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BANKRUPTCY LAW

I. PERFECTING A SECURITY INTEREST IN COMMODITIES STORED IN THE STATE WAREHOUSE SYSTEM

In *Hodges v. Anderson (In re George B. Kerr, Inc.)*,¹ the United States Bankruptcy Court for the District of South Carolina held that a creditor had a perfected security interest in grain deposited by the debtor in the state field warehouse system. The court found perfection on three alternative grounds: (1) the warehouse receipts in the creditor's possession were negotiable; (2) the commodities were in the possession of a bailee with notice of the creditor's security interest; and (3) the description of the collateral in the financing statements was sufficient to cure the defective description contained in the security agreements.

The adversary proceeding arose when First National Bank (First National) released warehouse receipts in its possession to the bankruptcy trustee in exchange for repayment of its loan to the debtor. The warehouse receipts represented agricultural commodities which Kerr had stored in the state warehouse system. The plaintiff, on behalf of farmers who had sold commodities to Kerr on unsecured credit terms, filed a complaint alleging that First National did not have a valid security interest in the warehouse receipts or the commodities.² The court granted summary judgment for First National.³

The bankruptcy court first determined that First National had a perfected security interest in the stored commodities by virtue of the bank's possession of negotiable warehouse receipts covering the goods.⁴ The receipts were issued by the warehouse

1. 25 B.R. 2 (D.S.C. 1981), *aff'd*, 696 F.2d 990 (4th Cir. 1982).

2. *Id.* at 5.

3. *Id.* at 9.

4. During the period that goods are in the possession of the insurer of a negotiable document therefor, a security interest in the goods is perfected by perfecting a security interest in the documents, and any security interest in the goods otherwise perfected during such period is subject thereto. S.C. CODE ANN. § 36-9-304(2) (1976). A security interest in negotiable documents may be perfected by the secured party's possession of the documents or by filing a financing statement describing the documents. S.C. CODE

manager for the South Carolina Department of Agriculture.⁵ They were issued in Kerr's name and bore his endorsement on the back.⁶ The court rejected plaintiff's contention that the receipts were not negotiable because they contained neither the word "order" nor "bearer."⁷ The court found the receipts negotiable because they represented absolute title to the goods,⁸ were issued to the debtor, were endorsed by the debtor in blank, and were delivered to First National.⁹ The court also noted that in the agricultural commodities business, warehouse receipts issued by the State of South Carolina are normally treated as negotiable instruments.¹⁰

As the second ground for finding perfection, the bankruptcy court held that even if the warehouse receipts were not considered negotiable, First National had a perfected security interest because the commodities were in the possession of an independent bailee who had notice of First National's security interest.¹¹ Kerr's storage facilities were leased to the state and functioned

ANN. §§ 36-9-302(1)(a), -304(1), -305 (1976). If the documents are in the possession of the secured party, no written security agreement is necessary. S.C. CODE ANN. § 36-9-203(1) (1976). The term "documents" includes warehouse receipts. S.C. CODE ANN. §§ 36-1-201(15), 36-9-105(1)(e) (1976).

5. Patricia M. Rogers was both general manager for the debtor and warehouse manager for the South Carolina Department of Agriculture. Kerr's storage facilities, leased to the state pursuant to a recorded lease agreement, functioned as state warehouses under the control of the South Carolina Department of Agriculture. 25 B.R. at 6. *See infra* note 12.

6. Each receipt also bore the following legend: "Under the Statute Laws of South Carolina, this receipt carries absolute title to the products herein described which will be delivered only upon presentation of this receipt and payment of all warehouse charges and expenses." 25 B.R. at 6.

7. Plaintiff cited *R.E. Huntley Cotton Co. v. Fields*, 551 S.W.2d 472 (Tex. Civ. App. 1977), which held that a warehouse receipt stating that the goods would be delivered to the named depositor or to order or bearer, was negotiable. The bankruptcy court, however, refused to make the inference that receipts lacking such words were non-negotiable. 25 B.R. at 7.

8. *See supra* note 5.

9. 25 B.R. at 7. A warehouse receipt is negotiable if, by its terms, the goods are to be delivered to bearer or to the order of a named person. S.C. CODE ANN. § 36-7-104(1)(A) (1976). THE TERM "BEARER" INCLUDES THE PERSON IN POSSESSION OF A WAREHOUSE RECEIPT ENDORSED IN BLANK. S.C. CODE ANN. § 36-1-201(5) (1976).

10. 25 B.R. at 6. The Department of Agriculture mandates the form of warehouse receipts issued by the state warehouse system. S.C. CODE ANN. § 39-21-100 (1976).

11. 25 B.R. at 7. A security interest in goods in the possession of a bailee who has not issued a negotiable document of title therefor may be perfected by the bailee's receipt of notification of the secured party's interest or by the filing of a financing statement as to the goods. S.C. CODE ANN. § 36-9-304(3) (1976).

as a part of the state warehousing system.¹² Patricia M. Rogers, who was both Kerr's general manager and warehouse manager for the Department of Agriculture, issued the receipts and knew that these receipts were delivered to First National as security for debt owed by the debtor.¹³ The court rejected plaintiff's assertion that possession by a bailee with notice did not occur because Rogers was under Kerr's control and was not an independent bailee.¹⁴ Instead, the court found that the Department of Agriculture was the independent bailee and that Rogers, as its agent, had properly received notice of First National's security interest.¹⁵

As the third ground for finding perfection, the bankruptcy court held that First National's security agreements were adequate in view of the additional descriptive language found in the financing statements.¹⁶ Kerr signed security agreements with First National which listed some of the receipts as collateral but did not describe the commodities.¹⁷ First National then filed financing statements executed by the debtor which described all

12. 25 B.R. at 6. On appeal to the Fourth Circuit Court of Appeals, the plaintiff asserted that Kerr's facilities were not valid field warehouses because there was no actual bailment, Rogers was not an independent bailee, and the arrangement itself did not result in true divestiture of possession and adequate notice to third parties. Brief for Appellant at 32. *See infra* note 15.

13. 25 B.R. at 6.

14. *Id.* at 8. The court, following *In re Copeland*, 391 F. Supp. 134 (D. Del. 1975), *aff'd*, 531 F.2d 1195 (3d Cir. 1976), rejected the proposition that possession of collateral by a bailee under the sole dominion and control of the secured party was required.

15. 25 B.R. at 8. In so holding, the bankruptcy court assumed that the warehousing arrangement was valid. This issue was raised on appeal to the Fourth Circuit Court of Appeals. Plaintiff asserted that a valid bailment did not exist because there was no notice to third parties that the grain was transferred to a state warehouse and because Kerr did not surrender possession of the grain to Rogers. Brief for Appellant at 34-36. There was no evidence of any notice to the farmers that the warehouse was a state operation. Rogers only issued the receipts when Kerr requested them as collateral for First National. *Id.* at 37.

Many courts have relaxed the requirement of actual, open, and exclusive possession by a bailee when adequate notice is provided, thereby allowing the debtor limited access to the goods. *See, e.g.,* *Ribaudo v. Citizens Nat'l Bank*, 261 F.2d 929 (5th Cir. 1958); *Bostian v. Park Nat'l Bank*, 226 F.2d 753 (8th Cir. 1955); *Barry v. Lawrence Warehouse*, 190 F.2d 433 (9th Cir. 1951). The United States District Court for the District of South Carolina, however, has found a field warehousing arrangement invalid because the operation lacked the appearance of exclusive possession, actual substantial control and possession by the warehouseman. *Harrelson v. Lewis (In re Colonial Distributing Co.)*, 293 F. Supp. 1235, 1240 (D.S.C. 1968), *appeal dismissed*, 418 F.2d 246 (4th Cir. 1969).

16. 25 B.R. at 8. *See supra* note 11.

17. 25 B.R. at 5.

the warehouse receipts as well as the commodities.¹⁸ The debtor's intent to grant a security interest in all of the commodities was clear,¹⁹ but the security agreements were flawed standing alone. The court cured the defects in the security agreements by reading the financing statements²⁰ together with the warehouse receipts, the security agreements, and the two promissory notes thus satisfying the requirement²¹ of a signed security agreement which describes the collateral.²² This decision is consistent with a significant line of cases adopting a composite documents approach for analyzing the sufficiency of a security agreement.²³

In conclusion, the practitioner should beware of relying on the court's first two grounds for finding a perfected security interest. Even though the court upheld the creditor's perfection in this case, the issues are highly dependent upon the facts. *In re Kerr*, however, does provide useful precedent for the secured creditor seeking to cure a defective security agreement by relying on the composite documents rule to cure deficiencies in the description of the collateral. To ensure perfection of a security interest in warehoused agricultural commodities, lending institutions are best advised to use a blanket security agreement and file a properly executed financing statement.

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18. *Id.*

19. *Id.* at 9.

20. The financing statements described the commodities in both quantity and kind. 25 B.R. at 9.

21. S.C. CODE ANN. § 36-9-203(1)(b) (1976).

22. 25 B.R. at 9. The court cited *In re Bollinger Corp.*, 614 F.2d 924 (3d Cir. 1980); *In re Amex-Protein Dev. Corp.*, 504 F.2d 1056 (9th Cir. 1974); *In re Numeric Corp.*, 485 F.2d 1328 (1st Cir. 1973); and *In re Carmichael Enters., Inc.*, 334 F. Supp. 94 (N.D. Ga. 1971), *aff'd per curiam*, 460 F.2d 1405 (5th Cir. 1972), as persuasive authority for considering the cumulative effect of the various documents.

23. See *supra* note 22. See generally *Commercial Law—Secured Transactions: The Formal Requirements of Uniform Commercial Code § 9-203(1)(a) are Satisfied When a Financing Statement, a Promissory Note and the Course of Dealings Between the Parties Collectively Reveal an Intent to Create or Provide for a Security Interest*, 50 U. CIN. L. REV. 225 (1981).