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## Commercial Transactions

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# COMMERCIAL TRANSACTIONS

*John Kraemer\**

**T**HIS Article discusses cases decided under the Uniform Commercial Code as adopted in Texas (the Code) and reported since publication of last year's Texas' Survey.<sup>1</sup> Because 1998 was not a legislative year in Texas, no amendments to the Code are discussed in this Article. The reader should be alert to the possibility, however, that by the time this Article is published, substantial amendments to the Code may have been passed affecting Letters of Credit and Secured Transactions.<sup>2</sup>

## I. DEFINITIONS & GENERAL PROVISIONS

### A. "CONSPICUOUS"

In *Littlefield v. Schaefer*,<sup>3</sup> the Texas Supreme Court held that a release purporting to relieve the operator of a motorcycle race from liability for injuries suffered by riders during a race was not "conspicuous" as required by section 1.201 of the Code.<sup>4</sup> The court described the release as

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1. The Texas version of the Uniform Commercial Code comprises the first eleven chapters of the Texas Business and Commerce Code. Unless otherwise noted, all references in this Article are to the Uniform Commercial Code as enacted in TEX. BUS. & COM. CODE ANN. §§ 1.101-11.108 (Vernon 1994 & Supp. 1998).

2. With two main exceptions, the Texas version of the Code is much the same as the Official Text of the Code as promulgated by the National Conference of Commissioners on Uniform State Laws. These exceptions are Article 5, "Letters of Credit," U.C.C. §§ 5-101 to -117 (1995) and Article 9, "Secured Transactions," U.C.C. §§ 9-101 to -708 (1998). The revision of Article 5 approved by the National Conference of Commissioners in 1995 unexpectedly failed to win passage during the 1997 Texas legislative session because of a point of order raised by Representative Wohlgemuth on May 30, 1997. See H.J. OF TEX., 75th Leg., R.S. 3809-10 (1997). This point of order prevented consideration of some fifty-two bills, including Article 5, and occurred too late in the session to be remedied. The revision of Article 9 was approved by the National Conference of Commissioners on July 31, 1998, and the Texas Legislature will have its first opportunity to consider this revision in the 1999 legislative session. It is impossible to predict, of course, whether either or both revisions will be introduced and win passage during the session, but the reader should be aware of these possible changes affecting Texas commercial law. The full Official Text of the Article 5 and Article 9 revisions can be obtained from the National Conference of Commissioners' Web site at <http://www.law.upenn.edu/library/ulc/ulc.htm>.

3. 955 S.W.2d 272, 274-75 (Tex. 1997).

4. The Code defines "conspicuous" in the following manner:

A term or clause is conspicuous when it is so written that a reasonable person against whom it is to operate ought to have noticed it. A printed heading in capitals (as: NON-NEGOTIABLE BILL OF LADING) is conspicuous. Language in a body of a form is conspicuous if it is larger or other contrasting type or color.

“a six-paragraph release printed in minuscule typeface” on the front of an entry form which used a typeface and font size that was “easily readable” for questions that entrants were required to answer. However, the release itself was “practically illegible.”<sup>5</sup> The court reaffirmed its prior holding that it would apply the Code standard of conspicuousness to contracts of all types regardless of whether the contracts were otherwise governed by a specific chapter of the Code and the release in question failed to meet this standard.<sup>6</sup>

## B. “GOOD FAITH”

In Texas, as elsewhere, questions surrounding application of the doctrine of “good faith” have generated extensive litigation.<sup>7</sup> Cases reported

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TEX. BUS. & COM. CODE ANN. § 1.201(10) (Vernon 1994).

5. *Littlefield*, 955 S.W.2d at 273-74. A copy of the release is reprinted in the opinion, and the court noted that it “is as legible as the copy in the court record.” The headings in the release are described as being in four-point type with 28 characters to the inch, and the body of the release is in an even smaller type described as being 38 characters per inch. *See id.* at 274. Many laser printers today will print in fonts as small as two points, and the reader may wish to experiment with two, three, and four point sizes to get an idea of the size of such “fly-speck” fonts.

6. *See id.* at 274. The court announced this application of the Code definition in *Dresser Indus., Inc. v. Page Petroleum, Inc.*, 853 S.W.2d 505 (Tex. 1993). In *Dresser*, the court also held that whether a clause is conspicuous is a question of law for the court. *See id.* at 274.

7. Although admittedly a crude measure, a Westlaw search generated the following yearly results for Texas cases (including federal cases involving Texas law) in which the phrase “good faith” appeared: 1980: 334, 1981: 383, 1982: 319, 1983: 305, 1984: 297, 1985: 308, 1986: 343, 1987: 341, 1988: 392, 1989: 386, 1990: 462, 1991: 449, 1992: 544, 1993: 545, 1994: 517, 1995: 499, 1996: 610, 1997: 551, 1998 (to date) 537. The total number of cases in which the phrase appeared in cases reported since January 1 of 1980 is: 8122, an average of 427 cases per year for 19 years. Can anyone imagine doing this kind of case-counting before the advent of computerized legal research? On the other hand, can anyone imagine a reason to do it after the advent of computerized legal research? *But see* Fred R. Shapiro, *The Most-Cited Law Review Articles*, 73 CALIF. L. REV. 1540 (1985), discussing his *hand-counted* list of law review citations to determine the most-frequently cited law reviews. Nonetheless, and despite the rough nature of the search, it does seem to be a fair statement to say that the phrase “good faith” required explicit mention more frequently in recent years than in the past. The seminal case on the subject in Texas law stating that a duty of good faith would be imposed if there was a “special relationship” between the parties is *English v. Fischer*, 660 S.W.2d 521, 524 (Tex. 1983) (Spears, J., concurring) (stating that duty of good faith arises in fiduciary relationships and in special relationships). Since that time, several cases have addressed the question of whether the parties have such a “special relationship.” *See, e.g.*, *Associated Indem. Corp. v. CAT Contracting, Inc.*, 964 S.W.2d 276, 280-82 (Tex. 1998) (finding no special relationship between surety and principal; principal adequately protected by existing law and no independent duty of good faith should be imposed); *Formosa Plastics Corp., USA v. Presidio Engineers & Contractors, Inc.*, 960 S.W.2d 41, 52 (Tex. 1998) (affirming that a duty of good faith does not arise in ordinary commercial transactions absent a special relationship); *Crim Truck & Tractor Co. v. Navistar Int'l Transp.*, 823 S.W.2d 591, 594 (Tex. 1992) (concluding that a relationship between franchisor and franchisee is not a special relationship); *FDIC v. Coleman*, 795 S.W.2d 706, 708-09 (Tex. 1990) (holding that no special relationship creating a duty of good faith exists between a debtor and creditor); *Aranda v. Ins. Co. of North America*, 748 S.W.2d 210, 212 (Tex. 1988) (applying duty of good faith to the relationship between a worker and a worker's compensation carrier); *Arnold v. National County Mut. Fire Ins. Co.*, 725 S.W.2d 165, 167 (Tex. 1987) (finding a duty of good faith in a relationship between insurance company and insured).

during this Survey period indicate that such questions continue to arise.

One such case is *Northern Natural Gas Co. v. Conoco, Inc.*<sup>8</sup> in which a pipeline company entered into a contract with a processor to gather and compress natural gas before it was resold by the pipeline company to its customers. Due to federal deregulation of the natural gas industry, it was no longer economical for pipeline companies to buy and resell gas since gas customers were free to buy directly from gas producers. This change prompted the pipeline company to stop buying gas, and the processor sued on two grounds. First, the plaintiff claimed the pipeline company breached the processing contract because it failed to act in good faith under section 1.203 of the Code by canceling its purchasing contracts with gas producers.<sup>9</sup> Second, section 2.306 of the Code governing output contracts requires the pipeline company to continue purchasing gas for compression by the processor.<sup>10</sup> The court held that the duty of good faith stated in section 1.203 of the Code does not create an independent cause of action. Rather, the duty of good faith is simply a way of measuring a party's performance under a contract otherwise governed by the Code.<sup>11</sup> Thus, the pipeline company's good faith might be relevant in measuring its performance. However, the pipeline company had no independent duty to act in good faith. As to the application of section 2.306, the court ruled that the gas processing contract was a service contract and not a sales contract because the processor did not buy the gas.<sup>12</sup> The processor merely compressed the gas for transport through the pipeline. Because the processing contract was a service contract and not a contract for the sale of goods, the court refused to "import into the Agreement a requirement from the Code's sales article."<sup>13</sup> The only remaining question was whether there was an implied common law duty that required the pipeline company to continue purchasing gas for processing. On this point, the court's opinion is curious. In what turned out to be its first opinion in this case (*Northern I*), the court, in an 8-0 decision, held that there was no such duty and rendered a take nothing judgment against the processing company.<sup>14</sup> After granting a rehearing, however, the court reversed its direction in a second opinion (*Northern II*), withdrew its opinion in

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8. 986 S.W.2d 603 (Tex. 1998).

9. Section 1.203 of the Code provides that "[e]very contract or duty within this title imposes an obligation of good faith in its performance or enforcement." TEX. BUS. & COM. CODE ANN. § 1.203 (Vernon 1994).

10. Sections 2.306(a) and (b) require that quantities tendered or demanded in sales contracts be such quantities as occur in good faith and that sellers and buyers in exclusive dealing contracts use best efforts to supply or promote the goods. See TEX. BUS. & COM. CODE ANN. §§ 2.306(a), (b) (Vernon 1994).

11. See *Northern Natural Gas*, 986 S.W.2d at 606.

12. See *id.*

13. *Id.* at 607. The court reached this conclusion despite a clause in the contract providing that it "shall be interpreted in accordance with the rules of construction and interpretation set forth in the Texas Uniform Commercial Code." *Id.* at 603 (quoting the parties' agreement on natural gas processing and transportation).

14. See *Northern Natural Gas Co. v. Conoco, Inc.*, No. 97-0182, 1998 WL 178591 (Tex. Apr. 14, 1998).

*Northern I*, and, again by an 8-0 decision, held that a common law duty of good faith should be imposed on output and requirements contracts.<sup>15</sup> The court remanded the case for a new trial in which the processor could “attempt to prove that [the pipeline company] canceled its gas purchase contracts without a valid business reason and in bad faith.”<sup>16</sup>

In *El Paso Natural Gas Co. v. Minco Oil & Gas Co.*,<sup>17</sup> the court applied the Code standard of good faith to the modification of a “take-or-pay” gas sales contract. To determine if the contract modification had been obtained in bad faith, the court considered: (1) whether the modification was sought for legitimate commercial reasons; (2) whether the modification was obtained by extortionate means; and (3) whether agreement to the modification was obtained by trickery, artifice, or misrepresentation.<sup>18</sup> In reviewing these factors, the court concluded that the evidence supported the trial court’s finding of bad faith on the part of the defendant.<sup>19</sup> The court also held, however, that the evidence supporting a finding of bad faith was insufficient to support a finding of unconscionable action by the defendant.<sup>20</sup> On this point the court noted that “the theories of unconscionability and good faith/bad faith . . . are distinct. . . . [I]t may be that the existence of bad faith may be weighed in determining whether someone acted unconscionably, but it alone does not establish unconscionability.”<sup>21</sup>

The question of good faith also figured in the case of *Eller v. National Bank of Texas, N.A.*<sup>22</sup> in which the court held that the relationship between a bank and a depositor was merely that of debtor and creditor and did not rise to the level of a special relationship giving rise to a duty of good faith on the part of the bank. In reaching its decision, the court rejected a contrary holding, that a special relationship giving rise to a duty of good faith exists between a bank and its depositors in *Plaza National Bank v. Walker*.<sup>23</sup> This rejection was posited on the ground that *Plaza* had been “implicitly overruled”<sup>24</sup> by the decision in *Formosa Plastics Corp. USA v. Presidio Engineers & Contractors, Inc.*<sup>25</sup> in which the Texas Supreme Court held that a duty of good faith does not arise in ordinary commercial dealings.<sup>26</sup>

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15. See *Northern*, 986 S.W.2d at 603.

16. *Id.*

17. 964 S.W.2d 54 (Tex. App.—Amarillo 1997, pet. granted).

18. See *id.* at 67-68.

19. See *id.* at 70.

20. See *id.* at 74 n.3.

21. *Id.*

22. 975 S.W.2d 803, 809 (Tex. App.—Amarillo 1998, no pet. h.).

23. 767 S.W.2d 276 (Tex. App.—Beaumont 1989, writ denied).

24. *Eller*, 975 S.W.2d at 809.

25. 960 S.W.2d 41 (Tex. 1998).

26. See *id.* at 52. In *Eller*, a depositor was suing a bank for the loss of money and valuables the depositor had allegedly put in a safe deposit box. The court upheld the validity of a release clause contained in the contract under which the box was leased against claims of negligence, deceptive trade practices, and breach of a warranty of habitability. See *Eller*, 975 S.W.2d at 808-09. The court remanded the case, however, on the one claim that had not been addressed by the bank in its motion for summary judgment, namely,

## C. ACCELERATION &amp; USURY

In *Star Food Processing, Inc. v. Killian*,<sup>27</sup> the court held that a waiver clause did not effectively waive the right to notice of acceleration because the waiver clause did not “clearly and unequivocally” waive such notice under the *Shumway v. Horizon Credit Corp.*<sup>28</sup> standards. The *Shumway* court required separate waivers of a notice of acceleration and a notice of intent to accelerate.<sup>29</sup> Because the debtor had not waived notice of acceleration, the remittance of a late installment payment, made before notice of acceleration was received, caused an attempted acceleration to be ineffective and resulted in a take nothing judgment against the creditor in the creditor’s action to collect the accelerated balance of the note.<sup>30</sup>

In *Coastal Cement Sand v. First Interstate Credit*,<sup>31</sup> the court held that a claimed savings clause was actually only a severability clause that, by its own terms, applied only to security agreements executed as part of the transaction and not to the promissory notes executed as part of the same transaction. Because the terms of the clause did not apply to the notes and did not expressly disclaim an intention to collect unearned interest upon acceleration, the court held that the notes were usurious on their face.<sup>32</sup>

In addition to problems arising from the inclusion of unearned interest when a note is accelerated, mistakes in calculation may result in usurious charges. For example, in *Oyster Creek Financial Corp. v. Richwood Investments II, Inc.*<sup>33</sup> a note originally held by a savings and loan was acquired by the RTC and subsequently sold to a bank. While the bank held the note, Richwood defaulted, and the bank gave written notice of default and private foreclosure. The notice stated that the balance due, including interest, was approximately \$1.2 million. Before private foreclosure actually commenced, however, the note was sold again to an investment trust for \$1.17 million (ninety-five percent of the claimed balance due). A few days later, the investment company notified the debtor that the balance due, including interest, was \$1.6 million (\$400,000 more than the amount stated by the bank). The notice did not itemize the elements that went into this total. When the debtor questioned this amount, he was told that the bank had used the wrong maturity date in its calcula-

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breach of an implied warranty of fitness for a particular purpose in the rental of a safe deposit box. *See id.* at 810. The court noted that it did not express any opinion on the viability of this claim, but merely held that the bank had failed to address the claim in its motion for summary judgment. *See id.* at 808-09. Although not mentioned in the opinion, arguably the lease of a safe deposit box is a lease of personal property governed by Chapter 2A of the Code and carries with it the implied warranties stated in TEX. BUS. & COM. CODE ANN. §§ 2A.212 & .213 (Vernon 1994), and any disclaimer of warranties must comply with TEX. BUS. & COM. CODE ANN. § 2A.214 (Vernon 1994).

27. 954 S.W.2d 124, 126 (Tex. App.—San Antonio 1997, pet. denied).

28. 801 S.W.2d 890 (Tex. 1991).

29. *See id.* at 894-95.

30. *See Star Food Processing*, 954 S.W.2d at 127.

31. 956 S.W.2d 562, 576 (Tex. App.—Houston [14th Dist.] 1997, pet. denied).

32. *See id.* at 572.

33. 957 S.W.2d 640 (Tex. App.—Amarillo 1997, pet. denied).

tions and that the attorney for the investment company had recalculated the amount due. The debtor refused to pay the new amount on the ground of usury and sued to enjoin foreclosure. The court consolidated the countersuit by the investment company.

The debtor sought to obtain the calculations made by the investment company attorney to determine the basis for the increase in the amount due. However, the trial court ruled the calculations were the attorney's work product and quashed a subpoena duces tecum obtained by the debtor.<sup>34</sup> Evidence of the calculations was ruled inadmissible at trial.<sup>35</sup> On appeal, the court held that the calculations had been made to effect a private foreclosure and not in preparation for litigation.<sup>36</sup> Because the calculations were, therefore, not work product protected by the attorney-client privilege, they were fully discoverable and should have been admitted by the trial court.<sup>37</sup> The case was remanded for a new trial on the debtor's claim.<sup>38</sup>

In *Pentico v. Mad-Wayler, Inc.*,<sup>39</sup> the creditor included nearly eleven thousand dollars in late charges as part of its claim. When the debtor challenged this inclusion, the creditor admitted that the charges were "erroneous" but did not attempt to show that the miscalculation was the result of an accidental and bona fide error. The court held that "[m]erely brushing the miscalculation aside as 'erroneous' and presenting arguments based on the correct figure does not establish that the issue is settled as a matter of law."<sup>40</sup> On remand, absent a showing of accidental and bona fide error, the late charges were to be treated as interest and a determination made if the amount made the creditor's claim usurious under the spreading doctrine.<sup>41</sup> Denial of the creditor's motion for summary judgment was affirmed.<sup>42</sup>

## II. SALE OF GOODS

### A. STATUTE OF FRAUDS

In *Den Norske Stats Oljeselskap, A.S. v. Hydrocarbon Processing, Inc.*,<sup>43</sup> two companies entered into contracts for the sale of propane through a broker acting as agent for both parties. After both companies

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34. *See id.* at 645.

35. *See id.*

36. *See id.* at 648.

37. *See id.*

38. *See id.* at 650.

39. 964 S.W.2d 708 (Tex. App.—Corpus Christi 1998, pet. denied).

40. *Id.* at 713.

41. *See id.* at 716.

42. *See id.* at 719. Because the facts of this case arose while the Texas Credit Code was still in effect, the opinion is based on various sections of TEX. REV. CIV. STAT. ANN. art. 5069. However, the court was careful to provide parallel citations to the Texas Finance Code adopted in 1997, which contains most provisions that were formerly in the Texas Credit Code. *See* TEX. FIN. CODE ANN. §§ 301.001 to 394.103 (Vernon 1998). This makes the opinion a helpful current reference for some issues that arise in Texas usury litigation.

43. 992 F. Supp. 913 (S.D. Tex. 1998).

notified the broker that the contract terms were acceptable, the broker prepared, signed, and faxed copies of the contract to both parties. The court held that each fax constituted “a writing . . . signed by . . . [an] authorized agent or broker” within the terms of section 2.201.<sup>44</sup> The court also noted that, even if the statute of frauds was not otherwise satisfied, the faxes operated as effective confirmations within the merchants’ exception. Both faxes began by saying, “[W]e are pleased to confirm the following transactions.”<sup>45</sup> Since neither party was required to respond, or to do anything further in regard to the transaction, the faxes met the requirements of the merchants’ exception in section 2.201.<sup>46</sup>

The statute of frauds and the parol evidence rule both figured in the decision of *J. Parra e Hijos, S.A. de C.V. v. Barroso*<sup>47</sup> in which the court held that a written contract for the sale of goods satisfied the statute of frauds and operated to bar introduction of evidence concerning an alleged personal guaranty by the principal shareholder of a corporate buyer. The court also noted that section 26.01 of the Code provides a separate statute of frauds requiring that promises to answer for the debt of another must be in writing to be enforceable.<sup>48</sup> Thus, both the parol evidence rule and a separate statute of frauds requirement prevented the introduction of evidence about the claimed personal guaranty.

## B. WARRANTIES

Although it appeared that the doctrine of privity was laid to rest in Texas several years ago in *Nobility Homes of Texas, Inc. v. Shivers*,<sup>49</sup> the decision of *Hininger v. Case Corp.*<sup>50</sup> reincarnated privity concept in a somewhat different form. The scope of the *Hininger* doctrine was consid-

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44. *Id.* at 915 (referring to TEX. BUS. & COM. CODE ANN. § 2.201(a) (Vernon 1994)).

45. *Id.* at 916 (referring to the parties’ agreement). The merchant’s exception in TEX. BUS. & COM. CODE ANN. § 2.201(b) (Vernon 1994) provides that, as between merchants, a confirming writing received by a party will satisfy the statute of frauds as against that party if no objection is made to the contents of the writing within ten days after receipt.

46. *See Den Norske*, 992 F. Supp. at 916.

47. 960 S.W.2d 161, 167-68 (Tex. App.—Corpus Christi 1997, no pet.).

48. *See id.* at 170. TEX. BUS. & COM. CODE ANN. § 26.01 (Vernon 1991) is a typical example of statutes requiring guaranty contracts to be in writing.

49. 557 S.W.2d 77, 81 (Tex. 1977).

50. 23 F.3d 124 (5th Cir. 1994). For a thorough discussion of *Hininger*, see John Krahmer, *Commercial Transactions*, SMU L. REV. 973, 982-83 (1995). The *Hininger* court held that, while a manufacturer of finished goods can be liable to remote purchasers for economic losses caused by a breach of warranty, the rule should be otherwise for manufacturers of component parts. *See Hininger*, 23 F.3d at 128. The court reasoned that component manufacturers, unlike manufacturers of finished goods, may not be able to effectively disclaim warranties because their components simply become part of another product and because their disclaimers of component warranties might not be communicated to the ultimate purchasers of the finished products. *See id.* at 129. The court also noted that Texas law does not permit the recovery of damages for economic loss on theories of strict liability or negligence. *See id.* at 127-28. Such damages are recoverable, however, if personal injury or property damage has resulted from the breach. *See Signal Oil & Gas Co. v. Universal Oil Prod.*, 572 S.W.2d 320 (Tex. 1978). The development of Texas law in regard to the recovery of damages for economic loss is discussed in William Powers, Jr. & Margaret Niver, *Negligence, Breach of Contract, and the ‘Economic Loss’ Rule*, 23 TEX. TECH L. REV. 477 (1992). The rule preventing recovery of damages for economic loss in a negli-



ered in *Metro National Corp. v. Dunham-Bush, Inc.*<sup>51</sup> in which a manufacturer of compressors made representations directly to a remote purchaser, including a statement that the compressors were warranted for five years. Because of these direct communications, the court held that the compressor manufacturer was liable to the remote purchaser for breach of express warranty when the compressors failed to function properly.<sup>52</sup> The court reasoned that *Hininger* did not extend to a situation where a component, available separately under its own brand name, was a central element of the sale of a complete cooling system for a hospital and the manufacturer actively encouraged use of its component in the system.<sup>53</sup> The lack of contractual privity under these circumstances does not bar claims for breach of either an express warranty or the implied warranty of fitness for a particular purpose.<sup>54</sup>

In addition to its claim for breach of warranty, the buyer asserted a claim of fraudulent inducement to enter the contract. As to this claim, the court held that the buyer's damages could be measured in one of two ways: (1) by the difference between the value paid and the value received (out-of-pocket damages); or (2) by the difference between the value represented and the value received (benefit of the bargain damages).<sup>55</sup> The court noted that these were the damage measures described in *Formosa Plastics* in which the Texas Supreme Court held that a tort claim for fraudulent inducement to enter into a contract was a proper cause of action "irrespective of whether the promise is later subsumed within a contract."<sup>56</sup> In regard to the choice between these two measures of damages, the court in *Metro* pointed out that, while the usual measure of damages for breach of warranty is expectation damages (benefit of the bargain damages), section 2.714 of the Code allows use of another measure if "'special circumstances show proximate damages of a different amount.'"<sup>57</sup> The court concluded that there were too many unknown factors to permit calculation of expectation damages with any reasonable certainty and that a more appropriate measure of damages would be the amount spent by the buyer in reasonable reliance on the breached warranties (out-of-pocket damages).<sup>58</sup> This conclusion means that damages on the fraudulent inducement claim and the warranty claim were identical. However, the court recognized "that [the buyer's] warranty claim entitles it to attorney's fees" and entered judgment on the warranty claim

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gence action was applied during the Survey period in *Indelco, Inc. v. Hanson Indus. N. Am.*, 967 S.W.2d 931 (Tex. App.—Houston [14th Dist.] 1998, pet. denied).

51. 984 F. Supp. 538 (S.D. Tex. 1997).

52. *See id.* at 559.

53. *See id.* at 558-59.

54. *See id.* at 561.

55. *See id.* at 562.

56. *Formosa Plastics*, 960 S.W.2d at 46.

57. *Metro*, 984 F. Supp. at 566 (quoting TEX. BUS. & COM. CODE ANN. § 2.714(b) (Vernon 1994)).

58. *See id.*

instead of the fraud claim.<sup>59</sup>

In *Church & Dwight Co. v. Huey*,<sup>60</sup> the court also considered the liability of a remote manufacturer. In this case, the manufacturer was the source of a finished product used as the active compound in a paint removal system. Although it was not the seller of the removal system, the manufacturer met directly with the remote purchaser to encourage acquisition of the system and provided literature about the benefits of the removal compound. After the compound failed to perform as represented, the purchaser sued for breach of warranty and DTPA misrepresentations. Because of the direct communication between the remote manufacturer of the removal compound and the purchaser of the removal system, the court held that both claims would lie despite the lack of contractual privity between the parties.<sup>61</sup>

In *General Motors Corp. v. Brewer*,<sup>62</sup> the Texas Supreme Court held that the need to detach and reattach seatbelts in a vehicle did not amount to a breach of the implied warranty of merchantability. On this point the court stated that "a product which performs its ordinary function adequately does not breach the implied warranty of merchantability merely because it does not function as well as the buyer would like, or even as well as it could."<sup>63</sup>

### C. RISK OF LOSS FOLLOWING DELIVERY

In *Ojeda v. Wal-Mart Stores, Inc.*,<sup>64</sup> a buyer tried unsuccessfully to fit a round peg into a square hole by asserting a Chapter 7 conversion claim for misdelivery by a bailee in a Chapter 2 sales case involving delivery by a seller. The plaintiff buyer, a retailer located in Mexico, ordered and paid for a large quantity of hair spray from a Sam's Club located in the United States. Following his usual practice for such orders, the buyer hired a transfer agent to provide a trailer and loader to pick up the goods and transport them through customs to the buyer's store in Mexico. The transfer agent and the loader received the goods at Sam's warehouse on a Friday and loaded them on a trailer for transportation to Mexico on the following morning. Because a flat tire was discovered on the trailer on Saturday, however, the trailer remained parked in a lot surrounding the warehouse over the weekend. On Monday the driver discovered that the trailer had been stolen. The buyer argued that Sam's had converted the

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59. *Id.*

60. 961 S.W.2d 560 (Tex. App.—San Antonio 1997, pet. denied).

61. *See id.* at 568-69. As to the DTPA claim, the court distinguished *Amstadt v. United States Brass Corp.*, 919 S.W.2d 644, 649 (Tex. 1996), holding that upstream component suppliers were not liable for DTPA violations if the alleged violations did not occur in connection with the consumer transaction giving rise to the claim. Here, unlike *Amstadt*, the component supplier met with the remote purchaser to promote the removal system and provided literature about the removal compound used in the system directly to the purchaser.

62. 966 S.W.2d 56, 57 (Tex. 1998).

63. *Id.* at 57.

64. 956 S.W.2d 704, 705 (Tex. App.—San Antonio 1997, pet. denied).

goods by breaching the duty of a bailee to deliver the goods to the proper party.<sup>65</sup> The court rejected this argument because it viewed Sam's as a seller of goods who had properly delivered them to the buyer on Friday under a contract of sale rather than a bailee who had agreed to store the goods over the weekend. After the loading was complete, the seller "had nothing further to do with the goods."<sup>66</sup>

### III. NEGOTIABLE INSTRUMENTS, GUARANTIES, & BANK TRANSACTIONS

#### A. TRANSFER OF INSTRUMENTS

Although decided under the prior version of Chapter 3 of the Code, the decision by the Texas Supreme Court in *Southwestern Resolution Corp. v. Watson*<sup>67</sup> showed a willingness to apply the liberalized standards of the revised Chapter 3 of the Code governing negotiable instruments to the affixation of an allonge to an instrument.<sup>68</sup> The court cited and discussed the relaxed requirements of the revised Chapter 3 and held that, as a matter of law, attachment of an allonge by staples satisfied the affixation requirement.<sup>69</sup>

In *Ashcraft v. Lockadoo*,<sup>70</sup> the court of appeals ruled, *inter alia*, that assignment of a note did not carry with it an assignment of a guaranty securing payment of the note. This ruling appears to be mere dicta, however, because the plaintiff was also unable to produce the original guaranty and was only able to introduce an unauthenticated photocopy that the court held was insufficient to prove the plaintiff's ownership of the guaranty. In a *per curiam* denial of a writ of error, the Texas Supreme Court specifically noted that "the Court neither approves nor disapproves of the court of appeals' discussion of whether the assignment of a promissory note also operated as an assignment of a guaranty of that note."<sup>71</sup> Thus, the question of whether assignment of a note carries with it an assignment of an associated guaranty seems to be an open one in Texas.

65. See TEX. BUS. & COM. CODE ANN. § 7.403 (Vernon 1991).

66. *Ojeda*, 956 S.W.2d at 708. On this point, the court cited TEX. BUS. & COM. CODE ANN. § 2.401 (Vernon 1994) regarding the passage of title upon physical delivery of goods to a buyer. Although not mentioned by the court, TEX. BUS. & COM. CODE ANN. § 2.509(c) (Vernon 1994) provides an even clearer indication that the risk of loss passes to a buyer upon delivery of the goods.

67. 964 S.W.2d 262 (Tex. 1997).

68. Chapter 3 of the Code was completely revised by the Act of May 28, 1995, 74th Leg., R.S., ch. 921, § 1, 1995 Tex. Gen. Laws 4582 (codified as TEX. BUS. & COM. CODE ANN. §§ 3.101-.605 (Vernon Supp. 1998)). The new Chapter 3 became effective on January 1, 1996. See Act of May 28, 1995, 74th Leg., R.S., ch. 921, § 1, 1995 Tex. Gen. Laws 4582, 4643.

69. To similar effect, see *Winfield v. Dosohs I, Ltd.*, No. 01-97-00997-CV, 1998 WL 436895 (Tex. App.—Houston [1st Dist.] July 30, 1998, no pet.) (not designated for publication). The *Winfield* court held that an endorsement by the FDIC on a separate piece of paper permanently attached to a note with glue was effective to transfer a promissory note to a holder even though there was still room on the note for endorsements. See *id.* at \*5.

70. 952 S.W.2d 907, 920 (Tex. App.—Dallas 1997), pet. denied, *per curiam*, 977 S.W.2d 562 (Tex. 1998).

71. *Ashcraft*, 977 S.W.2d at 562.

## B. LOST INSTRUMENTS

Under section 3.309 of the revised Chapter 3 of the Code, a person not in possession of an instrument may still enforce it if: (1) the person was in possession of the instrument and entitled to enforce it when possession was lost; (2) the loss of possession was not the result of a transfer by the person seeking to enforce the instrument or the result of a lawful seizure of the instrument; and (3) the person cannot obtain possession because the whereabouts of the instrument are unknown, it has been destroyed, or it is in the wrongful possession of a person who cannot be found or reached by legal process.<sup>72</sup>

In *Geiselman v. Cramer Financial Group, Inc.*,<sup>73</sup> the assignee of two promissory notes acquired them from the FDIC and sought to recover on them under the provisions of section 3.309 of the Code.<sup>74</sup> Based on the testimony of two witnesses, the trial court granted a summary judgment in favor of the assignee.<sup>75</sup> The court of appeals reversed, noting that the witnesses neither offered testimony accounting for the loss or destruction of the original notes nor testified from personal knowledge that the assignee ever had possession of the notes or that copies of the notes were true and correct copies of the original notes.<sup>76</sup> Because of these defects in satisfying the elements required by the Code, the court held that summary judgment was improperly granted and remanded the case for a new trial.<sup>77</sup>

In *Geiselman*, the court pointed out that *Western National Bank. v. Rives*<sup>78</sup> had previously discussed the possession requirement. Specifically, the *Western National* court said that in "recodifying the provision under [section] 3.309 of the amended Code, [the legislature] declared that 'a person who is not in possession of an instrument is entitled to enforce' it if he 'was in possession . . . and entitled to enforce it when loss . . . occurred.'"<sup>79</sup> In light of the revision and based on its reading of the prior section 3.804 on lost instruments,<sup>80</sup> the court of appeals in *Western National* held that proof of possession was required, and this holding was followed in *Geiselman*.<sup>81</sup>

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72. See TEX. BUS. & COM. CODE ANN. § 3.309(a) (Vernon Supp. 1998).

73. 965 S.W. 2d 532 (Tex. App.—Houston [14th Dist.] 1997, no pet.).

74. TEX. BUS. & COM. CODE ANN. § 3.309 (Vernon Supp. 1998).

75. See *Geiselman*, 965 S.W.2d at 539.

76. See *id.*

77. See *id.* at 540.

78. 927 S.W.2d 681 (Tex. App.—Amarillo 1996, writ denied).

79. *Id.* at 685 (quoting TEX. BUS. & COM. CODE ANN. § 3.309(a)(1) (Vernon Supp. 1996)).

80. See Act of May 25, 1967, 60th Leg., R.S., ch. 785, § 1, 1967 Tex. Gen. Laws 2343, 2440, amended by Act of May 28, 1995, 74th Leg., R.S., ch. 921, § 1, 1995 Tex. Gen. Laws 4582 (codified as TEX. BUS. & COM. CODE ANN. §§ 3.101-.605 (Vernon Supp. 1998)).

81. This apparent change in the requirements for recovering on lost instruments was noted in *Dennis Joslin Co. v. Robinson Broad. Corp.*, 977 F. Supp. 491, 494-95 (D.D.C. 1997), in which the court held that the assignee of a note that was apparently lost by the FDIC prior to assignment of the note as part of an FDIC loan "package" could not recover against the guarantors on the note because the plaintiff was not in possession of the note at

## C. RIGHTS OF A HOLDER

Under Chapter 3 of the Code, a holder in due course takes an instrument free of many defenses that might otherwise be available to the maker or drawer.<sup>82</sup> Per contra, if a holder does not qualify as a holder in due course, the holder remains subject to the claims and defenses of the obligor.<sup>83</sup> In *World Help v. Leisure Lifestyles, Inc.*,<sup>84</sup> the court added an interesting twist to these basic rules by holding that a provision in a note, which requires a payee to give notice of default and an opportunity to cure, does not apply to a holder of the note. The court reasoned that, because section 1.102 of the Code<sup>85</sup> permits its effects to be varied by agreement, the clause in question made the notice provision operative only against the payee and that a subsequent holder, even one who was not a holder in due course, was not bound to give notice of default before seeking payment of the balance due on the note.<sup>86</sup> According to the court, the parties had agreed to give subsequent holders greater enforcement rights than the payee had.<sup>87</sup>

Although it now seems settled that a reasonable interest rate can be substituted when a note calls for payment based on the prime rate of a defunct bank, the note holder is still required to prove such a "reasonable rate." In *Commercial Services of Perry, Inc. v. Wooldridge*,<sup>88</sup> the court held that a creditor's failure to prove a reasonable rate of interest to substitute for the prime rate of the failed bank prevented the creditor from recovering on a note because the amount due and owing could not be determined. The court rejected an argument that section 3.112 of the Code<sup>89</sup> allows use of the judgment rate in lieu of proving a rate because using the judgment rate would "in effect, be rewarding [the creditor] for

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the time it was lost. Although the court recognized that there was no "logical reason to distinguish between a person who was in possession at the time of the loss and one who later comes into possession of the rights to the note," the statutory language of the revised section 3.309 requires the plaintiff to show both possession of the note at the time of loss and that the plaintiff was a person entitled to enforce the note when it was lost. *Id.* at 495. To similar effect, see *McKay v. Capital Resources Co.*, 940 S.W.2d 869 (Ark. 1997). In *Beal Bank, S.S.B. v. Caddo Parish-Villas S., Ltd.*, 218 B.R. 851, 855 (N.D. Tex. 1998), however, the court held that an assignee could recover on a note lost by the assignor when the assignment included an assignment of the right to recover on the note and when the assignor met all of the requirements of section 3.309, including the requirement of possession at the time of loss.

82. See TEX. BUS. & COM. CODE ANN. § 3.305(b) (Vernon Supp. 1998). To qualify as a holder in due course, the holder must meet the requirements stated in TEX. BUS. & COM. CODE § 3.302(a) (Vernon Supp. 1998).

83. See TEX. BUS. & COM. CODE ANN. § 3.305(a) (Vernon Supp. 1998).

84. 977 S.W.2d 662, 679-80 (Tex. App.—Fort Worth 1998, no pet.).

85. TEX. BUS. & COM. CODE ANN. § 1.102(c) (Vernon 1994).

86. See *World Help*, 977 S.W.2d at 677. In pertinent part, the clause in question read: "[n]otwithstanding any other term or condition hereof, the Payee shall give the undersigned (a) ten (10) days, after written notice ("Notice") that an event has occurred that would be a monetary default hereunder . . . to cure same before Payee declares a default hereunder." *Id.*

87. See *id.*

88. 968 S.W.2d 560, 565-66 (Tex. App.—Fort Worth 1998, no pet.).

89. TEX. BUS. & COM. CODE ANN. § 3.112(b) (Vernon Supp. 1998).

its failure to prove its case.”<sup>90</sup> The court held that section 3.112 was intended to deal with cases where an instrument calls for the payment of interest but is silent on the rate to be used.<sup>91</sup> A take-nothing judgment in favor of the debtor was affirmed.<sup>92</sup>

#### D. NEGOTIABLE INSTRUMENTS AND ARBITRATION

If the parties have included a broad arbitration clause in a note or in associated agreements, the holder of the note may be bound by a discharge of the maker in arbitration even if the holder was not a party to the arbitration but had interests that were congruent with those of the parties involved in the arbitration. In *Nauru Phosphate Royalties, Inc. v. Drago Daic Interests, Inc.*,<sup>93</sup> the court held that an arbitration award discharging a purchaser of land from liability on a promissory note issued to the land developer was binding on the noteholders even though they were not parties to the arbitration because payment of the note was conditioned on performance of the underlying development contract between the purchaser and the developer.

The same concept of a congruency of interests was applied to obligors rather than holders in *Nationwide of Bryan, Inc. v. Dyer*.<sup>94</sup> In *Nationwide*, the court held that an agreement to arbitrate was binding on a non-signing party because the non-signer was a third-party beneficiary of a retail installment contract signed by her husband to purchase a mobile home for use as their homestead.<sup>95</sup> As a third-party beneficiary, the wife’s claims against the seller of the mobile home for alleged defects in the home were so closely connected with the husband’s claims for the same defects that the wife could not “pick and choose” which contract provisions applied to her claims.<sup>96</sup> An order to compel arbitration was approved.<sup>97</sup>

##### 1. Ownership of Bank Accounts

In the case of an account established as a joint account, the Texas Probate Code provides a uniform deposit contract to designate the contractual relationship between the parties and the bank.<sup>98</sup> In *Allen v. Wachtendorf*,<sup>99</sup> the court held that a signature card that used the statutory contract language properly designated a certificate of deposit account as a joint account with right of survivorship and that the survivor was enti-

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90. *Wooldridge*, 968 S.W.2d at 565.

91. *See id.* (citing the State Bar UCC Committee Comment to TEX. BUS. & COM. CODE ANN. § 3.112 (Vernon Supp. 1998) and *Bailey, Vaught, Robertson & Co. v. Remington Invs., Inc.*, 888 S.W.2d 860 (Tex. App.—Dallas 1994, no writ)).

92. *See Wooldridge*, 968 S.W.2d at 565.

93. 138 F.3d 160, 166 (5th Cir. 1998).

94. 969 S.W.2d 518 (Tex. App.—Austin, 1998, no pet.).

95. *See id.* at 520.

96. *See id.* at 520.

97. *See id.* at 522.

98. *See* TEX. PROB. CODE ANN. § 439A (Vernon Supp. 1998).

99. 962 S.W.2d 279, 283-84 (Tex. App.—Corpus Christi 1998, pet. denied).

bled to the funds in the account following the death of the other joint owner.

#### IV. LETTERS OF CREDIT

##### A. INJUNCTIONS AGAINST HONOR

In *AIG Risk Management, Inc. v. Motel 6 Operating L.P.*,<sup>100</sup> a customer who had obtained the issuance of several letters of credit sought a temporary injunction against the beneficiary named in the letters of credit to prevent the beneficiary from drawing on the credits until sixty days after notice of any proposed future draw was given to the customer. The court held that the customer had established a probable right to recover funds already paid to the beneficiary because the beneficiary had made previous draws on letters of credit established for one transaction to pay bills arising under other transactions.<sup>101</sup> The court further reasoned that the temporary injunction did not prohibit the beneficiary from making draws based on the proper transaction. Therefore, the case was not one arising under section 5.114 but, rather, one arising under the common law.<sup>102</sup> On this point, the court found that the customer had established a probable right to recover because of a breach of contract by the beneficiary, a likelihood of imminent harm, and irreparable injury.<sup>103</sup>

#### V. SECURED TRANSACTIONS

##### A. CLASSIFICATION OF COLLATERAL

In the decision of *In re Bonnema*<sup>104</sup> the court addressed the question of how "capital retains," which are funds retained by agricultural cooperatives from the sale of members' products, should be classified under Chapter 9 of the Code.<sup>105</sup> The two most likely possibilities were classifi-

100. 960 S.W.2d 301 (Tex. App.—Corpus Christi 1997, no pet.).

101. *See id.* at 308.

102. *See id.* at 306 (citing TEX. BUS. & COM. CODE ANN. § 5.114(b) (Vernon 1994). This section of the Code permits an injunction against payment on a letter of credit in limited circumstances.)

103. *See AIG Risk Management*, 960 S.W.2d at 308-09. The court recognized that the "independence principle" normally prohibits examination of the contract between a customer and a beneficiary that underlies a letter of credit. In this case, however, the court found that the independence principle did not apply because:

The instant case does not involve the issuer's obligation nor whether the issuer acted properly in honoring [the beneficiary's] draft . . . . It is, therefore, necessary to look at the underlying agreement . . . . Reviewing the underlying agreement does not violate the independence principle, which requires that the terms of a letter of credit alone control whether payment is to be made. Because payment in this case has already been made, the letter of credit has served its purpose. The question remaining is whether [the beneficiary] obtained payment under false pretenses, and to answer that question, we must look at the agreement [between the customer and the beneficiary].

*Id.* at 308.

104. 219 B.R. 951 (Bankr. N.D. Tex. 1998).

105. TEX. BUS. & COM. CODE ANN. §§ 9.105, .106, .109, .115 (Vernon 1991 & Supp. 1998) contain an elaborate classification scheme for property used as collateral in a Chap-

cation as “investment property” because the cooperative issued certificates to its members or classification in the catch-all category of “general intangibles.”<sup>106</sup> The certificates specifically and conspicuously stated that they were non-transferable and were subject to redemption only by action of the board of directors of the cooperative. The court held that the capital retains were not “investment property” because, despite the existence of certificates, the capital retains were not “of a type dealt in or traded on securities exchanges or securities markets” as required by section 8.102 of the Code.<sup>107</sup> Since the only remaining category was that of “general intangibles,” the capital retains fell into that classification. From the standpoint of the secured party who had taken a security interest in the capital retains, however, a further difficulty remained vis-a-vis the trustee in bankruptcy: What effect did the restraint on alienation stated on the certificates have on the security interest? If the restraint was ineffective, the security interest was valid. If the restraint was effective, the capital retains were property of the bankruptcy estate. On this issue, the secured party argued that the terms of section 9.318<sup>108</sup> made the restraint ineffective.

The court disagreed, however, because the bankruptcy debtors’ interest in the capital retains was treated as a capital contribution under the by-laws of the cooperative, and the debtor’s interest was, therefore, an equity interest rather than a right to the payment of money.<sup>109</sup> Since the cooperative was not an “account debtor” within the meaning of section 9.318, that section was inapplicable. Concommittantly, the restraint on alienation was effective.<sup>110</sup> The net result was that the security interest did not attach to the capital retains. The capital retains were property of the debtors’ bankruptcy estate.

## B. CROSS-COLLATERALIZATION AND FUTURE ADVANCES

In the decision of *In re Conte*<sup>111</sup> a secured party attempted to use a cross-collateralization clause on an auto loan to secure a subsequent credit card debt. While the court agreed that Texas permits the use of cross-collateralization clauses, it also pointed out that such clauses are limited to indebtedness that was reasonably within the contemplation of

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ter 9 secured transaction. The proper method for perfecting a security interest is often dependent on the classification of the collateral.

106. “Investment property” is defined in TEX. BUS. & COM. CODE ANN. § 9.115(a)(6) (Vernon Supp. 1998), and “general intangibles” is defined in TEX. BUS. & COM. CODE ANN. § 9.106 (Vernon 1991).

107. *In re Bonnema*, 219 B.R. at 955 (referring to TEX. BUS. & COM. CODE ANN. § 8.102(a)(15)(C)(i) (Vernon Supp. 1998)).

108. TEX. BUS. & COM. CODE ANN. § 9.318(d) (Vernon 1991) provides: “A term in any contract between an account debtor and an assignor is ineffective if it prohibits assignment of an account or prohibits creation of a security interest in a general intangible for money due or to become due or requires the account debtor’s consent to such assignment or security interest.”

109. *See In re Bennema*, 219 B.R. at 956.

110. *See id.*

111. 217 B.R. 767 (Bankr. E.D. Tex. 1998).



the parties when the security agreement was signed.<sup>112</sup> In reviewing the relevant portions of the security agreement, the court concluded that the parties did not intend the auto loan to secure a later unrelated credit card debt because the cross-collateralization clause at issue appeared in small print on the reverse side of the form and was not disclosed on the face of the form unlike another cross-collateralization clause that was disclosed concerning the use of account deposits as additional security.<sup>113</sup> Considering the transaction as a whole, the court held that the security interest on the auto had been paid in its entirety and that the cross-collateralization clause did not give the secured party a valid lien on the vehicle.<sup>114</sup>

### C. PROCEEDS

Under Chapter 9 of the Code, while proceeds can consist of anything received by the debtor upon the sale, exchange, collection, or other disposition of collateral, *In re Value-Added Communications, Inc.*<sup>115</sup> points out that use of equipment is not a "disposition of collateral" within the meaning of the term "proceeds." As the court succinctly put it, "[i]f fruits and products from the use of collateral were treated as proceeds, every creditor with a security interest in equipment would have a security interest in all items produced from the equipment as well as the revenues earned by the equipment."<sup>116</sup> If the secured party had properly described the products as collateral in its financing statement, such an arrangement may have passed judicial muster. But the secured party omitted any such description and the attempt to reach the products by recharacterizing them as proceeds was denied.<sup>117</sup>

The *time* when a security interest attaches to proceeds of collateral can be important for a variety of reasons. For example, section 9.306 of the Code requires a secured party to act within specified periods of time to continue a perfected security interest in certain forms of collateral such as identifiable cash proceeds or proceeds acquired with cash proceeds.<sup>118</sup> An interesting twist on this issue of timing arose in the decision of *In re Rees*<sup>119</sup> in which a secured party claimed a perfected security interest in the proceeds of the bankruptcy debtors' 1996 cotton crop insurance indemnity payment. Under regulations of the Federal Crop Insurance Corporation (FCIC), which acts as a reinsurer of crop insurance issued by private insurance companies, an assignment of the right to receive payment under a crop insurance policy must be filed with the FCIC to be

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112. *See id.* at 770-71.

113. *See id.*

114. *See id.* at 771-72.

115. 139 F.3d 543, 546 (5th Cir. 1998).

116. *Id.* at 546.

117. *See id.*

118. TEX. BUS. & COM. CODE ANN. § 9.306(c) (Vernon 1991) provides a ten day period of temporary perfection. But after the lapse of that time, the secured party may be required to take additional steps to continue the perfection.

119. 216 B.R. 551 (Bankr. N.D. Tex. 1998).

effective.<sup>120</sup> Although the secured party had perfected its security interest in the cotton crop and proceeds of the crop, it failed to file an assignment of the right to receive payment under the crop insurance policy. Because of the failure of their 1996 crop, the debtors received a crop insurance payment and subsequently filed a Chapter 12 bankruptcy reorganization plan. The debtors argued that the federal regulations preempted application of Chapter 9 of the Code and prevented the secured party from reaching the proceeds of the crop insurance. The secured party contended that the regulations only prevented attachment of the security interest to the *right* to receive payment but did not prevent attachment of the security interest to the insurance proceeds themselves. Based on a careful reading of the Federal Crop Insurance Act under which the FCIC promulgated its regulations, the court ruled that the Act only “prohibits liens on policy proceeds ‘before payment to the insured’” and does not prohibit a security interest in the policy proceeds themselves.<sup>121</sup> The court held, in effect, that the scope of federal preemption under the Act was very narrow and that the broader preemption found in the regulations was essentially “boot-strapping” by the FCIC that did not have a foundation in the statutory language.<sup>122</sup>

In *Phippen v. Deere & Co.*,<sup>123</sup> the secured party asserted a conversion claim against the purchaser of the debtor’s business when neither the debtor nor the purchaser remitted all of the proceeds from inventory sales that took place before the business was sold. The purchaser argued that conversion would not lie because the proceeds had not been segregated but had been deposited into the seller’s operating account, commingled with other funds, and spent by the seller. The court agreed with the purchaser on this point, noting that an action for conversion lies for the recovery of money only if the money can be identified as a specific chattel.<sup>124</sup> Fortunately for the secured party, however, he also had asserted claims for fraud, for money had and received, and for unjust enrichment. On these claims, the court had no difficulty granting recovery to the secured party because there was overwhelming evidence that the seller and purchaser had conspired to conceal the proceeds of the inventory sales and to avoid paying the secured party.<sup>125</sup>

#### D. PRIORITIES

In *Alan Acceptance Corp. v. East Texas National Bank of Palestine*,<sup>126</sup> the secured party successfully asserted a conversion claim against a competing claimant who repossessed a variety of dental equipment from the

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120. See 7 C.F.R. § 457.8, pt. 26 (1995).

121. *In re Rees*, 216 B.R. at 554 (emphasis added).

122. See *id.* at 555.

123. 965 S.W.2d 713 (Tex. App.—Texarkana 1998, no pet.).

124. See *id.* at 724.

125. See *id.* at 725.

126. No. 12-097-00074-CV, 1998 WL 596706 (Tex. App.—Tyler August 13, 1998, no pet.).

debtor. The secured party had a valid and perfected security interest in the equipment that came into existence before the transaction with the second party occurred. Even if both security interests had been perfected, the first secured party would have prevailed. In this case, however, the court held there was "no evidence" that the debtor and the second party had entered into a loan transaction or had even created a security interest in favor of the second party.<sup>127</sup> Under these circumstances, the second party had no right to "repossess" the equipment and the conversion claim was upheld.<sup>128</sup>

In *Franklin National Bank v. Boser*,<sup>129</sup> a bank made loans to a dairy farmer during 1992 and 1993 that were secured by a security interest in all of the debtor's dairy cattle, both then-owned and thereafter acquired. The security interest was properly perfected by a filing in the office of the Texas Secretary of State. In 1994 the farmer obtained an additional sixty head of cattle from another person under a contract that was titled a "lease purchase agreement." The lessor/seller also completed a UCC-1, but, relying on advice from the county clerk's office and his familiarity with the filing rules in his home state, the lessor/seller filed the financing statement in the office of the county clerk where the dairy farm was located within twenty days after the farmer received the cattle. In 1995 the dairy farmer told the bank he was going out of the dairy business, and the bank conducted a lien search in the Secretary of State's office. The search revealed only the two financing statements filed by the bank in 1992 and 1993. The bank repossessed and sold all of the cattle, including the sixty head acquired a year earlier. After learning of the repossession and sale, the lessor/seller sued the bank contending that he had a superior interest in the sixty cattle, either on the ground that his interest was founded on a lease under which title to the cattle never passed to the debtor or on the ground that he had priority because his interest in the cattle was a purchase money security interest.

The court had no difficulty in declaring that the "lease purchase agreement" was actually a security agreement regardless of what it was called by the parties because it contemplated that, upon completion of the lease payments, the lessee would become the owner of the cattle and the lessee had no option to terminate the lease before the end of the lease term.<sup>130</sup> The court held that, under section 1.201 of the Code, the economic realities of the transaction made the interest of the lessor nothing more than a disguised security interest.<sup>131</sup> The more interesting question, however, was whether filing by the seller in the wrong filing office would protect the purchase money security interest against the bank's security interest

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127. *See id.* at \*2.

128. *See id.*

129. 972 S.W.2d 98 (Tex. App.—Texarkana 1998, pet. denied).

130. *See id.* at 103.

131. *See id.* TEX. BUS. & COM. CODE ANN. § 1.201(37) (Vernon 1994) contains an elaborate definition of the factors to be considered in determining if a lease is a true lease or merely a disguised security interest.

in after-acquired property. The seller argued that section 9.401 of the Code gave him priority because the filing was made in good faith and the bank had knowledge of the contents of the financing statement by virtue of the seller's claim to the cattle that he asserted after the repossession.<sup>132</sup> On this issue, the court reasoned that section 9.401 was intended to protect good faith filings against subsequent lenders who knew of the contents of improperly filed financing statements but was not intended to protect later filings against prior lenders who had already properly filed.<sup>133</sup>

The only Texas precedent on a similar issue interpreted the operation of section 9.401 in the context of a purchase money security interest in inventory.<sup>134</sup> Although not squarely on point, the *Franklin National Bank* court was persuaded by the *Borg-Warner* court's reasoning and chose to follow its interpretation.<sup>135</sup>

*State Bank & Trust Co. v. Insurance Co. of the West*<sup>136</sup> concerned the application of the special priority rule that arises in a construction context when a contractor or subcontractor borrows money from a secured party and grants a security interest in accounts receivable. If the contractor or subcontractor defaults on its obligations under the construction contract and a surety completes the work, is the secured party or the surety entitled to any undisbursed progress payments? In general the courts have held that the surety's rights to the proceeds are superior to the lender's perfected security interest because the surety's right to equitable subrogation is not a security interest subject to Chapter 9 of the Code. Therefore, the lender does not gain priority over the surety by perfecting a security interest in the proceeds.<sup>137</sup>

In *State Bank & Trust*, however, the court held that this general rule does not prevent a secured party from claiming a superior right to tangi-

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132. See TEX. BUS. & COM. CODE ANN. § 9.401(b) (Vernon 1994).

133. See *Franklin Nat'l Bank*, 972 S.W.2d at 105. The court summarized its position in the following terms:

Even if the good faith filing section would otherwise apply in this case, section 9.401(b) obviously contemplates that the "knowledge" of the contents of the misfiled financing statement must be knowledge that the competing security interest holder had *at the time he acquired his security interest*. To allow subsequent knowledge to trigger the good faith exception would render the knowledge requirement meaningless, because in every case the competing security interest holder would at some point, i.e., at foreclosure, suit, or whenever the conflict arose, have knowledge of the other security interest. Here, [the bank] did not have any knowledge of [the seller's] interest when it took its interests, because [the seller's interest] was not in existence.

*Id.* (emphasis added).

134. See *Borg-Warner Acceptance Corp. v. Wolfe City Nat'l Bank*, 544 S.W.2d 947 (Tex. Civ. App.—Dallas 1976, no writ).

135. See *Franklin Nat'l Bank*, 972 S.W.2d at 105. The conflicting cases cited by the court were: *Community Nat'l Bank v. Moyer*, 836 P.2d 1198 (1992); *Temporaries, Inc. v. Maryland Nat'l Bank*, 626 F. Supp. 1025, 1028 (D. Md. 1986); and *In re Johnson*, 28 B.R. 292, 297 (Bankr. N.D. Ill. 1983).

136. 132 F.3d 203 (5th Cir. 1997).

137. See, e.g., *Interfirst Bank Dallas v. United States Fidelity & Guar. Co.*, 774 S.W.2d 391 (Tex. App.—Dallas 1989, writ denied).

ble collateral, such as equipment and materials owned by the contractor. This is because the interest in the tangible collateral is not dependent on the contractor's right to receive payment by completion of the contract.<sup>138</sup>

#### E. REPOSSESSIONS, REALES, & FORECLOSURES

While issues of perfection, proceeds, and priorities are significant in creating and enforcing a security interest, the chickens often come home to roost when the debtor defaults and the secured party must take steps to repossess and dispose of the collateral. Between the "indelegable duty" rule of *MBank El Paso v. Sanchez*<sup>139</sup> and the "absolute bar" rule of *Tanenbaum v. Economics Laboratory, Inc.*<sup>140</sup> the secured party must tread carefully while carrying the weight of the burden of proof imposed by *Greathouse v. Charter National Bank-Southwest*.<sup>141</sup>

The secured party slipped from this path in *Milliorn v. Finance Plus, Inc.*<sup>142</sup> by failing to give a required notice of public sale for the nonjudicial foreclosure of a collateral note secured by real estate. The court held that failure to perform the foreclosure sale in a commercially reasonable manner prevented the secured party from recovering a deficiency on a \$320,000 note under the absolute bar rule of *Tanenbaum*.<sup>143</sup> Whether by luck or by design, however, not all was lost for the secured party because the same debtor had executed a series of notes, and the notice of foreclosure sent to the debtor did not list a separate \$38,000 note secured by the same collateral. As to this note, the court held that the secured party was still entitled to recover a judgment for the balance due because the note was not involved in the commercially unreasonable foreclosure sale.<sup>144</sup> The court summarized its reasoning by stating, "Our holding penalizes the creditor in accordance with *Tanenbaum* . . . on the one loan and one

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138. See *State Bank & Trust*, 132 F.3d at 207. As stated by the court:

[W]hen tangible personal property—distinct from contract proceeds—is at issue, the rationale for elevating the surety over the secured creditor has no application. Unlike the contractor's inchoate or potential rights in the contract proceeds, the contractor comes into the construction contract with present and effective ownership and the right to possess and use its own tools, equipment, and inventory. If the contractor has previously given a creditor a security interest in these materials—even those subsequently acquired—the creditor's right to realize on its collateral is not contingent on the contractor's full performance of its obligations. As the creditor's interest in its tangible collateral is not derivative of the contractor's right to collect payment under its contract, the surety cannot claim an equitable right to possess and use its defaulted principal's construction materials to complete the project that the surety has bonded. In fact, granting such use at no cost would result in a windfall to the surety, who would thus avoid the anticipated expense of providing materials necessary for project completion.

*Id.*

139. 836 S.W.2d 151 (Tex. 1992).

140. 628 S.W.2d 769 (Tex. 1982).

141. 851 S.W.2d 173 (Tex. 1992).

142. 973 S.W.2d 690 (Tex. App.—Eastland 1998, no pet.).

143. See *id.* at 692.

144. See *id.* at 693.

item of collateral. It does not reward the defaulting debtor by providing a windfall avoidance of personal liability on all loans owed to the creditor."<sup>145</sup>

In *Vera v. North Star Dodge Sales, Inc.*,<sup>146</sup> a father made arrangements to purchase a car for his son. After the buyer made a downpayment and took delivery of the car, the car dealer discovered that the buyer had provided incorrect financial information on the purchase application. The dealer demanded return of the car and tendered a refund of the buyer's downpayment by sending a check to the buyer. The back of the check included language indicating that, by cashing the check, the buyer released the seller from all claims arising from the purchase of the car. The buyer endorsed and cashed the check, but refused to return the car and the dealer repossessed the vehicle. The buyer and his son both sued the dealer for conversion, unlawful debt collection, wrongful repossession, and Deceptive Trade Practice Act (DTPA) violations. The court held that the release was effective to waive all of the buyer's claims relating to the purchase of the car.<sup>147</sup> The court further held, however, that the release did not waive a separate claim by the son for conversion of personal property that was allegedly in the vehicle when it was repossessed.<sup>148</sup> The case was remanded to the trial court for determination of the son's claim.

In *Bank One, Texas, N.A. v. Stewart*,<sup>149</sup> the court held that a senior secured party was not liable to a junior secured party for selling a defaulted note to a maker of a collateral note nor for the subsequent foreclosure of the realty securing the collateral note. The convoluted situation arose from a series of transactions that began with the sale of realty by the junior secured party (who was then the original owner of the realty). The seller financed part of the sale by retaining a purchase money lien, but this interest was subordinate to a first lien in favor of a savings association. The purchaser of the realty later sold its interest to a joint venture, and the joint venture issued a promissory note in partial payment of the purchase price. This note was endorsed and collaterally assigned to the savings association, and the original seller of the realty was given another promissory note by the first purchaser secured by a second lien in the joint venture note. By letter, the savings association acknowledged the second lien status of the original owner and agreed that it would act as bailee for him. At this point, time passed, and, through a series of assignments and bank failures, the notes came to rest in the hands of a bank. By this time the joint venture defaulted on its note, resulting in the default of the maker on the notes issued by the first purchaser to the original owner and to the savings association (this latter note was now in the hands of the bank). The bank initiated collection of

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145. *Id.*

146. No. 04-96-00749-CV, 1998 WL 484716 (Tex. App.—San Antonio Aug. 19, 1998).

147. *See id.* at \*4.

148. *See id.* at \*6.

149. 967 S.W.2d 419, 439 (Tex. App.—Houston [14th Dist.] 1998, no pet.).

the first purchaser's note. After a series of attempts to restructure the obligation, and, after a bankruptcy reorganization plan proved unsuccessful, the bank sold the first purchaser's note to one of the makers of the joint venture note and assigned its interest in the collateral joint venture note to the same maker (this party to the joint venture had withdrawn from the venture some two years before). The maker then purchased the collateral note by foreclosing on the original purchaser's note and subsequently foreclosed on the realty, thus terminating the interest of the junior secured party who was the original seller.

The junior party sued the bank, the joint venture maker who had acquired the notes and realty, and the joint venture, asserting claims for conversion, breach of the bailment agreement, breach of a duty of good faith and fair dealing, violation of Code duties of reasonable care of collateral and commercially reasonable disposition of collateral, fraud, and tortious interference with the business relationship between the bank and the junior secured party. The court found in favor of the bank on all issues noting: (1) the bailment agreement only operated to perfect the junior secured party's interest in the collateral note and was not breached by the bank;<sup>150</sup> (2) the junior secured party was not a debtor to the bank and the bank did not owe a duty of reasonable care to him under section 9-207;<sup>151</sup> (3) the duty of good faith and fair dealing under section 1-203 of the Code did not create an independent cause of action and there was no breach of a contract nor any "special relationship" that would support such a claim;<sup>152</sup> (4) there was no evidence of fraud showing an intention by the joint venture not to perform its obligations on the collateral note at the time the note was issued;<sup>153</sup> (5) because of its withdrawal from the joint venture, the acquiring maker did not convert and did not interfere with the business relationship between the junior secured party and the bank;<sup>154</sup> and (6) although there was evidence that the sale of the collateral note was not commercially reasonable, there was no loss to the junior secured party because the jury found that the value of the collateral note was less than the amount of the debt remaining on the unpaid note issued by the first purchaser; thus, even a commercially reasonable sale would not have yielded any proceeds to apply to the claim of the junior secured party.<sup>155</sup> A take nothing judgment was rendered against the junior secured party in favor of all defendants.<sup>156</sup>

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150. *See id.* at 434-35.

151. *See id.* at 438-39 (discussing TEX. BUS. & COM. CODE ANN. § 9.207 (Vernon 1991)).

152. *See Stewart*, 967 S.W.2d at 441-42. The duty of good faith is more fully discussed in the text at note 7, *supra*.

153. *See id.* at 445.

154. *See id.* at 449.

155. *See id.* at 453-54.

156. *See id.* at 456.