Sales of Collateral "Out of Trust:" Recent Cases Define Creditors' Rights

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I. Introduction

A series of recent cases has addressed some of the issues that can arise when a debtor sells collateral “out of trust” (i.e., in violation of the terms of a security agreement) or fails to remit the sales proceeds to the secured party as required. Together these cases reflect a hierarchy of remedies, subject to certain limitations, that provides a creditor with significant tools to use in protecting its secured position, both in and outside of bankruptcy.

II. The Ninth Circuit Cases: A Split Personality

A. Introduction

A pair of bankruptcy law decisions from the U.S. Court of Appeals for the Ninth Circuit illustrates some of the crucial issues in this area of law. These cases involve an important creditor remedy: the ability to seek nondischargeability of a debt when the debtor files bankruptcy, under Bankruptcy Code section 523(a)(6).

Section 523(a)(6) provides that the debtor’s bankruptcy discharge does not discharge liability for any debt resulting from willful and malicious injury by the debtor to another’s person or property. A debtor’s sale of collateral “out of trust,” or a willful failure to remit the proceeds, may qualify as a “willful and malicious injury” under section 523(a)(6). In such case the debtor’s bankruptcy discharge will not affect his or her liability to the secured party; the creditor will be able to seek collection from the debtor’s subsequent income as if the bankruptcy never occurred. In the context of Chapter 7 bankruptcy cases, this is primarily important with regard to individual debtors or individual guarantors of corporate debts, since a corporation liquidated in Chapter 7 will not have significant post-discharge income.

A crucial question in these cases is whether the debtor’s behavior constituted “willful and malicious injury.” The courts have developed a series of general tests to apply in making this determination. Unfortunately, the Ninth Circuit cases illustrate the uneven manner in which these tests have sometimes been applied.

B. The Cecchini Test

In re Cecchini was not a secured transactions case, but it did articulate the test for determination of whether a debtor’s actions constitute “willful and malicious injury.” Cecchini involved a promotional contract for a Mexican hotel. Mr. Cecchini was a principal in a partnership that contracted to promote the hotel to potential American tourists. The partnership advanced funds to an agent hired to do the promotional work, then was reimbursed by the hotel. The agent would receive checks for hotel deposits from tourists, and forward these checks directly to the hotel, which would then remit reimbursements to the partnership.

The partners began to believe that the hotel was not making full reimbursement. This belief was incorrect, but Mr. Cecchini acted on this mistaken belief by instructing the promotional agent to divert the tourist deposit checks by sending them directly to the partnership. As a
result the hotel was deprived of revenues that it was entitled to under the contract. When the hotel sued to recover these payments, Cecchini and his partner filed bankruptcy. The hotel sought to have the debt held nondischargeable under section 523(a)(6). The lower court issue was whether section 523(a)(6) requires that the debtor intentionally injure the creditor; or whether it required that the debtor make the action or transaction that ultimately results in a financial injury to the creditor. In Cecchini the bankruptcy court and Ninth Circuit Bankruptcy Appeal Panel applied the stricter test concluding that the debt was nondischargeable only if the debtor intended to maliciously injure the creditor. Under this standard Cecchini's conduct was not sufficient to render the debt nondischargeable. On appeal the Ninth Circuit Court of Appeals reversed, holding that section 523(a)(6) requires only a deliberate and intentional act that necessarily injures the creditor (here, the hotel). The court concluded that "a wrongful act such as conversion, done intentionally, necessarily produces harm and . . . is "willful and malicious" even absent proof of a specific intent to injure." Under this standard Cecchini's conduct was sufficient to require the bankruptcy court to deny the discharge.

C. The Littleton Case

Following the clear-cut statutory analysis in Cecchini, a different panel of Ninth Circuit judges confronted essentially the same issue (nondischargeability of a debt on grounds of conversion) in the context of a debtor's sale of an intangible intangibility collateral "out of trust." In re Littleton[6] illustrates this problem in the context of a typical inventory security agreement: the corporate debtor wrongfully sold collateral without remitting the proceeds to the secured party. The funds were used instead to pay general corporate expenses. Later the corporation and its officers (who had personally guaranteed the debt) filed bankruptcy. Clining Cecchini, the secured party sought to have the debt declared nondischargeable under section 523(a)(6). The Ninth Circuit agreed that the debtors acted intentionally, but concluded that the debtor's acts in withholding the proceeds were not malicious, because the debtor was acting with the "hope and expectation" that diversions of the funds would help keep the business going. Thus, none were used for Mr. Padgett's personal, family or household expenses.

When the business became insolvent, both the corporation and Mr. Padgett faced bankruptcy. The creditor sought to have the debt declared nondischargeable under section 523(a)(6), and the Ninth Circuit considered whether the debtor's diversions of proceeds constituted a "willful and malicious" injury. The court construed "willful" to mean "knowing" and expressed "little doubt" that the debtor willfully and consistently failed to remit the proceeds as required. The court then turned to the question of whether this diversions was malicious. The court cited In re Purk[20] for the following description of the applicable test:

'The focus of the "malicious" inquiry is not on the debtor's actual knowledge or the reasonable foreseeability that his conduct will result in injury to the creditor, but on abstract and perhaps moralistic notions of the "wrongfulness" of the debtor's act.'

The court further noted that:

[Malicious intent] may be demonstrated by evidence that the debtor had knowledge of the creditor's rights and... with that knowledge, proceeded to take action in violation of those rights. The debtor's experience in the auto business is one of the sales, and his admission that he read and understood the security agreement, were factors deemed to provide a basis for inferring such knowledge. The Purk court had no difficulty finding that the debtor intentionally diverted proceeds of the security interest into his personal expenses and that the diversion was a willful and malicious act.

The Ninth Circuit Court of Appeals upheld the bankruptcy court's finding that the debtor acted willfully and maliciously.

IV. Willful and Malicious in the Tenth Circuit: Compos and Pasek

There are two cases from the Tenth Circuit that are potentially troublesome for creditors seeking nondischargeability of a debt under section 523(a)(6). In re Compos[22] relies on legislative history and the bankruptcy court decision in Cecchini (later reversed by the Ninth Circuit)[23], rejected a nondischargeability claim on grounds that section 523(a)(6) requires an intent to injure. The reversal of Cecchini, and widespread skepticism concerning the persuasiveness of Legislative history as a counterpoint to the statutory language, serve to undermine the continuing viability of Compos. In addition, drunk driving cases involve different considerations, and less compelling evidence of intent, than cases like Purk; finally, the legislative history relied on in Compos makes clear that only an intentional act, and not an intentional injury, is required for nondischargeability. [With this text may have been sufficient to allow dischargeability in a drunk driving case like Compos, it should not be helpful to a debtor who has intentionally breached a contract as in Cecchini and Purk.]

A more recent case, In re Pasek[24] considered the "maliciousness" test under section 523(a)(6), noting that the statute requires both willful and malicious behavior in order to hold a debt nondischargeable. In Pasek, the supplier accused the bankruptcy court of bad faith, quashing its "firm and engaging in a lien superior to the perfection of the security interest in the general inventory." The Tenth Circuit concluded that the debtor's action was willful, but not malicious, and that the creditor relied on a legal opinion indicating the covenant was not enforceable. It is unlikely that such a defense would be available where the debtor breaches a security agreement. The Purk case also found that the secured party's breach was justified because the CPA firm "sought to alter materially its agreement with the Debtor by attempting to control it, probably because of the Debtor's (and those of his wife), matters wholly outside (and inappropriate to) the partnership agreement, and by imposing an unreasonable and illegal hour quota."[25]

While somewhat far-fetched, this suggests the possibility that a debtor might assert creditor overreaching or creditor control issues as a defense to nondischargeability.

V. Recovery from the Trustee Outside Bankruptcy

In the circumstances discussed above the secured party may have another remedy, in addition to seeking nondischargeability of the debt in bankruptcy. Where the traditional personal affairs (and those of his wife), matters wholly outside (and inappropriate to) the partnership agreement, and by imposing an unreasonable and illegal hour quota. But, more to the point, the secured party's breach was justified because the CPA firm "sought to alter materially its agreement with the Debtor by attempting to control it, probably because of the Debtor's (and those of his wife), matters wholly outside (and inappropriate to) the partnership agreement, and by imposing an unreasonable and illegal hour quota."[25]

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guilty of conversion, by exercising "dominion and control over another's property in denial of or inconsistent with his rights."[31]

The court noted that the secured party's rights survived the transfer, so that the transferee took subject to the security interest. As a result the secured party was entitled to recover damages from the transferee (presumably as an alternative to repossession of the collateral), in tort for conversion, in the amount of the value of the converted property plus interest.

VI. Limits of the Secured Party's Claim Against Third Parties

Often the secured party's claim to either the collateral or its proceeds will be cut off by a transfer in the ordinary course of business. A sale of the collateral to a buyer in the ordinary course of business will cut off any security interest created by the seller, and a transfer of the proceeds in the ordinary course of the debtor's business will likewise cut off any claim to such proceeds of a security interest.

The latter point is illustrated by J. I. Case Credit Corp. v. First Nat. Bank,[35] where inventory collateral was sold in the ordinary course of business and the proceeds were paid to other creditors in the ordinary course of business. While the secured party was unsuccessful in alleging common law and criminal conversion against the debtor, the secured party could not recover the proceeds of the collateral from the third party transferee because that party received the funds in the ordinary course of business.[37]

In J. I. Case the Seventh Circuit reversed a district court holding that, even though the transferee of the proceeds had no actual knowledge of their source, the transferee's knowledge of the debtor's financial problems should have given it sufficient notice that "something was awry," thereby precluding ordinary course treatment. The Seventh Circuit applied the test at UCC section 1-301(9), which defines "buyer in the ordinary course of business" as one taking "in good faith and without knowledge" of a third party claim, properly imputing that definition into the "ordinary course of business" language at section 9-306 Comment 2(c). The court noted that "knowledge" means "actual knowledge." Since the transferee of the proceeds had no actual knowledge of their source, it qualified as a transferee in the ordinary course pursuant to section 9-306, Comment 2(c). The court then recognized Comment 2(c) as an exception to the statutory language at section 9-306(2) (otherwise permitting the secured party to trace and claim proceeds of the collateral).

VII. Unjust Enrichment and Constructive Trust

As a final "wild card" in these situations, one should take note of cases like In re Howard's Appliance Corp.[39] In Howard's the borrower moved the inventory from New York (where the lender's security interest was perfected by filing) to New Jersey (where there was no perfection), then filed under Chapter 11 of the Bankruptcy Code and as debtor in possession sought to treat the debt as unsecured. The court responded by recognizing a constructive trust in favor of the secured party, on equitable grounds. While Howard's can be criticized on policy grounds, for allowing equitable considerations to modify a clear-cut UCC rule on priority and perfection, a lender's counsel cannot ignore the Howard argument when dealing with intentional efforts of a debtor to frustrate the lender's secured claim.

Truth in Lending Cases Highlight Lender Concerns

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The Eighth Circuit agreed with the bank that "immediate preceding examination" means exactly what it says: the latest examination, whether for compliance or safety and soundness. This case was decided over two years ago, yet it apparently has not yet permeated some of the regulatory agencies. It is a particularly interesting case in view of reports that some agency personnel are demanding audits and adjustments of entire loan portfolios, dating to the origination of all such loans and spanning periods covered by numerous previous examinations.

If Congress and the regulatory agencies want to foster more affordable credit for marginal borrowers, they might start by bringing some order to the chaos that we call consumer credit laws.