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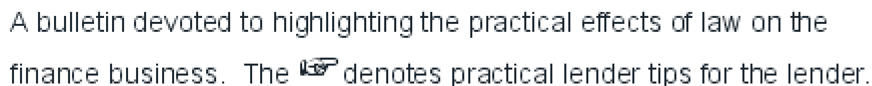
The Practical Lender



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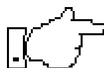
April 1998

PRIOR PERFECTED SECURITY INTERESTS: AN ALARMING APPLICATION OF THE HOLDER-IN-DUE-COURSE RULE

Senior secured lenders normally take comfort in the fact that their prior perfected security interests in accounts receivable are superior in interest to any subsequent perfected security interests. However, mere prior perfection may not always be enough. Application of the holder-in-due-course rule can lead to the elimination of competing interests which would otherwise be superior, including prior perfected security interests. The 1995 Arizona state court decision in the *Familian* case (described below) should alert senior secured lenders to a rather troubling application of the holder-in-due-course rule. Several practical suggestions are made below to avoid *Familian's* harsh outcome.

The Familian Case

In *Financial Management Services, Inc. v. Familian Corp.*, 183 Ariz. 497, 905 P.2d 506 (1995 Court of Appeals of Arizona), the court surprisingly ruled in favor of a junior secured lender after a somewhat bizarre application of the holder-in-due-course rule. In summary, the court held that a junior secured lender was entitled to proceeds of accounts receivable free of the senior secured lender's prior perfected security interest because the court found that the junior secured lender was a holder-in-due-course.



As a general matter, debtors should be prohibited from incurring unpermitted funded indebtedness under loan and security agreements.

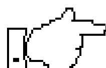
In order to understand the decision in *Familian*, the following facts are integral. Pursuant to a series of promissory notes and security agreements, Lender A (the "Senior Secured Lender") was granted a security interest in all of the debtor's accounts receivable, inventory and equipment, and a financing statement was filed with the appropriate Secretary of State. The security agreements did not restrict, however, the debtor's ability or right to use payments on the accounts receivable in the ordinary course of its business. Several years later the debtor entered into a security agreement with Lender B (the "Junior Secured Lender") also covering the debtor's accounts receivable, and another financing statement was filed.

The Junior Secured Lender became concerned with the size of the debt of the debtor after learning that substantial amounts were owed and paid to the Senior Secured Lender. Consequently, and without the knowledge of the Senior Secured Lender, the Junior Secured Lender and the debtor agreed to a debt-reduction plan (the "Plan") in which the debtor's accounts receivable customers would make all further payments jointly to the debtor and the Junior Secured Lender. Letters were sent to the debtor's customers informing them of the Plan. Pursuant to the Plan, the debtor notified the Junior Secured Lender when it received a joint check, and the debtor and the Junior Secured Lender would agree on how to divide the amount. The debtor would then make a check payable to the Junior Secured Lender for the portion which they determined the Junior Secured Lender was entitled to receive. In return, the Junior Secured Lender would endorse the joint check and negotiate it to the debtor.

The debtor ceased business operations and the Senior Secured Lender sought to recover from the Junior Secured Lender the proceeds of accounts receivable received by the Junior Secured Lender.

Despite the existence of the Plan, the judge in *Familian* found relevant that both the Senior and Junior Secured Lenders considered the debtor a good customer, and that neither ever suspected that the debtor was in financial trouble. Pursuant to their security agreements with the debtor, neither the Senior nor Junior Secured Lender considered the debtor to be in "default" on the loans. *However, the court indicated that pursuant to a UCC-1 search the Junior Secured Lender knew that the Senior*

Secured Lender was a prior secured lender of the debtor throughout the time of the Plan's existence.



Senior secured lenders should consider inserting notations on UCC-1 financing statements which put potential junior secured lenders on notice that proceeds of the collateral cannot be used for any purpose with the exception of certain payments in the ordinary course permitted by the applicable loan and security agreement.

After deciding that the Senior Secured Lender's security interest attached to the accounts receivable proceeds collected by the Junior Secured Lender, the court nevertheless stripped the Senior Secured Lender of any rights to those proceeds by finding that the Junior Secured Lender was a holder-in-due-course of those proceeds. To qualify as a holder-in-due-course, four requirements exist under the Uniform Commercial Code (the "UCC") in effect in Arizona: 1) the party must have been a "holder", 2) for value, 3) in good faith, and 4) without notice that the instrument was overdue or had been dishonored or of any defense against or claim to the instrument on the part of any person. The source of the dispute in this case focused on the third and fourth requirements of the four-part test.

First, the court held that the "in good faith" requirement was governed by a subjective (or "honesty-in-fact") test. That is, a mere "reason to know" that something was wrong was found by the court to be immaterial. Although the Junior Secured Lender was aware of the prior perfected security interest of the Senior Secured Lender, the court found that knowledge of the prior secured financing itself could not implicate the Junior Secured Lender with knowledge that either it or the debtor was acting wrongly by consummating the Plan. The court went on to state that had the Junior Secured Lender believed that the debtor was on the verge of bankruptcy or unable to pay its debts, its actions may have constituted bad faith.

With respect to the fourth requirement, the court held that "notice" incorporates "actual knowledge of a defense or of such facts that would alert a holder to a possible defense." Again, the court stated that the existence of a prior security

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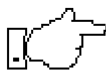
interest did not give the Junior Secured Lender notice of a possible claim to the checks because the Junior Secured Lender had no reason to suspect that the debtor could not pay the Senior Secured Lender. The court reasoned that recipients of routine checks in the normal course of business should not be required to make speculative inquiries before accepting payment.



Senior secured lenders should consider the use of greater restrictions in their loan and security agreements on a debtor's ability to use proceeds from accounts receivable or other forms of collateral (even in the "ordinary course of business").

Finally, after summarizing various other arguments, the court rejected the Senior Secured Lender's claim that even if the Junior Secured Lender was a holder-in-due-course, the Junior Secured Lender was still liable for conversion because UCC Article 3 (governing the holder-in-due-course rules) is subject to UCC Article 9 (secured transactions). The court summarily disposed of that argument by stating that, pursuant to UCC Section 9-309, a junior secured lender who is a holder-in-due-course of a negotiable instrument takes the instrument free of any party's prior security interest in the instrument.

Conclusion

Although the *Familian* decision is troubling for senior lenders and possibly incorrect, it highlights the importance of drafting security agreements which include provisions restricting and/or limiting the ability of debtors to either advertently or inadvertently use proceeds from accounts receivable and other forms of collateral to pay down debts with junior secured or unsecured lenders at the expense of the senior secured lender. By drafting security agreements with careful language and appropriate notice requirements as recommended above, the likelihood of adverse results in *Familian* circumstances can be minimized.

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