PUBLICATION UPDATE

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Uniform Commercial Code Reporter—Digest

Publication 747 Release 219 August 2021

HIGHLIGHTS

- **Revised Article 3: A bank was entitled to exercise its power of sale under a mortgage even though it only had constructive possession of the mortgage note through its agents at the time of loss.**
- **Revised Article 4: Revised Article 4 did not apply to a bank distributing funds held in escrow.**
- **Article 9: A factor could not import its status as a security interest assignee into Section Rev. 9-406's use of the term "assignee."**
- **A purchase-money creditor had priority to the collateral under the "attachment" approach to Section Rev. 9-324(a).**

Revised Article 3

A bank was entitled to exercise its power of sale under a mortgage even though it only had constructive possession of the mortgage note through its agents at the time of loss.

According to Massachusetts law, Section Rev. 3-309 requires a person seeking to enforce a note to actually possess it at the time of loss. But, nothing in Sections Rev. 3-301 or Rev. 3-309 precludes a person from enforcing a lost note when the person had constructive possession through its agent at the time the note was lost.

In *Bishay v. U.S. Bank N.A.*, 2020 Mass. LC LEXIS 195, 103 U.C.C. Rep. Serv. 2d 218 (Oct. 27, 2020), a borrower executed a note and secured it with a mortgage on her house. The note and mortgage underwent multiple assignments. It was eventually assigned to U.S. Bank. U.S. Bank gave the note to its document custodian. The document custodian then released the note to U.S. Bank's loan servicer. Ocwen Loan Servicing, LLC acquired the loan servicer. Years later, Ocwen searched its files and could not locate the note. It then executed a lost note affidavit. Meanwhile, U.S. Bank sent the borrower a notice of default, accelerating the note. Six years later, U.S. Bank moved to foreclose on the borrower's house.

U.S. Bank could rely on Ocwen's lost note affidavit to establish its authority to enforce the lost note. It constructively possessed the note through Ocwen.

Additionally, U.S. Bank could foreclose on the mortgage even though the six-year limitations period on note enforcement had run. The law has long held that a person can foreclose on a mortgage, even if the statute of limitations has run on the underlying note, if the debt remains unpaid. Although Section Rev. 3-118(a) may bar enforcement of a note against an obligor, it does not bar *in rem* proceedings against property.

Finally, the Massachusetts Obsolete Mortgage Statute did not preclude U.S. Bank's foreclosure action. Acceleration of the note did not accelerate the mortgage's maturity date. Accordingly, U.S. Bank was entitled to exercise its power of sale under the mortgage.

Revised Article 4

Revised Article 4 did not apply to a bank distributing funds held in escrow.

Revised Article 4 governs banks. Section Rev. 4-105 defines "bank" as "a person engaged in the business of banking." Admittedly, Revised Article 4 does not define "the business of banking." But, "the business of banking" necessarily involves the collection of funds.

In *Chi Chen v. U.S. Bank N.A.*, 2020 U.S. Dist. LEXIS 234630, 103 U.C.C. Rep. Serv. 2d 721 (W.D. Wash. Dec. 14, 2020), Chinese citizens invested in a mining company while seeking permanent residence in the United States. The investors and the mining company entered into a Master Escrow Agreement with a bank. The Master Escrow Agreement stated the bank would hold the investments in escrow until the United States approved the investors' residency petitions. It also limited the bank's liability to "gross negligence or willful misconduct." The mining company, nevertheless, directed the bank to distribute the investment funds before the United States approved the residency petitions. The bank complied.

Admittedly, Section Rev. 4-103(a) prohibits a bank from disclaiming liability for failure to exercise ordinary care. Revised Article 4, however, did not apply. The bank was not collecting funds. It was *distributing* them as an escrow agent. Thus, it was not engaged in the business of banking. Therefore, it was not a "bank" for Revised Article 4 purposes.

Nevertheless, the bank could not limit its liability in the Master Escrow Agreement as a matter of public policy. First, escrow businesses are generally suited for public regulation. Second, the bank was willing to perform this service to any qualified member of the public. Third, the bank had a decisive advantage in bargaining strength. Fourth, the bank presented the investors with a standardized adhesion contract containing an exculpatory clause. Fifth, the very nature of the escrow arrangement subjected the investors and their property to risk. In addition, the investors were members of the public. Finally, the bank's escrow services are of great importance to the public. They involve an essential public service for some members of the public. Accordingly, the bank's limitation of liability for ordinary negligence was unenforceable as a matter of law.

Article 9

A factor could not import its status as a security interest assignee into Section Rev. 9-406's use of the term "assignee."

According to Section Rev. 9-406, an account debtor can discharge its obligation by paying the assignor until, but not after, it receives an authenticated notice that the amount due has been assigned and that it must pay the assignee. Admittedly, "assignee" has no specific meaning. According to case law, however, recovery under Section Rev. 9-406 requires an actual assignment of the right to receive payment. As such, a creditor has no right to collect on a particular account unless it purchased the account or ownership was otherwise transferred to it.

In *Factor King LLC v. Housing Auth. of the City of Meriden*, 197 Conn. App. 459, 231 A.3d 1186 (2020), a contractor gave the factor an option to purchase its accounts. It also granted the factor a security interest in the contractor's purchased and unpurchased accounts. The factor purchased two accounts. It did not purchase an account debtor's account. Nevertheless, the factor sent the account debtor a notice of assignment. The account debtor, however, continued to remit payment to the contractor, not the factor. The factor sued the account debtor.

The factor was not an assignee within the meaning of Section Rev. 9-406. The contractor did not sell the account debtor's account to the factor. That account was merely collateral. Moreover, the factor could not collect on that account absent the contractor's default. The contractor did not default.

Admittedly, the factor sent the account debtor a notice of assignment. But, a notice of assignment does not trigger an account debtor's obligation to pay the purported "assignee" without an actual assignment. A security interest in an account is not an assignment of an ownership interest. Therefore, the factor had no right to receive payment from the account debtor. Accordingly, the lower court did not err when it granted the account debtor's motion for summary judgment.

A purchase-money creditor had priority to the collateral under the "attachment" approach to Section Rev. 9-324(a).

Section Rev. 9-324 governs purchase-money security interests ("PMSI"). A purchase-money creditor will have priority over conflicting security interests if it perfects within twenty days of the debtor receiving possession of the collateral.

Courts disagree on when the twenty-day clock begins to run on PMSI perfection. Some courts hold a purchase-money creditor has priority if it perfects within twenty days after the debtor receives *possession* of the collateral. Other courts hold the clock begins to run when the purchase-money creditor's security interest *attaches*. The Official Comments to Article 9 support the "attachment" approach.

In *Farmland Capital Sols., LLC v. Michigan Valley Irrigation Co.*, 2021 Mich. App. LEXIS 258 (Jan. 14, 2021), a farmer granted a secured party a security interest in all its current and after-acquired equipment in 2014. The farmer then purchased equipment from a seller on credit. Two months later, the farmer financed that equipment through a bank with an "equipment lease agreement." The bank took and perfected a security interest in the equipment. The bank later foreclosed on the equipment. It then sold the equipment to the seller. The secured party sued the seller, claiming it had a superior security interest.

As an initial matter, the parties seemed to agree the bank's agreement with the farmer was a security agreement even though it was denominated as a lease. The agreement appeared to bind the farmer to become the equipment owner. Moreover, it did not appear the farmer could terminate its obligations under the agreement.

The farmer executed its agreement with the bank on June 2, 2016. The equipment became collateral in relation to the farmer's agreement with the bank at that time. Therefore, under the "attachment" approach, the farmer received possession of the collateral for Section Rev. 9-324(a) purposes on that date. The bank filed its financing statement six days later, on June 8. Thus, the bank perfected its security interest well within Section 9-324(a)'s twenty-day period. Therefore, the bank had priority to the equipment over the secured party. Accordingly, the lower did not err when it granted the seller summary judgment.

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Publication 747, Release 219, August 2021

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Publication 747 Release 219 August 2021

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