

community BANKER

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Welcome to the latest issue of the COMMUNITY BANKER.

The Community Banker is prepared by attorneys at Olson & Burns P.C. to provide information pertaining to legal developments affecting the field of banking. In order to accomplish this objective, we welcome any comments our readers have regarding the content and format of this publication. Please address your comments to:

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The attorneys at Olson & Burns represent a wide range of clients in the financial and commercial areas. Our attorneys represent more than 30 banks throughout North Dakota.

AN OVERVIEW OF A LENDER'S GOLDEN TICKET -- UCC PRIORITY

Being perfected in the collateral doesn't always mean that your bank has priority in the loan collateral. "Perfection" means that the bank has completed the process required by the UCC to make a security interest in collateral in force and enforceable against third parties. "Priority" is the first-in-time ranking of that perfected security interest among lenders. The point of perfection is for your bank to claim priority over other claimants to the collateral.

Often, two or more secured parties may be perfected in the same collateral; lenders not only want to be perfected, they also want to make sure, as much as they are able, that the bank's perfected security interest



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has priority in that collateral. In language that we are all familiar with in secured financing, this means that the lender wants and seeks a "first priority" security interest - standing at the head of the line of all other perfected security interests in the same collateral.

Priority Isn't Bulletproof

However, even if your bank is at the head of the line, a secured junior lienholder is still able to foreclose upon the collateral of the debtor. Sometimes this happens, even though the foreclosure proceeds from the sale of the collateral are still subject to the lien of the first-priority lienholder and the lender at the front of the line still gets paid first. If a priority lender does not want a junior lienholder to exercise its right to foreclose on the collateral, it can see if the junior is agreeable to an intercreditor agreement where it won't exercise its right to foreclose until some stated time or event. The senior lienholder may have to even consider subordinating its position to the junior in exchange for the junior holding off on foreclosure if having the collateral in use by the debtor will lead to a better payment outcome.

North Dakota's Article 9 sets out in N.D.C.C. § 41-09-37 to § 41-09-59 the priority rules that position competing security interests in the same collateral. Generally, perfected security interests have priority over unperfected ones; but, in the interest of promoting commercial transactions, perfected and unperfected lienholders have no rights against buyers of goods in the ordinary course of business, even if the security interest is perfected and the buyer had actual knowledge of the perfected lien. N.D.C.C. § 41-09-40. (However, note that a buyer of farm products does *not* take free of a security interest created by the seller, even if it's a buyer in the ordinary course of business. North Dakota's buyer of goods statute addresses ag production and is twice as long as that of the Uniform Code, describing the requirements of a CNS filing, issuing checks with both the name of the secured party and the seller, and other matters specific to crop and livestock buyers.)

The protection of commercial transactions is also seen in N.D.C.C. § 41-09-52, which states that transferees of money, including money in deposit accounts, take title free of a security interest in a deposit account "unless the transferee acts in collusion with the debtor in violating the rights of the secured party." A transfer of funds from a deposit account normally will be made by check, by funds transfer, or by debiting the debtor's deposit account and crediting another depositor's account.

Example: Debtor has a deposit account with Bank A, subject to a perfected security interest in favor of Lender. Debtor draws a check on the account, payable to Payee. Inasmuch as the check is not the *proceeds* of the deposit account (it is an order to pay funds from the deposit account), Lender's security interest in the deposit account does *not* give rise to a security interest in the check. Payee deposits the check into its own deposit account, and Bank A pays it. Unless Payee acted in collusion with Debtor in violating Lender's rights, Payee takes the funds (the credits running in favor of Payee) free of Lender's security interest. This is so regardless of whether Payee is a holder in due course of the check and even if Payee gave no value for the check.

So, lenders should be aware that as a general matter, under N.D.C.C. §41-09-35 a security interest attaches automatically to any identifiable proceeds of collateral and there are certain automatic, temporary perfection rules to give continuous perfection of proceeds of collateral. The exceptions to this are the buyer in the ordinary course of business (except for farm products) because it is not commercially reasonable to

check the lien status of every purchase, and the transferee of money.

First to File or Perfect

For competing perfected liens, priority is determined by the time of filing or perfection - the earlier of the date the financing statement is filed or perfection is first accomplished. N.D.C.C. § 41-09-42. For collateral that requires filing as the only means of perfection (like inventory), the first creditor to file its financing statement has priority.

Example. On February 1, Bank A files a financing statement covering a certain item of Debtor's equipment. On March 1, Bank B files a financing statement covering the same equipment. On April 1, Bank B makes a loan to Debtor and obtains a security interest in the equipment. On May 1, Bank A makes a loan to Debtor and obtains a security interest in the same collateral. Bank A has priority even though Bank B's loan was made earlier and was perfected when made. It makes no difference whether Bank A knew of Bank B's security interest when Bank A made its advance.

Why does Bank A have priority if Bank B closed the loan first? Because the public filing records show that Bank A filed before Bank B - and the only material fact is who filed first. N.D.C.C. § 41-09-42(1)(a). The “first to file” priority rule is why “pre-filing” financing statements has become common with secured creditors, who will file financing statements *before* loan closing; closing is then dependent upon a UCC-11 search confirming that lien has priority. Because N.D.C.C. § 41-09-80(1)(a) requires that the debtor authorize the secured creditor to file a financing statement before closing, lenders sometimes modify their pre-closing documents or commitment or proposal letters to include an unambiguous, specific debtor authorization to file financing statements. *After* closing, this authorization is not necessary. N.D.C.C. § 41-09-42(2) provides that a debtor’s signed security agreement is authority for the creditor to file a financing statement on the collateral described in the security agreement.

Perfection by Control

First to act is also applicable to priority questions for collateral where perfection is accomplished by control (such as stock certificates or deposit accounts). N.D.C.C. § 41-09-47(1) and N.D.C.C. § 41-09-48(1) make clear that creditors with control over this type of collateral have priority over creditors who do not have control. For deposit accounts, where the only method of perfection (other than automatic perfection where the depository is the secured creditor) is by a control agreement, a secured creditor has priority over an unsecured creditor. Rarely, several creditors are perfected in the same deposit account when each creditor holds an effective control agreement. N.D.C.C. § 41-09-47(2) ranks priority according to the time of obtaining control.

Securities Accounts

A lender may accomplish perfection in a securities account in one of two ways: by control, as described in N.D.C.C. § 41-09-06 or through the filing of a financing statement under N.D.C.C. § 41-09-32. Although both ways can accomplish perfection, two different creditors might perfect against the same securities account through the two different methods. The UCC thinks of everything: N.D.C.C. § 41-09-48 does not follow the first-in-time rule and here holds that the creditor that perfects through control has priority over the party that perfected by filing, even when the filing happened *before* perfection by control.

This result recognizes the commercial practices of the securities industry where general practice is to use control agreements.

The Effect of the Priority Rules on Fixture Filings

Priority rules for fixtures are a bit different from other collateral because they address the ordering of priority in typical and common collateral where perfection can be accomplished through two different types of filings: a centralized filing with the secretary of state, *or* a local real estate fixture filing, filed in the office of the Recorder in the county where the real estate is located. How is priority in competing liens in fixtures determined where both creditors have achieved perfection through a fixture filing? Under N.D.C.C. § 41-09-54(5), where one creditor has perfected its interest in fixtures by filing in the office of the Recorder and another creditor has perfected its interest in the same collateral through a centralized UCC-1 filing with the office of the Secretary of State, the real estate fixture filing will have priority over the UCC-1 financing statement filing, even if the financing statement is filed first.

Changes in the Makeup of the Collateral

A change in the identity of a Bank's collateral can also affect UCC's priority rules. If secured collateral is sold, it becomes proceeds, which may be classified differently than the original collateral for perfection purposes (think of goods which are sold, creating "accounts receivables"). Too, a secured creditor's collateral may be "changed" in the ordinary course of business. The collateral may be licensed, may be physically united with other collateral without losing its original identity (like a GPS system installed in tractor), or the collateral may be physically united with other assets and lose its original identity (your farm product eggs made into a cake), referred to as "commingling." These events create questions over competing priority claims: one claim to the "original" collateral, the other as in the reconstituted collateral. The priority rules respond to each of these situations with a series of narrow ranking rules. See N.D.C.C. § 41-09-42 for priority disputes over proceeds, N.D.C.C. § 41-09-41 for priority of licensees of general intangibles, N.D.C.C. § 41-09-55 on accessions (the GPS/tractor example), and N.D.C.C. § 41-09-56 for commingled goods.

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