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# UCC Case Law Update

By **Gordon M. Shapiro** and **Brian A. Kilpatrick**

We have recently seen some potentially significant Uniform Commercial Code (UCC) decisions in Texas in the last few months which may be of interest to our financial institution clients. We have given a brief synopsis of these cases below, along with our analysis of the impact that such cases may have on our clients.

**Statute of Repose in UCC Section 4.406 Runs from Date of Administrator's Appointment**
***Jefferson State Bank v. Lenk, 323 S.W.3d 146 (Tex. 2010)***

In *Jefferson State Bank v. Lenk*, the Texas Supreme Court decided a case that is important to financial institutions (and estate administrators) with respect to when the statute of repose under Section 4.406 of the UCC begins to run in the case of an estate administrator's appointment after the death of an accountholder.

Melvyn Spillman was a low level county clerk in Bexar County, Texas. For some time he engaged in an elaborate scheme of fraud by creating bogus letters of administration for various decedents, naming himself as administrator, and then withdrawing large sums of money from the various decedents' accounts at financial institutions around the state. The scheme made national headlines on the television program *48 Hours* because of the large scope of fraud (Spillman is alleged to have stolen close to $5 million).

In the matter making its way to the Supreme Court, Spillman had stolen funds from the account of Mickey Marcus, a deceased accountholder of Jefferson State Bank who had died in March 2000. Spillman presented the bank with fraudulent letters of administration purporting to appoint himself as administrator of the Marcus Estate. The bank, relying on what it believed to be valid letters, gave Spillman access to the Marcus account. Throughout the next several months, Spillman withdrew most of the account balance.

In September 2003, a little over two years after Spillman had committed his fraud, Christa Lenk was appointed as the administrator of the Marcus Estate. By February 2004, she was aware of the bank account, but she made no effort to contact the bank for over two years. In June 2005, she sent the bank a demand for payment of the amount allegedly withdrawn by Spillman. When the bank refused to pay, Lenk sued to recover the funds.

The bank relied on UCC Section 4.406, which precludes a customer from bringing a claim based on an unauthorized transaction if the customer fails to report the transaction to the bank within one year after the bank provides the customer with the relevant account statement (the period had been shortened to 60 days by Jefferson State Bank's deposit contract).

The Texas Supreme Court affirmed the trial court's summary judgment for the bank, holding that the notice of improper payments came too late under Section 4.406 (as shortened by contract). The Supreme Court held that in the context of a deceased customer that (1) the bank satisfies its burden by retaining account statements for retrieval by the estate administrator, and (2) the response period begins to run once an administrator is appointed. Because the administrator was appointed in September 2003 and learned of the bank account in February 2004, her action in not contacting the bank until June 2005 was untimely.

The Supreme Court did, however, reject the bank's argument that it satisfied its burden by sending statements to Spillman. The Supreme Court reasoned that even with reliance on a fraud, Spillman was never the bank's customer, as required by Section 4.406(a). The Supreme Court also rejected the Court of Appeals' conclusion that the statute of repose never began to run because the bank never sent statements to its rightful customer – Lenk. The Supreme Court held that the bank satisfied its burden by retaining the statements. The Court noted that such a rule requires administrators to act swiftly in handling the estate's banking matters, but such a rule furthers the UCC's focus on certainty and predictability in commercial transactions.

So, while this case stands for the proposition that a bank has a burden to retain account statements, the estate administrator has a more onerous burden to quickly identify bank accounts of the decedent and examine such statements for unauthorized activity so as to timely notify the bank of fraudulent or unauthorized transactions within one year of appointment (or within an otherwise contractually shortened time period). The case also reaffirmed the earlier seminal case of *American Airlines Employees. Federal Credit Union v. Martin*, 29 S.W.3d 86 (Tex. 2000), where the Texas Supreme Court upheld the right of banks to contractually shorten the statute of repose in Section 4.406 in the first place.

**Common Law and Equitable Claims May Co-Exist with UCC Claims**
***Ross v. Bank of America, N.A.,* 693 F.Supp.2d 692 (S.D. Tex. 2010)**

In *Ross v. Bank of America, N.A.,* United States District Judge Lee Rosenthal, a well-respected federal jurist in Houston, issued a memorandum opinion denying a motion to dismiss filed by the defendant bank which requested dismissal of a "money had and received" claim as displaced by the UCC, and held that the revised Section 3.420 of the UCC does not preclude the claim. This is the first Texas case (albeit in federal court) to decide the precise question of whether a "money had and received" claim is displaced by the UCC.

In this bookkeeper embezzlement case, the plaintiff alleged that the bank improperly honored several checks that contained restrictive endorsements. The plaintiff alleged a cause of action for conversion, under Section 3.420 of the UCC, as well as an equitable claim for "money had and received."

In a check fraud case, it is not unusual for a plaintiff to assert common law, tort, or statutory theories of liability against a bank which contradict or vary from the UCC's statutory standard of liability under Section 3.420 (conversion). We have handled dozens of such cases for bank clients, and have argued that because Section 3.420 of the UCC provides a comprehensive liability scheme for negotiable instrument fraud, such statutory provision occupies the entire field and displaces all common law liability claims. We have relied on various authorities for this proposition, including *Bank One v. Little*, 978 S.W.2d 272, 279 (Tex. App.—Fort Worth 1998, pet denied) (rejecting plaintiff's attempt to impose extra common law duties on a bank with respect to letters of credit, holding that "imposition of a duty in this case could work to undermine the UCC and the ordinary customs and practices of banks in letters of credit transactions"), and *Miller-Rogaska, Inc. v. Bank One, Texas, N.A.,* 931 S.W.2d 655, 662 (Tex.App.--Dallas 1996, no pet.) (holding that common law conversion is displaced by the UCC conversion statute).

In *Ross*, the defendant bank made a similar argument with respect to the plaintiff's "money had and received" claim. In its motion to dismiss, the defendant contended that liability, if any, should be determined based on the UCC conversion statute, Section 3.420, and other UCC provisions which set forth a statutory scheme of liability. While there did not appear to be any published Texas decision answering the specific question regarding a "money had and received" cause of action, the defendant bank relied on various authorities, including *AMX Enterprises, Inc. v. Bank One*, *N.A.*, 196 S.W.3d 202, 207 (Tex. App.—Houston [1st Dist.] 2006, pet denied) ("Section 3.420 of the UCC preempts common law causes of action that supplant the provisions of the UCC in a suit to recover losses involving negotiable instruments"), and certain out of state decisions.

Judge Rosenthal, in denying defendant's motion to dismiss, held that the revised UCC does not automatically displace all other applicable sources of law, including the "money had and received" claim asserted by plaintiff. She held that if the common law claim is not completely displaced by the UCC, it can survive if it is tailored to meet UCC restrictions.

Judge Rosenthal relied on *Peerless Insurance Co. v. Texas Commerce Bank-New Braunfels*, a Fifth Circuit case that decided this same issue under the former version of the UCC in 1986. 791 F.2d 1170, 1180 (5th Cir. 1986) (citing *Bryan v. Citizens National Bank in Abilene*, 628 S.W.2d. 761 (Tex. 1982)). Judge Rosenthal held that *Peerless* was still good law – even under the revised UCC and in spite of the authorities cited by defendant to the contrary. She went on to point out that a comment to the revised UCC that was not included in its predecessor supports this liberal construction. The comment states that common law and equitable principles may supplement the UCC to the extent they are not inconsistent with its provisions. See *AMX Enterprises, Inc. v. Bank One, N.A.*, 196 S.W.3d 202, 207-208 (Tex.App.—Houston 2006, pet. denied); and *Mazon Associates, Inc. v. Comerica Bank*, 195 S.W.3d 800, 804-806 (Tex.App.—Dallas 2006, no pet.). This means that while inconsistencies should be resolved in the Code's favor, a common law claim not preempted by the Code will stand if it accommodates the restrictions identified in the relevant UCC provisions. So, Judge Rosenthal allowed the "money had and received" claim to go forward, but noted that plaintiff's damages under such claim would be limited to the face amount of the check, which was a limitation in Section 3.420 of the UCC.

We expect that plaintiffs' lawyers will begin citing *Ross* for the proposition that non-UCC claims should be allowed to go forward, at least insofar as the UCC provision does not completely displace the claim. We expect that the financial institution defendants will argue that *Ross* should be limited to "money had and received" claims in the context of Section 3.420 of the UCC, and not be expanded to other common law claims or UCC provisions. To the extent plaintiffs seek further expansion, though, Judge Rosenthal's more liberal approach may ultimately be a distinction without a difference, if the applicable UCC provision provides adequate restrictions that can be read into the non-UCC cause of action. However, where such restrictions are not present, or are less restrictive than desired, this decision will arguably open up additional bases of liability and/or damages for plaintiffs in cases arguably governed by the UCC.

**Refining the Definition of "Commercial Reasonableness" Under UCC Article 9**
***Regal Finance Co., Ltd. v. Tex Star Motors, Inc.*, ____ S.W.3d ____, 2010 WL 3277132, 53 Tex. Sup. Ct. J. 1034 (Tex. 2010)**

In *Regal Finance Co., Ltd. v. Tex Star Motors, Inc.*, the Texas Supreme Court issued an opinion concerning the appropriate standard for "commercial reasonableness" under Article 9 of the UCC when secured creditors dispose of collateral (repossessed vehicles in this case) and seek to recover a deficiency judgment after foreclosure and sale. Rejecting a court of appeals' decision which essentially transformed the standard to a "reasonable dealer" standard, at least insofar as the jury charge in that case was concerned, the Supreme Court held that a "reasonable dealer" standard was only one, non-exclusive method of proving commercial reasonableness.

Tex Star, a used car dealer, had entered into a loan agreement with Regal Finance, in which various used cars served as collateral for the loan. When Tex Star defaulted on the contract, Regal Finance repossessed the cars, sold them at auction pursuant to Article 9 for less than the amounts owed, and sued Tex Star for the deficiency.

Article 9 of the UCC requires a secured creditor to act in good faith and in a commercially reasonable manner when disposing of secured collateral through public sale such as an auction. Several examples of commercially reasonable practices or “safe harbors” are listed in Article 9. These safe harbors are not the exclusive means of proving commercial reasonableness.

The trial court instructed the jury on the meaning of good faith and commercial reasonableness. As part of these instructions, the jury charge read:

> Every aspect of the disposition, including method, manner, time, place and other terms must be commercially reasonable. A sale is commercially reasonable *if* it conforms to reasonable commercial practices among dealers in the type of property that was subject of the sale. (emphasis added)

The jury found that Regal Finance sold some of the vehicles in good faith and a commercially reasonable manner (but not all), and awarded Regal Finance a judgment for $4 million. On appeal, the court of appeals interpreted the word “if” in the jury instruction to mean “only if” and effectually transformed the safe harbor example into a mandatory “reasonable dealer” standard. Measured against this standard, the court of appeals found that Regal did not offer evidence that it acted as a reasonable dealer would have and reversed the trial court’s judgment.

In an 8-1 decision, the Texas Supreme Court reversed. The Court noted that the above instruction appears to trace the language of Article 9, specifically Sections 9.610(b) and 9.627(b)(3). The Court disagreed that the “if” created a mandatory standard. Rather, the Court found that when read in the context of the entire instruction, the “reasonable dealer” standard was a non-exclusive example and allowed for alternative methods to prove commercial reasonableness. In this instance, the Court held that Regal Finance introduced legally sufficient evidence that it acted in a commercially reasonable manner even though it did not act as a reasonable dealer would have.

The dissent characterized the Court’s analysis as a departure from the well-established rule that evidentiary sufficiency be measured against the jury charge. The majority disagreed, noting that “we simply disagree about what the charge requires” and how to read or interpret such charge. Read in context, the Court believes that the language “if” did not mean “only if” and the jury was properly instructed on the Article 9 standard.

Accordingly, when drafting jury instructions under Article 9 regarding commercial reasonableness of sale, one should be cautious to use non-exclusive language and list the various examples, or safe harbors, as non-exclusive methods of proving commercial reasonableness. Although the creditor was ultimately saved by the Supreme Court in this case, a better crafted jury instruction would have avoided the reversal at the court of appeals level, and perhaps even better enabled the jury to decide the ultimate issue and not deny some of the claims.

If you have any questions regarding this e-Alert, please contact **Gordon M. Shapiro** at 214.953.6059 or **gshapiro@jw.com**, or **Brian A. Kilpatrick** at 214.953.5933 or **bkilpatrick@jw.com**.

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