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SECURED TRANSACTIONS

A Perfected Lien Is Trumped: Must It Be 'Use It or Lose It'?

By
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As creditors well know, a lien holder must be vigilant in both perfecting and maintaining the perfection and priority of its lien. But even a creditor that properly maintains its lien may find that enforcement of (or more specifically, failing to enforce) that lien can affect priority.

In a recent column, we examined a Second Circuit decision as one in a line of cases analyzing when a lien holder, by electing to participate in a debtor's bankruptcy proceeding, risks extinguishing that lien.[1] In another line of cases involving deposit accounts, courts in jurisdictions such as Florida, Illinois, Indiana, Nebraska, Oregon and Pennsylvania[2] have been the site of an ongoing battle between creditors who garnish a deposit account to satisfy the debt of an obligor and the bank where such obligor's account is maintained.

In a number of these cases, courts have concluded that merely having a prior perfected security interest is not enough to defeat the rights of a judgment creditor. Prompt enforcement of that security interest is also required. From the U.C.C. perspective, that conclusion seems puzzling and possibly at odds with the requirements of Article 9.

Today we examine these cases in the context of *American Home Assurance Company v. Weaver Aggregate Transport*,[3] one of the more recent decisions in this continuing judicial debate.

Bank Rights in Respect of Borrower Deposit Accounts.

To understand *American Home*, we must first understand the competing rights of a bank and a garnishing judgment creditor with respect to a borrower deposit account.

A deposit account represents a debt the depositary bank owes to its depositor in the amount of the account balance. In general, a bank that holds a deposit account of a borrower has, in respect of such account, the common law rights (and in some states, statutory rights as well) of recoupment and set-off, meaning the right of a party to reduce the amount another owes it by the amount so owed, arising either from a related (i.e., recoupment) or unrelated (i.e., set-off) transaction.

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U.C.C. §9-340 addresses the rights of recoupment and set-off of a depositary bank under Article 9. This section makes it clear that a depositary bank can have both a security interest as well as rights of recoupment and set-off in a deposit account, with one exception.[4] That exception occurs when a secured party (that is not the depositary bank) with a lien on such account perfects by control under U.C.C. §9-104(a)(3)—meaning the account is maintained in the name of the secured party. In that circumstance, the right of set-off (but not the right of recoupment) based on a claim of the depositary bank against the debtor is ineffective as against such secured party. Said another way, under §9-340, a bank exercising set-off rights against a deposit account will prevail against a secured creditor unless that secured creditor perfects its lien by becoming the bank's customer, in which case that secured creditor will prevail.[5]

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A judgment creditor garnishing a bank account, on the other hand, is not a secured creditor under Article 9 but rather a "lien creditor." A "lien creditor" is defined in U.C.C. §9-102(a)(52), and includes "a creditor that has acquired a lien on the property involved by attachment, levy or the like." Lien creditors are subject to a separate rule of priority under §9-317(a)(2). That rule is very simple: Except for filing collateral, first in time to perfect prevails.

As noted above, set-off rights are preserved as separate rights of a depositary bank under Article 9, and so may be exercised whether or not it has a security interest. The conditions to exercise by a bank of set-off generally consist of the following: (1) mutuality of obligation, (2) the funds to be set off must belong to the depositor, (3) the funds must be in a general, and not special purpose, account and (4) the debt owed to the bank by the depositor must be matured.[6]

Finally, judgment lien creditors seeking to garnish bank accounts must contend not only with the rules of Article 9 and laws regarding set-off, but state common law and statutory garnishment requirements. Although largely procedural in nature, one common requirement is notable. That is, that a garnishing creditor steps into the shoes of its debtor—it cannot obtain greater rights against the garnishee bank than the debtor itself has in respect of the garnished debt.[7]

American Home.

In *American Home*, American Home Assurance Company had obtained a judgment against Weaver Aggregate Transport for contract and tort claims. It then served a writ of garnishment on Farmers and Mechanics Bank seeking to collect against monies in Weaver's deposit account at the bank. Farmers Bank resisted the writ of garnishment, claiming that Weaver owed it money under six different loans, that it had a perfected security interest in the funds in Weaver's account pursuant to a security agreement and that the loans were in default upon its receipt of the writ. It then asserted that none of the money in Weaver's account should be subject to garnishment and demanded instead that the court set-off against the obligations owed to the bank.

The court began its analysis by reviewing the requirements of U.C.C. §9-340. It then, somewhat inexplicably (and incorrectly), stated that the bank may request a right of set-off *provided* it can show it has a perfected security interest. Although the court determined that the bank indeed had a perfected security interest in the deposit account, applying Illinois law it went on to hold that the bank must show not only that it has a perfected security interest in the account, but that at the time the writ of garnishment was served it had declared the loans in default and taken affirmative steps to enforce its rights as a secured creditor. The court ruled that since the bank had not shown the loans to be in default at or prior to the time the writ was served, it had at such time no rights to enforce as lender and would not be entitled to the requested set-off.

Notably, in reaching its conclusion, the court in *American Home* relied heavily on two Illinois District Court decisions: *S.E.I.U. Local No. 4 Pension Fund v. Pinnacle Health Care of Berwyn*[8] and *One CW v. Cartridge World North America*.[9] Both of those cases, as well as *American Home*, involved what *American Home* described as "apparently prevalent boilerplate language for security agreements in Illinois" entitling the bank to exercise its rights in the collateral upon a default but giving the debtor possession and beneficial use of the collateral until default. Most importantly, the language of the security agreement stated "[i]f an Event of Default occurs under this Agreement, at any time thereafter, Lender shall have all of the rights of a secured party under the Illinois Uniform Commercial Code."[10] In the court's mind, this translated into the bank did not have rights of a secured creditor prior to default.

But the court did not rest on its laurels with this conclusion. It went on in dicta to state that mere default was still insufficient to preserve priority. Rather, affirmative remedial actions under the loan documents were also required. In doing so, the court cited as authority not only *S.E.I.U.* and *One CW* but *Frierson v. United Farm Agency*,[11] a 1989 Eighth Circuit decision.

Are Default and Enforcement Necessary to Preserve Priority?

'Frierson' and Illinois Cases. In each of *American Home*, *One CW* and *S.E.I.U.* the court concluded that the bank had the rights of a secured creditor, but only after default. However, those decisions went even further to adopt a concept espoused in *Frierson*, namely, that to defeat a garnishment claim, a bank secured creditor must also show it has affirmatively acted upon such default.

In *Frierson*, the court found that a default existed at the time of garnishment, but noted that the bank in that case, Merchants Bank, had not exercised its rights in respect of that default. Quoting the lower court, the decision emphasized that secured loans have numerous "technical defaults" (although noting in this instance that the default was more than technical)[12] and that Merchants could not refuse to exercise its rights under the security agreement while it impaired the status of other creditors by preventing them from exercising valid liens. To do so would "fly in the face of all Article 9."[13]

In *S.E.I.U.*, the court observed that while the bank could exercise rights of collection and notification at any time, those rights were distinct from those exercisable upon an event of default. It then stated that the bank's security agreement gave it the rights of a U.C.C. secured creditor only after a default.[14] Shrugging off what it described as a "technical default,"[15] the court held that since the bank did not formally declare a default, or follow procedures required to enforce its U.C.C. rights, it did not have a present right to the account monies nor a basis on which to object to their release.

In *One CW*, Signature Bank declared the debtor to be in default when served with the writ of garnishment.[16] However, it was then found to be inconsistent in pursuing remedies and allowed assets in the account to be unfrozen. The court found virtually identical security agreement language in that case to that of *S.E.I.U.* and issued virtually the identical ruling, stating that because the bank had opted not to exercise rights and remedies it did not have a present right to funds in the account.[17]

A Different Perspective. As mentioned above, there is a line of cases supporting the opposite view from *Frierson*, *One CW*, *S.E.I.U.* and *American Home*. That view is articulated well in the 2010 decision of the Indiana Court of Appeals in *Fifth Third Bank v. Peoples Nat. Bank*.[18]

In *Fifth Third*, the bank perfected its security interest in the debtor's account through control, and the parties conceded that a default existed at the time of garnishment. The issue presented there was whether Fifth Third Bank had lost its status as a secured creditor in respect of the debtor's checking account by failing to exercise its right of set-off after default and by continuing to honor checks.

The court held that as a secured creditor with a prior perfected security interest, Fifth Third had superior rights to the garnishing lien creditor. It did not lose those rights when it did not freeze the account, emphasizing that a secured party's decision to allow a debtor to receive funds from its deposit account is not inconsistent with perfection by control.[19] The court concluded that the general purpose and effect of perfection under the U.C.C. is to secure the priority of the lien of the secured creditor against subsequent lien holders, and that Fifth Third was thus entitled to allow the debtor access to deposit funds without sacrificing the priority of its security interest.[20]

Default and Enforcement? The notion articulated in the *Frierson* and Illinois law cases that there must exist a defaulted, matured debt has merit in the context of set-off. As noted above, set-off as a remedy requires a matured debt. The additional requirement imposed by courts of enforcement does not appear supported by Article 9 notwithstanding the comment of the *Frierson* court. To the contrary, the holding of *Fifth Third* to the effect that nothing in Article 9 requires a secured creditor to exercise a set-off right or any other remedy to prevail against a lien creditor appears consistent with the intent and language of the priority rule of U.C.C. §9-317(a)(2)—namely first in time to perfect prevails.

Frierson may have been the product of its times and that critical distinction may have been lost on the Illinois court and other cases that continue to follow it. As noted by commentators,[21] that case was decided under Article 9 prior to the revisions that became effective in 2001. Under pre-revised Article 9, a transferee of funds from a liened deposit account took such funds subject to such lien. Under revised Article 9 that is generally no longer true.[22] The *Frierson* court specifically cited and clearly relied on that result in its decision, noting that Merchants' security interest in the funds would continue after release to the garnishor and Merchants could therefore trace and recapture its monies when it chose to declare the loan in default and accelerate the debt.

Conclusion.

The complex interaction of the rules of garnishment and set-off and the priority rules of Article 9 has created a division among courts. *American Home* is the latest in this foray into uncertainty. In many of these cases, the default giving rise to the right of set-off is in fact the competing judgment lien. These decisions therefore create a quandary for both creditors and debtors. Those creditors willing to forbear to allow debtors the chance to resolve the circumstances giving rise to such liens may, by virtue of such forbearance, forfeit their priority status and set-off rights.

No matter where courts come out in the analysis, one important takeaway for secured creditors is the effect of the security agreement language cited in *S.E.I.U.*, *One CW* and *American Home*. The courts in those cases were clearly influenced by provisions stating that the lender acquired the rights of a secured creditor upon default, their view being that secured creditor status did not exist prior to default. Practitioners representing bank secured creditors should be clear in their security documents that secured creditor status exists from the outset, notwithstanding that exercise of certain rights may be conditioned upon the occurrence of a default.

1. See Barbara M. Goodstein, "Extinguishment of Liens in Bankruptcy Proceedings," 254 N.Y.L.J. No. 64 (Oct. 1, 2015).

2. See *Barsco v. H.W.W.,* 346 So. 2d 134 (Fla. Dist. Ct. App. 1st Dist. 1977); *Fifth Third Bank v. Peoples Nat. Bank*, 929 N.E.2d 210 (Ind. Ct. App. 2010); *One CW v. Cartridge World North America*, 661 F. Supp. 2d 931 (N.D. Ill. 2009); *Myers v. Christensen*, 776 N.W.2d 201 (Neb. 2009); *Davis v. F.W. Financial Services*, 317 P.3d 916 (Or. Ct. App. 2013); *In re Szymanski*, 413 B.R. 232 (E.D. Pa. 2009).

3. 84 F. Supp. 3d 1314, 85 U.C.C. Rep. Serv. 2d 684 (M.D. Fla. 2015) (*American Home*).

4. U.C.C. §9-340(b).

5. Note that this is generally consistent with the priority rules of security interests in deposit accounts under U.C.C. §9-327. Under U.C.C. §9-327(4) (N.Y.U.C.C §9-327(d)), a security interest perfected by control by virtue of the secured party being the customer on the deposit account has priority over a security interest held by the bank with which the deposit account is maintained. Otherwise, under U.C.C. §9-327. Under U.C.C. §9-327(3) (N.Y.U.C.C §9-327(c)), a security interest in favor of the depositary bank has priority over a security interest held by another secured creditor.

6. See *Szymanski*, 413 B.R. at 245 (2009).

7. Id. at 243.

8. 560 F. Supp. 2d 647 (N.D. Ill. 2008).

9. 661 F. Supp. 2d 931 (N.D. Ill. 2009).

10. *American Home*, 84 F. Supp. 3d at 1325, n.11.

11. 868 F.2d 302 (8th Cir. 1989).

12. Id. at 304. The default was apparently the entry of the judgment by the garnishing creditor.

13. 560 F. Supp. 2d 650.

14. Id at 650.

15. Id at 651. The borrower apparently made 14 late payments on its loan.

16. The court noted that the commencement of foreclosure or forfeiture proceedings by a creditor was a default. 661 F. Supp. 2d at 935.

17. Id.

18. 929 N.E.2d 210.

19. The court cited comments to U.C.C. §9-104(b) in support of its position.

20. 929 N.E. 2d at 217. See also *Myers*, 776 N.W.2d at 204, n.2.

21. See "UCC Spotlight," Comm. Law Newsletter (A.B.A. Joint Comm. of the Commercial Finance and Uniform Commercial Code Committees), Fall 2015, at 12.

22. See U.C.C. §9-332(b).

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