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## **Commercial Transactions**

John Krahmer

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# COMMERCIAL TRANSACTIONS

*John Krahmer\**

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**A**LTHOUGH 2007 was a legislative year, only a handful of amendments were made in the Texas Uniform Commercial Code (the “Code,” or the “Texas UCC”).<sup>1</sup> The most important of these affected only Chapter 9 and are described below in the Secured Transactions section. Most of this *Survey*, therefore, discusses recent cases interpreting and applying various provisions of the Code.

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\* Professor of Law and Foundation Professor of Commercial Law, Texas Tech University. B.A., J.D., University of Iowa; LL.M., Harvard University.

1. The Texas version of the Uniform Commercial Code is contained in the first eleven chapters of the Texas Business and Commerce Code (the “Code”). *See* TEX. BUS. & COM. CODE ANN. §§ 1.101-11.108 (Vernon 1994, 2002 & Supp. 2008). These chapters are designated as follows:

- Chapter 1: General Provisions
- Chapter 2: Sales
- Chapter 2A: Leases
- Chapter 3: Negotiable Instruments
- Chapter 4: Bank Deposits and Collections
- Chapter 4A: Funds Transfers
- Chapter 5: Letters of Credit
- Chapter 7: Documents of Title
- Chapter 8: Investment Securities
- Chapter 9: Secured Transactions; Sales of Accounts and Chattel Paper
- Chapter 10: [Reserved for Expansion]
- Chapter 11: 1973 Transition Provisions

## I. GENERAL PROVISIONS

### A. GOOD FAITH

Chapter 1 of the Code was revised during the 2001 legislative session to reflect changes made to Article 1 in the Official Text.<sup>2</sup> The revision changed the definition of “good faith” from “honesty in fact” (a subjective standard), to include both honesty in fact and “the observance of reasonable commercial standards of fair dealing” (an objective standard).<sup>3</sup> The revision also moved the provision imposing an obligation of good faith on every contract or duty within the Code from section 1.203 to section 1.304. In *Apache Corp. v. Dynegey Midstream Services, L.P.*,<sup>4</sup> the court recognized that section 1.304 imposes a duty of good faith, but held no separate cause of action for breach of the duty arises absent a contract provision to which the duty can be tied. The contract in question required a processor of natural gas to resell the gas and remit a percentage of the proceeds to the producer. The contract did not, however, contain any requirement that the processor obtain the best possible price for the gas. Absent such a provision, the court held the producer did not have an independent claim for breach of the duty of good faith.<sup>5</sup> This ruling is consistent with prior Texas law applying the former Section 1.203.<sup>6</sup> In contrast to *Apache*, the court in *Aluchem, Inc. v. Sherwin Alumina, L.P.*,<sup>7</sup> made the inexplicable statement that “[s]ection 1.203 . . . has been deleted from the Texas UCC. . . . The new [s]ection 1.203 does not address any implied covenant of good faith, and such an implied covenant is not included in the revised Texas UCC.”<sup>8</sup> Apparently, neither court nor counsel realized the obligation of good faith had not been deleted, but had simply been moved from section 1.203 to section 1.304.<sup>9</sup>

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2. The Official Text of the Code is promulgated jointly by the National Conference of Commissioners on Uniform State Laws and the American Law Institute. The Official Text of Article 1 may be found in 1 UNIFORM COMMERCIAL CODE REPORTING SERVICE, Revised Article 1 (Thomson/West 2006). The Official Text, with some non-uniform variations, was adopted in Texas by Act of June 20, 2003, 78th Leg., R.S., ch. 542, §§ 1-21, 2003 Tex. Gen. Laws (Vernon) and codified as TEX. BUS. & COM. CODE ANN. §§ 1.101-310 (Vernon Supp. 2008). The changes made by the revision are described in John Krahmer, *Commercial Transactions*, 57 SMU L. REV. 700-703 (2004).

3. See TEX. BUS. & COM. CODE ANN. § 1.201(b)(20) (Vernon Supp. 2008).

4. 214 S.W.3d 554 (Tex. App.—Houston [14th Dist.] 2006, pet. granted).

5. *Id.* at 563.

6. See, e.g., *N. Natural Gas v. Conoco, Inc.*, 986 S.W.2d 603 (Tex. 1998); *Wells Fargo Bank, N.A. v. Citizens Bank of Tex., N.A.*, 181 S.W.3d 790 (Tex. App.—Waco 2005, pet. denied); and *Commercial Nat'l Bank of Beeville v. Batchelor*, 980 S.W.2d 750 (Tex. App.—Corpus Christi, 1998, no pet.).

7. No. C-06-183, 2007 WL 1100473 (S.D. Tex., April 11, 2007).

8. *Id.* at \*n.6.

9. *Aluchem* is not the only recent decision where a relevant provision of the Code went unrecognized. In *Vt. Info. Processing, Inc. v. Mont. Beverage Corp.*, 227 S.W.3d 846 (Tex. App.—El Paso 2007, no pet.), the plaintiff alleged that the parties had entered into a lease of computer equipment and software. When the lessee stopped making payments, the lessor sued for the remaining payments due under the lease. The lessee defended on the ground that the lease agreement was unenforceable because there was no written agreement and, this violated the statute of frauds requirements in TEX. BUS. & COM. CODE ANN. §§ 2.201 & 26.01 (Vernon 1994 & Supp. 2008). Section 26.01 contains general statute

In addition to the definition of good faith and the general rule imposing a duty of good faith in transactions governed by the Code in chapter 1, a requirement of good faith is explicitly stated in other chapters of the Code.<sup>10</sup> Section 2.305 allows parties to enter into enforceable contracts for the sale of goods even if the parties have not agreed on a price. In such “open price” contracts, the price can be established under one of the default rules provided in that section.<sup>11</sup> One such default rule allows the price to be fixed by the seller or by the buyer if the price is fixed “in good faith.”<sup>12</sup> In *Exxon Mobil Corp. v. Gill*,<sup>13</sup> the court certified a class action by gasoline retailers alleging a wholesale producer breached the duty of good faith under section 2.305 by failing to provide economic benefits promised under the producer’s rebate program. The court carefully distinguished *Shell Oil Co. v. HRN, Inc.*,<sup>14</sup> previously decided by the Texas Supreme Court. In *HRN*, the supreme court held that a price fixed by the seller would not violate the duty of good faith if the price was commercially reasonable and did not result “in a commercial injury distinct from the price increase itself.”<sup>15</sup> In *Gill*, the court reasoned that the failure of the producer to provide the economic benefits promised by its rebate programs would, if proven, satisfy the *HRN* standard as a commercial

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of frauds rules applicable to contracts not covered by a more specific statute of frauds provision in another statutory provision. Section 2.201 is an example of a more specific provision applicable to contracts for the sale of goods.

The court held that part performance of the alleged lease would remove the bar of the statute of frauds under either statutory provision. Whether part performance had occurred, however, was a question of material fact. Because this question of fact had not been resolved, the court ruled that summary judgment should not have been granted in favor of the lessee and the case was remanded.

The court may have reached the right decision for the wrong reason. Leases of goods are covered by chapter 2A of the Code and that chapter contains a statute of frauds specifically applicable to leases. There is no mention anywhere in the opinion to TEX. BUS. & COM. CODE ANN. 2A.201 (Vernon 1994), a section that would seem to apply to the transaction in this case, including a provision dealing with part performance. See TEX. BUS. & COM. CODE ANN. 2A.201(d)(3) (Vernon 1994).

10. See, e.g., TEX. BUS. & COM. CODE ANN. § 2.305 (Vernon 1994) (price to be fixed by seller in good faith); 2.306 (output or requirements quantities must be such as occur in good faith); TEX. BUS. & COM. CODE ANN. § 3.302 (Vernon 2002) (to qualify as a holder in due course the holder must act in good faith); § 4.103 (bank’s duty of good faith cannot be disclaimed); § 9.330 (rights of purchaser of chattel paper acting in good faith).

11. TEX. BUS. & COM. CODE ANN. § 2.305 (Vernon 1994) provides:

(a) the parties if they so intend can conclude a contract for sale even though the price is not settled. In such a case the price is a reasonable price at the time for delivery if

- (1) nothing is said as to price; or
- (2) the price is left to be agreed by the parties and they fail to agree; or
- (3) the price is to be fixed in terms of some agreed market or other standard as set or recorded by a third person or agency and it is not so set or recorded.

(b) A price to be fixed by the seller or by the buyer means a price for him to fix in good faith.

12. *Id.* § 2.305(b).

13. 221 S.W.3d 841 (Tex. App.—Corpus Christi 2007, pet. filed).

14. 144 S.W.3d 429 (Tex. 2004).

15. *Id.* at 436.

injury distinct from the price itself.<sup>16</sup> The court of appeals determined this issue satisfied the commonality requirement for a class action and that the other requirements for a class action were satisfied as well. The trial court class action certification order was affirmed.<sup>17</sup>

## II. SALE OF GOODS

### A. CONTRACT FORMATION AND ENFORCEABILITY

Chapter 2 is more liberal than the common law in allowing parties to form a contract for the sale of goods. Instead of using the “mirror image rule” of the common law requiring a “mating dance” with an acceptance that mirrors an offer, section 2.104 allows a contract to be formed in any manner sufficient to show agreement, including conduct by both parties recognizing the existence of a contract.<sup>18</sup> In addition, an offer to make a contract is construed as inviting acceptance in any manner and by any medium that may be reasonable under the circumstances.<sup>19</sup> Even if an acceptance states terms that are additional to or different from those contained in the offer, a contract may be formed unless the acceptance is expressly made conditional on agreement to the additional or different terms.<sup>20</sup> In *K.L. Enterprises, Inc. v. Home Depot International, Inc.*,<sup>21</sup> based on a price quotation received from the seller, a buyer placed a purchase order for electrical supplies. The purchase order differed from the quotation by requesting that the quoted prices be held until a few days later when the buyer would provide a check for the full purchase price. The seller did not object. When the check was delivered to the seller on the stated date, the seller acknowledged receipt in writing with a proviso that an order would be placed for the goods “upon the processing of [this] check.”<sup>22</sup> On the following day, the seller told the buyer that a mistake had been made in the quotation and refused to deliver the goods.

In an action by the buyer for breach of contract and negligent misrepresentation, the court, referring to the Code sections described above, held that neither the additional terms in the purchase order, nor the seller’s proviso regarding processing of the check, were fatal to the formation of a valid contract. The court also rejected an argument by the seller that, under the Code, a sale had not occurred because the goods were never delivered to the buyer and, therefore, title to the goods had

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16. *Gill*, 221 S.W.3d at 852.

17. *Id.* at 884.

18. The mirror image rule and the Code rules on contract formation are discussed in E. ALLEN FARNSWORTH, *CONTRACTS* § 3.21 (4th ed. 2004). *See also* 1 JAMES J. WHITE & ROBERT S. SUMMERS, *UNIFORM COMMERCIAL CODE: PRACTITIONER’S TREATISE SERIES* § 1-2 (5th ed. 2006).

19. *See* TEX. BUS. & COM. CODE ANN. § 2.206(a) (Vernon 1994).

20. *See id.* § 2.207(a).

21. No. 4:06-CV-722-A, 2007 WL 1629236 (N.D. Tex., June 1, 2007).

22. *Id.* at \*2.

not passed.<sup>23</sup> The court held that passage of title was irrelevant on the issue of whether a contract had been formed.<sup>24</sup> The seller's motion for summary judgment on the breach of contract and negligent misrepresentation issues was denied.<sup>25</sup>

In contrast to the generally liberal rules in chapter 2 regarding contract formation, the rules governing sales by auction are relatively formal. Under section 2.328, a sale by auction is complete when the hammer falls or when the auctioneer declares the sale to be final in some other customary manner.<sup>26</sup> An auction may be conducted "with reserve" or "without reserve." If the auction is "with reserve," the seller can withdraw the goods at any time before the sale is complete. In an auction conducted "without reserve," the goods cannot be withdrawn unless no bid is made within a reasonable time. Unless designated as being "without reserve," the default rule is that the auction is "with reserve."

In *Cedyco Corp. v. PetroQuest Energy, LLC*,<sup>27</sup> after a completed sale by auction of its interest in two oil wells, the seller discovered that it could not deliver clear title to the wells and refused to transfer title to the successful bidder. In an action by the bidder for breach of contract, the seller argued it could withdraw the goods because the auction was conducted "with reserve," or, alternatively, the bidder was aware the sale was subject to a condition—that the consent of another party was required before the seller could transfer title. Applying section 2.328, the court held the seller could not withdraw the goods because the sale had been completed and the right to withdraw in a "with reserve" auction ends at the moment of completion.<sup>28</sup> The court did agree, however, that the existence of a condition precedent for the transfer of title was known by the buyer when the auction was conducted. On this basis, the court ruled in favor of the seller.<sup>29</sup>

Even if a contract is formed under chapter 2, a party seeking to enforce the contract must satisfy the statute of frauds requirements in section 2.201 if the price of the goods is five-hundred dollars or more.<sup>30</sup> In *Hartis v. Century Furniture Industries, Inc.*,<sup>31</sup> a furniture manufacturer consigned furniture to a furniture showroom. Over a period of time, a substantial

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23. The seller based this argument on TEX. BUS. & COM. CODE ANN. §§ 2.106(a) (Vernon 1994) and 2.401(b) (Vernon Supp. 2008) (which deals with the passage of title to goods identified to the contract). *K.L. Enters.*, 2007 WL 1629236, at \*5.

24. *K.L. Enters.*, 2007 WL 1629236, at \*5.

25. *Id.* \*6.

26. TEX. BUS. & COM. CODE ANN. § 2.328(a) (Vernon 1994).

27. 497 F.3d 485 (5th Cir. 2007).

28. *Id.* at 488.

29. *Id.* at 488-89.

30. TEX. BUS. & COM. CODE ANN. § 2.201 (Vernon 1994) provides several ways in which the statute of frauds can be satisfied. These include a writing signed by the party against whom enforcement is sought; by a failure of a merchant to promptly object to the terms of a communication confirming an oral agreement; by commencing manufacture of custom goods that are not suitable for sale to others; by admission in pleadings, testimony, or otherwise; or by accepting or paying for the goods.

31. 230 S.W.3d 723 (Tex. App.—Houston [14th Dist.] 2007, no pet.).

quantity of the consigned furniture was sold, but the showroom did not remit any proceeds to the manufacturer. In an effort to settle the debt, the showroom reached an agreement allowing the manufacturer to take possession of the remaining consigned furniture as well as other furniture in the possession of the showroom, and credit the value of the furniture against the amount of the debt. The manufacturer sued the showroom for the balance remaining due after crediting the value of the furniture to the debt. The showroom counterclaimed for breach of contract, arguing that the credit of the furniture against the debt was less than the parties had agreed to in valuation lists exchanged after possession had been transferred. The court held the showroom had produced no evidence showing the existence of a new contract superseding the earlier agreement; instead, the exchange of valuation lists merely addressed the amount of the offset to be applied to the existing debt, and did not satisfy the statute of frauds in section 2.201.<sup>32</sup> Indeed, in the view of the court, that section was inapplicable because the communications dealt with a debt and not with the sale of goods.<sup>33</sup> Judgment in favor of the manufacturer was affirmed.<sup>34</sup>

Application of the statute of frauds was also considered in *East Hill Marine, Inc. v. Rinker Boat Co., Inc.*,<sup>35</sup> where a boat manufacturer terminated distributorship agreements with two boat dealers. The dealers sued the manufacturer for breaching alleged oral agreements promising the dealers exclusive distributorships. The action was premised on two contentions. First, the termination violated various provisions of the Texas Occupations Code governing distributorship contracts.<sup>36</sup> Second, the contracts were contracts for services rendered by the dealers and not contracts for the sale of goods.<sup>37</sup> As to the alleged violation of the Occupations Code, the court held the claim would not lie because the distributor contracts were not in writing.<sup>38</sup> The court reasoned that without a written agreement, the requirement that termination be for good cause did not apply.<sup>39</sup>

As to the claim that the contracts were contracts for services rather than contracts for the sale of goods, the court noted that only a single Texas case had discussed the issue.<sup>40</sup> However, that case, along with the "overwhelming majority" of other jurisdictions, hold that distributorship

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32. *Id.* at 733.

33. *Id.*

34. *Id.*

35. 229 S.W.3d 813 (Tex. App.—Fort Worth 2007, pet. denied).

36. TEX. OCC. CODE ANN. §§ 2352.051, 2352.053 (Vernon 2004) require dealership agreements to be in writing, and provide, that a manufacturer must have good cause before a dealer can be terminated.

37. If the contracts were for services rather than goods, the dealers could attempt to prove the existence of oral distributorship agreements without running afoul of the sale of goods statute of frauds in TEX. BUS. & COM. CODE ANN. § 2.201 (Vernon 1994).

38. *East Hill Marine*, 239 S.W.3d at 817.

39. *Id.* at 817-18.

40. *Id.* at 819. The case cited by the court was *Cont'l Casing Corp. v. Siderca Corp.*, 38 S.W.3d 782 (Tex. App.—Houston [14th Dist.] 2001, no pet.).

contracts are contracts for the sale of goods subject to the Code. On this basis, the court ruled that the breach of contract claim also failed because the oral agreements did not satisfy the chapter 2 statute of frauds.<sup>41</sup> Summary judgment in favor of the manufacturer was affirmed.

The Texas Courts of Appeals are in conflict on whether the Code or the Texas Certificate of Title Act govern contracts for the sale of motor vehicles.<sup>42</sup> In *Vibbert v. Par, Inc.*,<sup>43</sup> the court agreed with those cases holding that the Code prevails over the Certificate of Title Act, and ruled that the sale of a motor vehicle had effectively occurred even though the certificate of title was not transferred at the time of sale.

## B. WARRANTIES, DISCLAIMERS, AND REMEDIES

Under the economic loss rule, if a defective product causes damage only to the product itself, a cause of action for breach of warranty is governed by the Code and a claim in tort will not lie. If the product causes damage to persons or to other property in addition to causing damage to itself, the economic loss rule does not preclude a tort action.<sup>44</sup> In *Equistar Chemicals, L.P. v. Dresser-Rand Co.*,<sup>45</sup> a buyer purchased two gas compressors for use in its chemical business. The compressors contained two forty-two inch impellers. These operated to increase the pressure of incoming gas and compress it into a smaller volume. Several years later, the buyer asked the seller to upgrade the compressors by installing forty-four inch impellers to increase output. After installation, the new impellers suffered various breakdowns. At the request of the buyer, the seller modified one of the impellers by physically trimming it to forty-two inches. The seller advised the buyer that output could be increased by running the modified impeller at a higher speed. The modified impeller later failed, damaging the compressor as well as parts of the buyer's factory. The seller provided repair and replacement engineering services to the buyer to rebuild the damaged compressor. In the course of making repairs, the seller replaced the failed impeller with one of the original impellers purchased by the buyer years before. The replacement itself

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41. *East Hill Marine*, 229 S.W.3d at 820.

42. *Compare* *Park Cities Ltd. P'ship v. Transpo Funding Corp.*, 131 S.W.3d 654 (Texas App.—Dallas 2004, pet. denied) (Certificate of Title Act controls and sale of motor vehicle void if certificate of title not transferred at time of sale); *Gallas v. Car Biz, Inc.*, 914 S.W.2d 592 (Tex. App.—Dallas 1995, writ denied) (same), *and* *Pfluger v. Colquitt*, 620 S.W.2d 739 (Tex. App.—Dallas 1981, writ ref'd n.r.e.) (same) *with* *First Nat'l Bank of El Campo v. Buss*, 143 S.W.3d 915 (Tex. App.—Corpus Christi 2004, pet. denied) (Code controls and sale is not void even though certificate of title not transferred at time of sale), *and* *Hudson Buick, Pontiac, GMC Truck Co. v. Gooch*, 7 S.W.3d 191 (Tex. App.—Tyler 1999, pet. denied) (same). The conflict arises because of differing interpretations of the statutory language in TEX. TRANSP. CODE ANN. § 501.071(a) (Vernon 2007) and TEX. BUS. & COM. CODE ANN. § 2.401 (Vernon Supp. 2008).

43. 224 S.W.3d 317 (Tex. App.—El Paso 2006, no pet.).

44. *See, e.g.,* *Mid Continent Aircraft Corp. v. Curry County Spraying Serv., Inc.*, 572 S.W.2d 308, 309-13 (Tex. 1978); *Signal Oil & Gas Co. v. Universal Oil Prods.*, 572 S.W.2d 320, 326-29 (Tex. 1978).

45. 240 S.W.3d 864 (Tex. 2007).



subsequently failed and again caused damage to the compressor and the factory. The buyer sued the seller on theories of negligence, strict liability, and breach of warranty.

At trial, the jury was asked only a single damages question: What amount of money was necessary to restore the buyer's plant to the condition it was in prior to the failure of the compressor? The seller did not object to this question, but did lodge a no-evidence objection. The jury rendered a verdict in favor of the buyer. In the court of appeals, the seller contended the no-evidence objection was sufficient to preserve error on whether the economic loss rule should have been applied by the trial court.<sup>46</sup> The court of appeals agreed and held that application of the economic loss rule barred recovery because, under the rule, the buyer's claim sounded only in contract for breach of warranty and the warranty claim was barred by limitations.<sup>47</sup> On further appeal, the Texas Supreme Court held the court of appeals was in error in concluding the defendant's no-evidence objection was sufficient to preserve appellate review about application of the economic loss rule.<sup>48</sup> The supreme court pointed out that the defendant should have objected to the single damage instruction and requested separate instructions on tort and contract damages.<sup>49</sup> The case was remanded to the court of appeals for consideration of the seller's factual sufficiency objection.<sup>50</sup>

The effectiveness of warranty disclaimers has been litigated in numerous Texas cases.<sup>51</sup> In *Davidow v. Inwood North Professional Group—Phase I*,<sup>52</sup> the supreme court held that a lease of commercial property carries with it an implied warranty that the property is suitable for the

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46. *Equistar Chems., L.P. v. Dresser-Rand Co.*, 123 S.W.3d 584 (Tex. App.—Houston [14th Dist.] 2003, *rev'd* 240 S.W.3d 864 (Tex. 2007)). The limitation period for breach of warranty actions is four years commencing from the time of tender of delivery of the goods. TEX. BUS. & COM. CODE ANN. § 2.725 (Vernon 1994). The limitation period for tort claims is only two years, but the time begins to run when the injury takes place. TEX. CIV. PRAC. & REM. CODE § 16.003 (Vernon Supp. 2008). It is possible, therefore, for a tort claim to arise for an injury that occurs more than four years after tender of delivery. Thus, in cases like *Equistar*, a warranty claim might be barred because goods were purchased more than four years earlier, like the original impeller that was purchased in the 1970s, but a tort claim does not arise until years later when the goods cause damage, such as the failure of the original impeller that was reinstalled in 1999, with an action for damages filed in 2000.

47. *Equistar Chems.*, 123 S.W.3d at 588.

48. *Equistar Chems, L.P. v. Dresser-Rand Co.*, 240 S.W.3d 864, 868 (Tex. 2007).

49. *Id.*

50. *Id.*

51. The cases have addressed disclaimers in both Code and non-Code cases. *See, e.g.*, *Centex Homes v. Buecher*, 95 S.W.3d 266, 274-75 (Tex. 2002) (implied warranty of good workmanship in construction of home can be disclaimed if contract provides for manner of performance or for standard of construction); *Prudential Ins. Co. of Am. v. Jefferson Assocs., Ltd.*, 896 S.W.3d 156, 161 (Tex. 1995) ("as is" disclaimer places risk of defect on buyer of commercial building); *Dresser Indus. v. Page Petroleum, Inc.*, 853 S.W.2d 505 (Tex. 1993) (definition of "conspicuous" in TEX. BUS. & COM. CODE ANN. § 1.201(10) (Vernon 1994) (now § 1.201(b)(10) (Vernon Supp. 2008)) applies to contracts of all types even if contract not otherwise governed by the Code); *Cate v. Dover Corp.*, 790 S.W.3d 559 (Tex. 1990) (disclaimer known to the buyer is effective even if it is not conspicuous).

52. 747 S.W.2d 373 (Tex. 1988).

tenant's purposes.<sup>53</sup> The opinion in *Davidow* noted that the parties could expressly agree that the tenant was responsible for repairing certain defects, but did not directly address the question of how the warranty of suitability might be disclaimed. In *Gym-N-I Playgrounds, Inc.*,<sup>54</sup> the supreme court finally returned to the disclaimer issue and held the warranty of suitability could be effectively disclaimed by a lease clause specifying that the tenant was leasing the property "as is."<sup>55</sup> The supreme court pointed out this decision was consistent with its ruling in *Prudential Insurance Co. of America v. Jefferson Associates, Ltd.*<sup>56</sup> that an "as is" disclaimer, in the sale of commercial property negates the causation element necessary for a buyer to recover on a breach of warranty claim.<sup>57</sup>

Facts giving rise to a breach of warranty claim often support claims for breach of contract and negligence as well.<sup>58</sup> However, if the asserted warranty is one of those created by case law rather than by the Code, the court may determine that a cause of action for breach of warranty should not lie if other adequate remedies remain available.<sup>59</sup> In *Cessna Aircraft Co. v. Aircraft Network, L.L.C.*,<sup>60</sup> the court applied this rationale in holding that an airplane owner had adequate remedies in its action against a repair service for breach of contract and negligence for improper repair of an aircraft.<sup>61</sup> Further, the court found no need to imply a warranty of good workmanship as an additional basis for recovery.<sup>62</sup> The court also held it was error for the trial court to admit evidence of both rental costs and replacement costs for temporary loss of use of the aircraft because these damages were duplicative.<sup>63</sup>

### III. NEGOTIABLE INSTRUMENTS

#### A. LIABILITY OF PARTIES

Under chapter 3, a fundamental difference between a note and a draft is that a note is a promise to pay while a draft is an order instructing a third party to make payment according to the terms of the draft.<sup>64</sup> In either instance, however, the instrument must be signed by the maker or

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53. *Id.* at 376-77.

54. 220 S.W.3d 905 (Tex. 2007).

55. *Id.* at 908.

56. 896 S.W.2d 161 (Tex. 1995).

57. The court reasoned that whether property was being purchased, as in *Prudential*, or leased, as in *Gym-N-I*, both the purchaser and the lessee assume the risk of defects if the purchase or lease takes place under a contract containing an "as is" clause. See *Gym-N-I Playgrounds*, 220 S.W.3d at 912.

58. An excellent example of the overlap in these causes of action appears in *Crosbyton Seed Co. v. Mechura Farms*, 875 S.W.2d 353 (Tex. App.—Corpus Christi 1994, no writ).

59. See *Rocky Mountain Helicopter, Inc. v. Lubbock County Hosp. Dist.*, 987 S.W.2d 50 (Tex. 1999).

60. 213 S.W.3d 455 (Tex. App.—Dallas 2007, pet. denied).

61. *Id.* at 467-68.

62. *Id.*

63. *Id.* at 465.

64. TEX. BUS. & COM. CODE ANN. § 3.104(a) & (e) (Vernon Supp. 2008).

drawer.<sup>65</sup> In the case of a note, it is not uncommon for a lender to require additional parties to sign the note as co-makers, indorsers, or guarantors.<sup>66</sup> A guaranty may appear on the note itself or may consist of a separate contract of guaranty. The liability of a guarantor comes into play when the principal obligor fails to pay and the lender seeks to enforce the guaranty.

In *First Commerce Bank v. Palmer*,<sup>67</sup> four business partners entered into an agreement with a lender in 1983, to refinance a debt for the purchase of land. As part of the refinancing, the lender required each of the partners to guaranty the loan. The partners agreed and signed separate contracts of guaranty. Five years later, the partnership renewed the loan and the shareholders again agreed to guarantee the loan even though the guaranties were not provided to the lender until approximately four months later. The agreements were backdated to the refinancing date. Four years later, the lender demanded payment from the guarantors, stating the partnership had defaulted on the loan. Three of the partners settled with the bank. One partner, however, chose to litigate the dispute, alleging the guaranty agreements were not supported by adequate consideration and that the guarantors had been discharged from liability because the lender impaired the collateral given for the loan by allowing the partnership to sell the property securing the loan.

The supreme court ruled the backdated guarantor agreements were valid because they were related to the underlying financing arrangement.<sup>68</sup> Because the agreements were not independent transactions, they did not require additional consideration. Addressing the impairment of collateral claim, the supreme court held that under the terms of the guaranty, the partner waived the right to assert a defense based on impairment of collateral.<sup>69</sup>

In *Beal Bank, SSB v. Biggers*,<sup>70</sup> two officers of a corporation issued a \$70,800 note to a creditor. The officers signed in their corporate capacities and also executed personal guaranties in favor of the creditor. A provision in the guaranty provided the terms of the guaranty could be modified, but specifically excluded liability for an increase in the principal amount of the note. The officers later executed a modification to the note increasing the principal to \$130,800. Both officers signed the modification in their corporate capacities and as borrowers. Beneath their signatures, the modification contained language stating that each guarantor consented to the modification agreement, however, the signature lines under this statement were left blank. Years later, the corporation filed for bank-

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65. See TEX. BUS. & COM. CODE ANN. §§ 3.103(a)(5), (7) (Vernon Supp. 2008).

66. Such parties are all classified as accommodation parties under Chapter 3. See TEX. BUS. & COM. CODE ANN. § 3.419 (Vernon Supp. 2008), and are liable as secondary obligors under TEX. BUS. & COM. CODE ANN. § 3.605 (Vernon Supp. 2008).

67. 226 S.W.3d 396 (Tex. 2007).

68. *Id.* at 398-99.

69. *Id.* at 399.

70. 227 S.W.3d 187 (Tex. App.—Houston [1st Dist.] 2007, no pet.)

ruptcy. Three years after the bankruptcy, the creditor sold the note and guaranties to another party who attempted to collect the debt.

The court held the modification of the note could not be construed as a guaranty of the additional principal.<sup>71</sup> The court explained that the original guaranty specifically excluded the creditor's ability to increase the principal amount of the note. As a result, the court categorized the original guaranty as a specific guaranty, that is, a guaranty limited to the liability specified in the original guaranty contract.<sup>72</sup> Because the officers' consent to the increased amount was not intended as a guaranty of the additional sum, they were liable only for the original amount of the note.<sup>73</sup>

Although the terms of a note are subject to the parol evidence rule generally applicable to any contract, parol evidence is admissible to show that a note, though valid on its face, actually represents a usurious transaction.<sup>74</sup> In *Sturm v. Muens*,<sup>75</sup> the maker signed a note for a one year loan of eighty-five thousand dollars at eighteen percent interest. However, the note also provided that the maker was to pay an additional thirty-five thousand dollars for the repurchase of accounts receivable assigned by the maker to the lender at the time of the loan for the stated consideration of ten dollars. The maker contended that payment of interest, coupled with repurchase of the accounts receivable, made the loan usurious. The trial court excluded evidence that repurchase of the accounts receivable was part of the loan transaction and granted summary judgment in favor of the lender on this issue.<sup>76</sup>

The court of appeals disagreed.<sup>77</sup> Although the transaction purported to be for both a loan and a repurchase obligation, the parol evidence introduced by the maker was sufficient to raise a fact issue on whether the lender's payment of ten dollars for the assignment and repurchase of the accounts receivable was actually a device to conceal usury.<sup>78</sup> Summary judgment was reversed and the case was remanded.<sup>79</sup>

The maker of a note in *Noell v. Crow-Billingsley Air Park L.P.*<sup>80</sup> was less successful in introducing parol evidence to show the parties had

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71. *Id.* at 192.

72. *Id.*

73. *Id.* at 193.

74. This point was established in *Town N. Nat. Bank v. Broaddus*, 569 S.W.2d 489 (Tex. 1978). See also *Transamerican Leasing Co. v. Three Bears, Inc.*, 586 S.W.2d 472 (Tex. 1979). As to application of the parol evidence rule to notes, see, e.g., *Simmons v. Compania Financiera Libano, S.A.*, 830 S.W.2d 789 (Tex. App.—Houston [1st Dist.] 1992, writ denied); *Litton v. Hanley*, 823 S.W.2d 428 (Tex. App.—Houston [1st Dist.] 1992, no writ); *Mfrs. Hanover Trust Co. v. Kingston Investors Corp.*, 819 S.W.2d 607 (Tex. App.—Houston [1st Dist.] 1991, no writ); *Bailey v. Gulfway Nat'l Bank*, 626 S.W.2d 70 (Tex. Civ. App.—Corpus Christi 1981, writ ref'd n.r.e.).

75. 224 S.W.3d 758 (Tex. App.—Houston [14th Dist.] 2007, no pet.).

76. *Id.* at 761.

77. *Id.* at 764.

78. *Id.* at 763-64.

79. *Id.* at 766-67.

80. 233 S.W.3d 408 (Tex. App.—Dallas 2007, pet. denied).

signed a separate option agreement involving the purchase of real estate that would relieve the maker from liability on the note. The court held this proffered evidence could not be introduced where there was no evidence of "trickery or artifice" by the payee, and the maker was represented by counsel who was available throughout the transaction and prepared the necessary documents.<sup>81</sup>

In *Lavender v. Bunch*,<sup>82</sup> a bank loaned money to a corporate debtor in exchange for a promissory note guaranteed by four of the corporation's founders and a lien on a certificate of deposit (CD) owned by one of the founders. When the corporation defaulted, the bank assigned the note to the guarantor who had provided the CD as collateral and, as assignee, he released the lien on the CD and sued the other three guarantors for payment of the full amount of the note. These three guarantors moved for summary judgment arguing that release of the CD amounted to an accord and satisfaction of the debt and, alternatively, that the assignee could only pursue the guarantors for their proportional share of the debt. The assignee filed his own motion for summary judgment arguing that, according to the guaranty agreement, he had the right to release the CD and the right to collect the full amount of the note from all or from any one of the guarantors. The trial court granted the assignee's motion and ordered the three remaining guarantors to pay the full amount of the outstanding debt.

The court of appeals held the assignee was only entitled to recover three-fourths of the outstanding debt.<sup>83</sup> Noting a paucity of case law in Texas on this matter, the court cited the only Texas case addressing the issue.<sup>84</sup> Agreeing with that case, the court reasoned there is an implied rule among co-guarantors that each is required to pay his or her propor-

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81. See *id.* at 417. The maker also argued that as against a holder who was not a holder in due course, the maker could introduce evidence of "want or failure of consideration, non-performance of a condition precedent, non-delivery, delivery for specific purpose, fraud, and all other defenses that would be available on a simple contract." See *id.* at 417. Unfortunately, the maker cited sections 3.306(2) and (3), and section 3.307 for this proposition. The court dismissed this argument by stating that section 3.306(2) and (3) did not exist in the business and commerce code and section 3.307 was not relevant. *Id.* Thus, the court ruled there was no supporting authority for the maker's argument, and was therefore waived. *Id.* at 418. Somewhat like the situations in *Aluchem, Inc. v. Sherwin Alumina, L.P.*, No. C-06-183, 2007 WL 1100473 (S.D. Tex., April 11, 2007), discussed *supra*, at note 7, and *Vi. Info. Processing, Inc. v. Mont. Beverage Corp.*, 227 S.W.3d 846 (Tex. App.—Houston [14th Dist.] 2007, no pet.) discussed above in note 10, something went awry in the legal research. The citations for the maker's argument about the introduction of evidence against a non-holder in due course, seems to be referring to sections 3.306(2) and (3), and section 3.307 as they existed *before* the 1995 revision of Chapter 3 in Texas, while the court's discussion describes the *post-1995* sections. As renumbered in 1995, the correct references are Texas Business and Commerce Code sections 3.305 and 3.306, and these sections support the maker's argument. TEX. BUS. & COM. CODE ANN. §§ 3.305-3.306 (Vernon 2002 & Supp. 2008). One is reminded of the old saying about, "For want of a nail, etc."

82. 216 S.W.3d 548 (Tex. App.—Texarkana 2007, no pet.).

83. *Id.* at 554.

84. *Id.* at 553 (citing *Byrd v. Estate of Nelms*, 154 S.W.3d 149 (Tex. App.—Waco 2004, pet. denied)). Although only one Texas case seems to have previously addressed this issue, the court could also have referred to section 3.116(b) in support of the proposition that

tionate share of a debt.<sup>85</sup> Therefore, as a co-guarantor, the assignee was only entitled to proportional contributions from the other three guarantors. The court noted that, without such a rule, every guarantor would race to the creditor to purchase a note upon a debtor's default as a way to avoid paying his or her share of the obligation.<sup>86</sup> The court reduced the assignee's award to three-fourths of the outstanding principal and interest on the note.<sup>87</sup>

Section 3.311 of the Code provides a statutory analog to the common law rules of accord and satisfaction when a negotiable instrument is used for this purpose.<sup>88</sup> A person against whom a claim is asserted must prove four elements to establish an accord and satisfaction: "(1) that person in good faith tendered an instrument to the claimant as full satisfaction of the claim; (2) the amount of the claim was unliquidated or subject to a bona fide dispute;" (3) that the instrument or an accompanying written communication contained a conspicuous statement that the instrument was tendered as full satisfaction of the claim; and (4) that the claimant obtained payment of the instrument."<sup>89</sup> In *Petty v. Citibank (South Dakota)*,<sup>90</sup> the person against whom a claim was asserted failed to prove that a credit card debt was either unliquidated or disputed. Under these circumstances, the court held that section 3.311 was not applicable.<sup>91</sup> Even though section 3.311 was inapplicable, the court noted that the person against whom the claim was asserted could use the common law of accord and satisfaction for an unliquidated, undisputed claim if the necessary elements were met.<sup>92</sup> On this issue, however, an accord and satisfaction also failed because there was no consideration for the claimant to accept a lesser amount in full payment of the debt.<sup>93</sup>

Summary judgment in favor of the claimant was affirmed.<sup>94</sup>

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guarantors who have the same liability are entitled to contribution and not indemnity from co-guarantors. See TEX. BUS. & COM. CODE ANN. § 3.116(b) (Vernon Supp. 2008).

85. *Lavender*, 216 S.W.3d at 553.

86. *Id.* at 554.

87. *Id.*

88. See TEX. BUS. & COM. CODE ANN. § 3.311 (Vernon 2002).

89. See § 3.311(a), (b)

90. 218 S.W.3d 242 (Tex. App.—Eastland 2007, no pet.).

91. *Id.* at 246.

92. *Id.*

93. *Id.* at 247 (citing *Prather v. Citizens Nat'l Bank of Dallas*, 582 S.W.2d 903, 906 (Tex. Civ. App.—Waco 1979, writ ref'd n.r.e.), the court stated:

The mere payment of part of a debt which is undisputed is not a sufficient consideration to support a promise to accept the same in full payment of the debt, and does not bar the creditor's suit to recover the balance. Stated conversely, either an unliquidated claim or a good faith dispute as to liability on a liquidated claim furnishes sufficient consideration to support an accord and satisfaction.

*Id.*

94. *Id.*

## IV. BANK DEPOSITS AND COLLECTIONS

## A. RELATIONSHIP WITH CUSTOMERS

Although chapter 4 defines the term “customer,” it does not contain rules about establishing a bank account or the ownership rights of account holders.<sup>95</sup> This is left to agreement of the parties and any other applicable law.<sup>96</sup> Texas has sought to clarify ownership interests in accounts by enacting statutory guidelines requiring specification of account types.<sup>97</sup> To establish an account as a joint account with a right of survivorship, there must be a written agreement signed by the decedent stating that the interest of the decedent survives to the other party.<sup>98</sup>

In *In re Estate of Dellinger*,<sup>99</sup> a customer opened a joint account with one of his sons at a credit union. The customer and his son both signed a Membership and Account Application (“Account Application”), and each of them received a copy of a document entitled, “Account Agreement, Disclosures and Privacy Policy” (“Account Agreement”). This agreement provided that any multiple-party accounts included a right of survivorship unless otherwise stated on the Account Application. The Account Application did not state otherwise. Two years later, the customer died. The customer’s other son was the executor of the estate. The executor brought a declaratory judgment action seeking a determination that the proceeds of the account be included in the customer’s estate. The joint account owner (the first son) argued that he owned the funds by virtue of the right of survivorship provided in the account agreement.

After examining the account agreement, the court concluded that even though some parts of the agreement were blank, the agreement created a right of survivorship in the joint account, although the account application standing alone did not.<sup>100</sup> As a result, the court held that the application, which incorporated the agreement by reference, was sufficient to confer a right of survivorship in the joint account owner.<sup>101</sup>

In *In re Estate of Wilson*,<sup>102</sup> the court reached a similar result where the decedent and his wife placed an “X” on the signature cards for three separate accounts next to a line that stated, “Joint with Right of Survivorship.” They also marked through lines on the cards describing other types of accounts. The court held they had shown a “clear and unequivocal in-

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95. TEX. BUS. & COM. CODE ANN. § 4.104(a)(5) (Vernon Supp. 2008). This statute defines a “customer” as “a person having an account with a bank or for whom a bank has agreed to collect items, including a bank that maintains an account at another bank.” See *id.*

96. See § 4.103 (Vernon 2002).

97. TEX. PROB. CODE ANN. §§ 439(a) & 439A (Vernon 2003). Section 439A is a statutory form that can be used as part of an account agreement to specify that an account is an individual account, a joint account with right of survivorship, or a payable-on-death account, “POD,” account. *Id.*

98. See *id.*

99. 224 S.W.3d 434 (Tex. App.—Dallas 2007, no pet.).

100. *Id.* at 440.

101. *Id.*

102. 213 S.W.3d 491 (Tex. App.—Tyler 2006, pet. denied).

tent” to create an account with a right of survivorship and the funds, therefore, passed to the wife upon her husband’s death and not to his estate.<sup>103</sup>

In addition to designating the type of account, an account agreement can include numerous provisions governing the relationship between the account holder and the bank.<sup>104</sup> In *In re Bank One*,<sup>105</sup> a customer sued a bank for the improper payment of several checks drawn on the account that were allegedly forged by two of the customer’s employees. An arbitration clause in the account agreement was incorporated by reference in the signature card, but the customer contended that he was unaware of the clause.<sup>106</sup> However, the signature card contained an acknowledgment that the customer had received a copy of the account agreement and agreed to be bound by its terms.<sup>107</sup> As a result, the court held the customer was bound by the agreement and directed the trial court to compel arbitration.<sup>108</sup>

A different situation was presented in *Owens v. Comerica Bank*,<sup>109</sup> where a bank customer fraudulently opened bank accounts under the assumed names of two sole proprietorships. The customer subsequently defrauded a number of victims and deposited almost two million dollars worth of checks issued by the victims to the sole proprietorships. The victims, who were not customers of the bank, were aware that the checks were being deposited into these checking accounts, but believed the money would be used for loan repayments and to purchase investments. Eventually, the victims discovered the money had been misappropriated and sued the bank for negligence. The victims argued the bank could foresee that a failure to adhere to “industry standards” in opening and maintaining the accounts created a duty of care owed to the victims.

The court stated the general rule is that a bank “owes no duty to someone who is not a customer and with whom the bank does not have a relationship.”<sup>110</sup> The court also noted that foreseeability is the principal

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103. See *id.* at 495. The law governing joint tenancy with rights of survivorship in brokerage accounts parallels that governing bank accounts. In *Holmes v. Beatty*, 233 S.W.3d 494 (Tex. App. Houston [14th Dist.] 2007, pet filed), the court held that a brokerage account containing the notation “JT TEN” next to the names of the husband and wife who opened the account was not sufficient to create a right of survivorship, but marking a box designated as “Joint (WROS)” on an account opened at a different brokerage was sufficient to show intent to create an account with a right of survivorship. *Id.* at 515, 521-21.

104. A typical account agreement may include a choice of law clause, a clause regarding the bank’s right of setoff, provisions dealing with stop payment orders, garnishment, or other legal process, notices of funds availability, and the like. Examples of clauses often contained in account agreements may be found in UNIFORM COMMERCIAL CODE FORMS: TEXAS FORMS ANNOTATED 2 JOHN KRAHMER, UNIFORM COMMERCIAL CODE FORMS, TEXAS FORMS ANNOTATED § 4.103 (4th ed. 2007).

105. 216 S.W.3d 825 (Tex. 2007).

106. *Id.* at 826.

107. *Id.*

108. *Id.* at 827.

109. 229 S.W.3d 544 (Tex. App.—Dallas 2007, no pet.).

110. See *id.* at 547.



factor to be considered in determining whether a duty of care exists.<sup>111</sup> Because there was nothing that would alert the bank to foresee harm to non-customers, the court declined to create a duty of care based on "unspecified 'industry standards.'"<sup>112</sup> Summary judgment in favor of the bank was affirmed.<sup>113</sup>

In *Citibank Texas v. Progressive Casualty Insurance Co.*,<sup>114</sup> a bank was sued in state court for allowing the deposit of 1.7 million dollars in checks made payable to a partnership into the personal account of one of the partners. The bank asked its insurer to defend the action, but the insurer declined to do so. The state trial court entered judgment against the bank and, in the course of doing so, held the fidelity bond issued by the insurer to cover "unauthorized signatures" included coverage of unauthorized indorsements as well as unauthorized drawer's signatures. When the insurer refused payment, the bank sued the insurer in federal court for breach of contract. The district court entered judgment in favor of the bank on two grounds.<sup>115</sup> First, the insurer was collaterally estopped from relitigating the issue of unauthorized indorsements because this issue had been determined in the state court litigation.<sup>116</sup> Second, even if the insurer was not collaterally estopped, the district court would agree with the state court that the definition of "unauthorized signatures" in the fidelity bond covered unauthorized indorsements.<sup>117</sup> Judgment was entered in favor of the bank.<sup>118</sup>

On appeal to the Fifth Circuit, the circuit court affirmed the decision of the district court barring relitigation of the issue of "unauthorized signatures" in federal court following the insurer's election not to participate in the state court proceedings.<sup>119</sup> The court further held that a provision in the fidelity bond provided that if the issuer elected not to defend the bank, it would not be bound by a judgment against the bank, nor would a settlement of the action shield the issuer from the collateral estoppel effect of the state court determination.<sup>120</sup> The court added, in dicta, that it would agree with the district court that unauthorized indorsements were covered by the bond definition of "unauthorized signatures," but that it did not need to reach the issue in light of its collateral estoppel finding.<sup>121</sup>

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111. *See id.*

112. *See id.*

113. *Id.* at 547-48.

114. 508 F.3d 779 (5th Cir. 2007).

115. *Id.* at 781.

116. *Id.*

117. *Id.* at 781-82.

118. *Id.* at 782.

119. *Id.* at 785.

120. *Id.* at 783.

121. *Id.* at 784 n.12.

## V. SECURED TRANSACTIONS

### A. CREATION OF A SECURITY INTEREST

Under chapter 9, a security interest is created when the debtor has rights in the collateral, value is given by the secured party, and there is a written or electronic agreement that the security interest attach or the collateral is in the possession of the secured party.<sup>122</sup> A security interest may be created in collateral already owned by the debtor, or the secured party may provide funds for the purpose of allowing the debtor to acquire the collateral. In the latter case, the security interest is known as a “purchase money security interest.”<sup>123</sup> A purchase money security interest generally has a higher priority than that of a security interest created in collateral already owned by the debtor.<sup>124</sup> A current issue surrounding purchase money security interests involves the effect of the so-called “hanging paragraph” enacted in amendments made to the Bankruptcy Code in 2005.<sup>125</sup> As part of the amending legislation, an unnumbered paragraph was added at the end of § 1325(a) in the Bankruptcy Code, which deals with allowed secured claims.<sup>126</sup> A discussion of the various difficulties caused by this paragraph is beyond the scope of this *Survey*, but the basic problem and its relation to purchase money security interests can be briefly described.

During automobile financing, a buyer often trades in an old car when buying a new car. If the buyer has not paid off the loan on the old car, the lender or seller who finances the purchase of the new car will usually include the amount needed to pay off the prior loan as part of the financing for the new car. The amount needed to satisfy the earlier loan is called “negative equity.” This is the point where purchase money security interests and the hanging paragraph intersect—the issue being whether a secured party should have a purchase money security interest for the full amount of the loan needed to buy the new car (that is, the price of the

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122. See TEX. BUS. & COM. CODE ANN. §§ 9.203(a), (b) (Vernon Supp. 2008).

123. To create a purchase money security interest, the secured party may be a seller who finances the sale directly by extending credit to a buyer for the purchase of collateral sold by the seller, or the secured party may be a lender who advances funds that are used by the debtor to acquire the collateral from a third party seller. See TEX. BUS. & COM. CODE ANN. § 9.103 (Vernon 2002).

124. See, e.g., TEX. BUS. & COM. CODE ANN. § 9.317(e) (Vernon 2002) (a secured party has a grace period of twenty days after debtor receives possession of collateral to perfect purchase money security interest against intervening lien creditor); TEX. BUS. & COM. CODE ANN. § 9.324(b)-(f) (Vernon 2002) (purchase money security interest gains priority over competing security interests if provisions in these sections are followed); TEX. BUS. & COM. CODE ANN. § 9.334(d) (Vernon 2002) (purchase money security interest in fixtures can gain priority over conflicting interests of encumbrancers or owners).

125. Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, 119 Stat. 23 (2005).

126. 11 U.S.C. § 1325(a) (2000 & Supp. 2007). One author has noted that the hanging paragraph “has no alphanumeric designation and merely dangles at the end of [11 U.S.C.] § 1325(a). There is no way to cite to this provision other than its proximity to other citable provisions.” See Dianne C. Kerns, *Cram-a-lot: The Quest Continues*, 24 NOV. AM. BANKR. INST. J. 10, 10 (2005).

new car plus amount of negative equity), or whether the secured party should be limited to the price of the new car alone.

In *In re Sanders*,<sup>127</sup> the court held that a dealer who financed the purchase of a new car was limited to claiming a purchase money security interest based on the price of the car alone and not for any negative equity financed as part of the transaction.<sup>128</sup> While this conclusion is the same as ones reached in several other bankruptcy cases around the country, *Sanders* decided the issue under federal law rather than state law.<sup>129</sup>

Before *Sanders*, two principal lines of authority had developed on the issue of whether a secured party was entitled to claim the entire amount of a car loan as a purchase money security interest, or was instead limited to claiming a security interest for the funds applied to the price of the car. One line of authority, focusing on the term "price of the collateral" in section 9-103, found the term to be ambiguous, and examined other state statutes to determine if the "price" included funds advanced as part of the same transaction to enable the debtor to acquire the collateral.<sup>130</sup> These courts concluded that such funds were part of the price, allowing the creditor to assert a purchase money security interest for the entire amount of the loan.<sup>131</sup> Another line of cases held that a creditor could only assert a purchase money security interest for funds applied to the purchase price of a new vehicle and not for funds used to pay off negative equity resulting from the trade-in of a debtor's old vehicle.<sup>132</sup> Both lines of cases utilized state law in reaching these opposing conclusions. While the implications of the *Sanders* approach in applying federal law to the issue remain unclear, the issue itself is far from resolved.<sup>133</sup>

Another serious issue concerning the creation of a security interest in collateral revolves around the use of payments to beneficiaries under structured settlement agreements. While sections 9.406 and 9.407 make restrictions on the assignment of payment intangibles and general intangibles generally ineffective, both sections recognize that other law may

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127. 377 B.R. 836 (Bankr. W.D. Tex. 2007).

128. *Id.* at 864.

129. *Id.* at 858.

130. See, e.g., *Gen. Motors Acceptance Corp. v. Peaslee*, 373 B.R. 252 (Bankr. D.N.Y. 2007); *In re Graupner*, 356 B.R. 907 (Bankr. M.D. Ga. 2006); *In re Vega*, 344 B.R. 616 (Bankr. D. Kan. 2006).

131. See, e.g., *Gen. Motors Acceptance Corp.*, 373 B.R. at 262; *In re Graupner*, 356 B.R. at 923; *In re Vega*, 344 B.R. at 624.

132. See, e.g., *In re Westfall*, 376 B.R. 210 (Bankr. Ohio 2007); *In re Pajot*, 371 B.R. 139 (Bankr. E.D. Va. 2007); *Citifinancial Auto v. Hernandez-Simpson*, 369 B.R. 36 (D. Kan. 2007).

133. Within two weeks after *Sanders* was reported on WestLaw, the bankruptcy court in *In re Hayes* expressed doubt about the approach used in *Sanders* by noting, "The hanging sentence mixes state and federal legal principles in the complicated manner discussed above. Overlaying a federal transformation rule produces a wobbly three-legged stool anchored by no obvious congressional policy choice in this context." *In re Hayes*, 376 B.R. 655, 676 at n.30 (Bankr. M.D. Tenn. 2007).

affect the enforceability of a security interest.<sup>134</sup> In *Coffey v. Singer Asset Finance Co., L.L.C.*,<sup>135</sup> the issue was whether the Texas Insurance Code prohibits the creation of a security interest in funds payable to a beneficiary resulting from the structured settlement of a personal injury claim. The court distinguished an absolute assignment of the right to payment from creation of a lien on future payments, noting that while the Insurance Code bars absolute assignments, it does not prohibit the creation of liens.<sup>136</sup> The court further held that there was no public policy barring the creation of a security interest in structured settlement payments, so long as the secured party complied with the Texas Structured Settlement Protection Act by obtaining court approval of the transaction.<sup>137</sup>

Compliance with the Structured Settlement Protection Act was the primary focus of the courts in *Rapid Settlements, Ltd. v. Symetra Life Insurance Co.*,<sup>138</sup> and *Symetra Life Insurance Co. v. Rapid Settlements, Ltd.*,<sup>139</sup> In both cases, the payees under structured settlements assigned their right to future payments in exchange for a discounted lump sum. In neither case did the assignee obtain court approval of the transactions. When the insurance company that had issued annuities to fund the structured settlements refused to pay the assignee, the assignee sought to enforce the assignment by asserting a contractual arbitration contained in the assignment documents. Under the theory advanced by the assignee, the Federal Arbitration Act preempted state structured settlement protection acts and, therefore, state court approval of the assignments was not required.<sup>140</sup> Both courts rejected this argument and upheld temporary injunctions against the assignee's enforcement attempt by arbitration.<sup>141</sup> Hearings on whether permanent injunctions should issue were to be scheduled on a later date.<sup>142</sup>

Assignment of the right to payment was also the focus in *Holloway-Houston, Inc. v. Gulf Coast Bank & Trust Co.*,<sup>143</sup> but in the context of a factoring arrangement rather than a structured settlement. In *Holloway*, a bank took an assignment of a steel company's accounts receivables. The bank notified one of the account debtors of the assignment in three separate letters, and advised the account debtor to remit future payments to the bank as assignee. The account debtor continued to make payments to the assignor instead of to the bank. The assignor kept the payments and

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134. TEX. BUS. & COM. CODE ANN. §§ 9.406, 9.407 (Vernon 2002). See, e.g., Texas Structured Settlement Protection Act, TEX. CIV. PRAC. & REM. CODE ANN. §§ 141.001-007 (Vernon 2005); TEX. INS. CODE ANN. §§ 1108.051 1108.102 (Vernon Supp. 2008).

135. 223 S.W.3d 559 (Tex. App.—Dallas 2007, no pet.).

136. *Id.* at 566-67.

137. *Id.* at 570.

138. 234 S.W.3d 788 (Tex. App.—Tyler 2007, no pet.).

139. No. H-05-3167, 2007 WL 114497 (S.D. Tex., Jan. 10, 2007).

140. *Rapid*, 234 S.W.3d at 796; *Symetra*, 2007 WL 114497, at \*16.

141. *Rapid*, 234 S.W.3d at 802; *Symetra*, 2007 WL 114497, at \*36-37.

142. *Rapid*, 234 S.W.3d at 802; *Symetra*, 2007 WL 114497, at \*37.

143. 224 S.W.3d 353 (Tex. App.—Houston [1st Dist.] 2006, no pet.).

later filed for bankruptcy. The bank sued the account debtor to collect on the assigned accounts.

The court held that the debt, as well as the debtor's obligation, was fully assigned to the assignee.<sup>144</sup> Section 9.406 provides that once an account debtor receives notification that a debt has been assigned and that payments are to be made to the assignee, the account debtor's obligation will not be discharged by paying the assignor.<sup>145</sup> The court determined that there was sufficient evidence for the trial court to hold that the account debtor had acknowledged the assignment and agreed to pay the assignee at the assignee's designated address.<sup>146</sup> The court held the account debtor was liable to the assignee for the unpaid amount of the debt, and the judgment of the trial court was affirmed.<sup>147</sup>

### B. PERFECTION OF SECURITY INTERESTS

While a rose may be a rose by any other name, it better be called a rose on a UCC-1 to effectively perfect a security interest. Under section 9.503 of the Code, a financing statement must use the correct name of the debtor.<sup>148</sup> Under section 9.506, if a search, using the debtor's correct name and the standard search logic of the filing office fails to disclose the existence of a financing statement, the financing statement is deemed misleading and will not perfect the security interest.<sup>149</sup> Two creditors learned this lesson in *In re Jim Ross Tires, Inc.*,<sup>150</sup> where financing statements filed by the creditors failed to state the debtor's correct name, albeit in different ways. One of the creditors filed in the name "Jim Ross Tires, Inc. dba HTC Tires & Automotive Centers." According to the records of the Texas Secretary of State, the correct name of the debtor was "Jim Ross Tires, Inc." and did not include the dba name. The court reasoned that since a search of the records using the search logic of the Texas Secretary of State for UCC filings would not locate a filing that included a dba name, the filing did not perfect the security interest.<sup>151</sup> The second creditor came closer to making a proper filing, missing only one letter. This creditor's filing named the debtor as "Jim Ross Tire Inc.," omitting the letter "s" on the word "tires." Here, again, the filing failed the test of being searchable under the standard search logic of the filing office.<sup>152</sup> Because neither security interest was perfected, the court held the hypothetical lien creditor rights of the bankruptcy trustee were supe-

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144. *Id.* at 359.

145. *See* TEX. BUS. & COM. CODE ANN. § 9.406(a) (Vernon 2002).

146. *Holloway*, 224 S.W.3d at 359.

147. *Id.* at 362-63.

148. TEX. BUS. & COM. CODE ANN. § 9.503(a) (Vernon Supp. 2008).

149. TEX. BUS. & COM. CODE ANN. § 9.506(b), (c) (Vernon 2002).

150. 379 B.R. 670 (Bankr. S.D. Tex. 2007).

151. *Id.* at 677.

152. *Id.* at 678.

rior to the claims of the creditors.<sup>153</sup>

Part of the problem facing secured parties in correctly naming a debtor stems from difficulty in determining the debtor's correct name. Several cases have addressed the problem of filings made in a diminutive name or nickname of an individual debtor.<sup>154</sup> Several others have concerned misspellings or incomplete statements of a debtor's name.<sup>155</sup> In an attempt to simplify the problem of determining the correct name of a debtor, Texas approved a non-uniform amendment to section 9.503 in 2007, to provide a safe harbor filing rule.<sup>156</sup> Under this amendment, a financing statement sufficiently provides the name of an individual debtor if it "provides the individual's name shown on the individual's driver's license or identification certificate issued by the individual's state of residence."<sup>157</sup> If the debtor is an organization organized solely under the law of a single state or of the United States, such as a corporation, a limited liability partnership, or the like, the name of the debtor is sufficient if it is the name indicated "on the debtor's formation documents that are filed of public record in the debtor's jurisdiction of organization to create the registered organization and that show the debtor to have been organized."<sup>158</sup>

While these amendments may be of some assistance in determining the correct name of a debtor, they do not solve the problem of misspellings, diminutives, and the like. A separate enactment during the 2007 legislative session, provides a way to address these concerns by enabling title insurers to insure against the risk that a financing statement may fail to perfect a security interest.<sup>159</sup> As a new line of business for title insurers, only time will tell if this is a viable way to guard against filing errors at a reasonable premium rate.

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153. *Id.* at 680. Under 11 U.S.C. § 544(a)(1) a trustee is vested with the rights of a hypothetical lien creditor as of the date of bankruptcy, enabling the trustee to avoid unperfected security interests. 11 U.S.C. § 544(a)(1) (2007).

154. *See, e.g., In re Kinderknecht*, 308 B.R. 71 (B.A.P. 10th Cir. 2004) (using nickname "Terry Kinderknecht" incorrect where debtor's name was "Terrance Kinderknecht"); *In re Berry*, No. 05-14423, 2006 WL 3499682 (Bankr. D. Kan. 2006) (filing in name "Mike Berry" not effective where correct name was "Michael Berry"); *In re Erwin*, 50 U.C.C. Rep. Serv. 2d 933 (Bankr. D. Kan. 2003) (using name "Mike Erwin" ineffective where name should have been "Michael Erwin").

155. *See, e.g., Pankratz Implement Co. v. Citizens Nat'l Bank*, 130 P.3d 57 (Kan. 2006) (misspelling of name as "Roger House" did not perfect security interest where name should have been spelled "Rodger House"); *Host Am. Corp. v. Coastline Fin., Inc.*, No. 2:06CVS, 2006 WL 1579614 (D. Utah 2006) (filing in name "KVM Electronics Corporation" ineffective where periods omitted from correct name of "K.V.M. Corporation"); *Receivables Purchasing Co., Inc. v. R & R Directional Drilling, L.L.C.*, 588 S.E.2d 831 (Ga. Ct. App. 2003) (identifying debtor as Net work Solutions, Inc. " instead of "Network Solutions, Inc." fatal to financing statement due to space inserted in middle of first word in debtor's name).

156. *See* TEX. BUS. & COM. CODE ANN. § 9.503 (Vernon Supp. 2008).

157. § 9.503(a)(4).

158. § 9.503(a)(1).

159. *See* TEX. INS. CODE ANN. §§ 2751.051-055 (Vernon Supp. 2008).

## C. DISPOSITION OF COLLATERAL

After a default occurs, section 9.610 requires every aspect of the disposition of collateral to be "commercially reasonable."<sup>160</sup> The official comment to that section notes that preparation or processing of the collateral may be part of a commercially reasonable disposition, but the "courts should not be quick to impose a duty of preparation on the secured party."<sup>161</sup> In *Whitney National Bank v. Air Ambulance by B & C Flight Management, Inc.*,<sup>162</sup> the court addressed the question of whether a secured party acted in a commercially reasonable manner when it failed to make repairs on a repossessed aircraft, to obtain a certificate of airworthiness, before disposing of the aircraft by private sale conducted with sealed bids. The court determined that requiring the secured party to make repairs estimated to be between a half-million and one and one-half million dollars, when the likelihood of recovering the costs was problematic at best, would impose too great of a duty on the secured party.<sup>163</sup> The court granted partial summary judgment in favor of the secured party on its motion to recover a deficiency resulting from the sale of the aircraft.<sup>164</sup>

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160. See TEX. BUS. & COM. CODE ANN. § 9.610(b) (Vernon 2002).

161. See § 9.610 cmt. 4.

162. 516 F. Supp. 2d 802 (S.D. Tex. 2007).

163. *Id.* at 813-14.

164. *Id.* at 817.