United States Bankruptcy Court
Western District of Wisconsin

Cite as: [Unpublished]

Peter M. Gennrich, Trustee, Plaintiff, v.
Mercantile Bank of Northern Iowa, Defendant
(In re Terry L. Burens and Lana L. Burens, Debtors)
Bankruptcy Case No. 96-30711-7; Adv. Case No. 96-3096-7

United States Bankruptcy Court
W.D. Wisconsin

September 4, 1996

Susan V. Kelley, Lee, Kilkelly, Paulson & Kabaker, Madison, WI, for plaintiff.
Mark F. Conway, Swisher & Cohrt, P.L.C., Waterloo, IA, for defendant.

Robert D. Martin, United States Bankruptcy Judge.

MEMORANDUM DECISION

The debtors, Terry and Lana Burens, filed a chapter 7 bankruptcy on February 26, 1996. Their bankruptcy trustee brought this adversary proceeding to avoid the security interests claimed by Mercantile Bank of Northern Iowa ("the bank") in the debtors' snowmobile and jetski. The parties filed a joint pretrial statement in which they stipulated to the material facts and submitted briefs on the contested legal issues.

In November of 1994 and June of 1995, while living in Iowa, the debtors purchased two snowmobiles and a jetski. The bank supplied financing and properly perfected its security interests by filing financing statements in Iowa.

The debtors and the collateral moved to Wisconsin in September of 1995. In early November of that year, the debtors traded in their two snowmobiles for one Arctic Cat snowmobile. The parties executed "substitution of collateral" papers. The bank then filed a new financing statement for the Arctic Cat in Iowa. No financing statement was ever filed in Wisconsin.

The trustee proceeds under 11 U.S.C. § 544(a). We are asked to decide whether the failure to file a financing statement in Wisconsin within four months after the collateral was moved into the state renders the bank's security interest unperfected and subject to rights of the bankruptcy estate. In short, it does.

11 U.S.C. § 544(a), the "strong-arm clause," gives the trustee the status of a hypothetical judicial lien creditor from the date of the filing of the bankruptcy petition. In the Matter of Wey, 827 F.2d 140 (7th Cir. 1987). The statute provides:

(a) The trustee shall have, as of the commencement of the case, and without regard to any knowledge of the trustee or of any creditor, the rights and powers of, or may avoid any transfer of property of the debtor or any obligation incurred by the debtor that

is voidable by --

(1) a creditor that extends credit to the debtor at the time of the commencement of the case, and that obtains, at such time and with respect to such credit, a judicial lien on all property on which a creditor on a single contract could have obtained a judicial lien, whether or not such creditor exists[.]

Under the strong arm clause, the trustee can defeat an unperfected security interest just as an actual levying creditor could. "The strong-arm clause is the ultimate Article 9 enforcer." Barkley Clark, The Law of Secured Transactions Under the Uniform Commercial Code ¶9.04 at 9-31 (rev. ed 1993).

§ 409.103(1)(d)(1) Wis. Stat., provides that:

When collateral is brought into and kept in this state while subject to a security interest perfected under the law of the jurisdiction from which the collateral was removed, . . . if the action is not taken [to perfect the security interest] before the expiration of ... the end of 4 months after the collateral is brought into this state, . . . the security interest becomes unperfected at the end of that period and is thereafter deemed to have been unperfected as against a person who became *a purchaser after* removal[.] Id. (emphasis added).

"Purchaser after removal" is not defined by statute. Courts and commentators have distinguished between those who acquire an interest in the collateral *during* the four-months and those who do *so after* the four-months. There is agreement that the definition of "purchaser" during the four-months is very narrow -- basically only purchasers in the ordinary course and other secured creditors. See James J. White & Robert S. Summers, Uniform Commercial Code § 31-21, at 224-5 (4th ed. 1995) ("A lien creditor ... who levies inside the four-month period ... or a trustee in a bankruptcy occurring within that period should lose. . . ."); see also Clark, supra (commenting that during the four-month period ordinary purchasers and competing secured creditors are "purchasers," but not judgment creditors or the trustee in bankruptcy).

However, in the present case the trustee obtained no interest until the four months had run.[(1)] Some courts hold that a security holder's interest "becomes unperfected in the future as against the claims of all other secured creditors, *regardless of whether they are purchasers."* Rockwell Int'l Credit Corp v. Valley Bank, 707 P.2d 517 (Idaho Ct. App. 1985) (emphasis added); see also In the Matter of Dennis Mitchell Industries, Inc., 419 F.2d 349 (3d Cir. 1969).[(2)] In Rockwell, a faster secured creditor intervened and in Mitchell, the trustee did. Under Rockwell and Mitchell, any perfected lien creditor would, after the four-months, prime the bank's security interest if not reperfected within the four months. In our case, the trustee as a § 544 lien creditor would be first in line.

However, for some, "first in line" is not enough. A few courts, including the Second Circuit, have read the four-month rule broadly and used equitable remedies "where to fail to do so [would] result in an unjust enrichment." In re Howard's Appliance Corp., 874 F.2d 88, 94 (2d. Cir. 1989) (quoting D'Ippolito v. Castoro, 51 N.J. 584, 588 (1968)).

In Howard's, the court created a constructive trust in favor of a secured creditor, Sanyo, who failed to reperfect its security interest in home appliances. The security agreement required the debtor to keep all the appliances in New York, but the debtor secretly moved them to New Jersey. More than four months after the move the debtor filed for chapter 11. The bankruptcy court held that the original secured creditor had a validly perfected interest in the appliances because it was not fair that the debtor "concealed the fact that it was storing the subject inventory in the ... warehouse in New Jersey." The district court reversed but the Second Circuit reversed again and reinstated the

constructive trust on the appliances dating back to the time the debtor moved them on a finding that the debtor's sneaky behavior contributed to Sanyo's failure to reperfect. It went on to find that under § 541 the beneficiary of a constructive trust that attached before the bankruptcy prevails over a hypothetical lienholder, and that it did not have to decide if § 544 precludes the use of equitable remedies.

Barkley Clark criticized the Howard's result, finding that the Second Circuit in effect repealed the four-month rule: "this is a classic example of a court's misuse of common-law principles to override express priority rules of Article 9." Clark, supra at 9-25 n.70. The same was said of In Re C Tek Software, Inc., 117 B.R. 762 (Bankr. D.N.H. 1990), the case on which the bank principally relies in arguing that the trustee cannot be a "purchaser." [(3)] In C Tek, an investment firm, NYSBVP, had a senior perfected security interest in the debtor's banking software but was unaware that the debtor, with the aid of a junior creditor, had moved the software to New Hampshire. NYSBVP never perfected in New Hampshire. The debtor-in-possession ("DIP") challenged NYSBVP's unperfected interest, first against a trustee's § 544 powers, and second against the junior lien holder who, having known about the move, had perfected in New Hampshire. Id. at 767. The C Tek court did not recognize any distinction between intervention *during* and intervention *after* the four-months, holding the DIP could not have the standing of a "purchaser after removal." Furthermore, the court used equitable principles to find that even though the junior creditor perfected within the four-months while NYSBVP had not, it would not be fair to enforce the four-month rule to prime NYSBVP because the junior creditor was not an innocent third party. The court stated that the U.C.C. should be liberally construed to promote its underlying policies, which, for the four-month rule, is "the protection of innocent third parties in the second state . . . ." Id. at 768 (quoting First Nat'l Bank in Brookings v. John Deere Co., 409 N.W.2d 664 (S.D. 1987)). Not finding an innocent third party, the court looked to "the equities."

The facts in the present case are distinguishable from those in Howard's and C Tek. The bank does not allege that the debtor broke an agreement to keep the jetski and snowmobile in the state. There was nothing sneaky about it. Nor was the trustee in cahoots with the debtor to further an individual interest, but rather is representing the interests of all the debtors' unsecured creditors under § 323(a). There is no element of "culpability" in this case warranting consideration of any equitable remedy, even if such an alternative were determined to be a part of the law to be applied (which is by no means clear).

Both the debtors and the bank acted in good faith. The bank is charged with the risks involved in lending money. Although losing its security interest in the jetski and snowmobile is a considerable loss, it is not an unpredictable one. Borrowers and their collateral often move out of state. Both Howard's and C Tek turn on idiosyncratic courts' views that it would be unfair to allow the debtor or a culpable third-party to profit from a strict reading of the four-month rule. They neither control this court nor instruct on our facts.

Since the bank failed to maintain perfection of its collateral until the date on which this bankruptcy was commenced, its claim to security is defeated by the trustee. Judgment consistent with the demand of the complaint may be entered accordingly.

END NOTES:

1. The bank never reperfected in Wisconsin -- not within the four-months, and not before the debtors filed for bankruptcy one month later. But if the bank had reperfected in that short period -- after the four-months but before the bankruptcy -- Barkley Clark suggests that the trustee could most likely void the security interest as a preference under § 547:

In such a situation, Bank's perfection is not continuous; instead, it dates only from the filing of the [new] financing statement in State B. And although the debtor's trustee ... could not seize the equipment as a levying creditor under § 544(a) ... the security interest could probably be set aside as a voidable preference....

Clark, id. at 9-31. If, however, the bank had reperfected within the four-months, the timing of the debtors' bankruptcy -- in relation to the four-months -- would be irrelevant:

Conversely, if Bank refiles in State B three months after removal and bankruptcy occurs one week thereafter the security interest is considered continuously perfected and is thus insulated from all attack by the trustee.

Id. at 9-32.

2. See also White & Summers, supra at 226 (4th ed. 1995) ("The interest of a purchaser or lien creditor that arose after the four-month period would be superior to the claim of the secured creditor in the original state."); and Clark, supra ¶ 9.04 (commenting that the debtor's trustee in bankruptcy as a lien creditor may avoid an unperfected security interest after the four-months).

3. See Clark, supra at 9-28 (commenting that C Tek seems to misconstrue the four-month rule).