Grading Guides for Past Examinations in Secured Transactions and Commercial Paper
Prof. Gregory E. Maggs
The George Washington University Law School

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Grading Guide for Final Examination In
SECURED TRANSACTIONS & COMMERCIAL PAPER
(Course No. 6281-10; 4 credits)
Professor Gregory E. Maggs

In Problems I–V, questions A and B were worth 7 points, and questions C and D were worth 6 points. In Problems VI–VII, question A was worth 7 points, and questions B, C, and D were worth 6 points.

PROBLEM I.

PTO McKee                                      returned
HGE         McKee                             unpaid
Houston   -----> McKee -----> RR Maloan -----> Houston    -----> RR Maloan
Gold     <-----                                Gold      <-----
Exchange  watch                                Exchange's
Bank

A. What arguments should RR Maloan make in its lawsuit against Houston Gold Exchange?

RR Maloan should make three arguments. First, Houston Gold Exchange, as the drawer of the check, is liable on the check because the check was dishonored by the drawee, Houston Gold Exchange's bank. § 3-414(b). Second, RR Maloan is entitled to enforce the check under § 3-301(i) as a holder. RR Maloan is a holder because the check was issued to McKee, and McKee negotiated the check to RR Maloan. § 3-201(a); § 1-201(21)(b). Third, although Houston Gold Exchange may have a claim in recoupment for breach of warranty against McKee because the Rolex watch was not genuine, RR Maloan is not subject to this claim in recoupment because RR Maloan is a holder in due course. § 3-305(a)(3),(b). From the facts, it appears that RR Maloan is a holder in due course because it took the check in good faith, for value, and without notice of the claim in recoupment (or other problems). § 3-302(a)(2).

B. Does RR Maloan have any rights against McKee or Houston Gold Exchange's bank?

RR Maloan would have a claim against McKee based on McKee's indorsement of the check (unless McKee indorsed the check without recourse) because an indorser is liable on a check if it is dishonored. § 3-415(a).

RR Maloan also may have a claim against McKee for breach of the transfer warranty that no one could assert a claim in recoupment against McKee. § 3-416(a)(4). As noted above, Houston Gold Exchange may have a claim in recoupment against McKee for breach of the warranty that the watch was a Rolex. But if RR Maloan is a holder in due course, and is not subject to Houston Gold Exchange's defense, then RR Maloan likely will not have suffered any damages from this breach of transfer warranty. § 3-416(b).

RR Maloan has no rights against Houston Gold Exchange's bank. As the drawee, the bank had no duty to the holder to pay the check. § 3-408.

C. What rights, if any, would Houston Gold Exchange's bank have if it had paid the check?
Houston Gold Exchange's bank could revoke the payment if it returned the check by its midnight deadline. § 4-215(a)(2).

If Houston Gold Exchange's bank did not return the check by its midnight deadline, the bank would not have a right to charge Houston Gold Exchange's account because the check was not properly payable given the stop payment order (assuming the stop payment order was received in time for the bank to act). § 4-401(a); § 4-403(a). But upon payment, the bank would be subrogated to RR Maloan's rights against the drawer, and therefore could enforce the check against Houston Gold Exchange. See § 4-403 cmt. 7. And if RR Maloan is a holder in due course, then the bank would be subrogated to the rights of a holder in due course against the drawer, § 4-407(1), and Houston Gold Exchange could not assert its apparent claim in recoupment against RR Maloan, § 3-305(b).

Houston Gold Exchange's bank could recover from RR Maloan or McKee under a theory of restitution for mistaken payment under § 3-418(a)(1), unless the Price v. Neal exception in 3-418(c) applies. The Price v. Neal exception probably applies to RR Maloan, which appears to have taken the check in good faith and for value. But the Price v. Neal exception would not apply to McKee if McKee did not act in good faith in selling the watch.

D. Houston Gold Exchange attempted to protect itself by issuing a post-dated check and then a stop payment order. How effective were these measures? Were there better options?

Stopping payment on a check may have protected Houston Gold Exchange in a typical transaction in which all of these conditions are met: (1) the payee does not negotiate the check to a holder in due course but instead deposits the check directly into his or her bank; (2) Houston Gold Exchange stops payment before the check is presented to the payor bank; and (3) the payor bank dishonors and returns the check before the payee withdraws any credit given by the depositary bank. In such cases, although the payee (in this case McKee) would have a right to enforce the returned check against Houston Gold Exchange, § 3-414(b), Houston Gold Exchange could assert any defense or claim in recoupment that it might have, § 3-305(b). (Note: Under § 4-401(c), a bank may pay a post-dated check before the date on the check unless the customer notified the bank of the postdating.)

But stopping payment was not effective in this case because it could not prevent a holder in due course such as RR Maloan from enforcing the check. A better method would be for Houston Gold Exchange not to issue a check until it knows that there will be no defenses. For example, perhaps Houston Gold Exchange could have inspected the purported Rolex watch carefully before paying for it. Paying with a negotiable instrument is like paying with cash if the negotiable instrument is negotiated to a holder in due course.

PROBLEM II.

PTO Merchants Banks
$400,000
/s/ David
/s/ Elizabeth

A. If David had answered the complaint, but did not deny the authenticity of his signature or raise any defense, what evidence would Merchants Bank need to present at trial to prevail against him on the note?

The only evidence that Merchant's Bank would need to present would be the note itself. Under § 3-308(a), the validity of the signatures on the note would be admitted because they were not specifically denied. Under § 3-
308(b), because the validity of the signatures is admitted and there is no defense, Merchants Bank would only have to show that it was entitled to enforce the note. Producing the note would prove that Merchant's Bank was a holder because it would show that Merchant's Bank is in possession of the note and that the note is payable to it. § 1-201(b)(21). As a holder, Merchant's Bank would be entitled to enforce the note. § 3-301(i). (Note: This question is very similar to Prob. (1), pp. 649-650.)

B. How should Merchants Bank respond to Elizabeth's arguments?

In response to Elizabeth's argument that she signed the note only "to give a security interest in her and David's residence" but not to incur liability for paying the note, Merchants Bank should argue that Elizabeth signed the note in the same capacity as Michael, that she is therefore a co-maker of the note, and that as a co-maker she is jointly and severally liable on the note. § 3-412(a), § 3-116(a).

In response to Elizabeth's argument that she did not receive consideration, Merchants Bank should make alternative arguments depending on whether Elizabeth is an accommodation co-maker or an ordinary co-maker (see next question). If Elizabeth is an accommodation co-maker because she did not receive a direct benefit from the loan, then lack of consideration is not a defense. Although an ordinary maker of an instrument has a defense if the instrument is issued without consideration, § 3-303(b), an accommodation party cannot raise this defense, § 3-419(b). On the other hand, if Elizabeth is not an accommodation maker then by the definition of accommodation maker in § 3-419(a), she received a direct benefit from the loan, which would be consideration for promising to pay. (Note: The holder in due course doctrine would not strip away a defense of lack of consideration because (a) Merchants Bank would have notice of this defense and (b) the doctrine in any event only strips away defenses "against a person other than the holder," § 3-305(b).)

C. If Elizabeth pays Merchants Bank, what rights will she have?

Elizabeth's rights depend on whether she is an accommodation co-maker or an ordinary co-maker. A co-maker who does not receive a direct benefit from the loan is an accommodation co-maker. § 3-419(a). The facts suggest that Elizabeth did not receive a direct benefit from the loan because it was a business loan to David and Merchants Bank reviewed David's financial information in making the loan. But more information would be necessary to say for sure whether she received a direct benefit. If Elizabeth is an accommodation co-maker because she did not receive a direct benefit from the loan, she will have a right to reimbursement from Michael. § 3-419(f). In addition, she will be subrogated to Merchants Bank's rights to the collateral. § 3-419 cmt. 5. If she is an ordinary co-maker and not an accommodation co-maker, then she will have only a right to contribution from David. § 3-116(b).

D. How, if at all, would the rights of the parties be different if Elizabeth had written the words "for accommodation" or "without recourse" next to her signature?

If Elizabeth had written the words "for accommodation" next to her signature, the words would create a presumption that she is an accommodation party. § 3-419(c). But as explained above, the facts already suggest that she is an accommodation party, with or without those words, because she did not receive a direct benefit from the loan. § 3-419(a).

If Elizabeth had written the words "without recourse" next to her signature, then she would not have personal liability on the note. § 3-415(b). Merchants Bank could still exercise its rights against the collateral--the residence that she co-owned with David--but it could not
recover from her for any deficiency. (Note: Non-recourse loans secured by real estate are not uncommon.)

PROBLEM III.

PTO Law Office
of Goodson
/s/ First
Aid Corp.

Forger ------------> David   ------> RBS       --> Fed. --> First
Goodson <------  Citizens <--  Res. <--  America <-- Aid
Bank          Bank        Bank        Corp.

A. Under what circumstances, if any, would First American Bank have had a right to charge First Aid Corporation's account?

In general, a bank can charge its customer's account only for a check that is properly payable. § 4-401(a). Because the two checks in this problem were forged, and thus were unauthorized, First American Bank would have a right to charge First Aid Corp.'s account only if it could show an exception to the properly payable rule. § 4-401(a). The facts as stated are insufficient to establish the applicability of any exception, but possible exceptions would include: (1) negligence by First Aid Corp that substantially contributed to the making of the forgery, § 3-406(a); reporting delay by First Aid Corp. that caused a provable loss, § 4-406(d)(1); (3) reporting delay by the First Aid Corp. where First Aid Corp. delayed more than a reasonable time after receiving its statement showing the first forgery by the same wrongdoer, § 4-406(d)(2); and (4) delay beyond one year before reporting the forgery, § 4-406(f), or a shorter deadline imposed by the contract between First Aid Corp and First American Bank.

B. Under what circumstances, if any, could First American Bank recover from RBS Citizens Bank?

The payor bank generally bears the risk of loss from forged checks. But First American Bank could recover from RBS Citizens Bank under a theory of breach of presentment warranty if RBS Citizens Bank knew that the drawer's signature was forged (which seems unlikely). § 4-208(a)(3). And First American Bank could recover from RBS Citizens Bank under a theory of restitution if RBS Citizens Bank did not act in good faith (which also seems unlikely). A payor bank that pays a check by mistake can recover in restitution under § 3-418(a) unless the Price v. Neal exception in § 3-418(c) applies. The Price v. Neal exception does not apply if the depositary bank does not act in good faith. Id.

Note: First American Bank also could recover from RBS Citizens Bank if it had returned the checks before its midnight deadline, § 4-301(a), but First American Bank apparently did not do that in this case.

C. Did RBS Citizens Bank need permission to destroy the original checks and present electronic copies? Did it lose any rights by doing so?

RBS Citizens Bank did not need permission to destroy the original checks. Even if the checks had to be returned, RBS Citizens could create a substitute check. Section 5003(a) of the Check 21 Act says no permission is necessary to create and use a substitute check.

But RBS Citizens Bank did need permission to present the check electronically. § 4-110(a). But if RBS Citizens Bank did not receive permission, it could present a substitute check. Check 21 Act § 5003(b).
RBS Citizens Bank did not lose any rights by destroying the original checks because a substitute check can be used for all purposes. Check 21 Act § 5003(b).

D. What advice would you give Goodson about potential risks in these two transactions and how to avoid them?

Goodson may not have incurred a loss in this case because the loss for forged checks usually falls on the payor bank. But Goodson faced a risk that First America Bank would dishonor and return the checks and that RBS Citizens Bank would revoke any credit to his account under § 4-214(a). Revoking the credit could cause Goodson to suffer a loss if he had already sent the money to Anderson and could not get it back.

Goodson could avoid the risk that First American Bank would dishonor the checks by determining whether the checks were properly payable and whether First Aid Corp. had enough money in its account to pay the check. To determine whether the checks were properly payable, Goodson should have called First American Bank to ask whether it actually had issued the checks to Anderson and by requiring Anderson to prove he was in fact the intended payee. He could also ask First American Bank whether First Aid Corp. had a sufficient balance to clear the checks.

Goodson could avoid a loss if RBS Citizens Bank revoked the credit from his account by not forwarding the money to Anderson until the checks had been finally paid. (Note: Writing "without recourse" on the checks would not prevent RBS Citizens Bank from revoking credit.)

Anderson's story sounds a lot like other fraudulent scams involving complex stories by foreigners for why they need assistance with checks and bank accounts. It might be better to avoid all risks and all hassles if something goes wrong by just not getting involved.

PROBLEM IV.

The transfer of the tractor most likely did not diminish Agricredit's security interest in the tractor. Unless an exception applies, the buyer of goods takes the goods subject to any security interest in the goods. § 9-315(a)(1). It seems unlikely that any exception would apply in this case. The Partnership would have notice of the security interest if the security interest was indicated on a certificate of title, which the state probably requires for tractors and loaders, § 9-311(a)(2). In addition, the Partnership presumably did not buy the tractor and loader in the ordinary course unless Odette is in the business of selling such equipment.

Transfer of the tractor and loader to the Partnership was a default under the security agreement. Under § 9-601(a), this default gave Agricredit...
whatever rights were provided in the security agreement and all the rights identified in part 6 of UCC art. 9, including the rights to proceed judicially or to take possession of the property.

B. Why might Agricredit have decided to seek a writ of execution and have the sheriff seize the tractor and the loader instead of privately taking possession of them?

Agricredit may have been worried that it could not take possession of the tractor and loader without a breach of the peace, § 9-609(b), and would have faced liability if it caused a breach of the peace, see Williams v. Ford Motor Credit. In addition, if the sheriff damaged the Partnership’s property when repossessing the goods, then Agricredit would not be liable. See Major's Furniture v. Castle Credit.

C. For what business purpose might Jack Shields Sales and Service have assigned the sales contract to Agricredit?

Jack Shields Sales might have preferred to have the immediate cash from selling the sales contract to Agricredit than to have periodic payments from Odette. Jack Shield Sales may have needed the immediate cash to buy additional inventory and to pay its operating expenses. Agricredit might have purchased the sales contract at a discount (i.e., for less the what Odette promised to pay) and therefore would make a profit in the transaction. See, e.g., Co-Mac v. Riddle.

D. What advice would you have given the Partnership when it was contemplating acquiring the tractor and loader?

The Partnership should have determined whether the tractor and loader were subject to a security interest. In most states, tractors and farm vehicles are subject to certificate of title statutes. § 9-311(a)(2). In those states, any security interests would be identified on the certificate. If the Partnership still wanted to purchase the items, it should have contacted Agricredit to obtain permission. If the tractor and the loader were not covered by a certificate of title, the Partnership should have checked financing statements in the state in which Odette lives, § 9-301(1), and previously lived within the past four months, § 9-316(f)(2).

PROBLEM V.

security interest in accounts
Hunt Tractor -------------> CNH
<------------------

loan

security interest in pledged stock
Pogano --------------> Commonwealth
<------------------- Bank
line of credit
& loan

$825,347
check
KYDOT ------> Hunt ----------> Commonwealth
Tractor <-------- Bank
credit
to pay off
bank loans
A. Why would Pagano pledge his own property as collateral for a loan to Hunt Tractor?

If a lender believes that a small business is not sufficiently creditworthy for a loan, the lender may ask the owner of the small business to guarantee the loan or provide collateral for a loan. One example is Madison Capital v. S & S Salvage. In this case, Commonwealth Bank may have thought that Hunt Tractor was not creditworthy because Hunt Tractor had already given a security interest in most of its assets to CNH.

Pagano might be willing to pledge his own property as collateral for a loan to Hunt Tractor because he is the co-owner of the business. If the loan will benefit Hunt Tractor, then it indirectly will benefit him as well. He may have information which causes him to believe that the business is more creditworthy than Commonwealth Bank thinks that it is.

B. Assume Hunt Tractor gave Commonwealth Bank a security interest in its checking account when it obtained the Bank Loans. What would determine who had priority in the $825,347.00 deposited into the account?

The first-to-file-or-perfect rule in § 9-322(b)(1) would determine who had priority in the deposit. If CNH had filed a financing statement covering either the inventory or the proceeds of the inventory before the check was deposited, then CNH would have a perfected security interest in the check. § 9-315(c). This perfection would continue into the bank account because the bank account would be cash proceeds. § 9-315(d)(2); § 9-102(a)(9).

On the other hand, if CNH had not filed a financing statement, Commonwealth Bank would have priority when the check was deposited. Commonwealth's security interest would be perfected by its control over the deposit account. § 9-314(a); § 9-104(a)(1).

C. What interest, if any, does CNH have in the backhoes that were sold to KYDOT?

Absent an agreement to the contrary CNH would not have any interest in the backhoes after they were sold to KYDOT. Under § 9-320(a), a buyer in ordinary course of business--as KYDOT apparently was in this case--takes free of a security interest created by the buyer's seller (i.e., Hunt Tractor), even if the security interest is perfected and the buyer knows of its existence. Otherwise, no one would buy goods from a merchant if the merchant had financed its inventory.

D. What advice would you have given CNH in drafting the security agreement with Hunt Tractor?

The problem here is that Hunt Tractor misused the proceeds from the sale of inventory to pay back a loan to Commonwealth Bank rather than to repay CNH's loan. Pagano may have caused Hunt Tractor to take this action because Commonwealth Bank could have foreclosed on the stock that Pagano had pledged as collateral and Pagano did not want that to happen. CNH may be protected, as described above, because of its security interest in the proceeds from the sale of the backhoes. But CNH could have given itself even more protection by specifying in the security agreement that it would be a default for Hunt Tractor (1) to incur any other indebtedness without permission; (2) to pay off any other indebtedness without permission; or (3) to use the proceeds from the sale of inventory other than in specified ways. These clauses or similar ones might have dissuaded Hunt Tractor and Pagano from acting as they did.
Inventory Financing/Floor planning

security interest in
accounts, chattel paper,
equipment, inventory
Integrity ---------------------> Eclipse
<------------------------ (inventory/floor-planning lender)
loan to buy inventory

Sale of chattel paper

chattel paper
(sales contracts granting
security interests)
Snowbear -------------------> Integrity  -------------> Action
<-------------------            <--------------
trailers                          $$

Additional Financing

security interest in
accounts and contract rights
Integrity  ----------------------------> Action
<----------------------------
loans

A. What arguments might Eclipse and Action make in support of their
respective claims of priority in this case?

Eclipse (the inventory lender) and Action (the chattel paper purchaser) each claim priority in the 1700 trailers that were sold to Snowbear but that were still in Integrity's possession at the time of default.

Eclipse's arguments: If the trailers were still inventory (i.e., if title to them had not passed to Snowbear), then Eclipse will argue that it had priority over them because the security agreement did not give Action a security interest in inventory. Alternatively, if title to the trailers had passed to Snowbear, Eclipse will argue that it has priority because its original security interest in the trailers persisted notwithstanding the sale. Although a buyer in the ordinary course generally takes goods free of any security interest, § 9-320(a), this rule does not apply when the seller retains possession, § 9-320(e).

Action's argument: If Snowbear granted a security interest in the trailers to Integrity when it bought them on credit, and Integrity sold the chattel paper to Action, then Action will argue that it has priority under the rule that the purchaser of chattel paper (i.e., Action) has priority over the inventory financer (i.e., Eclipse) who claims a security interest only as proceeds. § 9-330(a).

B. Why might a subordination agreement have been necessary to make Eclipse's interest in Integrity's accounts subordinate to Action's interest in those accounts?

Ordinarily, the first-to-file-or-perfect rule would determine which of the two secured parties had priority. § 9-322(a)(1). If the parties wanted Action to have priority, a subordination agreement might have been necessary because Eclipse may have been the first to file a financing statement covering the accounts or any proceeds of other collateral in which Eclipse had priority that would be deposited into the accounts.
A likely hypothesis is that (1) Integrity needed to borrow more money to continue to operate; (2) Eclipse did not want to lend any more money; (3) action would not lend money without an subordination agreement because Eclipse already had a security interest in all of Integrity's assets; and (4) Eclipse agreed to the subordination agreement because it feared that Integrity would not be able to continue in business -- and repay any its loans to Eclipse -- without additional financing.

C. Under what circumstances, if any, could Eclipse or Action take possession of trailers in Snowbear's possession?

Eclipse or Action could take possession of the trailers in Snowbear's possession if (1) they had security interests in the trailers and (2) Snowbear defaulted under the security agreement creating the security interests. § 9-609(a)(1).

On one hand, the facts suggest that Eclipse does not have a security interest in the trailers in Snowbear's possession. Under § 9-320(a), a buyer in the ordinary course--which Snowbear appears to be--takes free of a security interest granted by the seller in the goods. Accordingly, Eclipse could not take possession of the trailers in Snowbear's possession.

On the other hand, the facts suggest that Snowbear granted Integrity a security interest in the trailers when it bought them on credit, and that Integrity assigned the security interest to Action. Therefore, Action could take possession of the trailers if Snowbear defaulted.

D. How might Snowbear's actions have caused Integrity's default? How might the lenders have anticipated such a risk and addressed it in their security agreements?

Snowbear's failure to pay for the trailers may have caused Integrity's default by depriving Integrity of the funds it needed to repay its loans. The lenders might have anticipated this risk by requiring, in their security agreements, a review of the credit of buyers with whom Integrity entered major sales contracts. For example, they might have checked to see whether Snowbear could pay for all of the trailers that it ordered from Integrity.

PROBLEM VII.

Korotki
/|
| guarantee of
| Reserves's obligations
|\/
Sussex promise to build
County roads and drains
Council <------------ Reserves
(beneficiary) /
\(applicant"
letter / application
credit \ application
WTC
(issuer)

A. On what legal theories might WTC seek to recover from Reserves and Korotki?

Assuming the document is in fact a letter of credit (see question B
below), after WTC honored it by paying Sussex County, WTC acquired a right to reimbursement from Reserves. § 5-108(i). In addition, WTC became subrogated to Sussex County Council's rights against Korotki. § 5-117(a). WTC could recover from Korotki based on Korotki's guarantee. See Ochoco Lumber v. Fibrex.

B. Could WTC pay the $2,216,233.00 only if this amount was in fact reasonable and necessary to complete construction?

The facts do not provide enough of the text of the letter of credit to answer this question definitively.

If the letter of credit (1) made payment dependent on a documentary presentation asserting that "satisfactory performance has not occurred," and (2) said the bank would honor the letter of credit by paying drafts up to $2,216,233, then the actual amount that was reasonable and necessary to complete construction would not matter. The independence principle would make the underlying obligation independent from the letter of credit. § 5-103(d).

But the facts seem to say that WTC is undertaking (1) to pay only if performance is in fact not satisfactory, and (2) to pay only the amount that is actually reasonable and necessary. If this is true, then the "letter of credit" would not meet the definition of a letter of credit in § 5-102(a)(8) because payment would not depend on a documentary presentation. A court might construe the document as an ordinary guaranty. Wichita Eagle v. Pacific Nat'l Bank. Accordingly, only the actual money owed would be due.

C. How might WTC respond to the contention that its request for attorney's fees is unconscionable?

Section 5-111(e) says that "reasonable attorney's fees . . . must be awarded to the prevailing party in an action in which a remedy is sought under this article [i.e., article 5, which governs letters of credit]." Under this provision, WTC could recover attorney's fees from Reserve if (1) WTC prevails in an action to obtain reimbursement under § 5-108(i), and (2) the attorney fees are reasonable. But WTC could not recover an unreasonable or unconscionable amount of attorney fees.

Section 5-111(e) would not apply to an action by WTC to enforce Korotki's guarantee because that is not an action under article 5. Likewise, § 5-111(e) would not apply at all if the document in question is not a letter of credit. But it seems unlikely that a contract term providing for attorney's fees in a business transaction is per se unconscionable. Of course, the amount of the fees requested in a particular case could be unconscionable if the amount was too high.

D. Given the letter of credit securing Reserves' obligations, was it reasonable to ask Korotki for a personal guarantee?

Although the guaranty and the letter of credit are redundant in that they both back up Reserve's obligation to pay Sussex County, both Sussex County and WTC have grounds for arguing that asking for the personal guarantee was not unreasonable. WTC may have wanted Korotki to make the guaranty because it was worried that Reserves would lack the funds to reimburse WTC after WTC paid the letter of credit under § 5-108(i), which may have happened here. Sussex County may have wanted Korotki to guaranty Reserve's obligation because Sussex County may have been worried that Reserve would challenge WTC's payment of the letter of credit, which also happened here.
PROBLEM I. (26 points)

PTO PNB
/s/ Griscom Street
/s/ Smith, guarantor

Griscom -----------------> GreenPoint --------> PNC ----> FDIC ----> Bank
Street                      Mortgage

A. Must the Bank prove its ownership of the Promissory Note in order to enforce it?

No. The Bank does not have to prove its ownership of the note. The Bank can prove that it is entitled to enforce the note by showing that it is the holder of the note or a non-holder in possession with the rights of a holder. § 3-301(I) & (ii). Neither of these statuses would require the Bank to be the owner of the check. The Bank would be a holder if it was in possession of the instrument and the instrument was payable to the Bank or bearer. § 1-201(a)(21). The Bank would be a non-holder in possession with the rights of a holder if the instrument was transferred directly or indirectly to the Bank by a holder. § 3-203(b). For example, the Bank would be a non-holder in possession with the rights of a holder if PNC was a holder of the note but did not indorse the note when its assets were taken over by the FDIC (which is likely if the assets were transferred in bulk).

B. Under what circumstances, if any, would the Bank take the note free of Smith's asserted defense of unconscionability?

The Bank would take the note free of Smith's asserted defense of unconscionability if (1) unconscionability is an ordinary contract defense and (2) the Bank either (a) is a holder in due course or (b) has the rights of a holder in due course.

Under § 3-305(b), a holder in due course (or person having the rights of a holder in due course) takes an instrument subject to the "real" contract defenses listed in § 3-305(a)(1) but free of the "ordinary" contract defenses listed in § 3-305(a)(2). Unconscionability is not one of the defenses listed in § 3-305(a)(1), and it therefore appears to be an ordinary defense. Our textbook briefly discusses the argument that a holder in due course would take free of the defense of unconscionability on p. 690.

The Bank would be a holder in due course only if it met all of the requirements in § 3-302(a) or took the instrument from someone who met all of those requirements, see § 3-203(b). One of these requirements is that the person must take the instrument without notice of defenses. § 3-302(a)(2)(vi). Smith will argue that the Bank and everyone else who took the note had notice of the "extremely one-sided clauses" that in his view make the note unconscionable because these clauses appear in the note itself. The problem does not provide enough information to determine whether the terms of the note actually are unconscionable or whether the other requirements for holder in due course status are met.
Note: Although there are exceptions to the holder in due course doctrine for consumer transactions, this is not a consumer transaction because a corporation, Griscom Street LLC, made the note.

C. What rights would Smith have if he pays the Note?

The problem says that Smith "guaranteed" the note. A person who signs a note as a "guarantor" is presumed to be an accommodation party. § 3-419(b). As an accommodation party, Smith would have the right to reimbursement from Griscom Street, the accommodated party. § 3-419(e). Smith also would be subrogated to the Bank's right to enforce the mortgage. § 3-419 cmt. 5; Plein v. Lackey. The payment would also discharge Smith's liability on the note. § 3-602(a).

D. If the Bank cannot recover from Smith, who else might be liable to the Bank?

The Bank could recover from Griscom Street as the maker of the note. § 3-412. The Bank could also recover from GreenPoint, PNB, or the FDIC if they indorsed the note. The indorser of a note is liable if the note is dishonored, unless the indorser has signed without recourse (which would be uncommon in the transfer of mortgage notes). § 3-415(a). GreenPoint likely indorsed the note when GreenPoint sold the note to PNB. If the FDIC acquired and sold PNB's assets in bulk, it is possible that neither PNB nor the FDIC indorsed the note.

The FDIC made transfer warranties to the Bank if it transferred the note for consideration and did not disclaim the warranties. § 3-416(a). GreenPoint and PNB also would have made transfer warranties that would extend to the Bank if they had indorsed the note, transferred it for consideration, and did not disclaim the warranties. § 3-416(a). One transfer warranty is that the maker cannot assert any defenses against the transferor. § 3-416(a)(4). The FDIC and the other transferors may have breached this warranty if Griscom Street had a valid defense of unconscionability and the transferors are not holders in due course and do not have the rights of a holder in due course.

PROBLEM II. (26 points)

Troy Bank
PTO Cile
$100,000
/s/ Gilley

check
misencoded
as $1000

Gilley ----------> Cile ----> Citizens ----> Federal ----> Troy ----> Gilley
<---- Bank <---- Reserve <---- Bank <---
$1K/$99K $1K/$99K $1K/$563.57

A. Why might Troy Bank have believed that it had a duty to make a final payment of $99,000 even if there were insufficient funds in Gilley's account when the payment was made?

Troy Bank may have believed that it had a duty to make a final payment of $99,000 because a payor bank that does not return a check by its midnight deadline is accountable for the amount of the check. § 4-302(a)(1). Troy Bank missed its midnight deadline for returning the check to Citizens Bank because it never returned the check. The amount of the check was $100,000 because Gilley drew the check for that amount; the error in encoding did not affect the amount of the check. § 4-209 cmt. 2. Because Troy Bank had only paid $1000, it would still owe $99,000.

Note: A separate but closely related question is whether Troy Bank may
have believed that it had a duty to pay the check when it was initially presented. A payor bank is not liable on a check, § 3-408, and is free to revoke a settlement prior to its midnight deadline, § 4-301(a)(1). But Troy Bank might have worried that it would be liable to Gilley for wrongful dishonor if it did not pay the check because the check was properly payable and Gilley had sufficient funds to pay the check. § 4-402(a).

B. What amount may Troy Bank charge against Gilley's account?

Troy Bank may charge $100,000 against Gilley's account. The payor bank may charge its customer for the full amount of a properly payable check, even if this causes an overdraft. § 4-401(a). The full amount is the amount which the drawer authorized -- $100,000 -- not the encoded amount. § 4-209 cmt. 2.

C. On what legal theory might Troy Bank support its claim against Citizens Bank?

Troy Bank would have a claim against Citizens Bank for breach of encoding warranty under § 4-209(a) because Citizens Bank did not properly encode the check. Troy Bank can assert that $98,436.43 is the amount that it lost as a result of the breach, § 4-209(c), because it would have debited Gilley's account while he still had $100,000 if the check had been properly encoded.

D. If Citizens Bank pays the amount claimed by Troy Bank, what rights, if any, will it have against Gilley and Cile?

Citizens Bank will have no rights against Cile. A depositary bank can revoke credit given for a check only if it fails to receive final payment. § 4-214(a). In this case Citizens Bank did receive final payment when Troy Bank paid the full $100,000 for the check. Although Citizens Bank may be liable to Troy Bank for breach of an encoding warranty, nothing in the UCC allows Citizens Bank to pass this liability for its error on to Cile.

If Citizens Bank pays Troy Bank the amount of money that Troy Bank is unable to recover from Gilley, Citizens Bank arguably should be subrogated to Troy Bank's claim against Gilley for the amount of the check under § 4-401(a). But no provision in § 4-209 expressly affords this right.

PROBLEM III. (26 points)

PTO Martha <-- nominal payee
$s/ Jay's estate,
    by Cochonour, "Pay Jones & Co.
    Executor Martha" <-- signed by Cochonour
Cochonour ------> Cochonour --------> Jones ----> Dep. ----> Payor ----> Jay's
<-------- & Co. ---- Bank ---- Bank ---- Estate

A. What claims might Martha assert?

Martha might assert a claim against Jay's estate for $400,000, which is the amount of her inheritance. The check issued by Cochonour did not suspend this underlying obligation, in whole or in part, because Martha never "took" the check in payment. § 3-310(b).

Martha does not have a claim for conversion against Jay's estate (or against Cochonour) because she never received delivery of the check. § 3-420(a)'s last sentence.

B. What claims might Jay's estate assert?
Jay's estate might assert a claim against Cochonour, outside of the UCC, for misappropriation of the estate funds.

Jay's estate does not appear to have a claim against the payor bank for paying a check that was not properly payable. § 4-401(a). The bank will assert that the check was properly payable for two reasons. First, Cochonour had authority, as the executor of Jay's estate, to issue checks on behalf of the estate. § 3-402(a). Second, the check was made payable to a "nominal payee" because Cochonour evidently did not intend the person identified as the payee -- Martha -- to have any interest in the check. § 3-404(b). As a result, Cochonour's indorsement in the name of Mary was effective in favor of the bank. § 3-404(b)(2).

C. In subsequent litigation, the parties disagreed about whether Jones and Company had a duty "to ask Martha--the payee and purported endorser of the check--about the validity of that instrument." Did Jones and Company have this duty?

Under § 3-404(d), Jones & Company had a duty to exercise ordinary care when taking the check payable to Martha as a nominal payee and would be required to share the loss from the check if it did not exercise ordinary care. Ordinary care requires observance of reasonable commercial standards of fair dealing. § 3-103(a)(9). The parties are likely to dispute whether such standards would require inquiry into the validity of the signature. The estate might argue that the check was for a very large amount, that Jones & Company likely could tell from the signatures on the check that Cochonour was the trustee of the estate, and that it would be highly irregular for the payee of such a large check to sign it back over to the executor. It will assert that in these circumstances, good faith required inquiry. The decision in Maine Family Federal Credit Union v. Sun Life, although not directly on point, supports this argument by suggesting a higher standard for someone taking a check from a fiduciary. Jones & Company might respond that the entire premise of negotiable instrument law is that person taking an instrument has no duty to inquire into the validity of signatures or the nature of the underlying transaction that gave rise to the instrument. As Grant Gilmore wrote: "The stranger who purchased the [negotiable instrument] in the market was entitled to do so without inquiry into the facts of the underlying transaction or of previous transfers of the bill and without being affected by them." Textbook, p. 645. In further support of its position that a person taking an instrument need not conduct an investigation, Jones & Company will also cite the existence of transfer warranties which put the duty on the transferor rather than the transferee, § 3-416(a); the ability of a person to become a holder in due course so long as the person has no notice of irregularities (without an explicit duty to inquire), § 3-302(a); and the general presumption of the validity of signatures, § 3-308(a).

D. Under what circumstances, if any, might the holder in due course doctrine shield any of the parties from the claims of others?

If Jay's estate makes a claim for the check or its proceeds under § 3-306, Jones and Company and the depositary bank may assert that they are holders in due course and took the instrument free of such claims. They are holders, even though Martha did not indorse the check, because Martha was merely a nominal payee. § 3-404(b). In addition, they would be holders in due course if they took the check in good faith, for value, and without notice of claims and defenses. The problem does not provide sufficient facts with respect to these elements.

Note: It probably does not matter that the check was indorsed "pay Jones & Co." An instrument must be payable to order only at the time it is issued, § 3-104(a)(1), and even this requirement is loosened for checks, § 3-104(c).
A. Is Barretts's argument under § 9-203(b)(2) correct?

No. Section 9-203(b) says that a security interest in collateral cannot attach until "the debtor has rights in the collateral or the power to transfer rights in the collateral to a secured party." Barretts's argument is that Lucky Moon did not have rights in the cattle because it had not yet paid for the cattle. This argument is wrong for three reasons. First, Lucky Moon has paid for some of the cattle, and therefore presumably owned at least them. Second, whether a buyer has paid for goods does not determine whether a buyer has rights to the collateral or the power to transfer rights. In most cases in which a buyer buys goods on credit, the buyer obtains title to the goods before paying the full price. Third, in this case, we know that Lucky Moon had at least a possessory right to the collateral that it had not paid for.

B. Could Barretts prevail by arguing that it had a perfected security interest in the cattle under § 9-309(2)?

No. Section 9-309(2) says that "[t]he following security interests are perfected when they attach: . . . (2) an assignment of accounts or payment intangibles which does not by itself or in conjunction with other assignments to the same assignee transfer a significant part of the assignor's outstanding accounts or payment intangibles." This argument would fail because the transaction does not involve an assignment of accounts or payment intangibles; it involves a security interest in cattle. Cf. In re Tri-County Materials (assignment of accounts).

C. Would you have advised Barretts not to sell the cattle on credit to Lucky Moon given the apparent security agreement between Bank and Lucky Moon?

The apparent security agreement between the Bank and Lucky Moon is not, by itself, a sufficient reason to refrain from selling cattle on credit to Lucky Moon. Barretts could structure a transaction in which it sold the cattle on credit and had priority over the Bank's security interests by taking a purchase money security interest in the cattle. See 9-324(d). [Note: 9-324(a) is the general rule for PMSIs, while 9-324(d) concerns PMSIs in livestock.]

Other factors, however, might dissuade Barretts from selling the cattle on credit to Lucky Moon. For example, Barretts might worry that there is something wrong with Lucky Moon's business model if Lucky Moon has an outstanding debt of $2 million to the Bank which is secured by a dragnet clause and that it cannot pay. While taking a security interest in the cattle might lessen the risks in lending to Lucky Moon, the risks still might be too great.

D. If Lucky Moon sells some of its cattle, what rights will Bank have with respect to the cattle sold and to the proceeds?

The Bank will have a security interest in any identifiable proceeds of the cattle because a security interest in collateral automatically continues into the proceeds of the collateral. § 9-315(a)(2).

As for the a security interest in the cattle, a buyer of collateral takes the collateral subject to a security interest unless the secured party consents or an exception to this general rule applies. § 9-315(a)(1). In the security agreement, the Bank most likely authorized Lucky Moon to sell the
cattle free of the bank's security interest for two reasons. First, the Bank would want Lucky Moon to sell the collateral so that Lucky Moon has enough money to repay the Bank, and buyers would not want to purchase the collateral if it came subject to a security interest. Second, the Bank would be protected by its security interest in the proceeds (as discussed above). If the security agreement does not expressly authorize Lucky Moon to sell the collateral, then the issue is whether an exception applies. Article 9 contains an exception for buyers in the ordinary course, but this exception does not apply to buyers of "farm products," § 9-320(a), a term which includes livestock, § 9-102(a)(34)(b). [Note: Other law outside may provide an exception for the cattle, see 9-320 cmt. 4, but this was not something covered in class.]

PROBLEM V. (26 points)

loan
Americredit ----> Debtors
<-----
promise to
repay & lien

American Honda Finance

A. Why might the timing of the perfection of AmeriCredit's lien matter?

If AmeriCredit's lien was not perfected prior to the Debtors' filing of a bankruptcy petition, AmeriCredit would effectively have only an unsecured claim in bankruptcy. Bankruptcy Code § 544(a) gives the bankruptcy trustee the status of a hypothetical lien creditor. Section 9-317(a)(2) makes an unperfected security interest subordinate to the rights of a lien creditor. See Casebook, p. 49. In addition, if the Debtors have any actual lien creditors, the timing of the perfection of AmeriCredit's lien could determine whether AmeriCredit has priority over them.

B. If the state statute requiring a security interest in automobiles to be indicated on a certificate of title does not specifically address AmeriCredit's arguments, what UCC provisions might AmeriCredit cite by way of analogy?

There were several possible answers. What was key was to identify a UCC provisions and make good arguments by analogy. Most answers said that AmeriCredit should cite § 9-506(a), which says that minor errors or omissions do not make a filing statement ineffective unless they are seriously misleading and that the name of a debtor is not seriously misleading if it could be found using standard search logic. These answers argued that AmeriCredit could argue, by analogy, that even if the certificate of title listed the wrong name of the lien holder, anyone looking at the certificate of title would know that there was a lien on the vehicle, which is really what potential creditors would be interested in knowing. Other answers analogized what happened here to the failure of the filing office to index a record correctly, which does not affect the perfection of a security interest under § 9-517.

Note: Some answers missed the point of the question by simply citing § 9-311(a)(2), which says that state statutes outside the UCC govern the perfection of security interests in automobiles by indication on a certificate of title. The question was what arguments could be made if such state statutes were silent on the particular issue presented in the case.

C. If Dealer used secured credit from a lender to buy its inventory of cars, what rights, if any, would this lender have against the Debtors?
None. The lender's security interest would not continue in the car because the Debtors bought the car in the ordinary course. § 9-320(a). In addition, the security agreement presumably would give the dealer the right to sell the cars free of the security interest because otherwise no one would buy the cars and the dealer then could not repay the lender.

Note: Many answers went into elaborate detail about the rights that the lender would have against the Dealer, but that was not part of the question.

D. If AmeriCredit does not prevail in its dispute with the Trustee, what rights would AmeriCredit likely have?

As described above, AmeriCredit would have only the rights of an unsecured creditor against the debtors. AmeriCredit would share in whatever non-exempt assets were left in the estate, if any, after the secured creditors satisfied their interests.

AmeriCredit would have a claim, presumably for breach of contract or negligence, against the Dealer for its error in applying for the certificate of title.

PROBLEM VI. (25 points)

s.i. in
restaurant
equipment
Linn --------> March
<----------
equipment

A. What would be an example of how a secured party could dispose of collateral other than by selling it?

Section 9-610(a) describes how a secured party may dispose of collateral. One example is that a secured party might dispose of collateral by leasing it. § 9-610(a). For instance, in this case, March might have leased the restaurant equipment to another restaurant, if that would have been commercially reasonable. March would apply the rental payments to the debt and presumably would stop leasing the collateral and return it after the debt was fully paid.

B. Under what circumstances, if any, could a secured party repossess the collateral and not dispose of it?

The secured party could repossess the collateral and then hold onto it while it seeks a judicial remedy, so long as that would be commercially reasonable in the circumstances. Okefenokee Aircraft v. PrimeSouth Bank.

In addition, the secured party could repossess the collateral and not dispose of it in a case of strict foreclosure. § 9-620(a). The debtor, however, would have to agree to the strict foreclosure. § 9-620(a)(1).

Note: Some answers said that the secured party could disable the property. But the secured party does not usually do that if it repossesses the property. Compare § 9-609(a)(1) with § 9-609(a)(2).

C. If Linn had sold some of the equipment covered by the security agreement, what rights would March have?

March would have a security interest in the equipment unless he consented to the sale free of the security interest. A buyer of collateral
takes the collateral subject to a security interest unless an exception applies. § 9-315(a)(1). The exception for sales in the ordinary course of business would not appear to apply because Linn was not in the business of selling his equipment. § 9-320(a). The facts do not suggest any other likely exceptions.

March would also have a security interest in the proceeds of the sale. A security interest in collateral automatically continues into the proceeds from disposition of the collateral. § 9-315(a)(2).

March would also likely have a contract claim for breach of the security agreement and could exercise whatever rights the security agreement gave March upon default. § 9-601(a).

D. Would the UCC filing statement suffice to perfect security interests in fixtures (e.g., ovens) sold to Linn?

Although one would have to look at the description of the collateral in the UCC filing statement to know the answer for sure, the fact that the security interest is in fixtures should not by itself be a problem. Article 9 applies to security interests in both goods and fixtures. § 9-102. Security interests in fixtures may be perfected either by filing a financing statement in the Article 9 records or in the office in which a record of a mortgage on the related real property would be filed. 9-501 & cmt. 4.

PROBLEM VII. (25 points)

merchandise
Benetton Trading ----------------> Markowitz
promise to pay
Benetton USA  Weiss
(beneficiary)  (applicant)
\   /       \\
\   /       /HSBC
\  /       Bank
   /       (issuer)

A. Was the letter of credit valid even though Benetton USA did not have to warrant that Markowitz’s corporations owed Benetton USA a debt?

Yes. The only requirement for a letter of credit is that payment must be based on a documentary presentation. § 5-102(a)(10). What these documents say must be presented is left to the parties. There is no requirement that one of the documents must say that the beneficiary is owed a debt. This letter of credit was valid because it was payable upon a documentary presentation. It required HSBC to pay upon presentation of a written demand referencing the letter of credit number and the letter of credit itself.

B. What, if anything, would have prevented Benetton USA from making a baseless demand for payment?

This question does not have a simple answer because the word "prevented" could be read in two different ways. On one hand, nothing would have "prevented" Benetton from making a baseless demand for payment in the sense that if Benetton had wanted to make a baseless demand for payment (i.e., demanded money even if Markowitz owed no money), Benetton could have presented
the documents required by the letter of credit and HSBC could have and likely would have paid Benetton. This was possible because the documents were not required to say that Markowitz owed any money.

On the other hand, several factors likely would have "prevented" Benetton, as a practical matter, from making a baseless demand for payment. First, Benetton would worry about the harm to its business reputation. Second, Benetton would worry about criminal liability for fraud. Third, Benetton would worry about civil liability for breach of contract, breach of warranty, and the tort of deceit (or some other tort).

Note: This purely hypothetical question did not ask whether (or assert that) Benetton USA had made a baseless demand for money. It also did not ask how the parties could have restructured the transaction to provide more protection against baseless demands for money.

C. Assuming the letter of credit was valid, what rights do the parties have against each other now?

HSBC has no rights against any party. Upon paying the letter of credit, HSBC had a right to reimbursement from Weiss, which it realized by debiting his account in the full amount of the payment. § 5-108(a)(1).

Weiss might have a contract claim against Markowitz based on whatever they agreed when they entered into this arrangement. This agreement would be independent of the letter of credit. § 5-103(d).

Although Benetton Trading has received payment of $500,000, it would still have a claim against Markowitz under their underlying contract for any deficit remaining of the original debt of approximately $1 million. Under the independence principle, this claim would not be extinguished by issuance of the letter of credit. § 5-103(d).

D. Why might the parties have decided to use a standby letter of credit instead of a commercial letter of credit?

The parties could not use a commercial letter of credit because Markowitz was buying the goods on credit provided by the seller.

In a typical letter of credit transaction, the seller would present documents to the issuing bank upon shipping the goods, the issuer would pay the seller, and then immediately seek reimbursement from the buyer. That would not have worked here because Markowitz needed to sell the goods in order to have money to repay the seller. As a result, the seller agreed to sell the goods on credit to Markowitz and to use a standby letter of credit, not as a means of obtaining payment immediately, but to provide security for repayment of the credit extended.

Note: Some answers described the difference between commercial and standby letters of credit but never explained that Markowitz could not have used a commercial letter of credit because the seller was selling the goods on credit to Markowitz.