

# DOES A PRIOR PERFECTED SECURED CREDITOR WAIVE ITS PRIORITY BY FAILING TO TAKE ACTION BEFORE A JUDGMENT LIEN CREDITOR GARNISHES THE COLLATERAL?

*Legacy Bank v. Fab Tech Drilling Equip., Inc.*, 566 S.W.3d 922 (Tex. App.—Eastland 2018).

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On December 31, 2018, the Court of Appeals of Texas for Eastland considered an issue of first impression for Texas.<sup>2</sup> The issue was whether the holder of a prior perfected security interest waives its right to collateral by failing to take affirmative action prior to a junior creditor exercising rights on the same collateral.<sup>3</sup> The Court held that a prior perfected security interest holder does not waive its senior security interest by failing to exercise elective remedies prior to a junior judgment creditor exercising foreclosure rights.<sup>4</sup> The Court reasoned that a disposition by a junior creditor does not cut off a senior's security interest, thus, the senior security interest is entitled to take possession of collateral from the junior secured party and conduct its own disposition.<sup>5</sup> This was an issue of first impression in Texas, and the Court adopted its reasoning from the Oregon Court of Appeals.<sup>6</sup>

The Oregon court examined two distinct theories in an effort to interpret Article 9 of the UCC uniformly. First, the “wavier” approach imposes three preconditions on a secured creditor attempting to enforce its interest in garnished collateral funds: (1) a default has to occur; (2) the secured party must declare a default; and (3) the secured party must take an “affirmative step” to exercise its rights.<sup>7</sup> If a precondition remains unsatisfied as of the time the lien creditor garnishes funds, the secured party has waived its priority.<sup>8</sup> Conversely, under the “trace and recapture” approach, the secured party maintains its security interest, despite a period of inaction after default and before a judgment creditor takes the fund.<sup>9</sup>

After the Court analyzed each theory, the “trace and recapture” theory was the most consistent with the “UCC determination of priority, continuation of a security interest, and tracing the identifiable proceeds of collateral.”<sup>10</sup> Specifically, the official comments to Section 9.610 of the UCC expressly support the “trace and recapture” approach.<sup>11</sup> The official comments are persuasive authority, and the Court adopted the comment's interpretation of the statutory language.<sup>12</sup> Thus, while a junior security interest holder is entitled to exercise its disposition rights, it does so subject to senior security interest holders who are then allowed to later recover collateral from the junior creditor.

The Court agreed with the Oregon Court of Appeals that the senior security interest holder is entitled to later trace and recapture its collateral.<sup>13</sup> Thus, the UCC affords the prior perfected security interest holder the opportunity to trace and recapture even though it did not exercise those rights under equitable principals or by operation of law prior to the garnishment.<sup>14</sup>

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<sup>2</sup> *Legacy Bank v. Fab Tech Drilling Equip., Inc.*, 566 S.W.3d 922, 924 (Tex. App. 2018).

<sup>3</sup> *Id.* (The issue was “whether the holder of prior perfected security interest waives its priority right to collateral by failing to declare default or otherwise take an affirmative action to foreclose on the collateral prior to a judgment lien creditor exercising foreclosure rights on the same collateral through garnishment.”)

<sup>4</sup> *Id.*

<sup>5</sup> TEX. BUS. & COM. CODE ANN. § 9.610 cmt. 5 (West 2009).

<sup>6</sup> *Davis v. F.W. Fin. Servs., Inc.*, 317 P.3d 916, 925 (2013); *Legacy Bank*, 566 S.W.3d at 924, 929.

<sup>7</sup> *Legacy Bank*, 566 S.W.3d at 928; citing to *Davis*, 317 P.3d at 923; see S.E.I.U. Local No. 4 Pension v. Pinnacle Health, 560 F.Supp.2d 647 (N.D. Ill. 2008).

<sup>8</sup> *Legacy Bank*, 566 S.W.3d at 928; citing to *Davis*, 317 P.3d at 923.

<sup>9</sup> *Legacy Bank*, 566 S.W.3d at 928; citing to *Davis*, 317 P.3d at 924.

<sup>10</sup> *Legacy Bank*, 566 S.W.3d at 929; citing to *Davis*, 317 P.3d at 925.

<sup>11</sup> *Legacy Bank*, 566 S.W.3d at 930; TEX. BUS. & COM. CODE ANN. § 9.610 cmt. 5 (West 2009).

<sup>12</sup> *Legacy Bank*, 566 S.W.3d at 930; citing to *Lockhart Sav. & Loan Ass'n v. RepublicBank Austin*, 720 S.W.2d 193, 195 (Tex. App.—Austin 1986, writ ref'd n.r.e).

<sup>13</sup> *Legacy Bank*, 566 S.W.3d at 924, 929-30; *Davis*, 317 P.3d at 925.

<sup>14</sup> *Legacy Bank*, 566 S.W.3d at 931

Since the Court sustained the prior perfected security interest holder's rights, the trial court's judgment was reversed, and the Court rendered judgment for the senior security interest holder.<sup>15</sup>

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<sup>15</sup> *Id.* at 933.