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## FORECLOSING A SECURITY INTEREST DURING A PANDEMIC

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These are challenging times for everyone: individuals and businesses, debtors and creditors. Events beyond our experience have disrupted our lives and livelihoods in ways that few could have imagined and virtually no one anticipated. In this context, many secured creditors are refraining from enforcing their rights against defaulting debtors. Some have no choice because their remedies have been stayed by governmental order.<sup>1</sup> Others have made the business decision that patience is the best course because it will ultimately yield the most recovery and avoid potential damage to reputation. And no doubt some have decided that inaction is simply the morally proper thing to do under these circumstances.

The purpose of this article is not to encourage creditors to enforce their rights. However, for those creditors that choose to – or need to – enforce a security interest, shelter-in-place orders and the disruption to the economy can make it difficult to do so in a manner that complies with applicable law. Indeed, at least one court has issued a temporary restraining order prohibiting a secured party from completing a public sale of collateral<sup>2</sup> in response to a complaint that characterized the planned sale as an “improper and shameless attempt to capitalize on the COVID-19 pandemic.”<sup>3</sup> This article provides guidance to secured creditors, and to the lawyers who advise them, on how to reduce the legal risks associated with enforcing a security interest in personal property during these unprecedented circumstances.

## BACKGROUND ON THE LAW

Article 9 of the Uniform Commercial Code provides three ways – other than through judicial action – for a secured party to foreclose on a security interest in collateral (*i.e.*, to terminate the debtor’s right to redeem the collateral and to extinguish the debtor’s property rights in the collateral):

- (i) a sale, lease, license, or other disposition of the collateral;<sup>4</sup>
- (ii) collection, by enforcing the debtor’s rights to require an account debtor or other person obligated on collateral to make payment or render performance to the secured party;<sup>5</sup> and
- (iii) acceptance of the collateral – often referred to as “strict foreclosure” – by which the secured party retains the collateral in full or partial satisfaction of the secured obligation.<sup>6</sup>

Because the existence of a pandemic is most relevant to dispositions, this article focuses on that method of enforcing a security interest.<sup>7</sup>

A disposition may be effected through a public transaction (*i.e.*, an auction) or through a private transaction (anything other than an auction, such as an advertised sale with a firm price or an individually negotiated transfer). In either case, the main requirement<sup>8</sup> is that all aspects of the disposition be “commercially reasonable.”<sup>9</sup> This requirement cannot be waived or varied in the security agreement.<sup>10</sup>

Determining whether a disposition is commercially reasonable is highly fact-specific. Nevertheless, some principles can be extracted from the voluminous case law on the subject.

### *Manner & Method*

One of the best things that a secured party can do is to hire someone with expertise in selling the type of property involved to conduct the disposition.<sup>11</sup> Although doing so does not insulate the disposition from attack – if the expert fails to act in a commercially reasonable manner, the secured party’s hiring of the expert will not make the sale commercially reasonable<sup>12</sup> – few courts have concluded that a sale conducted by an expert was not commercially reasonable.

Regardless of who conducts the disposition, sufficient advertising of a public disposition or marketing for a private disposition is critical. In this context, advertisements in trade publications or on online platforms geared to the type of

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property involved is better than notices in newspapers of general circulation.<sup>13</sup> That said, advertisements in the Wall Street Journal can be sufficient if accompanied by other marketing activities.<sup>14</sup>

Perhaps even more important than advertising is allowing prospective purchasers to inspect or otherwise assess the collateral. While it is clear that a disposition – even a public disposition – can be conducted over the internet,<sup>15</sup> and thus prospective purchasers need not be given physical access to the collateral, the disposition process must facilitate due diligence by potential purchasers, particularly if the secured party will not be providing any warranties in connection with the disposition.<sup>16</sup>

Put simply, it might make for entertaining television for Monty Hall or Wayne Brady to sell unknown property hidden behind a curtain, but that is not a process a secured party may use while fulfilling its duty to act in a commercially reasonable manner.<sup>17</sup> Prospective purchasers must therefore be provided with either access to the collateral or information about the collateral.<sup>18</sup> It might be possible, in unusual cases, to conduct a commercially reasonable disposition without providing prospective purchasers such access or information,<sup>19</sup> but those situations are the exceptions, and the more valuable the collateral is the less likely such an exception will exist.

#### *Public or Private*

In choosing between a public and a private disposition, there are two things worth noting. First, although the text of the Uniform Commercial Code is agnostic on the issue, the method selected must be commercially reasonable and the official comments indicate that a private disposition is encouraged, at least if conducted “through regular commercial channels,” on the assumption that private dispositions frequently result in higher realization on the collateral.<sup>20</sup>

Second, a secured party may buy at a public disposition but may not buy at a private disposition unless the collateral is “of a kind that is customarily sold on a recognized market or the subject of widely distributed standard price quotations.”<sup>21</sup> It is unclear whether that limitation can be circumvented by having a person related to the secured party – such as subsidiary formed for the specific purpose of acquiring the collateral – purchase the collateral at a private disposition.<sup>22</sup> Nevertheless, the fact remains that any disposition to either the secured party or an affiliate of the secured party is likely to be scrutinized for commercial reasonableness more closely than would a disposition to an unrelated person. Courts do not hesitate to hold that a disposition to the secured party or its affiliate is unreasonable if there are other facts indicating that the process was designed to inhibit competitive bidding or otherwise keep the price low.<sup>23</sup> In the absence of such facts, however, a disposition to the secured party or an affiliate of the secured party will be commercially reasonable.<sup>24</sup>

#### *Time*

A secured party has the right – but no duty – to repossess and foreclose on collateral.<sup>25</sup> In part for this reason, a delay in acquiring possession or control of the collateral has no bearing on the commercial reasonableness of a later disposition.<sup>26</sup> However, a delay after the secured party acquires possession or control of the collateral can make the disposition unreasonable.<sup>27</sup> Key facts in making this determination will be whether the collateral is depreciating,<sup>28</sup> and whether the secured party bears responsibility for the delay.<sup>29</sup>

In contrast, an expedited sale – such as one conducted on a weekend or during a holiday season – can also be unreasonable, particularly if accompanied by other evidence that the time was chosen to inhibit bidding or orchestrate a sale to a related party.<sup>30</sup> Moreover, time might be required and a brief delay excused if commercial reasonableness requires that the collateral be sold in lots or blocks, rather than in bulk.<sup>31</sup>

#### **DISPOSITIONS DURING A PANDEMIC**

A pandemic probably has no material effect on a secured party’s ability to hire someone with expertise in the collateral or to properly advertise or otherwise market a planned disposition. A pandemic might, however, impact (i) a secured party’s ability to provide prospective purchasers with access to or information about the collateral; and (ii) the timing of a disposition. For reasons discussed below, secured parties should be careful about the former. In contrast, courts should disregard the latter, unless the timing impinges upon the ability of prospective purchasers to conduct appropriate due diligence.

#### *Facilitating Due Diligence*

A pandemic might make it more challenging to provide interested parties with access to the collateral. For example, if the collateral were precious gems or rare coins, the value of which is highly dependent on condition, prospective purchasers might insist on seeing the collateral. However, a secured party might find it difficult to provide access to goods in the secured party’s possession without violating a shelter-in-place order and might reasonably be reluctant to ship valuable gems or coins around the country to those who want to examine them. But while *access* to the collateral might be restricted, *information* about the collateral probably can still be disseminated to those who want it. There are, for example, reputable companies that grade gems and others that grade coins, and a secured party could send one or more items to them for inspection and grading. Using such a company might be a reasonable way to provide prospective purchasers with reliable information about the collateral.

Other examples abound. If the collateral were a motor vehicle, a secured party could have the vehicle inspected by a mechanic and provide the mechanic’s report to anyone

interested. The secured party could also take a video of the interior and exterior of the vehicle. If the collateral were accounts receivable or chattel paper, the secured party could provide information about the account debtors, how much each owes, and the debtor's history of collecting from them. If the collateral were thinly-traded securities or an equity interest in one or more subsidiaries or special-purpose vehicles, the secured party could establish a virtual data room to give prospective purchasers the information they need. Indeed, data rooms created for this purpose are often virtual, rather than physical, even when there is no pandemic.

In the unlikely event that the secured party cannot find a way to provide prospective purchasers with reliable information about the collateral, then the secured party should strongly consider deferring a disposition. Offering the collateral hidden behind the curtain does not suddenly become commercially reasonable merely because no one is peeking under the folds.

### *Timing*

In discussing the commercial reasonableness of a disposition, comment 3 to § 9-610 states that it might "be prudent not to dispose of goods when the market has collapsed." At first reading, this statement seems to make sense. After further consideration, the statement is questionable for several reasons.

First, although the statement refers only to goods, there is no reason to think that the principle is applicable only to some types of collateral. Why should a market collapse for promissory notes, chattel paper, investment securities, or Bitcoin be treated any differently from a market collapse for impressionist paintings, collectibles, or vehicles?

Second, and more fundamentally, what is a market collapse and how is anyone to know when one has occurred? Some types of property fluctuate significantly in value. A chart of the market price of Bitcoin, for example, looks like an EKG of a rather unhealthy person. When the market price drops, even precipitously, investors know that fact. But they never know when the bottom has been hit. Thus, they cannot know whether the price will fall further or start to rise. Consequently, who is to say when a market has "collapsed"? Put another way, the commercial reasonableness of a disposition cannot be assessed with hindsight; it must be determined based on the information available to the secured party at the time the disposition occurs.<sup>32</sup> Because one can never know whether the value of nonperishable property will increase or decrease in the near future, the secured party cannot have acted unreasonably merely because it guessed incorrectly.

Third, even if we could all agree on what a market collapse is and secured parties knew when one had occurred, such a collapse would still not be a justification for requiring a secured party to defer disposing of the collateral. The whole point of

taking a security interest in collateral is to reduce the risk of loss if the obligor fails to pay the secured obligation. The risk of a payment default is often greatest during financial crises, and probably greater still when the market for the debtor's assets has collapsed. In other words, a market collapse is precisely the time when the secured party most needs the right to foreclose on the collateral, and that is precisely for what the secured party has bargained for the right to do by getting the security interest. The debtor, not the secured party, bears the contractual risk of a financial crisis or market collapse, and it would be stretching the concept of commercial reasonableness for a court to enjoin a secured party from conducting a disposition, or to sanction a secured party for conducting one, merely because the disposition occurred during such a crisis or collapse.

### *Another Option*

Although the requirement that a disposition of collateral be commercially reasonable cannot be waived or varied,<sup>33</sup> the debtor and secured party can set the standards for measuring commercial reasonableness, provided those standards are not themselves "manifestly unreasonable."<sup>34</sup> If the security agreement contains such standards, the secured party should follow them, unless the pandemic has made compliance impossible or impracticable.<sup>35</sup> If the security interest does not contain such standards, the secured party might be able to get the debtor to agree to such standards in a forbearance agreement. That said, an agreement with the debtor regarding the standards for a disposition is unlikely to bind guarantors or other lienors who are not a party to the agreement. So a transactional lawyer should seek and obtain their agreement as well.

### CONCLUSION

If we are to get through this pandemic – and we will – commercial activity must continue. Loans must be made, and that requires some assurance of repayment. While secured creditors might, for any number of reasons, choose not to enforce their security interests during a pandemic, and their transactional lawyers might counsel restraint in light of the unfortunate suggestion in the official comments that a disposition during a market collapse would not be prudent, the fact remains that secured creditors must have the ability to enforce their security interests during a crisis. The requirement that a disposition of collateral be commercially reasonable is a vague standard, and one that is not lessened during a catastrophic event. But by properly advising their creditor clients, transactional lawyers can help them satisfy the requirement despite a pandemic, shelter-in-place orders, and the associated financial turmoil.

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**Notes:**

1. See, e.g., [N.Y. Executive Order 202.8](#) (March 20, 2020) (providing, among other things, that “[t]here shall be no enforcement of either an eviction of any tenant residential or commercial, or a foreclosure of any residential or commercial property for a period of ninety days”). See also National Consumer Law Center, [Covid-19 State Foreclosure Moratoriums and Stays](#) (May 5, 2020) (dealing with home foreclosures).

2. See Emma Cueto, *Lender Accused of ‘Sham’ Auction Plant at Paul Hastings Site*, [Law360](#) (May 4, 2020); Gary J. Mennitt, Jessica Seger Bula & Laura G. Ciabarra, *Mezzanine Foreclosures in the Time of Coronavirus*, [Lexology](#) (May 5, 2020).

3. [Verified Complaint at ¶ 1](#), 1248 Associates Mezz II LLC v. 12E48 Mezz II LLC, (N.Y. Sup. Ct. April 22, 2020). On May 18, the court declined to issue a preliminary injunction after concluding that the executive order against foreclosure, see *supra* note 1, did not apply to non-judicial enforcement of a security interest and that any damage resulting from failure to comply with Article 9 could be remedied after the sale.

4. See U.C.C. §§ 9-610 through 9-619.

5. See U.C.C. §§ 9-607, 9-608.

6. See U.C.C. §§ 9-620 through 9-622.

7. A secured party must act in a commercially reasonable manner when collecting on collateral if the secured party has full or partial recourse against the debtor or a secondary obligor. See § 9-607(c). This requirement of commercial reasonableness applies principally to any settlement or compromise that the secured party enters into with the account debtor. See § 9-607 cmt. 9. Although a pandemic might impact the account debtor’s ability to pay or limit the secured party’s ability to access the judicial system to compel the account debtor to pay, it does not really change the secured party’s duties with respect to collection. The reasonableness of any settlement or compromise will still turn on the likelihood of success of any claim or defense raised by the account debtor and the account debtor’s financial ability to pay.

Because acceptance requires the debtor’s consent after default, see § 9-620(a)(1), (c), there is no requirement that an acceptance be commercially reasonable. Hence, a pandemic is unlikely to have much or any impact on a secured party’s acceptance of collateral. Of course, a secured party’s proposal to accept must be made in good faith, see § 9-620, cmt. 11, but it is unlikely to be bad faith merely to seek the debtor’s consent, even during a pandemic; the debtor can simply refuse to consent. Cf. *Eddy v. Glen Devore Personal Trust*, [2006 WL 198077](#) (Wash. Ct. App. 2006) (strict foreclosure on \$90,000 promissory note to satisfy \$5,000 debt is not unconscionable); *McDonald v. Yarchenko*, [2013 WL 3809512](#) (D. Or. 2013) (by sending a written proposal and receiving no objection thereto

within 20 days, the secured party conducted an effective acceptance of the collateral – the debtor’s 1/6th interest in an LLC – in full satisfaction of the secured obligation even though the collateral was worth at least \$407,000 and possibly as much as \$1.6 million while the secured obligation was only about \$12,000).

8. Another requirement is that the secured party provide reasonable advance notification of the sale to the debtor, secondary obligors, and others with an interest in the collateral. See U.C.C. § 9-611(b), (c). This duty cannot be waived in the security agreement, see U.C.C. § 9-602(7), but can be waived after default, see U.C.C. § 9-624(a), and in some cases does not apply, see U.C.C. § 9-611(d).

9. See U.C.C. § 9-610(b). The requirement of commercial reasonableness applies only to a disposition conducted by the secured party; it does not apply to a disposition conducted by the debtor, provided the secured party is not controlling the debtor’s actions. Compare *MB Fin. Bank v. Jacobs*, [2018 WL 4099706](#) (Ill. Ct. App. 2018) (because the collateral was sold not by the secured party, but by the management company hired by the assignee for the benefit of creditors, and the assignee was the agent of the debtor, not the secured party, § 9-610(b) did not apply and there was no requirement that the sale be commercially reasonable); *Bremer Bank v. Matejcek*, [916 N.W.2d 688](#) (Minn. Ct. App. 2018) (a secured party had no duty to conduct the sale in a commercially reasonable manner because the secured party merely consented to the debtor’s sale; the secured party did not conduct the sale), with *Regions Bank v. Trailer Source*, [2010 WL 2074590](#) (Tenn. Ct. App. 2010) (senior secured creditor’s control over and approval of debtor’s sale of collateralized trailers after default was sufficient to trigger the requirement, with respect to junior secured creditor, that the sale be conducted in a commercially reasonable manner). See also *Border State Bank v. AgCountry Farm Credit Serv.*, [535 F.3d 779](#) (8th Cir. 2008) (lenders were not required to give junior secured party notification of a sale of the collateral, although held at their insistence, because the debtor itself conducted the sale and remitted the proceeds to the lenders); Stephen L. Sepinuck, *Debtor’s Negotiation of Foreclosure Sale Might Ease Secured Creditor’s Burden in Complying with Article 9*, [26 CLARKS’ SECURED TRANSACTIONS MONTHLY 7](#) (June 2010).

It is important to note that some non-uniform amendments to Article 9 – and laws outside Article 9 – impose additional duties or restrictions with respect to how a disposition is to be conducted. For example, Ohio law provides that a secured party whose interest was created through a retail installment sale must use a public sale to dispose of the collateral. See [Ohio Rev. Code § 1317.16](#); *Daimler/Chrysler Truck Fin. v. Kimball*, [2007 WL 4358476](#) (Ohio Ct. App. 2007). Florida law prescribes the manner in which a security interest in an alcoholic beverage license may be enforced. See [Fla. Stat. § 561.65\(5\), \(6\)](#); *VMI Ent., LLC v. Westwood Plaza, LLC*, [152 So. 3d 617](#) (Fla. Ct.



App. 2014). And federal law prohibits a disposition without a court order if the collateral is owned by a member of the military while the service member is on active duty or within various specified times thereafter. [50 U.S.C. § 3953\(c\)](#). See also *United States v. B.C. Enters., Inc.*, [667 F. Supp. 2d 650](#) (E.D. Va. 2009) (creditor is strictly liable for damages resulting from unauthorized sale regardless of whether the creditor knew of the debtor's military status). That federal law does not apply, however, if the collateral is owned indirectly by the service member, such as by a corporation owned and controlled by the service member. *Newton v. Bank of McKenney*, [2012 WL 1752407](#) (E.D. Va. 2012). The bottom line is that Article 9 is the place to start – but not the place to end – when searching for the rules that a secured party must follow when enforcing a security interest in personal property.

10. See U.C.C. § 9-602(7).

11. *395 Lampe, LLC v. Kawish, LLC*, [2016 WL 1449205](#) (W.D. Wash. 2016) (a secured party conducted a commercially reasonable sale of the debtor's minority interest in an LLC because the sale was conducted by the largest Pacific Northwest auction marketing firm, preceded by newspaper ads and direct marketing to 150 targeted prospects); *Icon Agent, LLC v. Kanza Constr., Inc.*, [2016 WL 197803](#) (Kan. Ct. App. 2016) (a foreclosure sale of railroad construction equipment conducted by the world's largest industrial auction company, which had experience auctioning heavy and rail equipment and a large database of equipment buyers was commercially reasonable); *Bank of America v. Dello Russo*, [610 F. App'x 848](#) (11th Cir. 2015) (a secured party acted in a commercially reasonable manner when it relied on an investment broker hired by the debtor to market the collateral and find a buyer; the broker used a national marketing campaign to identify prospective purchasers for the assets and the secured party then negotiated with the only potential buyer expressing interest in an effort to increase the purchase price); *Key Equip. Fin. v. Southwest Contracting, Inc.*, [2015 WL 5159073](#) (D. Colo. 2015) (a secured party's sale of a dredge for \$75,000 was commercially reasonable because the secured party engaged a company with experience in inspecting and evaluating commercial equipment, including dredges, to assess the condition of the dredge, that company hired a local individual who had knowledge and experience with dredges to assist in the process, and after the company assessed the condition of the dredge and made a rough estimate of its value, the company tried to find a buyer both on the internet and by having its sales people directly contact possible buyers); *Keybank v. Hartmann*, [2014 WL 641003](#) (E.D. Ky. 2014) (a private sale of encumbered boats that the secured party conducted through a broker, as the debtor suggested and later admitted would be commercially reasonable, merely with a different broker and for a higher price, was commercially reasonable); *GECC v. FPL Service Corp.*, [995 F. Supp. 2d 935](#) (N.D. Iowa 2014) (a secured party proved that it conducted a commercially reasonable disposition of the

collateral – two copiers – by showing that: (i) it hired a marketing firm that emailed approximately 2500 potential buyers, which the firm had identified from past transactions and marketing efforts as those that customarily purchase this type of equipment for parts; (ii) the firm sold the copiers to the highest bidder; and (iii) this process conforms to that used by copier dealers who wish to maximize the price of used copiers); *Deer Creek Excavating v. Hunt's Trenching*, [2013 WL 1400970](#) (Ohio Ct. App. 2013) (a secured party conducted a commercially reasonable disposition of a tractor by having professional auctioneers auction the tractor after advertising the sale and making the tractor available for inspection three days prior to auction); *Regions Bank v. Hyman*, [2012 WL 4479080](#) (M.D. Fla. 2012) (a secured party's disposition of an aircraft was commercially reasonable because it was conducted through a reputable, experienced broker who sold the aircraft in a manner consistent with standard industry practice; specifically, the broker marketed the aircraft, obtained offers from various entities, rejected a low bid, and ultimately sold the aircraft for the best offer it could get at that time); *Center Capital Corp. v. PRA Aviation, LLC*, [2011 WL 442107](#) (E.D. Pa. 2011) (a secured party conducted a commercially reasonable sale of an aircraft because the secured party used a reputable broker that sold the collateral in a manner consistent with standard industry practice, aggressively marketed the aircraft for three months, rejected two low bids, and sold the plane for the best offer it received).

12. See *Comerica Bank v. Mann*, [13 F. Supp. 3d 1262](#) (N.D. Ga. 2013) (a secured party's disposition of a yacht was not commercially reasonable in part because the broker hired by the secured party: (i) did not market the yacht to European buyers even though the yacht was geared to the European market due to its style and European manufacture and the European yacht market was stronger; (ii) failed to market the boat aggressively; and (iii) advertised the yacht as a bank repo); *CIT Group Equip. Fin., Inc. v. FRS Farms, Inc.*, [745 N.W.2d 88](#) (Wis. Ct. App. 2007) (a secured party did not conduct a commercially reasonable disposition of specialized collateral because the consultants it hired lacked expertise about the collateral, the sale was structured as a sale to the consultants, thereby creating a possible conflict of interest if the consultants marked up the price to the real buyers by more than their intended commission, and the price was far below estimate fair market value). See also *Harley Davidson Credit Corp. v. Galvin*, [807 F.3d 407](#) (1st Cir. 2015) (although the secured party's sale of a repossessed aircraft through a dealer specializing in the sale of repossessed aircraft, if fairly conducted, is commercially reasonable, it is the secured party's obligation to show that the sale was fairly conducted, which the secured party had not done when it moved for summary judgment, particularly given that the plane was vandalized while in the secured party's possession, and sold without repair while the plane could not be flown).

13. *Compare* People’s Cap. and Leasing Corp. v. McClung, [2018 WL 2996902](#) (W.D. Tex. 2018) (secured party marketed the collateralized oilfield equipment in an industry publication in print, online, and by direct e-mail to all the registered buyers of an asset management company); *395 Lampe, LLC*, [2016 WL 1449205](#) (a public auction preceded by newspaper ads and direct marketing to 150 targeted prospects), *with* Robb v. Bond Purchase, LLC, [580 S.W.3d 70](#) (Mo. Ct. App. 2019) (secured party advertised the disposition in three local papers, two of which regularly published real property foreclosure notices but not notices of sales of publicly traded stock); *Commercial Credit Group, Inc. v. Barber*, [682 S.E.2d 760](#) (N.C. Ct. App. 2009) (the secured party ran advertisements for the auction in two general circulation newspapers just two days before and one day after the Christmas holiday); *Gemcap Lending I LLC v. Crop USA Ins. Agency, Inc.*, [2015 WL 12746212](#) (C.D. Cal. 2015) (the secured party’s publication of one advertisement in the Wall Street Journal was not calculated to attract bidders); *In re Inofin, Inc.*, [512 B.R. 19](#) (Bankr. D. Mass. 2014) (auctioneer made no effort to solicit bids from individuals or entities in the industry by placing ads in trade publications and instead merely placed ads in the Boston Herald). *Cf.* *In re Adobe Trucking, Inc.*, [551 F. App’x 167](#) (5th Cir. 2014) (advertising drilling equipment for sale for one day in newspapers of general circulation was adequate because the security agreement provided that it would not be commercially unreasonable “to advertise dispositions of Collateral through publications or media of general circulation, whether or not the Collateral is of a specialized nature”).
14. *See, e.g.*, *Atlas MF Mezzanine Borrower, LLC v. Macquarie Texas Loan Holder, LLC*, (N.Y. Sup. Ct. March 30, 2020) (available [here](#)) (a secured party conducted a commercially reasonable disposition of the debtor’s interest in a limited liability company by marketing the collateral widely, including sending out email messages to more than 8,400 entities that acquire similar property and advertising the sale for seven consecutive days in the Wall Street Journal); *Edgewater Growth Cap. Partners LP v. H.I.G. Cap., Inc.*, [68 A.3d 197](#) (Del. Ch. Ct. 2013) (two advertisements for disposition were placed in the Wall Street Journal and invitations were sent to more than 60 entities identified by the financial consultant as the parties most likely to bid).
15. *See* U.C.C. § 9-610 cmt. 2 (“subsection (b) permits both public and private dispositions, including public and private dispositions conducted over the Internet”). *See also* U.C.C. § 9-613 cmt. 2 (including the Uniform Resource Locator (URL) or other Internet address for a public disposition satisfies the requirement that a notification state the place of the disposition).
16. *See* U.C.C. § 9-610(d), (e) (permitting a secured party to disclaim any warranties of title or quality that might otherwise be part of the transaction).
17. Concealing the assets sold might be an effective way to sell property of little or no value if, for example, prospective purchasers could be persuaded to view the transaction as a gamble with a chance for a big payday. But this could not be an effective long-term strategy. Once it became clear that there never was a big payoff – because it would not be a reasonable way to sell valuable property – the process would not work. There is a similar problem with the parable about King Solomon’s threat to split in two the baby claimed by two women. 1 Kings 3:16–28. As a method of decision making, the threat might work the first time a judge uses it. But if, sometime later, two other mothers each claim the same child, and if each is well represented by counsel, they will both know how to react to the judge’s threat to bisect the baby. As a result, the threat will no longer be a reliable way to determine parentage (or, if not parentage, at least which would be a more loving mother).
18. *Compare* *Security Alarm Fin. Enters., Inc. v. Parmer*, [2013 WL 593767](#) (N.D.W. Va. 2013) (a claim was stated against the secured party for conducting a commercially unreasonable disposition in part by alleging that the secured party refused to allow potential bidders to inspect or otherwise access the assets being sold); *Barber*, [682 S.E.2d 760](#) (a disposition was not commercially reasonable in part because the creditor sold the goods “as is” and while inoperable without explaining that the goods were covered by a warranty), *with* *Atlas MF Mezzanine Borrower*, (available [here](#)); *395 Lampe, LLC*, [2016 WL 1449205](#) (W.D. Wash. 2016) (each ruling that a disposition of the debtor’s interest in a limited liability company was commercially reasonable after the secured party set up a data room to allow potential bidders to acquire information about the company); *Deer Creek Excavating*, [2013 WL 1400970](#) (Ohio Ct. App. 2013) (a secured party conducted a commercially reasonable disposition of a tractor after making the tractor available for inspection three days prior to auction).
19. *See, e.g.*, *Airpro Mobile Air, LLC v. Prosperity Bank*, [2020 WL 2537196](#) (Tex. Ct. App. 2020) (a bank conducted a commercially reasonable private disposition of collateral even though the collateral was in the possession of a landlord who claimed a superior lien and who denied the bank the ability to inspect, manage, market, or appraise the collateral; the landlord’s actions did not obviate the requirement that the disposition be commercially reasonable but were relevant in determining whether the bank’s conduct complied with that standard; although the disposition was conducted a year before the bank’s lawsuit against the landlord was settled, the timing was reasonable given that a substantial portion of the collateral was already obsolete); *Adobe Trucking, Inc.*, [551 F. App’x 167](#) (the debtors could not complain about the secured party’s failure to make the collateral available for inspection given their refusal to turn the collateral over, identify its location, or otherwise cooperate with the secured party); *Regions Bank v. Trailer Source*, [2010 WL 2074590](#) (a secured party’s sale to a single

buyer of 241 trailers scattered around the country sight unseen and “as is” was commercially reasonable in part because the secured party did not know where the trailers were located and obtaining appraisals would have been excessively costly); *Bremer Bank v. John Hancock Life Ins. Co.*, [2009 WL 702009](#) (D. Minn. 2009) (a secured party conducted a commercially reasonable disposition of aircraft despite the fact that the aircraft was unavailable for inspection because it was understood that any buyer would likely continue to lease the aircraft to the airline currently leasing it).

20. See U.C.C. § 9-610 cmts. 2 & 3.

21. U.C.C. § 9-610(c). See also *id.* cmt. 7 (indicating that a secured party’s purchase of collateral at a non-qualifying private disposition is treated not as a disposition, but as an acceptance of collateral, and is governed by U.C.C. §§ 9-620 through 9-622).

Note, if the collateral is closely-held securities, federal securities laws might prohibit a public sale or restrict how such a sale is to be conducted. Even in that case, however, a sale to the secured party would be prohibited by § 9-610(c). See *Bruce v. Cauthen*, [515 S.W.3d 495](#) (Tex. Ct. App. 2017).

22. Article 9 contains a special rule for how a surplus or deficiency is calculated if the purchaser at a disposition is the secured party or “a person related to the secured party.” U.C.C. § 9-615(f). See also U.C.C. § 9-102(a)(62), (63) (defining “person related to”). In contrast, § 9-610(c), which limits a secured party’s ability to purchase at a private disposition, conspicuously omits reference to a person related to the secured party. *But cf. Edgewater Growth Cap. Partners*, [68 A.3d at 211](#) (a disposition of all the debtor’s assets to shell company formed by largest holder of the senior secured debt had to be public to comply with Article 9).

23. See, e.g., *Robb*, [580 S.W.3d 70](#) (a secured party’s public disposition of thinly traded shares of bank stock was not conducted in a commercially reasonable manner in part because the shares were purchased by a newly formed company controlled by a friend of and for the benefit of the individual who owned the secured party and who was a dissident shareholder of the bank); *In re Comprehensive Power, Inc.*, [578 B.R. 14](#) (Bankr. D. Mass. 2017) (the debtor’s bankruptcy trustee pleaded sufficient facts to state a claim that a secured party’s disposition of substantially all of the debtor’s assets was not commercially reasonable by alleging that the secured party, among other things, was the sole bidder at a sale conducted on only fourteen days’ notice, so that other potential purchasers were prevented from participating); *Highland CDO Opportunity Master Fund, L.P. v. Citibank*, [2016 WL 1267781](#) (S.D.N.Y. 2016) (neither party was entitled to summary judgment on the commercial reasonableness of conducting an auction sale of CDOs to the secured party); *Gemcap Lending*, [2015 WL 12746212](#) (a secured party that was the only bidder at a public

sale failed to demonstrate that it was entitled to summary judgment on the commercial reasonableness of the sale); *TAP Holdings, LLC v. Orix Fin. Corp.*, [2014 WL 5900923](#) (N.Y. Sup. Ct. 2014) (senior lenders that took control of the debtor’s board, orchestrated a transfer of assets to a newly formed entity in exchange for a promissory note, and then had the debtor assign the note to the senior lenders in return for a release from the secured obligations did not conduct an acceptance of collateral but instead held a private sale of the collateral; because the sale was conducted quickly, without the involvement of the junior creditors or equity holders, and without competitive dynamic, the debtor’s creditors raised a claim that the senior lenders had not conducted the sale in a commercially reasonable manner; *In re Inofin, Inc.*, [512 B.R. 19](#) (a secured party did not conduct a commercially reasonable auction of chattel paper because it made no reasonable efforts to market the loan portfolio and was the only bidder).

24. See, e.g., *Adobe Trucking*, [551 F. App’x 167](#) (a public sale of collateralized drilling equipment, at which the secured party made the winning bid of \$41 million, was commercially reasonable); *Edgewater Growth Cap. Partners LP*, [68 A.3d 197](#) (a sale of all the debtor’s assets to a shell company formed by largest holder of the senior secured debt was commercially reasonable); *People’s United Equip. Fin. Corp. v. Hartmann*, [447 F. App’x 522](#) (5th Cir. 2011) (public sales of collateralized equipment at which the secured party was the only bidder were commercially reasonable).

25. See, e.g., *First Nat’l Bank of Omaha v. Madison*, [2019 WL 4014206](#) (Ill. Ct. App. 2019) (secured party had no duty to repossess an aircraft, and therefore no duty to care for the aircraft); *Spizizen v. National City Corp.*, [516 F. App’x 426](#) (6th Cir. 2013) (a secured party could, after the debtors’ default, freeze the collateralized securities account containing securities entitlements valued in excess of the secured obligation; the secured party had *right* but not the *obligation* to sell the entitlements); *In re King*, [2010 WL 4290527](#) (Bankr. S.D.N.Y. 2010) (a secured party had no duty to repossess and dispose of the collateral, and therefore had a valid claim for the full amount of the debt despite having not foreclosed its security interest).

26. See, e.g., *WM Cap. Partners LLC v. Thornton*, [525 S.W.3d 265](#), 270–72 (Tenn. Ct. App. 2016).

27. *Id.* (ruling that the debtor had put commercial reasonableness at issue due to such a delay, and therefore summary judgment was not appropriate). See also *In re Estate of Nardoni*, [2015 WL 1514908](#) (Ill. Ct. App. 2015) (a bank that, after default, received certificates in its own name for the pledged stock, placed the certificates in a vault, and for three years refused to either sell the stock or permit the debtor to sell the stock to pay off the secured obligation, acted in a commercially unreasonable manner).

28. *See, e.g.*, USA Fin. Servs., LLC v. Young’s Funeral Home, Inc., [2010 WL 3002063](#) (Del. Ct. Comm. Pleas 2010) (a secured creditor’s sale of a hearse approximately one year after repossession was not commercially reasonable, particularly since vehicles are depreciating assets and the factors contributing to the delay were within the creditor’s control; Jefferson Loan Co. v. Session, [938 A.2d 169](#) (N.J. Super. Ct. App. Div. 2008) (a four-year delay between repossession and disposition of a vehicle, while interest continued to accrue on the secured obligation, was not commercially reasonable).

29. *See, e.g.*, Breckenridge v. Nissan Motor Acceptance Corp., [2019 WL 1863792](#) (E.D. Mich. 2019) (a secured party that did not dispose of a vehicle until ten months after the repossession was entitled to summary judgment on the debtor’s claim for failure to conduct a commercially reasonable disposition because there was an issue regarding the vehicle’s mileage, which delayed for nine months the secured party’s ability to get an accurate title for the vehicle); *395 Lampe, LLC*, [2016 WL 1449205](#) (W.D. Wash. 2016) (a secured party’s sale of the debtor’s minority interest in an LLC was commercially reasonable, even though delayed by three years, because the debtor did not show that the collateral had declined in value during that period, the collateral generated more in income during that period than the amount of default-rate interest that accrued on the secured obligation, and much of the delay was attributable to the debtor’s litigation). *See also* Dow Chemical Employees’ Credit Union v. Veiling, [2018 WL 2746331](#) (Mich. Ct. App. 2018) (sufficient evidence existed to support a jury determination that a secured party’s sale of a boat two years after repossession was commercially reasonable, despite the depreciation that occurred during that period, because the secured party had been actively marketing boat during that period).

30. *See, e.g.*, Highland CDO Opportunity Master Fund, L.P. v. Citibank, [2016 WL 1267781](#) (S.D.N.Y. 2016) (neither party was entitled to summary judgment on the commercial reasonableness of conducting an auction sale of collateralized debt obligations on December 31, 2008, allegedly when market participants are not fully staffed and do not have available balance sheet or appetite to purchase securities); *Parmer*, [2013 WL 593767](#) (a judgment lienor stated a claim against senior secured party for conducting a commercially unreasonable disposition by alleging, among other things, that the secured party conducted the sale on a Saturday morning in an effort to orchestrate a sale to a company owned by a related party). *But cf.* *MB Fin. Bank*, [2018 WL 4099706](#) (dicta that a disposition was commercially reasonable even though conducted on January 3).

31. *See* U.C.C. § 9-610 cmt. 3 (“it might be more appropriate to sell a large inventory in parcels over a period of time instead of in bulk”); *Smith v. Firstbank Corp.*, [2013 WL 951377](#) (Mich. Ct. App. 2013) (a secured party’s private sales of publicly

traded stock in blocks of 600,000 and 450,000 shares to brokerage firms at prices below the prevailing market price per share were commercially reasonable due to the concern that sales of such large blocks on the exchange would depress the price, a concern that was reasonable given it had occurred the previous year with respect to this stock).

32. *See Ross v. Rothstein*, [92 F. Supp. 3d 1041](#) (D. Kan. 2015) (a secured party’s sale of stock on the over-the-counter QB tier market (“OTCQB”) was commercially reasonable even though a sale a few hours later would have generated several thousand dollars more; the secured party had at the time no benefit of hindsight).

33. *See supra* note 10.

34. *See* U.C.C. §§ 1-302(b), 9-603(a). *See also* Gulf Coast Farms, LLC v. Fifth Third Bank, [2013 WL 1688458](#) (Ky. Ct. App. 2013) (because the security agreement covering equine collateral expressly provided that “any disposition of Collateral at a regularly scheduled auction where similar Collateral is ordinarily sold (*e.g.* Keeneland or Fasig–Tipton sales) with or without reserve . . . is per se commercially reasonable,” the bank’s sale of the collateral at a Keeneland sale was commercially reasonable). *But cf.* *In re Walter B. Scott & Sons, Inc.*, [436 B.R. 582](#) (Bankr. D. Idaho 2010) (a term in security agreement providing that disposition would be commercially reasonable if notification were provided to the debtor ten days in advance and an advertisement was published in a newspaper of general circulation at least ten days before a public sale was manifestly unreasonable and therefore unenforceable because it dealt only with notification and advertisement, not with the other aspects of the sale).

35. For this reason, agreed-upon standards for measuring the commercial reasonableness of a disposition should be phrased as a safe harbor, not as a requirement. *See Barber*, [682 S.E.2d 760](#) (N.C. Ct. App. 2009) (a secured party failed to comply with standards included in security agreement for conducting a commercially reasonable disposition because the standards specified that the sale be “upon terms of 25% cash down with the balance payable in good funds within 24 hours” but the terms stated in both the advertisement and at the start of the auction were that the creditor could, in its sole discretion, require full immediate payment); Stephen L. Sepinuck, *Drafting for a Commercially Reasonable Disposition of Collateral*, [1 The Transactional Lawyer 1](#) (Feb. 2011).





## What Choice Do I Have? – Choice-of-Law Clauses Governing Attachment of a Security Interest

*Stephen L. Sepinuck*

In its recent decision in *Landress v. Sparkman*,<sup>1</sup> the U.S. District Court for the Eastern District of North Carolina ruled that a choice of New York law to govern a security agreement applied to determine whether the security interest attached to the debtor’s interest in a Delaware limited liability partnership. As Professor Carl Bjerre and I explained – albeit briefly – in our most recent *Spotlight* column,<sup>2</sup> that ruling was incorrect. The Commercial Law Amicus Initiative was preparing a more detailed exposition of the court’s error in connection with a request to file an *amicus curiae* brief with the Fourth Circuit. Unfortunately, the case has apparently settled and the appeal will likely be dismissed. Accordingly, to assure that courts do not repeat the error made by the district court, and that transactional lawyers representing lenders understand how to conduct the due diligence that might be required of them, this article provides a more complete analysis of the issues raised.

### A BIT OF BACKGROUND

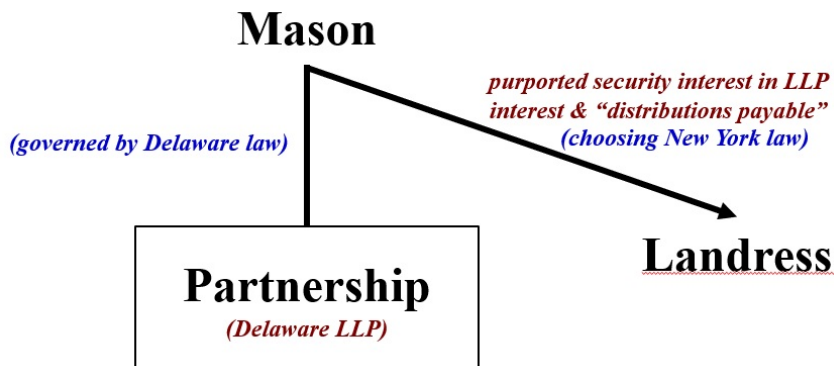
Partnership agreements and operating agreements for limited liability companies often purport to restrict the right of a partner or member to transfer the partner’s or member’s interest in the entity, either outright or without the consent of the entity or the other partners or members. Such a restriction is premised on the “pick-your-partner” principle: a concern that the owners of a small business should not be compelled to become associated with someone not of their choosing. In many cases, the restriction extends to the creation of a security interest in the partnership or membership interest, because a later foreclosure of the security interest could result in a transfer to someone with whom the other partners or members would not wish to be associated.

Although U.C.C. §§ 9-406 and 9-408 override many contractual provisions that purport to restrict the attachment of a security interest, they have limited applicability to a restriction on the grant of a security interest in a partnership or LLC interest. Instead, the two provisions generally respect the “pick-your-partner” principle inherent in partnership and LLC law. This point is supported by a draft PEB commentary that, although never issued in final form, rejected the conclusion that § 9-408 overrides restrictions on assignment in entity formation documents. The commentary was based largely on the observation that § 9-408 operates on “an agreement between an account debtor and a debtor”<sup>3</sup> but the entity itself, which is likely to be the “account debtor” with respect to a security interest in an interest in the entity, is usually not a party to its own formation documents.<sup>4</sup>

To bolster this conclusion, which is somewhat technical and nuanced, several states – including Delaware – have either adopted non-uniform language to Article 9 or enacted statutes outside Article 9 to exempt interests in such entities from Article 9’s anti-assignment rules.<sup>5</sup> Moreover, in 2018, the UCC’s sponsors adopted a new § 9-406(k) and a new § 9-408(f) to make it clear that neither section overrides a restriction on the transfer of an ownership interest in a general partnership, limited partnership, or limited liability company.<sup>6</sup> Unfortunately these amendments have not yet been widely adopted.

### THE DECISION

The debtor, James Mason, Jr., guaranteed a loan made to an entity in which he had a stake, and purported to secure this guaranty with his rights, including distributions payable, in a Delaware limited liability partnership in which Mason also had an interest. The partnership agreement, which Mason did not provide to the lender prior to closing, provided that any attempted transfer of a partnership interest – including the creation of a security interest – without the consent of all the managing partners is void. However, Mason, a resident of North Carolina, was in New York on vacation when he signed the security agreement and the security agreement contained a clause selecting New York law as the governing law. The following graphic diagrams the transaction:



In Mason's later bankruptcy, the trustee objected to the lender's status as the holder of a secured claim. The bankruptcy court, which was willing to assume that both New York's and North Carolina's versions of § 9-408 would override the restriction in the partnership agreement, nevertheless sustained the trustee's objection.<sup>7</sup> The court reasoned as follows: (i) the partnership agreement invalidates any attempt to create a security interest in a partnership interest without the consent of the managing partners, and there was no such consent for Mason's transaction; (ii) Delaware law governs the partnership agreement and, under the "internal affairs doctrine,"<sup>8</sup> governs the validity of the restriction on assignment; (iii) Delaware partnership law overrides Article 9's anti-assignment rules, and enforces the restriction on assignment of both an interest in a partnership and a partner's distribution rights.<sup>9</sup>

On appeal, the district court reversed. It concluded that the internal affairs doctrine, which in its words governs "intra-firm relationships," should be not "stretche[d]" so as to govern a pledge of a partner's economic interest and distribution rights.<sup>10</sup> Instead, and without further analysis, the court concluded that the validity of the anti-assignment clause should be controlled by the governing-law clause in the security agreement.<sup>11</sup> Then, applying the chosen law of New York, the court concluded that Mason's rights were payment intangibles, the partnership – which was a party to the partnership agreement – was an "account debtor," and New York's § 9-406(d) overrode the restrictions on creation of a security interest.<sup>12</sup>

### THE COURT'S ERROR

The district court created a false dichotomy: the court treated the choice-of-law problem as a binary choice between application of the internal affairs doctrine (which would lead to application of Delaware law) and application of the law chosen in the security agreement (New York law). But that was fundamentally incorrect. Even if, as the court concluded, the internal affairs doctrine did not mandate application of Delaware law,<sup>13</sup> it was a mistake to allow the law that Mason and the secured party selected in the security agreement to govern their respective rights and obligations to also determine the rights and obligations of the partnership and the other partners, who were not parties to the security agreement.

To be clear, Article 9 contains detailed rules on which state's law governs perfection, the effect of perfection or nonperfection, and the priority of a security interest in personal property.<sup>14</sup> Conspicuously absent from that list is attachment. Comment 2 to § 9-301 then notes that "the law applicable to issues such as attachment . . . and enforcement is governed by the rules in Section 1-301," and then adds that such law "typically is specified in the same agreement that contains the security agreement."<sup>15</sup> But "typically" is not always.

Section 1-301(a) is itself clear that, when a transaction bears a reasonable relationship to more than one state, the

parties may agree which of those states' law will govern "their rights and duties,"<sup>16</sup> but nothing in that statement suggests that contracting parties may, in their agreement, select the law that will govern the rights or obligations of third parties.<sup>17</sup> This limitation is confirmed in the very next sentence of comment 2 to § 9-301, which notes that "another jurisdiction's law" – that is, not the law of the jurisdiction selected by the parties to the security agreement – "may govern other third-party matters addressed in this Article."<sup>18</sup> It is also expressed in comment 3 to § 9-401, which states that "it might be inappropriate for a designation of applicable law by a debtor and secured party under Section 1-301 to control the law applicable to an independent transaction or relationship between the debtor and an account debtor."<sup>19</sup> The district court in *Landress* cited none of these provisions.

### WHAT LAW DOES GOVERN ATTACHMENT?

The discussion above is not meant to suggest that the law chosen in a security agreement to govern the parties' relative rights is never relevant in determining whether a security interest attaches. If there were, for example, a dispute about whether a security agreement contains a sufficient description of the collateral at issue,<sup>20</sup> or a dispute about what obligations the collateral secures,<sup>21</sup> it would be perfectly appropriate to resolve the issue by looking to the law chosen in the security agreement.

But attachment of a security interest also requires that the debtor have either rights in the collateral or the power to transfer rights in the collateral to a secured party.<sup>22</sup> If there is an issue about whether the debtor has such rights or power, one must look the law that governs the transaction or event pursuant to which the debtor purportedly acquired such rights or power.

Thus, for example, if the proffered collateral were goods associated with real property and the issue were whether the goods were fixtures – to which an Article 9 security interest could attach – or ordinary building materials incorporated into an improvement on land – to which no Article 9 security interest can attach, that issue would be governed by the law of the jurisdiction where the goods are located, not by whatever law the parties to the security agreement might happen to choose.<sup>23</sup> If the proffered collateral were goods that the debtor had purchased in a domestic transaction, one would need to examine U.C.C. Article 2 – as enacted in the jurisdiction whose law governed the purchase – to determine whether the debtor had the rights or power necessary to grant a security interest.

If the debtor purported to grant a security interest in property acquired through gift or inheritance, the law governing that gift or inheritance – not the law chosen in the security agreement – would need to be consulted. If the debtor's power to convey rights hinged on whether the debtor was the agent of someone else with rights, the law governing the alleged agency relationship would have to be consulted.<sup>24</sup>

Perhaps more telling are illustrations involving collateral other than goods. If the collateral were a liquor license, the law of the issuing state would determine whether the debtor had the rights or power needed to grant a security interest.<sup>25</sup> It is inconceivable that the law of some other state should intervene merely because that was the law chosen in the security agreement. Indeed, in none of the numerous cases involving a security interest in a liquor license did the court ever entertain the notion that some other state's law might apply, although it is not clear that the choice-of-law issue was raised in any of those cases.<sup>26</sup> The same is true when the collateral consists of a state lottery prize. All courts dealing with whether a security interest attached to a prize winner's annuity payments looked only to the law of the state governing the prize; there was no hint that the law chosen to govern the secured transaction – which was different from the law of the prize-awarding state – might be applicable.<sup>27</sup>

Applying this principle to the issue in *Landress*, if there is an issue about whether the debtor has sufficient rights or power to grant a security interest in an interest in a partnership or limited liability company, one must look to the law governing the partnership or limited liability company. This is so not because the issue necessarily involves the internal affairs of the entity, but because the law of that jurisdiction governs the debtor's rights and power with respect to the interest.

Moreover, this approach makes good sense. After all, the law governing a partnership agreement or operating agreement is the only germane body of law that can be known to and anticipated by all relevant parties.<sup>28</sup> In the *Landress* case, for example, the prospective lender could easily have reviewed the partnership agreement and consulted Delaware law before advancing funds, but Mason's fellow partners could not have consulted and planned around New York law, let alone every other state's law that Mason and some lender might later designate in their security agreement.

#### ADVICE TO TRANSACTIONAL LAWYERS

Despite the ruling in *Landress*, transactional lawyers representing prospective secured parties should not assume that the law chosen to govern the secured transaction will apply to determine whether the security interest has attached, at least not if there is an issue about whether the debtor has rights in or power to transfer the collateral. In particular, if the collateral is to include the debtor's rights in a partnership or limited liability company, the lawyer should obtain a copy of the most current partnership or operating agreement and carefully review it for any restriction on the debtor's right to grant a security interest. If there is such a restriction, the lawyer should determine whether the restriction is enforceable under the law that governs the partnership or operating agreement (*i.e.*, the law of the jurisdiction of organization).<sup>29</sup> Even if there is no restriction in the organizational documents, the lawyer should determine

whether the jurisdiction of organization has any statutory restrictions that might prevent the security interest from attaching.

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#### Notes:

1. [2020 WL 561893](#) (E.D.N.C.), *appeal filed*, (4th Cir. Feb. 6, 2020).
2. Carl S. Bjerre & Stephen L. Sepinuck, *Spotlight, Commercial Law Newsletter 11* (March 2020).
3. *See* U.C.C. § 9-408(a).
4. *See* U.C.C. § 9-102(a)(3) (defining “account debtor” to mean “a person obligated on an account, chattel paper, or general intangible”).  
Correlatively, the other partners or members, for whose benefit the restriction operates, are not account debtors because even though they might owe duties to the partner or member, those duties are not with respect to – and hence are not “on” – the partner's or member's ownership interest. *See* *Newcombe v. Sundara*, [654 N.E.2d 530](#) (Ill. Ct. App. 1995) (concluding that former U.C.C. § 9-318(4) did not apply to override a transfer restriction in a limited partnership agreement that required the general partner to consent to a limited partner granting a security interest in his limited partnership interest, because the general partner was not an “account debtor” under former Article 9). *Cf.* *In re Mason*, [600 B.R. 765](#), 773 n.10 (Bankr. E.D.N.C. 2019) (noting this reasoning but taking no position on it).
5. *See* [Ala. Code § 10A-5A-1.06\(e\)](#); [Colo. Rev. Stat. § 7-90-104](#); [Del. Code tit. 6, §§ 9-408\(e\)\(4\), 15-104\(c\), 15-503\(f\), 17-1101\(g\), 18-1101\(g\)](#); [Ky. Rev. Stat. §§ 275.255\(4\), 362.1-503\(7\), 362.2-702\(8\)](#); [Tex. Bus. & Com. Code § 9.408\(e\)](#); [Va. Code §§ 8.9A-406\(k\); 8.9A-408\(g\), 13.1-1001.1\(B\), 50-73.84\(C\)](#).
6. The amendments are available on the ALI's [web page](#) for the UCC. For further discussion of the amendments and the issues underlying them, see Carl S. Bjerre, Daniel S. Kleinberger, Edwin E. Smith & Steven O. Weise, *LLC and Partnership Transfer Restrictions Excluded From UCC Article 9 Overrides*, [BUSINESS LAW TODAY](#) (February 2019).
7. *In re Mason*, [600 B.R. at 773](#).
8. *See* [Restatement \(Second\) of Conflict of Laws § 302\(2\)](#).
9. *In re Mason*, [600 B.R. at 773–76](#) (relying on [Del. Code Ann. tit. 6, § 15-503\(f\)](#)).

10. [2020 WL 561893](#), at \*3.
11. Although the court did not cite to it, the court implicitly relied on U.C.C. § 1-301(a), which generally provides freedom of contract for governing-law clauses.
12. [2020 WL 561893](#), at \*4. The court concluded that the result would be the same if New York’s version of § 9-408 applied. *Id.*
13. The internal affairs doctrine probably does apply to the purported grant of a security interest in a partnership or membership interest – because that could affect the operation of and control of the entity – but probably does not apply to the purported grant of a security interest in Mason’s right to “dividends and distributions payable.”
14. *See* U.C.C. §§ 9-301 – 9-307.
15. U.C.C. § 9-301 cmt. 2.
16. U.C.C. § 1-301(a).
17. *See, e.g.*, Northwest Bank v. McKee Family Farms, Inc., [732 F. App’x 620](#) (9th Cir. 2018) (a bank that had a security interest in a seed licensee’s existing and after-acquired crops did not have a security interest in seed crops grown by independent growers; even though the license agreement expressly stated that, as between the owner of the variety and the licensee, the licensee was the owner, the growers were not a party to that agreement; although some of the agreements with the growers specified that ownership of the seed remained with the licensee, those agreements were not signed until after the crop was harvested, and the crop was never delivered to the licensee or its agent).
18. U.C.C. § 9-301 cmt 2.
19. U.C.C. § 9-401 cmt. 3.
20. *See* U.C.C. §§ 9-108 & 9-203(b)(3)(A) (collectively providing that a security agreement must contain a reasonable description of the collateral).
21. Section 9-203 does not expressly require that the security agreement identify the secured obligation; it states merely that value must have been given. *See* U.C.C. § 9-203(b)(1). However, § 9-203 does require that there be a “security agreement,” and that term is defined as “an agreement that creates or provides for a security interest,” U.C.C. § 9-102(a)(74), and “security interest” is defined as “an interest in personal property or fixtures which secures payment or performance of an obligation,” U.C.C. § 1-201(b)(35). Hence, a security agreement must identify the obligation secured.
22. *See* U.C.C. § 9-203(b)(2).
23. *See* U.C.C. § 9-334(a). *Cf.* In re Motors Liquidation Co., [2019 WL 387334](#) (Bankr. S.D.N.Y. 2019) (a security agreement describing the collateral as all “equipment and fixtures” now

owned or at any time hereafter acquired, and which adopted the definitions used in the state where the fixtures were located, did not encumber fixtures previously attached to a Louisiana facility because: (i) the security agreement expressly excluded property to the extent that the grant of a security interest in it is prohibited by applicable law; and (ii) Louisiana law defines fixtures differently from the U.C.C., as a component of immovable property, so that fixtures in Louisiana are real property, not goods, and thus a security interest in existing fixtures cannot be created under Article 9).

24. *Cf.* Zaremba Group, LLC v. FDIC, [2011 WL 721308](#) (E.D. Mich. 2011) (looking at Michigan law to conclude that the husband of managing member of a Michigan LLC had no apparent authority to grant bank a security interest in LLC’s certificates of deposit because apparent authority must arise from acts of the principal, not the agent, and the LLC did nothing other than make the initial deposit shortly after the husband said it would occur). *Cf.* Hepp v. Ultra Green Energy Servs., LLC, [2015 WL 1952685](#) (N.D. Ill. 2015) (refusing to apply the Illinois Limited Liability Company Act to determine whether the managing member of a Delaware LLC had actual or apparent authority to bind the LLC to a note and security agreement; applying instead the Illinois common law of agency because the parties agreed that it applied).

25. In re Circle 10 Restaurant, LLC, [519 B.R. 95](#), 128 (Bankr. D.N.J. 2014) (“the question of whether Debtor’s [New Jersey] Liquor License or the proceeds resulting from its sale are subject to [the secured party’s] lien is one of New Jersey state law”).

26. *E.g.*, In re Orama Hospitality Group, Ltd., [601 B.R. 340](#) (Bankr. D.N.J. 2019) (a landlord did not have a security interest in the tenant’s New Jersey liquor license because New Jersey law does not permit one); Semark Associates, LLC v. RCL, LLC, [2019 WL 1294831](#) (Pa. Super. Ct. 2019) (the trial court improperly awarded summary judgment against a secured party claiming a security interest in a liquor license because the record did not establish when Liquor Control Board approved the transfer to the debtor, such that the debtor would have rights in the license so that a security interest could attach); In re B & M Hospitality LLC, [584 B.R. 88](#) (Bankr. E.D. Pa. 2018) (a liquor license is property under Pennsylvania law and a creditor’s security interest did attach to it); In re Delano Retail Partners, LLC, [2017 WL 3500391](#) (Bankr. E.D. Cal. 2017) (a lender did not have a security interest in the proceeds of the debtor’s California liquor license because a liquor license is not property of the licensee under California law, and hence no security interest can attach to it); In re Circle 10 Restaurant, LLC, [519 B.R. 95](#) (a New Jersey liquor license is not property under New Jersey law, and hence no security interest can attach to it); In re Ciprian Ltd., [473 B.R. 669](#) (Bankr. W.D. Pa. 2012) (a Pennsylvania liquor license is personal property under Pennsylvania law and a reference to “general intangibles” in the



security agreement’s description of the collateral was sufficient to encumber the license); In re Jojo’s 10 Restaurant, LLC, [455 B.R. 321](#) (Bankr. D. Mass. 2011) (Massachusetts law gives a licensee limited property rights in a Massachusetts liquor license – and the ability to pledge the license – only if the pledge is approved by the licensing authority; because no approval was granted in this case, the debtor had no property rights in the license and no security interest attached to it); In re S & A Restaurant Corp., [2010 WL 3619779](#) (Bankr. E.D. Tex. 2010) (because New Jersey law prohibits liens on New Jersey liquor licenses, a landlord did not acquire a security interest in the tenant’s liquor licenses); Bischoff v. LCG Blue, Inc., [2009 WL 148519](#) (Cal. Ct. App. 2009) (under California law, no security interest can attach to a California liquor license); Banc of America Strategic Solutions, Inc. v. Cooker Restaurant Corp., [2006 WL 2535734](#) (Ohio Ct. App. 2006) (no security interest can attach to an Ohio liquor license because such a license is not property under Ohio law); In re Chris-Don, Inc., [367 F. Supp. 2d 696](#) (D.N.J. 2005) (a New Jersey liquor license is not property to which a security interest may attach under New Jersey law). Cf. Concorde Equity II, LLC v. Bretz, [2011 WL 5056295](#) (Cal. Ct. App. 2011) (although California law prohibits the granting of a security interest in a California liquor license, the lender’s security interest could and did attach to the proceeds of a liquor license sold by a court-appointed receiver).

27. For example, in Stone Street Cap., LLC v. California State Lottery Comm’n, [80 Cal. Rptr. 3d 326](#) (Cal. Ct. App. 2008), the court examined whether *California’s* commercial code overrode the state’s restriction on the assignment of lottery winnings, even though the assignment was created under Arizona law. Apparently, no one even suggested that the issue should be decided under Arizona law. Similarly, in Texas Lottery Comm’n v. First State Bank of DeQueen, [325 S.W.3d 628](#) (Tex. 2010), the court examined whether the *Texas* commercial code invalidated that state’s restriction on the assignment of lottery winnings, even though the alleged the assignment was created under Arkansas law. Again, no one suggested that Arkansas law did or could apply to the issue. See also Clark v. Missouri Lottery Comm’n, [463 S.W.3d 843](#) (Mo. Ct. App. 2015) (a bank obtained a security interest in individual’s right to future distributions of a Missouri lottery prize, despite a Missouri statute prohibiting the assignment of lottery proceeds, because Missouri’s § 9-406 provides otherwise, expressly purports to prevail in the event of conflict with other law, and thus overrides that statute).

28. Cf. James M. Wilson & William A. McGee, *The Past and Future of Debt Recharacterization*, [74 BUS. LAW. 91](#), 110–12 (2018) (suggesting that, to provide certainty, the law of the jurisdiction in which a business entity is organized should govern whether a loan to the entity should be recharacterized as equity, but only if the transaction documents lack an enforceable selection).

29. It is worth noting that if the partnership interest or membership interest constitutes a security – as it would if such interests are traded on securities exchanges or in securities markets or if the entity has opted into Article 8 of the Uniform Commercial Code, see U.C.C. § 8-103(c) – then neither § 9-406 nor § 9-408 would override any restriction on assignment.



## Recent Cases

### SECURED TRANSACTIONS

#### *Attachment Issues*

*The Mostert Group, LLC v. Mostert*,  
[2020 WL 1846884](#) (Ky. 2020)

Although the term “software” might, in other contexts, include source code, the term did not do so in the security agreement that a newly formed limited liability company executed in favor of one of its members because the parties had differentiated “software” from “source code” in a contemporaneously executed agreement under which the individual contributed “software programs and source codes” to the company.

*In re Porter*,  
[2020 WL 1860105](#) (Bankr. D.N.M. 2020)

A credit union’s security interest in a vehicle, granted by two co-owners, also secured two later obligations incurred by one of the co-owners because the agreements for all three transactions stated that “the security interest also secures any other loans . . . you have now or receive in the future from us.”

*Wells Fargo Bank v. Highland Constr. Mgmt. Servs., L.P.*,  
[2020 WL 1514771](#) (4th Cir. 2020)

A debtor that granted a lender a security interest in “50% of [the debtor’s 20%] membership interest” in an LLC thereby granted a security interest in only 10% of the membership interest. Although a later amendment to the security agreement contained a recital stating that the debtor agreed to increase the security interest to “50% of [the debtor’s] interest in [the LLC], which the parties agree is equal to sixteen percent (16%),” and the debtor was the half owner of another limited liability company that had a 24% interest in the LLC – and 50% of 50% of 24% explains the additional 6% – recitals are not binding and the fact remains that the debtor did not own and could not grant a security interest in property owned by the limited liability company.

*In re Clinkerbeard,*

[2020 WL 1517932](#) (Bankr. D. Kan. 2020)

Loan documents executed by the sole member of an LLC in his individual capacity were ineffective to grant a security interest in a truck titled in the name of the LLC.

*Pharmacy Corp. of America/Askari Consolidated Litigation,*

[2020 WL 1964175](#) (D. Del. 2020)

An operating agreement that required the assent of members holding at least 75% of the interests in the company to grant a security interest was not necessarily violated when a \$10 million secured loan, which had been approved by the requisite percentage, was later amended to increase the maximum amount to \$64 million. The agreement prohibited the granting of a security interest – *i.e.*, the creation of an encumbrance – without the requisite assent, but increasing the secured obligation did not involve the grant of a security interest.

### **Perfection Issues**

*In re Rancher's Legacy Meat Co.,*

[2020 WL 2026624](#) (D. Minn. 2020)

A secured party that filed an amendment to its financing statement more than four months after the debtor changed its name, and hence after the financing statement lapsed as to collateral acquired more than four months after the name change, did not thereby re-perfect as to such collateral. The secured party could have re-perfected by filing a new financing statement, but did not.

*In re Scorpion Fitness Inc.,*

[2020 WL 2529357](#) (Bankr. S.D.N.Y. 2020)

A secured party with a security interest in substantially all of the debtor's assets, and which security interest was perfected by a filed financing statement, had a perfected security interest in insurance proceeds of some of the collateral even though the secured party was not named as "loss payee" in the insurance policies. The financing statement covered all assets and "all proceeds (including insurance proceeds) from the sale, destruction, loss or other disposition of any of the Collateral."

### **Priority Issues**

*In re Richard M. Judy Family Trust,*

[2020 WL 1492773](#) (Bankr. W.D. Mo. 2020)

A lender with a perfected PMSI in an item of equipment destroyed by fire had priority in the portion of the insurance proceeds attributable to the item over a bank with a perfected security interest in all equipment, even though the bank was listed as the loss payee on the insurance policy. The bank's status as loss payee gave the bank no greater priority in the proceeds than the bank had in the equipment itself.

### **Enforcement Issues**

*Factor King, LLC v. Housing Auth. for the City of Meridian,*

[2020 WL 2602206](#) (Conn. Ct. App. 2020)

A factor that bought two of the debtor's accounts and had a back-up security interest the remainder of the debtor's accounts was not an "assignee" of the remainder of the accounts and had no right to collect such accounts from the account debtors, especially given that there was no evidence that the debtor had defaulted. The decision fails to cite new [PEB Commentary #21](#), which is to the contrary.

*Airpro Mobile Air, LLC v. Prosperity Bank,*

[2020 WL 2537196](#) (Tex. Ct. App. 2020)

A bank conducted a commercially reasonable private disposition of collateral even though the collateral was in the possession of a landlord who claimed a superior lien and who denied the bank the ability to inspect, manage, market, or appraise the collateral. The landlord's actions did not obviate the requirement that the disposition be commercially reasonable but were relevant in determining whether the bank's conduct complied with that standard. The bank assigned one of its employees, who had over 35 years of foreclosure experience to conduct the disposition, and was reasonable in concluding that, because of the landlord's interference, it was impractical to hire outside help or to advertise the disposition. The sales price of \$17,500 was reasonable despite the fact that the buyer later resold some of the property for \$60,000. Although the disposition was conducted a year before the bank's lawsuit against the landlord was settled, the timing was reasonable given that a substantial portion of the collateral was already obsolete.

## **BANKRUPTCY ISSUES**

### **Claims & Expenses**

*In re Firestar Diamond, Inc.,*

[2020 WL 1934896](#) (Bankr. S.D.N.Y. 2020)

A claim subject to disallowance under § 502(d) remains subject to disallowance after transfer. It does not matter whether the transfer is by way of assignment or sale.

*In re Thomas,*

[2020 WL 2569993](#) (Bankr. W.D. Tenn. 2020)

The debtor's interest in a single-member, Tennessee LLC – including both his financial rights and governance rights – became property of the estate. Although the Tennessee Revised Limited Liability Act provides that a member's interest terminates, and the member loses all governance rights, when the member files a bankruptcy petition, that rule is preempted by § 541(c). Moreover, because the debtor's governance rights are exercised for the benefit of the debtor, not the LLC, such rights are not excluded from the estate by § 541(b)(1). Because the LLC is member-managed, the right to manage the LLC passed to the trustee.

**Avoidance Powers***In re Hutchinson,*[2020 WL 2112275](#) (E.D. Cal. 2020)

Although the five federal tax liens on the debtors' real property secured taxes and interest that exceeded the value of the property, the bankruptcy court did not err in denying a motion to abandon the property. The tax liens also secured penalties and, to that extent, the liens could be avoided and preserved for the benefit of the estate. Moreover, the government could not aggregate the amount of taxes and interest secured by the five liens before accounting for the penalties, but instead had to deal with each lien in the order in which it was perfected. As a result, some of the avoided liens preserved value for the estate, and thus the property was not of inconsequential value to the estate.

*Blue Sky Real Estate, LLC v. Sunrise Banks,*  
[2020 WL 2119256](#) (Minn. Ct. App. 2020)

A bank that sold a promissory note secured by a mortgage was not liable to the buyer for breach of warranty, and the transaction could not be rescinded due to mutual mistake, even though the note makers' liability had been discharged in bankruptcy and the mortgage was allegedly unenforceable due to the bank's filing of an unsecured claim. The bank warranted only that it had made no prior assignment of and was the sole owner of the note and mortgage, that it had the power to make the assignment, and the amount of the outstanding balance. The bank expressly disclaimed any representation or warranty regarding the enforceability or collectability of the note and mortgage.

**LENDING, CONTRACTING & COMMERCIAL LITIGATION***Golden State Bank v. Monterey County Bank,*[2020 WL 2537451](#) (Cal. Ct. App. 2020)

A term in a loan participation agreement requiring arbitration of “[a]ny and all disputes, controversies and claims arising out of or relating to this Agreement or its performance,” did not cover a participant’s claim against the originator for the originator’s actions, after the lenders acquired the real property collateral at a nonjudicial foreclosure, that related to the property and which allegedly benefitted the originator and harmed the participants. The participation agreement addressed duties relating to the funding and administration of the loan; it did not address the manner in which the property would be managed after a nonjudicial foreclosure. Although the participation agreement did specify that the originator would make all decisions regarding the “administration and disposition of acquired security,” that language dealt with the collateral, and the real property ceased to be collateral after the foreclosure.

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