

# Into The Forest Primeval — Is It Real Property Or Goods; Or, Heaven Forbid, Inventory?

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## Don't get crushed when somebody yells "Timber!"

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**THE GRAY MIST** gently envelops the ancient trees that spread like an emerald blanket as far as you can see. As you stand there, gazing out from the Appalachian Trail, your mind wanders to a question: "Are these trees real or personal property?"

You might think the answer is obvious, but it's not. The answer turns on whether there is someone down there chopping down (or having the right to chop down) the trees, someone other than the land owner, how long he's got to cut down the trees and what happens when the time to cut expires. The answer will also tell you how to perfect a lien on the trees and what kind of lien insurance to buy — land title or UCC insurance.

This article begins from the perspective of commercial finance and the Uniform Commercial Code rather than from the perspective of real property law. It is much too simplistic to merely assume that real property includes the land itself and whatever is erected upon or growing upon or affixed to the land. Marching down the common law road can get you into trouble given modern statutory schemes. Perhaps the best place to begin our analysis is with the scope section of Article 9 of the Uniform Commercial Code — Section 9-109. (In this article, unless

the context otherwise requires, all references to the “Uniform Commercial Code” or the “UCC” are to the 2010 Edition of the Official Text of the UCC promulgated by the UCC’s sponsoring organizations, The American Law Institute and the Uniform Law Commission (also known as the National Conference of Commissioners on Uniform State Laws). Unless otherwise indicated, all “article” and all “Section” or “§” references are to articles and sections of the UCC.)

By its terms, Article 9 applies to consensual security interests in personal property and fixtures. *See* UCC §9-109(a)(1). Section 9-109(a)(1) extends coverage of Article 9 to every transaction that creates such a security interest regardless of its form. *See id.* However, Section 9-109(d) cuts back on the initial broad coverage of Article 9 with a list of exclusions from coverage. The most important such exclusion is probably the exclusion for “the creation or transfer of an interest in or lien on real property, including a lease or rents thereunder.” UCC §9-109(d)(11). This particular exclusion is subject to certain minor exceptions primarily involving fixtures. *See* UCC §9-109(d)(11)(A)-(D).

This exclusion should not be surprising because it reflects the general premise that Article 9 applies only to security interests in personal property and personal property constituting fixtures, not to real property. There are, however, a number of transactions that touch upon real property but are within the scope of Article 9. One of these exceptions to the real property exclusion involves “timber to be cut.” *See* UCC §9-102(a)(44) (providing that, for Article 9 purposes, “standing timber to be cut under a conveyance or contract for sale” is included in the definition of “goods,” a type of personal property).

### **SEEING THE TREES FOR THE FOREST •**

Drawing the demarcation line between real property and “timber to be cut” as a “good” under Article 9 may not be the easiest of endeavors, but it is the subject of this article.

We might as well begin at the beginning with a little statutory and common law history to at least set up the initial definitional framework needed to analyze the question as to when a tree is not simply a tree but also a good. At common law, an owner could convey an estate in fee simple in trees, or he could convey an estate determinable upon the failure to remove the trees within a time stated or within a reasonable period of time, or he could give a mere license to cut timber for a stated period. *See* Annotation, *Rights of Parties to a Timber Contract upon Failure of Purchaser to Remove the Timber Within the Time Fixed or Within a Reasonable Time*, 15 A.L.R. 41, 42 (1921). How the courts interpreted this general *précis* was often in the eye of the beholder and the discernment of the intent of the parties.

However, given that the determination of whether a sale or other conveyance of standing timber carried with it a right to have the timber remain on the property in perpetuity depended on the intent of the parties, the courts found it difficult to lay down any general test to determine the character of the sale or other conveyance. *See id.* at 43. For example, one court found that “a[n] absolute conveyance in fee simple, without conditions or limitations, of trees and timber suitable at the time for milling purposes, [conveyed] an estate in the timber which was not lost by failure to remove it within a reasonable period of time.” *See id.* at 46 (citing *Wilson Lumber Co. v. D.W. Alderman & Sons*, 61 S.E. 217 (S.C. 1908)). The fact that the grantee had entered the property and cut only part of the timber and then abandoned the operations did not deprive the grantee of the right to reenter the property and cut the remainder of the timber. However, a deed granting, bargaining, selling, and conveying to the purchaser all the trees of a certain variety and of a certain diameter, to have and to hold to the purchaser, his heirs and assigns forever, in fee simple, was held not to be a grant in perpetuity, but to require removal of the timber within a reasonable period of time. *See id.* at 54 (citing *Shippin Bros.*

*Lumber Co. v. Gates*, 70 S.E. 672 (Ga. 1911)). The court's conclusion does not seem to follow from the language of the grant.

### **Common Law View**

The common law majority view seemed to be that where a contract specified a time for the removal of the timber, the rights of the timber purchaser terminated upon his failure to remove the timber within the stated period and reverted to the landowner. *See id.* at 70. In this analysis, however, the intention of the parties was critical. The test generally applied was whether a forfeiture was intended through the time limitation. *See id.* Although some courts considered whether an estate in the timber was intended to be created in the purchaser, many courts did not adopt any technical theory as to what was going on but merely held that when a purchaser of standing timber failed to remove the timber within the stated time, the right to the timber simply terminated. *See id.* at 72.

### **Texas Approach**

In trying to draw distinctions, a number of Texas cases distinguished between a conveyance of the timber as personalty and a conveyance as real estate, basing the conclusion on whether the timber was to be removed within a reasonable time, or whether the conveyance should be treated as a grant in perpetuity. To quote one such court:

“Thus, there is made to plainly appear a sale made by the parties with the view and intention to the severance and removal of the trees from the land within a stipulated time. And so there is present in the sale all elements within the principle governing the effect given such conveyances of growing trees as a sale of chattels only.”

*Id.* at 74 (citing *Davis v. Conn*, 161 S.W. 39, 42 (Tex. Civ. App. 1911)).

Limiting the time to remove the timber and specifying the type of timber to be cut, from the array of timber available on the land, often to the courts indicated intent to treat the timber as personalty and not to convey an estate in the timber. To quote another Texas court: “The conveyance, taking it as a whole and ascertaining what the parties really intended, manifests, we think, an intention to sell and purchase all the timber of the dimensions specified, as the purchaser might cut and remove from the premises within the time limit specified, and no more. The parties were dealing with the timber as personalty, removable within a limited time. And thus the legal effect of the deed is to retain in the vendor title to the timber on the land not cut and removed therefrom by the purchaser at the expiration of the contractual period of time.” *Id.* (citing *North Texas Lumber Co. v. McWhorter*, 156 S.W. 1152, 1153-54 (Tex. Civ. App. 1913)). There is clearly the implication in these cases that if the timber was conveyed as an estate in realty, title to the trees would not revert to the landowner upon the failure of the purchaser to remove the trees within the time stated for removal. However, the cases also stand for the proposition that if a time period for removal was in fact stated, the time constraint moved the court a long way toward the conclusion that the parties intended to deal with the timber as personalty and not realty.

### **Other Approaches**

Not all courts, however, followed the Texas approach. A number of courts followed the reasoning that a sale of standing timber passed an interest in the timber or land which is then subject to divestment if the purchaser did not remove the timber within the time limit. *See id.* at 75-76. Other courts took a different view and considered a contract to remove timber within a stated period as passing to the purchaser only so much of the timber as is cut and removed from the land within the time designated, the balance remaining the property of the

landowner. *See id.* at 76. Finally, other courts viewed a time-limited grant as only a license to cut. *See id.* at 78. The license theory viewed a contract to remove timber with a stated period as granting the purchaser no beneficial interest in the land at all. The purchaser only obtained a right of entry during the time specified in the contract for cutting and removing the timber. Additionally, a writing which was held not to be sufficient to convey standing timber, because the writing had not been executed in a manner sufficient for recordation in the land records, was held to only convey to the purchaser of the timber a mere license to go upon the land and cut the trees until the expiration of the stated time period. *See id.* at 78-79 (citing *Gibbs v. Wright*, 57 So. 258 (Ala. Ct. App. 1911)).

And so the common law struggled with the intent of the parties and the intersection between the grant of an estate in the real property and a personal property transaction involving only the sale of specified timber or timber to be removed during a specified time frame. The cases, viewed as a totality, are not the greatest model of clarity as is probably to be expected given that the courts are divining the intent of the parties and trying to squeeze discerned intent into the pigeonholes of legal theory. To help the situation, the Uniform Sales Act came along in 1906 and began to clarify the intersection between personalty and realty in the world of timber. The Uniform Sales Act defined the term “goods” to include “all chattels personal other than things in action and money. The term includes emblements, industrial growing crops, and things attached to or forming part of the land which are agreed to be severed before sale or under the contract of sale.” Uniform Sales Act §76 (1906), available at <http://www.drbilllong.com/HistSales/USAXI.html>.

### **The Uniform Sales Act**

The Uniform Sales Act, drafted by Harvard law professor Samuel Williston, was a precursor to

Article 2 of the Uniform Commercial Code. Donald J. Smythe, *Transaction Costs, Neighborhood Effects, and the Diffusion of the Uniform Sales Act*, 1906-47, 4 Rev. L. & Econ. 341, 341 (2008). Between 1906 and 1947 it was adopted in 34 states. *Id.* The Act ultimately failed to achieve complete uniformity largely because the “neighborhood effects” that drove its adoption in most of the country were not present in the South. *Id.* The Southern states resisted legal unification in this area because (among other reasons) most of them were not well integrated into the national transportation network.

### **The Uniform Commercial Code**

This brief discussion of the Uniform Sales Act brings us to the Uniform Commercial Code and, in particular, Articles 2 and 9. Section 2-107 begins our statutory framework: Section 2-107, Goods to Be Severed From Realty: Recording. This section sets the premise that timber to be cut is a contract for the sale of “goods” regardless of whether the timber is to be severed by the buyer or the seller and notwithstanding the fact that the timber forms part of the realty at the time of contracting. The parties are also allowed to designate a present sale before severance. Section 2-107 goes on to state in subsection (3) that the provisions of Section 2-107 are subject to any third-party rights provided by law relating to realty records. Further, the contract for the sale of the timber may be executed or recorded as a document transferring an interest in land and shall then constitute constructive notice to third parties of the buyer’s rights under the contract of sale.

What Section 2-107 is apparently trying to do is to interrelate the real property world with the UCC world of the sale of goods. A contract for the sale of timber, regardless of who is to cut the timber, can stand alone as a contract for the sale of personal property and need not be recorded in the land records. However, the contract may be recorded in the land records and thereby put third parties on

constructive notice of the contract for sale of the timber. The language seems clear enough, but, as with many things, the devil is in the details.

Official comment 3 to section 2-107 provides that Article 9 governs security interests in the goods to be severed from the realty. The comment also points out that the definition of “goods” is different in Article 2 than in Article 9. Under Article 2, “goods” are defined as “all things that are movable at the time of identification to a contract for sale. The term includes future goods, specially manufactured goods, the unborn young of animals, growing crops, and other identified things attached to realty as described in Section 2-107.” UCC §2-103(1)(k). Section 2-105(1) adds to the basic definition in Article 2 by providing that goods must be both existing and identified before any interest in them may pass. Goods that are not both existing and identified are defined as “future” goods. However, a purported present sale of future goods or of any interest therein operates as a contract to sell.

Under Article 9, “goods” are defined as “all things that are movable when a security interest attaches. The term includes (i) fixtures, (ii) *standing timber that is to be cut and removed under a conveyance or contract for sale*, (iii) the unborn young of animals, (iv) crops grown, growing, or to be grown, even if the crops are produced on trees, vines, or bushes, and (v) manufactured homes.” UCC §9-102(a)(44) (emphasis added).

One significant point in the definition of “goods” in Article 9 is that the timber must be in existence (“standing”). Article 9, for its part, provides a specialized filing rule for the perfection of a security interest in timber to be cut, notwithstanding its inclusion in the definition of goods. Section 9-501(a)(1) provides that the appropriate office for filing a financing statement to perfect a security interest in timber to be cut, unlike for crops or other farm products, is the office designated for the filing or recording of a record of a mortgage on the related real property. The reason for this divergence

from the use of the central filing office is probably the realization that trees are a bit different and more permanent than annual crops and there is more room for mischief between the competing security interests of secured parties and mortgagees if the central filing office were to be used.

The Civil Code of the State of California has also been structured to mesh the world of real property with the UCC, a very helpful solution to confusion. Section 657 of the California Civil Code defines property to be either real or immovable or personal or movable. *See* Cal. Civ. Code §657. Section 658 of the California Civil Code includes within real or immovable property obviously land, but also “that which is affixed to land.” *Id.* §658. However, this section goes on to except from the definition for the purposes of sale “industrial growing crops and things attached to or forming part of the land, which are agreed to be severed before sale or under contract of sale” *Id.* and provides that such property is to be “treated as goods and be governed by the provisions of the title of this code regulating the sale of goods.” *Id.* Section 660 of the California Civil Code further provides that a thing is deemed to be affixed to the land when it is attached to it by its roots, as in the case of trees, but then goes on to repeat verbatim the exception to all of this set forth at the end of section 658 of the California Civil Code. *See id.* §660.

Adding to the possible confusion in the interaction between mortgagees and secured parties is that the courts are divided as to the power of a mortgagor to convey rights in timber. Some courts follow the rule that the mortgagor, remaining in possession before default, may cut off and sell timber, and that the mortgagee cannot pursue it into the hands of purchasers who have acquired it in good faith. However, these courts also hold that it is unlawful for the mortgagor to strip the land to such an extent as to seriously impair the value of the land as security. Other courts follow a different rule that provides that a property interest in timber to be cut

on the mortgaged premises lies in the mortgagee and that a purchaser from the mortgagor takes it subject to the paramount rights of the mortgagee. See 59 C.J.S. Mortgages §341 (2009). As we shall see, a possible resolution of the confusion of the courts is the realization that a mortgage, if sufficient, can be a financing statement to encumber timber to be cut as goods because, as mentioned above, the appropriate place to file a financing statement against timber to be cut is the real property records, so the systems can interconnect. However, as we shall also see, the real property records are not the appropriate place to file against inventory.

**SOME GUIDANCE** • So how do we put all of this into a cohesive whole? A few recent cases may be of some help. In the case of *Fischer v. Zepa Consulting AG.*, 732 N.E.2d 937 (N.Y. 2000), the Court of Appeals of New York was faced with the issue of whether timber rights held by Zepa constituted a valid, perpetual estate in land or only reflected a sale of goods subject to performance within a reasonable period of time. This case highlights the distinction based on time of performance between a grant of an estate in timber to be cut and a sale of goods subject to Article 2 of the UCC. The facts are that during the 1950s and 1960s, Harrer sold each of the parcels of real property at issue, excepting and reserving forever the right to all hardwood and softwood trees and timber on the lots. Eventually, the lots were separately conveyed to the plaintiffs in the action. The plaintiffs acknowledged that they took title under deeds that clearly excepted and reserved the timber rights. In November 1978, Harrer conveyed his reserved timber rights in each of the five parcels, together with the right of way and easement, in perpetuity to a corporate entity known as Imaco, Inc. In January 1991, Imaco, Inc. conveyed its rights to a Swiss entity that eventually became Zepa.

In February 1996, Zepa began harvesting the timber from the five parcels. In January 1997, the

plaintiffs commenced the trespass action against Zepa and certain other defendants involved in the logging operations. The defendants answered that Zepa held a valid freehold estate, in perpetuity, in all of the timber and trees on the five parcels. The plaintiffs countered with the argument that Zepa could not hold an interest in perpetuity in the timber because Article 2 of the UCC required that performance occur within a reasonable period of time. Section 2-309(1) provides in part that the time for any action under a contract if not provided in Article 2 or agreed upon in the contract shall be a “reasonable time.” The Appellate Division of the New York Supreme Court, affirming the trial court and citing an 1854 decision of the Court of Appeals of New York styled *McGregor v. Brown*, 10 N.Y. 114 (1854), held:

“Such a grant of timber, which transfers not only the timber then growing but also that which may grow in the future, and gives the buyer the right at any time thereafter to enter upon the premises and remove all the timber and wood, is a transfer of such an interest in land as constitutes a freehold estate.”

*Fischer v. Zepa Consulting A.G.*, 695 N.Y.S.2d 456, 457 (N.Y. App. Div. 1999), *affid.*, 732 N.E.2d 937 (N.Y. 2000).

The Appellate Division also affirmed the conclusion of the Supreme Court that the plaintiffs had purchased the properties with record notice of the defendants’ rights to the growing timber.

The plaintiffs argued, however, that the sale of the reserved timber rights was a sale of goods governed by Article 2 and not a conveyance of an interest in land, relying on Section 2-107, and that defendants’ failure to harvest the timber within a reasonable period of time resulted in an abandonment of their rights. Zepa and its predecessors-in-interest had failed to exercise their rights to harvest

the trees for 18 years. *See Zepa*, supra, 732 N.E.2d at 939. The defendants countered with *McGregor v. Brown*, supra, arguing that (1) the grant was in perpetuity, covering trees both growing and to be grown, and (2) coupled with the perpetual right to enter the land and remove the trees, the grant constituted the conveyance of an estate in land.

The Court, in response to the arguments, considered Sections 2-107(2) and 2-107(3) together. The rights *Zepa* purchased were not limited to merely cutting standing timber but rather encompassed the right in perpetuity to cut timber “now or hereafter” on the land, together with the perpetual right of entry. These two perpetual rights — the right to harvest standing and growing timber and the easement appurtenant thereto — represented a transfer of an interest in the land constituting a freehold estate. *See id.* For the Court, Section 2-107 permits but does not require that a contract for the sale of standing trees and timber constitute a contract for the sale of goods. *See id.* Applied to the facts before it, the Court determined that the conveyances at issue evidenced “an unmistakable intent to reserve and/or convey a freehold estate” *Id.* rather than to document a sale of goods. Significantly, the plaintiffs were not misled here. Rather, as the Court pointed out, the plaintiffs purchased their properties with record notice of the reserved timber rights. *See id.*

### Lessons From *Zepa*

Some of the conclusions that can be drawn from *Zepa* are:

- Section 2-309(1) (and Section 1-205 by analogy) cannot be used to turn a clear transfer of rights in perpetuity into a requirement for performance within a reasonable period of time to shoehorn the transfer of an estate in land into a sale of goods;
- The right to cut timber may be either a sale of goods or a transfer of an estate in land depending on the intent of the parties, the conveyance

language and the totality of the facts and circumstances;

- Section 2-107(3) makes clear that the law of real property is not upended by the UCC, that real property law and personal property law coexist and that a contract for sale may be recorded as a document transferring an interest in land and, as such, shall constitute notice to third parties of the buyer’s rights under the contract of sale; and
- The more “in perpetuities” you have in a grant, the more the transaction looks like a transfer of an estate in real property.

The next case of interest is the case of *Konas v. Coastal Lumber Co.*, 496 So. 2d 868 (Fla. Dist. Ct. App. 1986). In this case, a mortgagee (*Konas*) appealed from the judgment of the Circuit Court finding that an interest in timber to be cut acquired by a buyer (*Coastal*) under an oral agreement with the mortgagor (*Fathaly*) was superior to a mortgagee’s recorded mortgage on the same property. The District Court of Appeal held, in a decision with one judge in favor, one concurring and the chief justice in a better reasoned dissent, that the oral agreement of sale was not superior to the subsequently recorded mortgage on the same property, despite the classification of standing timber as “goods” under the UCC. The majority reasoned that, notwithstanding the classification of timber as goods, sales under Article 2 remain subject to the recording requirements under Article 9 relating to secured transactions. The Court concluded:

“*Coastal*’s interest, at the time *Konas* recorded his mortgage, had not yet been perfected, since *Coastal* had neither filed the requisite financing statement, nor recorded its interest with the Clerk of the Circuit Court for Gadsden County. That being so, *Konas*’ mortgage has priority since, when conflicting security interests are initially unperfected, the first to attach has priority.”

*Id.* at 870 (statutory citations omitted).

Excellent legal reasoning except for the minor fact that, as pointed out in the much better reasoned dissent, Coastal did not have a security interest! As discussed by the dissent, the sale of the timber to Coastal was a present sale of “goods” and title to the goods vested in Coastal at the time of sale. Konas delayed recording its mortgage during the period that Coastal negotiated the purchase of the timber and, as a result, Konas should be estopped from claiming that a subsequent recordation of the mortgage should encumber the timber as previously sold to Coastal. Because Konas delayed filing his mortgage, Coastal had no notice of the mortgage when it purchased the timber. *Id.* at 871.

More importantly, however, than the equitable arguments is the fact that no security interest under the UCC was created in the timber either by the mortgage or by the sale. In his dissent, the Chief Justice stated the obvious when he wrote that not all transactions in timber create a security interest. *See id.* Further, there was nothing in the record that indicated that Fathaly and Konas intended to create a security interest in the timber. The mortgage did not meet the statutory requirements for a financing statement (e.g., there was no description of the collateral and no signature of the secured party, a requirement under former Article 9 applicable to the case) even if it had been timely filed. The dissent restated the obvious that the UCC follows pre-code law in recognizing crops as goods, which may be the subject of sales or security interests apart from the land on which they are growing. *See id.* at 872 n.4. The dissent cited *Exchange National Bank of Tampa v. Alturas Packing Co.*, 269 So. 2d 733 (Fla. Dist. Ct. App. 1972), for the proposition that a landowner’s sale of his growing citrus crop constituted a “constructive” severance of the crop from the realty at the time of contracting so that a creditor’s subsequent levy upon the land and recording would not include the crop, *Konas*, supra,

496 So. 2d at 872. The dissent also pointed out that the distinction between crops and timber to be cut as to severance from the realty was removed with the 1979 amendment to the UCC. *Id.* As a result, through the acts or intention of the landowner, timber may be constructively severed and thus converted into personalty for the purposes of mortgage or sale. As concluded by the dissent: “Regardless of what the result might have been at common law, it now appears...that interests in crops and timber are not covered by a general real estate mortgage and even a recorded mortgage will not protect against an intervening sale or security interest in the absence of filing under the UCC.” *Id.* at 873.

The dissent may have the better part of this argument given that the mortgage was unrecorded when the sale occurred. The majority was a bit too interested in preserving a result at common law and ignored the clear statutory result under the UCC, having to call a “sale” a “security interest” to get to its result. However, as we will see in the following case, the answer with respect to a prior mortgage may turn on whether the timber, prior to being under a contract to harvest, is “real property” under local real estate law.

### **Lessons From *Konas***

In any event, based on the dissent, we can add the following questionable conclusions:

- A real estate only mortgage will not encumber timber to be cut severed from the realty by a sale meeting the requirements of Article 2, even if the real estate only mortgage is recorded prior to the sale; and
- A real estate mortgage can encumber timber to be cut, but the mortgage must meet the requirements for a financing statement as provided in Section 9-502(c).

In the case of *Feliciana Bank & Trust v. Manuel & Sessions, L.L.C.*, 943 So. 2d 736 (Miss. Ct. App. 2006). the Mississippi Court of Appeals provides

the better reasoning between the majority and the dissent in the *Konas* case discussed above. In this case, a bank holding a recorded deed of trust to land brought an action for damages resulting from timber cutting on the land. The Circuit Court found that Section 2-107 had altered the long-standing efficacy of deeds of trust on land to create security interests in the timber that grows on the land. *Id.* at 738. The Court of Appeals reversed, holding that a recorded deed of trust to property was sufficient to perfect a security interest in timber and, as a result, the bank could bring an action for waste after the timber was cut.

The answer turns on whether timber is part of the realty under local real property law. The Mississippi Court of Appeals concluded that under Mississippi law a conveyance of real property, without further elaboration and whether the conveyance is in trust, in fee simple or otherwise, grants everything that is part of the realty. *Feliciana Bank*, supra, 943 So. 2d at 739. As the Court noted, “[t]he deed of trust in issue conveyed to the trustee ‘the land described’ as well as ‘improvements and appurtenances now or hereafter erected on, and fixtures.’” *Id.* The Court considered this language sufficient to cover everything that is by law part of the realty, and concluded that Section 2-107(3) of the UCC represented the intent of the legislature to have “the UCC rest peaceably alongside real property law.” *Id.* Finally, and very important for our considerations, the Court also concluded that the bank’s compliance with the UCC was unnecessary because the deed of trust was sufficient to encumber all that comprised the realty.

The Court criticized the position of the lower court that the UCC displaced the common law on the securing of interests in timber. To follow that view led to the conclusion that either a deed of trust could no longer encumber timber or the security of the deed of trust would be lost as soon as a conveyance or contract for sale of the timber occurred. To the contrary, before the execution of a contract to

cut timber, the UCC did not cause timber to be reclassified as a “good.” Timber prior to the contract to cut remains realty. As such, and giving effect to Section 2-107(3), the UCC did not cancel the reach of a pre-existing deed of trust, which at a minimum would encumber any timber that was not subject to an existing contract for harvesting. See *id.* at 740.

The Court concluded that the proper analysis was not one of cancellation of an existing lien but of “priority” of the competing liens. Wrote the Court:

“We conclude that the proper analysis is not one of cancellation but of priority. Historically, a deed of trust granted a security interest in all property that was part of the realty. Under the UCC, though, if a typical deed of trust is executed after a contract for the cutting of the timber has been executed but before the actual harvesting of the trees, the deed of trust will either not apply to the timber at all because the timber is now personalty, or else the deed of trust will be subordinate to a prior UCC filing. Conversely, if the deed of trust predates any contract to cut the timber, the security interest vests in timber and cannot be divested simply by a contract for sale. Again, the matter is one of priority. A related statute makes clear that security interests in crops and fixtures filed under real property law remain valid encumbrances, but that competing security interests created under Article 9 of the UCC create issues of priority. Similarly, the previously quoted section on sales relating to timber recognizes the continuing effect of real property rules when it states that timber sales under the UCC “are subject to any third party rights provided by the law relating to realty records.”

*Id.* (statutory citations omitted).

The bank had a prior perfected security interest in the timber under real property law and, as such, the rights of any subsequent purchaser of the timber would be subject and subordinate to the pri-

or real property lien. Failure of the prior recorded deed of trust to satisfy the requirements for a financing statement under the UCC was irrelevant to the analysis.

### **Some Lessons From *Feliciana Bank and Konas***

Correlating the *Feliciana Bank* case with the *Konas* case discussed above, we can reach the following conclusions:

- A real estate mortgage will in fact encumber timber to be cut that has been constructively (as opposed to physically) severed from the realty by a sale meeting the requirements of Article 2, if the real estate mortgage is recorded prior to the sale of the timber, whether or not the mortgage meets the requirements of Article 9 for a financing statement, provided that under local real property law, the grant of the real property lien is sufficient to encumber the timber;
- A prior recorded real estate mortgage can encumber timber to be cut whether or not the mortgage meets the requirements for a financing statement as provided in Section 9-502(c); however, a real estate mortgage recorded after the contract to cut timber is executed would need to meet such requirements because the timber would now be “goods” and not “real property.”

So, where does all this take us? Perhaps a few hypotheticals would be useful.

#### **Hypothetical 1**

A mortgagee records a mortgage that is sufficient under local real property law to encumber all real property that is the subject of the mortgage, including standing timber. A good faith purchaser for value subsequently enters into a contract to cut some of the timber during a limited period of time. Before the timber is physically severed from the re-

alty, the landowner files bankruptcy. Who wins in a fight over the purchased timber?

The good faith purchaser would prevail against the trustee in bankruptcy because once the timber was purchased, the timber would not be an asset of the estate. However, the purchaser would have purchased the timber subject to the lien of the recorded mortgage. The answer would obviously be different if, under local real estate law, the mortgage was insufficient to grant a lien on the timber comprising real property. In that event, the buyer would take the timber free of any lien in favor of the mortgagee.

#### **Hypothetical 2**

A landowner enters into a contract to cut standing timber with a good faith purchaser for value. Subsequent to the contract, the landowner borrows from a bank and the bank records a mortgage against the real property. Under local real property law, the grant of a lien on the real property includes timber. The purchaser of the timber wins.

This is the classic case in which the landowner grants a timber deed to the logger, a grant which passes title to the timber to the logger at the time of the deed. As such, the timber would be within the language of Section 9-102 at the time the deed is made, and so becomes goods. This means that the logger can finance its ownership interest in the timber by granting an Article 9 security interest in it, even before it has been severed.

The timber has been constructively severed from the realty by the contract of sale. The contract is an “off record” matter, and the mortgagee needs to be aware of this. Having sold the timber to be cut constituting “goods,” the only property rights that the landowner retains are whatever rights the landowner has under the contract of sale covering the timber to be cut. This answer is no different, except for the mortgagee’s better ease of inspection, than if the landowner had cut the trees and then sold the cut lumber to a buyer. Cutting the

trees severs the timber from the realty and thereby eliminates any possibility of a post-severance real property encumbrance covering the timber.

### **Hypothetical 3**

A logger enters into a contract for timber to be cut with a landowner. There is a prior mortgage that encumbers the standing timber under local real property law. Buyer borrows from its bank funds needed to harvest the trees, and the bank files a sufficient financing statement in the real property records against the timber to be cut. No other financing statement is filed. The logger cuts the timber and stacks the formerly timber, now lumber at its lumber yard. The logger then files a bankruptcy petition. Who, if anyone, has a perfected security interest in the now lumber?

This hypo raises the issue of whether a lender who has a perfected security interest in the timber under the “standing timber” rules of Article 9 continues to have a perfected security interest in the timber after it’s no longer standing. As to the UCC security interest, attachment won’t be a problem if the original grant was drafted properly, but perfection is a bigger problem. The rules on perfection of a security interest in standing timber under Section 9-502(b) would by their terms not apply to the timber that has been cut and is now inventory. Both inventory and standing timber to be cut would constitute “goods” under Article 9, but the place to file an effective financing statement is different. The felled timber might be said to be proceeds of the standing timber and so allow invocation of the perfection-in-proceeds rules of Section 9-315. The problem, however, is that this will not help the inventory lender because it would have filed against the standing timber in the real estate records (see Section 9-501(a)(1)), and filing against the felled timber (ordinary goods) is a central filing, so the chief provision allowing continuity of perfection in proceeds, Section 9-315(d)(1), won’t apply. Continuing perfection would lapse after 20 days from

the date the timber to be cut becomes inventory unless the secured party files a new financing statement in the central UCC filing office against the inventory as original collateral. UCC §9-315(e)(2). Hence, the lender against what is now inventory would have had to make a central filing to perfect its security interest in the timber once the timber has been cut.

As to the real property lien, there may be some question as to whether the mortgage holder on the fee property can claim a security interest in the goods. The mortgage holder may, as discussed above in the *Feliciano Bank* case, have a perfected security interest in the goods until the trees are severed physically from the realty. While its mortgage may have created a lien on the timber while it was still standing timber, like the timber-to-be-cut lender, this lien would fail once the timber was cut and the result was lumber as “ordinary” goods — probably inventory. Most real property regimes relate only to the fee or other estate in land and any related improvements or appurtenant rights. It would be an unusual real property regime, indeed, that allowed the mortgagee’s lien to follow the timber once it was removed from the property, not to mention that the state’s real property regime would appear to be in direct conflict with the state’s UCC. Thus, it is highly doubtful that the mortgagee would have any security interest in the severed lumber. (The authors wish to thank John Hilson, of Paul, Hastings, Janofsky & Walker, LLP, for his thoughts on this question.)

So the answer to this hypo is that the trustee in bankruptcy wins. The real property encumbrancer has no continuing real property lien on the now inventory. The lender providing funds to the logger to harvest the trees would have had a subordinate lien on the timber to be cut, but once the trees were cut and morphed into inventory, the lender would no longer have a perfected lien absent a central filing of a financing statement. Therefore, our beloved

hypothetical lien creditor, the trustee in bankruptcy, prevails against all.

### **Some Additional Lessons**

In light of the foregoing, we reach the following conclusions:

- If you are a mortgage lender lending against real property with standing timber and you want a security interest in the standing timber, you need to check the real property records to see if either a mortgage or a financing statement covering the standing timber has previously been filed. You need to craft your mortgage so that the granting language is sufficient under real property law to pick up the timber to be cut. All of this due diligence may, however, be insufficient if the landowner had already sold the standing timber to a purchaser for value without notice under an appropriate sale contract or conveyance such as a timber deed. There appears to be no requirement that the sale contract be recorded, and the execution of the sale contract will sever the timber to be cut from the realty;
- If you are a buyer of timber to be cut pursuant to a contract or conveyance to cut the timber, you need to check the real property records to look for prior liens against both the real property and the timber standing alone. As the buyer, you will take the timber to be cut subject to prior recorded liens. Constructive (as opposed to physical) severance from the realty will not defease a prior recorded lien; and
- If you are a lender to the harvester of the timber pursuant to contract with the landowner, you need to check the real property records for prior liens, both under real property law and under the UCC.

A few other points may be in order. (The authors wish to thank Ken Kettering, of the University of Miami School of Law, for his assistance and insight

in raising many of these issues.) One point is the significance of the word “conveyance” in the definition of “goods” under Article 9, which provides that goods include “standing timber that is to be cut and removed under a conveyance or contract for sale.” UCC §9-102(a)(44). This language did not change materially in the 1998 revision of the UCC. The drafters probably phrased the definition in this manner because the typical way for a landowner to dispose of its standing timber separately from the land had been to execute a “timber deed” in favor of a logging company, by which the landowner conveys the timber to the logging company while the timber is still standing, and also grants the timber company the right to cut. The drafters also chose to deem standing timber to be “goods” if the deal is structured (perhaps for tax purposes) so that title to the timber stays with the landowner until after it is cut. In that case, the deal isn’t a present conveyance of the timber, only a contract for the sale of the timber in the future, hence the language “contract for sale” in the definition.

If the landowner contracts with the logger simply to cut the landowner’s standing timber and haul it away, without landowner selling the timber, the transaction isn’t within the Article 9 language at all because the timber isn’t to be cut “under a conveyance or contract for sale.” Hence the standing timber remains non-goods. The logger would have nothing in which to grant a security interest other than its contract rights with the landowner.

A few final words on the matter of title/UCC insurance. As the foregoing discussion should have made clear, depending on who is the client, the issues can get complex if you are the mortgagor, the mortgagee, the logger or the lender to the logger. A typical land title insurance policy covers land, usually defined as the “land” described or referred to in a schedule attached to the land title policy, and improvements affixed thereto which by law constitute real property. By its terms, the policy would

not cover timber to be cut that was excluded from the definition of “land” under the local real property law or had been severed from the land so as to constitute goods by a prior conveyance to or contract with a logger. On the other hand, a UCC policy would not, without endorsement, protect the lender to the logger from a prior mortgage that was sufficient to encumber the standing timber as real property. The answer if you are a lender to the landowner is to request both a real property policy and a UCC policy, tied together if applicable title insurance laws permit, to cover the standing timber in the alternative, as either real property or

goods depending on the facts of the transaction. If you are the lender to the logger, you want a UCC policy that specifically covers standing timber and covers against prior real property encumbrances of record, similar to fixture UCC coverage.

**CONCLUSION •** As seen from the above discussion, the fact patterns can be complex and the interaction between real property law and personal property law is not always as clear as it should be. Timber finance is a somewhat arcane world, and you should use counsel and a title company that have “been there and done that” before.

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