the presence of a common debtor between the two creditors. That does not exist in this case. James Chace is the debtor of the Jankes, and Jack Chace is the debtor of Farm Credit Bank. Therefore, marshaling of assets is not appropriate. Although not involving the foreclosure of land but, rather, the replevin of a pickup, *Platte Valley Bank of North Bend v. Kracl*, 185 Neb. 168, 174 N.W.2d 724 (1970), held that the equitable doctrine of marshaling rested upon the basic principle that a senior creditor who has two funds from which he may satisfy his debt may not defeat a junior creditor who may resort to only one of these assets.

*Kracl* makes it clear that in order to marshal the assets, both funds must be in the hands of a common debtor of both creditors. Marshaling will not be applied where the parties themselves have by contract fully defined their rights with reference to the priority of the marshaling of their assets. Marshaling will not be permitted if it would hinder or impose hardship on the paramount creditor, inconvenience him in the collection of his debt, or deprive him of his rights under the contract. Marshaling will be denied if final satisfaction to the paramount creditor is uncertain or where the effect of applying the doctrine will be to compel the paramount creditor to proceed by an independent action, such as one for the foreclosure of a mortgage, since that will place an additional burden on the paramount creditor. It is the paramount creditor that cannot be prejudiced.

Were we to stop here, the result might be technically correct that marshaling the assets is not available as a remedy to the Jankes, but the result would be patently unfair and unjust.
The parties to the case readily admit that the matter is heard by the court in equity and that
the court has before it all the parties and has proper jurisdiction. Where a court dealing in
equity has property or money under its jurisdiction, it has power to appropriately direct its
application in order to carry out justice. *Gatchell v. Henderson*, 156 Neb. 1, 54 N.W.2d 227
(1952). In *Gatchell*, the effect of the judgment was nevertheless to conclude that plaintiff did
not have a timely filed mechanic’s lien or right to a personal judgment against the owners, but
that he should have a lien upon $322.19, the balance of money concededly owing by the owners
to the contractor, despite the fact that they could have paid any part or all of it to the
contractor with safety and that the contractor was concededly then indebted to such owners in
the amount of $240 for breach of contract.

Although distinguishable on the facts, the *Gatchell* court’s willingness to apply
equitable principles in order to obtain justice is readily apparent. The court applied the rule
that ordinarily an owner has a right to offset damages for breach of contract against any sum
of money due on his building contract with the contractor. “To refuse to apply such a rule . . .
would require the innocent owners, who were guilty of no wrong whatever, to pay plaintiff
$322.19 when there was no liability to him therefor or for any other amount [and] was neither
justice or equity.” *Id.* at 11, 54 N.W.2d at 233.

To require the Jankes to pay $19,416.18 to Jack Chace via the debt to Farm Credit
Bank would be neither justice nor equity. * * * The paramount question, “Why should the
Jankes pay Jack Chace’s debt to Farm Credit Bank?” has not been answered by the appellees.

The parties to this litigation previously defined their rights with reference to the
priority of the assets by contract. The mortgage the Jankes foreclosed against James Chace
was executed on June 4, 1984, and filed 2 days later with the register of deeds of Stanton
County. However, the real estate mortgage covering the entire 280 acres in favor of Farm
Credit Bank was dated November 28, 1967, in the amount of $28,500, and recorded with the
register of deeds of Stanton County on November 29, 1967. When the Jankes made the loan to
James Chace, they knew, or should have known, that they were in a secondary position behind
Farm Credit Bank. The financial risk they took by being in a secondary position should have
been obvious to them. But the Jankes’ failure to obtain a subordination from Farm Credit
Bank does not justify their payment of Jack Chace’s debt.

Equity will not permit us to prejudice the rights of Farm Credit Bank, which clearly did
nothing but establish its rights by contractual agreement of record. Equity will also not
permit us to require the Jankes to pay the debt of Jack Chace to Farm Credit Bank without
imposing upon Chace some obligation to repay the debt to the Jankes. The basis for allowing
relief to the Jankes was stated in *Redding v. Gibbs*, 203 Neb. 727, 738-29, 280 N.W.2d 53, 60
(1979), quoting Justice Cardozo’s dissenting opinion in *Graf v. Hope Building Corp.*, 254 N.Y.
1, 171 N.E. 884 (1930):

True, indeed, it is that accident and mistake will often be inadequate to supply a
basis for the granting or withholding of equitable remedies where the consequences to
be corrected might have been avoided if the victim of the misfortune had ordered his
affairs with reasonable diligence. . . . The restriction, however, is not obdurate, for
always the gravity of the fault must be compared with the gravity of the hardship. . . .
Let the hardship be strong enough, and equity will find a way, though many a formula of inaction may seem to bar the path.

In the present case, the court was technically correct in denying the Jankes’ request to marshal the assets. This could prejudice an innocent party, Farm Credit Bank, but would create an undeserved windfall in favor of Jack Chace at a cost of $19,416.18 to the Jankes. The gravity of the fault of the Jankes must be weighed against the gravity of the hardship.

Having concluded that equitable principles require that the court devise a remedy to meet the situation, we direct that the debt of Jack Chace, as evidenced by the note assumed by him pursuant to an agreement entitled “Assumption Agreement and Notice of Change of Ownership,” dated March 18, 1969, and the mortgage securing the same duly recorded in book 64, page 203, of the mortgage records of Stanton County, Nebraska, in the amount of $19,416.18 as per the decree of the district court dated December 21, 1989, plus accrued interest shall be paid to Farm Credit Bank of Omaha from the proceeds of the foreclosure sale. Upon said payment, Farm Credit Bank shall sell, convey, transfer, and assign to Fredrick and Leona Janke all of its right, title, and interest in the note and mortgage on said real estate.

Fredrick and Leona Janke, upon assignment of said mortgage, are authorized to subordinate said mortgage to their mortgage duly recorded on June 6, 1984, in book 72, page 526, of the mortgage records of Stanton County, Nebraska, so as to be able to convey said 2-½ acres free and clear of the existing mortgage of Farm Credit Bank of Omaha. They shall apply the proceeds of the foreclosure first to the payment of the note to Farm Credit Bank, as described above, and the remaining proceeds shall be applied as set forth in the decree of the district court dated December 21, 1989.

Affirmed as modified.
The matter under consideration in this Chapter 11 case concerns the marshalling of the Debtor’s assets.

Defendant/Cross-Plaintiff NCNB National Bank of Florida (NCNB) filed a cross-claim against Defendant/Cross-Defendant Mac Papers, Inc. (Mac Papers), to compel Mac Papers to look to certain collateral for satisfaction of its debt prior to seeking satisfaction of its claim from the proceeds of a life insurance policy. The parties filed Motions for Summary Judgment alleging there remain no genuine issues of material fact. The Court reviewed the Motions, the Joint Statement of Facts and the remainder of the record and heard argument of counsel on January 27, 1988. The Court finds the undisputed facts to be as follows:

On April 19, 1983, the Debtor purchased a one million dollar key man insurance policy on the life of Howard Woolf, the Debtor’s former president and chief operating officer. Within the same month, the Debtor executed and delivered three separate assignments of this policy to the Pan American Bank, Sun Bank of Tampa Bay, and Mac Papers, Inc., as collateral for outstanding obligations of the Debtor to each of these assignees. Subsequently, on November 19, 1984, the Debtor executed and delivered to NCNB an assignment of the policy as collateral for a loan from NCNB to the Debtor.

As additional collateral for its obligations to Sun Bank, on November 27, 1984 the Debtor granted Sun Bank a security interest in all equipment, furniture, and fixtures then owned or thereafter acquired by the Debtor. Similarly, on September 19, 1986 the Debtor granted Mac Papers a security interest in all personal property of the Debtor, including furniture, fixtures, equipment, inventory, and accounts receivable. The obligations of the Debtor to Sun Bank were assigned by Sun Bank to Mac Papers pre-petition.

The Debtor filed its voluntary petition for relief under Chapter 11 of the Bankruptcy Code on April 16, 1987. On May 2, 1987 Howard Woolf died and the life insurance company issued a check in the amount of $1,020,444.21, made payable jointly to the Debtor, Mac Papers, and NCNB. The Debtor agreed to accept $20,444.21 in exchange for a full release of all claims to the proceeds of the policy.

The Pan American assignment was released pre-petition, when the Pan American loan was repaid. Thus, on the date of the bankruptcy filing, and at the time of death, there were three unreleased assignments of the policy:

1) The April 23, 1983 assignment to Mac;

2) The April 23, 1983 assignment to Sun Bank (which was assigned to Mac); and
The November 19, 1984 assignment to NCNB.

The issue to be addressed herein is the propriety of compelling Mac Papers under the doctrine of marshalling to seek recovery from the Debtor's personal property, including furniture, fixtures, equipment, inventory and accounts receivable prior to seeking recovery from the proceeds of the life insurance policy.

"Marshaling rests upon the principle that a creditor having two funds to satisfy his debt, may not by his application of them to his demand defeat another creditor, who may resort to only one of the funds." *Meyer v. U.S.*, 375 U.S. 233, 236 (1963). In such a case, the first creditor is forced to satisfy its claim from the collateral which the second creditor cannot reach before looking to the common funds. This allows the second creditor to recover more from its only source of security.

Three elements must be satisfied before the equitable doctrine of marshalling may be applied. These are:

1. The existence of two creditors with a common debtor;
2. The existence of two funds belonging to the debtor; and
3. The legal right of one creditor to satisfy his demand from either or both of the funds while the other may resort only to one fund.


In applying the legal principles of marshalling to the case at hand, it is apparent NCNB has met its burden of proving the three elements of marshalling. First, both Mac Papers and NCNB are creditors with a common debtor, Woolf Printing Corporation. Second, there are two funds belonging to the Debtor: 1) the proceeds of the life insurance policy; and 2) the Debtor's personal property consisting of furniture, fixtures, equipment, inventory and accounts receivable. Third, Mac Papers has a legal right to satisfy its demand from both funds, while NCNB may resort only to the insurance proceeds.

While the three elements are met, NCNB must still demonstrate the invocation of marshalling would not injuriously affect the rights of Mac Papers or a third person. *State Bank of Florida v. Roche*, 35 Fla. 357, 17 So. 652 (Fla. 1895). Undue delay or prejudice to the senior lienholder are the sort of injuries which will prohibit marshalling. *In re United Retail Corporation*, 33 B.R. 150 (Bankr. Hawaii 1983).

NCNB argues Mac Papers should satisfy its debt by first looking to the Debtor's personal property. In order to accomplish this satisfaction, Mac Papers would have to have relief from the automatic stay, then sell the property to satisfy the debt with the sale proceeds. There is no evidence to show the time frame within which the property could be sold. On the
other hand, if Mac Papers were not compelled to marshal, it would be able to look to the insurance proceeds first. This is ready cash which would be immediately available. Upon a review of the characteristics of the two funds it is clear that compelling Mac Papers to look to the Debtor’s personal property prior to the insurance proceeds would cause undue delay in satisfying the debt. Since marshalling would injuriously affect the secured interests of Mac Papers, this Court declines to compel the requested equitable relief. ***