SURETY TODAY PRESENTATION

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Baltimore, MD
August 8, 2016

THE SURETY AND THE UNIFORM COMMERCIAL CODE

This is the fourth edition of the Surety Today. Our topic today is the Surety and the Uniform Commercial Code. Lisa is going to lead off by giving us a run through of the UCC and the various titles.

Lisa: So, just as a framework and some background, the Uniform Commercial Code, which for a lot of people is a beast that is to be avoided, is an interesting promulgation. It is a combination of scholars at the American Law Institute and the Uniform Law Commission, which is comprised of delegates from all of the states. They have come up with ten articles or titles that have been adopted in most jurisdictions, but it's not uniform everywhere. States have the option of adopting some, none or all of the articles or titles. On occasion, States are offered variations to choose from, and some states will not only pick and choose between the articles and variations but sometimes they add their own variations at the time of enactment. One great thing about having uniform codes is that we do get some consistency among the states. We also get really good annotations and illustrations, which not all statutory schemes come with. Particularly, for those of you who have had the occasion to look at mechanic's lien statutes or prompt pay statutes or different things like that, you know they can be a bit of a mess and they don't come with a lot of explanation. However, the UCC does.

We are going to be referring to primarily the Maryland Code sections today, which are identical to the Uniform Code sections. I wanted to note that even though we have great parallelism, not all states do, and I certainly would encourage you to verify the current status and content of the UCC in the relevant and applicable jurisdiction for any matters that you have. It is possible that Code sections we are referencing do not exist in a particular state; they exist with a different section number or they have been modified. We are really going to focus on a couple of the articles of the Uniform Commercial Code this afternoon. I did want to give a run down, in addition to Articles 2 and 9 which we are most concerned with, of the other contents of the Code so that you have a sense of scope and there is a lot of inter relationships.

Article 1 provides general provisions and definitions. A lot of your important definitions are here. I want to point out that there is a provision that captures all of the common law of a particular state where the title is enacted, and it's going to include things like fraud, principal and agent, and concepts that make contracts void or voidable.

The Uniform Commercial Code doesn’t stand independently and it also doesn’t attempt to rewrite those concepts across all 50 states. It instead embraces what those states have and their differences.

Next up is Article 2 which governs the sale of goods. We are going to talk about that in a couple of our examples today. Most importantly, Article 2 provides a very different context for contract formation than common law. It also gives us warranty and remedy provisions that are comprehensive.

Article 2A governs the leases of goods. It is almost identical to Article 2 but not exactly the same. One of the key differences is that it does cover finance leases and those are substantially different from other sales and leases of good. I will note that you can distinguish a lease to be governed by Article 2A and a security interest to be governed by Article 9, which I will get to in a moment. By considering the useful life of the good at the end of the leased term and fair market value versus buy-out costs, the Code doesn’t really care how the document is captioned; it is more concerned with its affects. So, just because it says “lease” doesn’t mean it’s actually going to be a lease.

Articles 3 and 4, not an issue today, but I wanted to point out that Article 3 does cover negotiable instruments. Those are going to be your promissory notes and checks. Article 4 – bank deposits and collections of those checks. Certainly, Articles 3 and 4 issues do come up in the business of a surety now and again, but they are not routinely claims issues.

Article 5 deals with letters and credit, and most states have enacted Article 5. These are often an alternative for collateral. You’re going to look to Article 5 for your very basics on requirements, rights and obligations of the parties, as well as warranties and remedies when those are in use.

Article 6 deals with bulk transfers or bulk sales. Only a few states have that; Maryland is one of those states. That is when a business that deals in inventory sells more than half of its inventory at one time and it protects unsecured creditors, which probably is not a big issue for the surety.

Article 7 documents of title. This one does come up because it is warehouse receipts and bills of lading. These are going to be relevant when you are reclaiming supplies, particularly when reprocurement is problematic because you have custom manufactured goods like structural steel for a particular project or custom millwork, and also might be relevant when commodity prices are rising.

Article 8, which is not on our list for today’s discussions deals with investment securities

Article 9 - secured transactions, is a hot topic for us. Article 9 covers security interests in all personal property; that's tangible and intangible. It's pretty much everything except real estate. Within Article 9 we look at procedures for repossession and sales. A good point to bring up is that timely notice, when you have an Article 9 issue on the surety side, is very important, because self-help repossession by secured creditors moves very, very quickly. Article 9 also governs priorities in the same collateral among different creditors who all want to get the same stuff. It also governs how the creditors deal with a bankruptcy trustee.

Just to give you a flavor of these priority issues, there are three basic priorities. A perfected security interest will always trump an unperfected security interest. I think that is common sense for most of us. If both are perfected, the first to file or to perfect that security interest will win. If both are unperfected, the first to attach wins. So, those are the three basic rules that resolve most of our Article 9 issues. We do, however, have something that's called "line jumping" or almost a super-priority for a purchase money lender who enables a debtor to purchase new inventory or equipment notwithstanding an existing floating lien from another lender. There is an additional concept that gives our buyers in the ordinary course of business the benefit of an implied release of any security interest that may exist in the inventories that they purchase. Finally, I want to note on Article 9 that a security interest always attaches automatically to proceeds of collateral upon their disposition and that the surety's equitable subrogation rights arise from a complete different source and they are outside of the construct of Article 9. While it may sometimes have a similar affect, it is not the same concept. I think Mike is going to talk a little bit now about the first situation where we are dealing with the UCC in claims.

Mike: This is just a short one here; a quick one because I don't think it comes up that often, but it did come up for me earlier in the year. We had a situation with a bank claiming that the surety's rights to equitable subrogation were required to be perfected under the UCC. After I laughed at the guy on the phone, I then went back to find the support for that to make sure that I was correct. The great weight of authority holds that the surety's rights of equitable subrogation are not subject to the UCC, so you don't need to file a UCC-1 or comply with Article 9 in order to perfect your rights to equitable subrogation.

There is a huge number of cases on this point, one in particular, *In re Modular Structures, Inc*., 27 F.3d 72 (3rd Cir. 1994) states that "the overwhelming and essentially unanimous post-UCC decisions in federal as well as state courts have held that no UCC filing is necessary to perfect a surety's interest." Similarly, in the *In re JV Gleason* case (8th Cir.), the court stated that courts have held that the UCC covers consensual security agreements only, not those arising by operation of law and that the surety need not conform to the filing requirements of Article 9 to enforce its equitable right of subrogation. That's one of the ways to address the issue. Does Article 9 apply by its terms? Under section 1-103, the UCC expressly states that it does not displace the particular provisions of the principles of law in equity, which are deemed to supplement the UCC, so the contemplation is not that the UCC has done away with equitable rights, but rather it is a supplementation. I think as Lisa mentioned starting out. So, there is nothing in the UCC that expressly or explicitly refutes subrogation. Section 9-109 regarding the general scope of Title 9 provides that the title applies to a transaction regardless of its form that creates a security interest in personal property or fixtures by contract. This is what the court was saying, equitable subrogation arises by operation of law, it's not a right that arises by contract, so therefore it is not something that would fall under the scope of Title 9. So, that's further support for the fact that the surety's rights to equitable subrogation do not need to be perfected under Article 9. Article 9 has a provision and I have been unable to find any cases that really talk about this in the context of suretyship, but it provides in 9-109(b)(6), that's a provision of Article 9 that excludes various transactions from the application of Article 9, and it excludes an assignment of a right to payment under a contract to an assignee that is also obligated to perform under the contract. I think an argument could be made that a surety might be able to use that as a basis for arguing that Title 9 doesn't apply if you get into that situation. So, I think the issue is pretty clear. I've got a list of 20 or 30 cases that all address the issue of how the UCC does not apply to the surety's equitable right of subrogation. I'm going to turn this back over to Lisa.

Lisa: One of the instances where Article 2 comes in is going to be anytime the surety inherits by takeover or subrogation any kind of a supply contract, or gets a payment bond claim from a supplier. It's just going to be figuring out what the terms of that underlying contract are. The first step in that process is going to be a determination of whether it's an Article 2 contract or not. Most states utilize what's known as the "predominate purpose test", sometimes referred to as the "gravamen test" to determine if it's an Article 2 or what I generally refer to as a common-law contract. So, if you've got a hybrid with some sale and some service or installation component, you've got to figure out is the sale of goods predominant and the installation or service merely incidental? If so, then you are in fact, governed by Article 2. If it's the other way around, you're just utilizing that state's regular common law. The identical contracts, one governed under Article 2, one under the common law, could result in very, very different remedies and outcomes in litigation by the applicability of Article 2 or not.

So, once you get past that hurdle, the important thing to keep in mind is that if you are working in Article 2 and if it's a bare bones agreement and there are lots of blanks, lots of issues that are just silent, the UCC operates to backfill anything that's missing, so just because there's no mention of a warranty doesn't mean that there are no warranties. In fact, silence on that issue suggests substantial comprehensive warranties because that's what the Code would fill in for us. One of the really problematic issues even if you get past the hurdle of determining that it is an Article 2 contract because it's more about the goods than the services is what terms will apply. Sadly, no one ever gets together and negotiates a single integrated, fully executed contract for anything anymore, and certainly not for the sale of goods. What we see more commonly is that a buyer will send a purchase order, routinely by email at this point, to a seller. The seller will respond with some sort of acknowledgment form or perhaps will just ship the goods and include some sort of acknowledgment invoice or packing slip, and both of these documents are covered usually on the back in very small print with boilerplate terms and conditions that don't match at all. This leads us to what is affectionately known by the UCC geeks as the "battle of the forms" under Article 2, section 2-207.

The battle of the forms is an admittedly complex flow chart or even game board of an exercise in sorting out what terms and what conditions actually apply to an agreement. At common law for those of you who are familiar with the mirror image rule, you might remember that if an offer and acceptance didn't match perfectly, the acceptance was deemed a counteroffer. So, if the parties were to move ahead and perform notwithstanding a mismatched offer and acceptance, that acceptance, that last document dispatched, becomes the controlling document. We have completely done away with that under the Code, and instead we go through a complex analysis that examines what terms the parties agree on, what terms they don't agree on, if we've got two merchants, which is almost always the case. If the surety's involved, you've got a contractor and a supplier, two contractors, something like that, we examine things like whether additional terms that have not been agreed upon are material alterations, whether either party objected to the other party's terms and we even look for language called the "provisory language" if either party made their offer or acceptance expressly conditional upon their own terms. So, it's a fairly convoluted process when I said that it's a flow chart or a game board, I'm not exaggerating. I have a full color flowchart that I use to examine these and I probably get about once a month a battle of the forms issue to go through and figure out what the payment terms are, what the warranty terms are and it really does take some time to sort that out.

Once you do examine all of that and figure out what the applicable terms of the contract are, based on Article 2 backfill, based on the battle of the forms, offer terms, acceptance terms, one other thing to keep in mind (particularly if you've inherited a conflict situation), is that Article 2 emphasizes notice of claims and defects. If you are rejecting goods for cause and you don't want to pay for them, you have to give notice to the seller; you've got to itemize everything that was wrong with the tender of delivery. A failure to do so can lead to a waiver of those things, so as is often the case with the surety, you're picking up the pieces on the back end, mistakes have already been made and it may be difficult to go back and correct things if a reasonable time to give notice is long exhausted. To the extent that you are trying to triage the damage and deal with newer issues or catch up on things, giving good detailed notices under Article 2 is going to be your best bet at getting back on track and enforcing all of those warranties and remedies that you are hopefully going to have at the end of that battle of the forms analysis.

Mike: I'm going to talk about a situation that literally I'm just finishing up dealing with that came up here about a month or two ago. It involves a situation where the bonded principal, in my case, was a flooring subcontractor on several bonded jobs. Because of the nature of the flooring business, the principal had to buy the materials in advance and store them in its warehouse, and the reason is because obviously, a lot of that material is long lead-time and they need to have it on hand as soon as the project becomes available for the materials. It's not limited to flooring. You can have any of the trades being in the position of having to buy materials in advance and store them for periods of time until the project is ready for the materials to be used.

In this case, the flooring material was all in the warehouse and then the principal obtained a line of credit from a bank and took out a $2 million loan and gave the security interest to the bank and the security interest attached to all of the principal's interests, including the interest in the materials in the warehouse. Then, the principal promptly collapsed and went out of business, went into bankruptcy and the bank and trustee decided it would be a great idea to sell all of the materials in the warehouse so they could pay off the bank and create some funds for the estate of the debtor at that point.

Needless to say, this is a potentially nasty problem for a surety because on the one hand you've got contract funds that have already been used to pay for those materials or at least have been paid to the principal for those materials, and if those materials are sold, the surety is going to have to repurchase the same materials in order to finish the job, and may incur delay in doing that. If the principal didn't pay the suppliers for those materials, now you've got the possibility of payment bond claims coming up for those same materials that were in the warehouse that are now sold. So, it can be a pretty messy situation and I have heard of situations where the surety has had to essentially pay twice for materials.

So, there are a couple of ways under the UCC to attack this problem. The first is to assert that the title has passed to the materials and therefore the materials are not subject to the security interest of the bank and do not become property of the bankruptcy estate. The second is through your equitable rights of subrogation to assert that the obligee who paid for the materials was a buyer in the ordinary course and takes free of the security interest of the bank under the UCC. Finally you could assert that the sale of the inventory was authorized either expressly or by implication by the secured lender and it is free of the security interest under the UCC.

So, first, you look at it from the standpoint of whether the title has passed and the reason you're looking at title is because if the principal, the debtor, does not have title to the materials, then a subsequent security interest would not attach to those materials and the materials are not property of the bankruptcy estate. So, under §2-401, the title to goods passes from the seller to the buyer in any manner and under any condition explicitly agreed upon by the parties. Comment No. 3 to §2-401 provides that an "explicit agreement" can include usage of trade between the parties. So, initially you want to start looking at the contract documents to see if there is any language in those documents that would transfer title to the materials that were paid for and stored offsite. For example, in the AIA A201 contract, the standard form of contract, section 9.3.3 provides that title transfers to the owner at the time of payment for materials. In addition, you want to look for any bills of sale or other types of documents that might have expressly transferred title to the materials that were stored in the warehouse. In our case, we were able to find the bills of sale and we did have some contract language, so we were able to work with that. You just need to establish payment, establish copies of the checks and all that.

The second approach is to assert that there was a buyer in the ordinary course. Section 9-320(a), provides that a buyer in the ordinary course of business takes free of the security interest created by the buyer's seller, even if the security interest is perfected and the buyer knows of its existence. So, in our example, the seller here is the principal and the buyer, of course, would be the obligee. So the question is, what is a buyer in the ordinary course under §9-320? The UCC section 1-201(9) defines that term as a person that buys goods in good faith, without knowledge that the sale violates the rights of another person in the good and ordinary course from a person in the business of selling goods of that kind. A purchase is in the ordinary course if the sale to the person comports to the usual or customary practices in the kind of business that the seller has been engaged or if it comports with the seller's own usual or customary practices. Of course, "good faith" is also defined by the Code as honesty in fact in the conduct or transaction concerned. So basically, I think you can make that argument because typically in the construction context, the obligee, the general contractor, they are in the business of buying those materials and the trade subcontractors are in the business of selling those materials and ordinarily these things are happening on an ordinary basis with standard contract forms, etc. I think you can make that argument pretty good in a standard situation.

The third approach would be to argue that it was an authorized sale. So, section 9-315(a)(1) provides that a security interest continues in collateral notwithstanding a sale or other disposition unless the secured party authorized the disposition free of its security interest and such security interest attaches to the proceeds of the collateral. So, there are two aspects to this. One is there has got to be authorization and two, there has to be a continuation of the security interest in the proceeds if the materials are sold. The second requirement of the continuation of security interest is generally met under the UCC because there is a provision for automatic security interest in cash proceeds of sale of collateral. That part is covered. Authorized sale typically in the circumstance where materials have been purchased by the principal and are stored in a warehouse, at that point, the argument would be that they become "inventory". They are now the inventory of the principal in its transactions with the obligees and the general contractors. So, in that circumstance, I think you will typically find in any financing agreement with a bank, if you are able to get a copy of that, that the bank has authorized the sale of inventory because they want the inventory to be sold so that the money can be used to pay down the loan. Courts have recognized that as well saying, look if you are financing inventory, you want these things, you understand that the inventory is going to be sold so that the money can come in to pay back the loan, so the courts have looked at that and said there is an implicit authorization there that the goods be sold free of security interest. So, those are a couple of ways to get around that situation where you've got the principal collapsing with materials in the warehouse. We asserted all of those arguments in our brief in the bankruptcy court and we were able to convince the trustee to release our materials free and clear without any payment.

Lisa: Variation on Mike's example of that very recent matter is more so related to equipment than materials, but if you have an equipment lender under Article 9 or an equipment lessor under Article 2A seeking to recover equipment that is currently being used on a project, this could pop up for a financing or takeover surety or a subcontractor surety. You're going to have essentially someone claiming an interest in the equipment or materials, what I refer to as "inside the fence," something that is currently being used on the project. It is needed to complete the project and you have this party asserting an interest and seeking to remove it. A lessor might file a payment bond claim. The secured party is more likely to repossess, possibly in the middle of the night. A couple of things to look at here is whether there are contract provisions providing the owner or contractor has right to the equipment, look at the timing of that, and maybe consider some creative arguments about whether the contractor lacks sufficient rights to grant a security interest, or whether you can construe those contract provisions as a sublease upstream to a general contractor or an owner. Certainly, joint checks negotiating payment would be ideal here, but the real key should be keeping this equipment on the project so the project can finish rather than getting into a long battle over equipment that has already walked away.

Mike: Okay. Let's do a quick wrap up before we get into the question and answer session. The next edition of Surety Today will be Monday, September 12 at 12:30 EST, using the same call in number, code and pin. The topic will be "Recent Decisions in Non-Dischargeability in Bankruptcy." There have been a couple of Supreme Court decisions that have resolved some disputes or splits among the Circuit Courts regarding the fraud exception and regarding the defalcation exception so we will talk about those with Jason Potter of Wright Constable.

Now for a quick rundown of upcoming events in the surety world:

- August 18: the Atlanta Surety Claims Luncheon
- September 7 – 9: Pearlman conference in Seattle, WA.
- September 14: Philadelphia Surety Claims Association lunch in Philadelphia.
- September 21 – 23: Northeast Surety Claims Conference in Atlantic City. You can sign up for that on Forcon International's website. You can sign up online there and it's free for in-house company people. I hope to see everybody there. Wright Constable is a co-sponsor of that conference.

I want to thank everyone for calling in and we hope you will join us again on September 12.