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ARKANSAS COURT OF APPEALS

DIVISION II
No. CA09-1142

	Opinion Delivered September 1, 2010
CHARLES AND JULIA MCCOURT APPELLANTS	APPEAL FROM THE SEBASTIAN COUNTY CIRCUIT COURT [NO. CV2008-390]
V.	HONORABLE J. MICHAEL FITZHUGH, JUDGE
JACQUELINE TRIPLETT APPELLEE	DIRECT APPEAL MOOT; REVERSED AND REMANDED ON CROSS-APPEAL

DAVID M. GLOVER, Judge

Appellants, Charles and Julia McCourt, and appellee, Jacqueline Triplett, are creditors of McCourt Manufacturing Company (MMC). In circuit court, they asserted competing claims to $57,099.76 held in MMC's two bank accounts. The circuit judge awarded $37,099.76 to Triplett, as a judgment creditor, and $20,000 to the McCourts, as secured creditors, after attempting to apply a tracing method known as the lowest-intermediate-balance rule. Both sides appeal, each seeking all of the money in both accounts. For the reasons explained below, we reverse the court's order and remand with instructions to award the entire $57,099.76 to Triplett.

On May 11, 2006, Triplett obtained a judgment against MMC in the state of Iowa for

more than $500,000. She registered the judgment in Arkansas on March 4, 2008. Approximately one year later, she served a writ of garnishment on First National Bank of Fort Smith, where MMC had a checking account containing $51,454.76, and a savings account containing $5,645.00, for a combined total of $57,099.76. On June 2, 2009, the circuit court ordered First National to pay Triplett the $57,099.76 from both accounts.

The following day, the McCourts moved to quash the court's order, claiming a prior lien on MMC's bank accounts. Attached to their motion was a promissory note from MMC that was secured by various collateral, including the proceeds of MMC's inventory and accounts receivable. The McCourts asserted that the entire $57,099.76 on deposit at First National represented the proceeds of MMC's accounts receivable and inventory sales and therefore belonged to them as secured creditors.

The circuit court held a hearing on the McCourts' motion to quash on August 6, 2009. Mark McCourt, the son of appellant Charles McCourt, testified that he succeeded his father as president of MMC in January 2009. Mark stated that, prior to assuming the office of president, he was a shareholder in MMC with no office duties or involvement in the day-to-day affairs of the company. He said, however, that he had personal knowledge of the money deposited into MMC's bank accounts. According to him, the money in both the checking account and the savings account came from sales of inventory and accounts receivable. He further testified that the money his father loaned MMC was also deposited into the bank accounts; however, he did not say when those deposits occurred.

Charles McCourt testified that he and his wife had loaned money to MMC over the years and that, upon their retirement, wanted to document and safeguard the loans. As a result, MMC executed a $366,000 promissory note to the McCourts on January 3, 2008, and the McCourts perfected a security interest in, among other things, the company's accounts receivable, inventory, and the proceeds therefrom. According to Charles, MMC had only one checking account, and the money from the small savings account came from the checking account. He also stated that he had a "sweep" account so that when the checking account contained more than $20,000, it was swept into an investment account. With regard to the history of the checking account, Charles stated that the checking balance had dropped to as little as $1000, but probably not in the last couple of years. He said that, since January 2008, the account's lowest balance would probably have been "20 some thousand." However, he could not say so with certainty because the balance "fluctuates." Charles also testified that "almost all" of the money in the checking account came from MMC's accounts receivable, although the account may also have contained some interest from a tax return and some money from the loans that he had made to the company. Neither Charles nor Mark produced any deposit slips, bank statements, or other documentary evidence regarding the account balances.

The circuit court attempted to determine, on the testimonial evidence, what portion of the $57,099.76 on deposit at First National Bank constituted proceeds from MMC's accounts receivable and inventory sales, which would belong to the McCourts as secured

creditors, and what portion was derived from other sources, which would belong to Triplett. In post-hearing briefs, Triplett cited the lowest-intermediate-balance rule as a means of tracing and identifying the source of the accounts' funds but stated that the McCourts had not produced sufficient evidence to apply the rule. The court apparently disagreed and attempted to utilize the rule as follows:

> [U]nder the intermediate balance rule, the McCourts were entitled to the $57,099.76 unless the balance of the account was lower than $57,099.76. If there was a lower balance, the McCourts were entitled only to an amount equal to the lower balance. Here, by his own testimony, Mr. McCourt stated the lowest it got was twenty some thousand. Without any specificity being obtained from either direct or cross examination, the Court finds that the lowest the account got was $20,000.00. The McCourts would be entitled to that sum of money and [Triplett] would be entitled to $37,099.76.

The McCourts and Triplett filed timely notices of appeal from the court's order.

A secured creditor may retain an interest in the proceeds of collateral when those proceeds are deposited into the debtor's bank account. However, the proceeds must be "identifiable" as coming from the sale of collateral. *See* Ark. Code Ann. § 4-9-315(a) (Repl. 2001). Difficulties may arise in segregating collateral proceeds from other funds in a bank account when the debtor intermingles the proceeds with other types of deposits and draws on the account for operating expenses. In such instances, the Uniform Commercial Code (UCC) permits a secured creditor to identify the collateral proceeds by employing a tracing method. *See* Ark. Code Ann. § 4-9-315(b)(2) (Repl. 2001). It is the secured creditor's burden to trace and identify the funds as proceeds from the sale of secured collateral. *Metropolitan Nat'l Bank v. LaSher Oil Co.*, 81 Ark. App. 269, 101 S.W.3d 252 (2003). Thus, in this case, the

McCourts, as secured creditors, had the burden to trace and identify the funds in which they had a security interest.

The favored tracing method in instances such as this one appears to be the lowest-intermediate-balance rule. Under this rule, a presumption exists that the proceeds from the sale of collateral remain in the debtor's bank account so long as the balance equals or exceeds the amount of the proceeds. *Metropolitan*, *supra*. When the balance drops below the amount of the proceeds, the creditor's security interest in the account abates accordingly. *Id*. For example, if the debtor deposits $50,000 from the sale of collateral, the creditor has a security interest in that amount; however, if the debtor spends from the account and reduces the balance to $45,000, the creditor retains a security interest only to the extent of $45,000. When additional collateral proceeds are deposited, the creditor's security interest in the account increases correspondingly. But if the debtor again spends the account down below the new amount, a revised lowest intermediate balance is created. *See Universal C.I.T. Credit Corp. v. Farmers Bank of Portageville*, 358 F. Supp. 317 (E.D. Mo. 1973); Robert H. Skilton, *The Secured Party's Rights in a Debtor's Bank Account Under Article 9 of the Uniform Commercial Code*, 1977 S. Ill. Univ. L.J. 120 (1977). Subsequent deposits of proceeds will again increase the creditor's security interest in the account, but subsequent deposits of non-proceeds will not. *Metropolitan*, *supra*. The lowest intermediate balance is therefore a variable figure depending upon the nature and amount of the debtor's deposits and expenditures over time.

In the case at bar, the circuit court essentially treated the checking and savings accounts

as one account containing $57,099.76. The court attempted to establish the lowest intermediate balance in the accounts by using Charles McCourt's estimate of the lowest balance that had occurred in the checking account in the preceding few years. However, application of the lowest-intermediate-balance rule requires more than simply pinpointing an account's lowest historical balance; the court must view the debtor's deposits and expenditures over time to arrive at the lowest intermediate balance on the date that the competing claims arise. Because the court did not do so, we agree with both parties that reversal is in order.

The fighting point in this case is how to apportion the money in the checking and savings accounts upon reversal. The McCourts argue that they are entitled to the entire $57,099.76 contained in both accounts, citing Mark McCourt's testimony that both MMC accounts contained proceeds from its sales of inventory and accounts receivable. This testimony, however, does not meet the McCourts' burden, as secured creditors, to identify the account proceeds as originating from the sale of collateral. If the burden could be met that easily—by a simple, verbal identification of collateral proceeds without the support of any bank records whatsoever—it would be virtually meaningless. The McCourts cite *Metropolitan*, *supra*, in which our court held that a secured creditor was not required to produce invoices to "conclusively establish" that account funds were identifiable as collateral proceeds. However, the secured creditor in *Metropolitan* produced at least some bank records and explained the inability to produce further documentation. There, the person who handled the

debtor's accounts identified, from first-hand knowledge, several bank deposit slips as either containing proceeds from the sale of collateral or money from other sources. She also explained that she was unable to produce corroborating invoices because the debtor had been locked out of its offices at some point. These circumstances distinguish *Metropolitan* from the case at bar.

We therefore conclude that the McCourts did not meet their burden of identifying the money in MMC's accounts as proceeds from the sale of collateral. The money should be awarded on remand to MMC's judgment creditor, cross-appellant Jacqueline Triplett. Our resolution of this issue in Triplett's favor makes it unnecessary for us to address her argument regarding the McCourts' standing.

Direct appeal moot; reversed and remanded on cross-appeal.

HART and HENRY, JJ., agree.