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LENDER’S “SACRED RIGHTS” UNDER CREDIT AGREEMENT DID NOT PREVENT LENDER FROM BECOMING A SACRIFICIAL LAMB

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Newsletters and client alerts are abuzz with the news that, on June 19, 2020, the Supreme Court of New York (for New York County) refused to preliminarily enjoin a loan restructuring that would have the effect of subordinating a dissenting minority of existing lenders, after concluding that those lenders were unlikely to succeed on the merits of their claims.¹ This article explains what went wrong for those lenders and what transactional lawyers can do to protect their lender clients in future transactions.

The Case

In 2016, Serta, the mattress manufacturer, borrowed \$1.95 billion from a group of lenders.² The Credit Agreement between the debtor and the various lenders contains a typical clause requiring that all payments received on the loan, and all proceeds of collateral, be shared on a pro rata basis.³ It further provides that, if any lender receives payment on account of its loans in a proportion greater than that received by others, the excess value must be shared ratably among the other lenders.⁴

While most provisions of the Credit Agreement may be amended with the consent⁵ of lenders holding a majority of the loan, the Credit Agreement protects six lender rights – referred to by counsel as “sacred rights” – by barring any amendment that, without the consent of the adversely affected lender,

would: (i) increase the lender’s commitment to extend credit; (ii) reduce the principal amount owed or the amount of any installment due to the lender; (iii) extend the maturity date; (iv) reduce the interest rate; (v) extend the expiry date of the lender’s commitment; or (vi) alter the requirement that receipts be shared pro rata.⁶

After Serta encountered financial difficulties, it announced its intention to enter into a restructuring transaction with lenders owning a majority of the loan. Under this restructuring, Serta would incur approximately \$1.1 billion of new debt,⁷ to which the existing loan would be contractually subordinated, both in terms of payment and in lien priority. Serta would use the loaned funds to acquire, in open market transactions, the \$1.5 billion portion of the existing loan owned by the majority of the lenders. Such open market transactions are expressly exempted from the requirement that receipts be shared pro rata.⁸ In essence, the majority lenders participating in the restructuring would give up about \$400 million in debt but receive priority over the other lenders in the group.

Lenders owning approximately 30% of loan – and who had been excluded from the restructuring⁹ – sued Serta and the majority lenders, asserting causes of action for breach of contract, breach of the implied covenant of good faith, and tortious interference with contract.¹⁰

The Court’s Ruling

The plaintiffs focused on the waterfall provision of the Credit Agreement, which requires that receipts be shared pro rata, and the requirement that any adversely affected lender consent to an amendment that alters the requirement of pro rata sharing.¹¹ However, as the court observed, the plaintiffs “fail[ed] to address the exceptions in the waterfall provision.” Specifically the exception permits debt-to-debt exchange on a non-pro rata basis as part of an open market transaction,¹² and thus the proposed transaction does not appear to violate the waterfall. Moreover, because the proposed amendments to the Credit Agreement do not affect plaintiffs’ “sacred rights,” the plaintiffs’ consent was not required.¹³ Accordingly, the court concluded that the plaintiffs had not demonstrated a likelihood of success on the merits on their breach-of-contract claim.¹⁴ The court then further supported its decision not to issue a preliminary injunction by noting that the plaintiffs had not established irreparable harm, because money damages would be available, and in balancing the equities, “the harm to defendants in delaying this deal exceeds that to the plaintiffs.”¹⁵

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Advice to Transactional Lawyers

The court's decision seems to be a correct interpretation of the Credit Agreement. Nevertheless, it permits borrowers and a select group of favored lenders to consummate priming transactions that circumvent the pro rata distribution requirement in existing credit agreements, at least if the existing debt is traded in open market transactions. Transactional lawyers representing lenders should, at a minimum, advise their clients of this risk. They should also consider ways to reduce or eliminate the risk of such a priming transaction. Several options come to mind.

First, the list of "sacred rights" – the rights terms of a credit agreement that cannot be amended without the consent of every adversely affected lender – could be expanded to include a right against subordination of the debt, the liens securing it, or both.¹⁶ This approach has a drawback, however. As with any provision designed to protect lenders holding a minority of the debt, such a term could be used as a sword rather than a shield. It would give each lender the power to block a restructuring, and thereby extort special treatment. A middle option, such as a requiring a two-thirds majority to agree to a subordination, might lessen this risk. On the other hand, that middle approach is arguably subject to abuse in both directions. It would allow a supermajority to prime a small minority while also allowing a large minority to extort concessions from the majority.

A slightly more nuanced approach would be to require all adversely affected lenders to consent to subordination only if the priming loan is held by other lenders in the group or their affiliates. If the priming loan is made by unrelated parties, the normal rules on amending the credit agreement would apply. This would allow lenders holding a majority of the loan to consent to true third-party financing, but not allow them to structure a priming transaction that bypassed the pro rata waterfall provision.¹⁷

A third approach would be to provide in the credit agreement that all existing lenders in the credit facility have the right to participate on equal terms in any new loan, at least if the existing loan will be subordinated to the new loan. This should protect all lenders from being primed without their consent, at least if the lenders and their affiliates have the financial wherewithal and internal authority to provide the new loan.

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Notes:

1. See *North Star Debt Holdings, L.P. v. Serta Simmons Bedding, LLC*, [2020 WL 3411267](#) (N.Y. Sup. Ct. June 19, 2020).

2. The loan was a first-lien term loan. At the same time, Serta borrowed \$450 million under a second-lien term loan and entered into a \$225 million asset-based revolving credit facility. The case concerns only the first-lien term loan. Complaint ¶ 39.

3. Credit Agreement § 2.18(a), (b).

4. Credit Agreement § 2.18(c).

5. Like most such agreements, the Credit Agreement refers to "consent" to an amendment or modification. *Id.* § 9.02. Contract law would suggest, however, that an amendment or modification requires a manifestation of mutual "assent," not consent. See RESTATEMENT (SECOND) OF CONTRACTS § 17.

6. Credit Agreement § 9.02(b).

7. The new debt consisted of: (i) \$200 million tranche of newly funded first-out debt; (ii) \$875 million of second-out debt, into which holders providing the new money tranche could exchange their existing first lien and second lien term loans at specified discounts (apparently in one or more open market transactions), thus reducing Serta's overall debt load; and (iii) an unspecified amount of third-out debt to be used for future discounted exchanges of first lien and second lien term loans. [2020 WL 3411267](#), at *4.

8. Credit Agreement § 9.05(g).

9. The plaintiffs were, apparently, not participants in the original loan. Instead, they allegedly acquired their portions of the loan only three months earlier at deeply discounted prices. Lender Defendants' Memorandum of Law in Opposition to Plaintiffs' Application for a Temporary Restraining Order, Preliminary Injunction, and Expedited Discovery at 1. Moreover, during that three-month period, the plaintiffs had allegedly proposed a "predatory financing transaction" that would have captured for themselves the most valuable collateral. *Id.*

10. Complaint ¶¶ 76-92. The Complaint also asserted a claim for tortious interference with prospective economic relations and two claims for a declaratory judgment. *Id.* ¶¶ 93-108.

11. [2020 WL 3411267](#), at *2.

12. *Id.* at *4.

13. *Id.*

14. *Id.* With respect to the claim for breaching the implied covenant of good faith, the court ruled that the covenant cannot be construed so as to effectively nullify the express terms of the agreement. *Id.* at *5.

15. *Id.* at *5-6.

16. Several law firms with client alerts about the *Serta* case have suggested this. See, e.g., Matthew D. O'Meara & Sean T. Scott, [Serta Simmons \(Can Secured Lenders Sleep Well at](#)

Night? (Mayer Brown June 29, 2020) (suggesting that lenders consider “includ[ing] a provision prohibiting any subordination of the claims or liens granted to the lenders without the consent of each lender, or a super-majority (66 ⅔ percent), of lenders.”); Jeffrey E. Ross, Sunil William Savkar, Scott B. Selinger & Ramya S. Tiller, *NY State Court Refuses to Enjoin Serta’s Priming Credit Agreement Amendment* (Debevoise & Plimpton June 24, 2020) (“The argument that the lack of an anti-subordination clause in the credit agreement made the transaction possible is likely to make such clauses more prevalent.”).

17. Transactional lawyers following this approach should carefully review the credit agreement’s definition of “affiliate” to ensure that it is appropriate with respect to this provision about priming loans.



Recent Cases

SECURED TRANSACTIONS

Attachment Issues

Diversified Demolition, LLC v. Rosebird Properties, LLC,
[2020 WL 3124684](#) (Ky. Ct. App. 2020)

An oral agreement, memorialized via text messages, to consign goods removed from a building in connection with a demolition project did not create a security interest in favor of the consignor because the text messages did not contain enough information to allow the collateral to be reasonably identified.

Landcastle Acquisition Corp. v. Renasant Bank,
[2020 WL 3410348](#) (N.D. Ga. 2020)

Factual disputes prevented summary judgment on whether an individual who owned 50% of a corporation that was the sole member of an LLC had authority to pledge the LLC’s certificate of deposit to secure a personal loan to the individual. Although the articles of incorporation provide that no director can cause the corporation to guaranty the obligation of a person without a vote of the majority of the shareholders, the state LLC statute provides that a manager of an LLC lacking actual authority can nevertheless bind the LLC in connection with a transaction conducted in a way the business affairs of the LLC are usually conducted or if the other party has no knowledge that the manager lacks authority. In this case, there were factual disputes about both whether the transaction was carried on in the usual way for the LLC and whether the lender knew of the individual’s lack of corporate authority.

CHS Capital LLC v. Lena Farms Partnership LLC,
[2020 WL 3638806](#) (Minn. Ct. App. 2020)

Although an agricultural lender’s security interest in crops granted by two brothers and their various entities was not limited to crops grown on real property owned by the brothers and their entities, the security interest might not have attached to crops grown on property that the brothers and their entities leased to others. The leases were cash-rent agreements, not crop-share agreements, and thus the brothers and their entities did not own crops planted by their tenants. However, factual disputes about who planted the crops required further determinations by the trial court.

Perfection Issues

Ratcliff v. Rancher’s Legacy Meat Co.,
[2020 WL 4048509](#) (D. Minn. 2020)

A secured party that filed an amendment to its financing statement several years after the debtor changed its name, and after filing a continuation statement that did not amend the debtor’s name, retained a perfected security interest in collateral acquired by the debtor before or within four months after the name change and likely perfected its security interest in collateral acquired more than four months after the name change. The original financing statement never lapsed. Although there was a gap in perfection as to collateral acquired more than four months after the name change, and this gap might have allowed other secured parties to obtain priority with respect to that collateral, the secured party was entitled to a stay of the bankruptcy court’s lien avoidance order and sale order, so as to allow the secured party to credit bid at a pending sale of the collateral.

Priority Issues

Agrifund, LLC v. Regions Bank,
[2020 WL 3097425](#) (Ark. 2020)

A bank that financed a farmer’s 2014 operations under three partnerships, and had a perfected security interest in existing and after acquired crops, had priority in the proceeds of 2015 crops even though a different lender financed the farmer’s 2015 operations under three different partnerships and had a perfected security interest in the 2015 crops. All of the partnerships were mere shams and alter egos of the farmer and it would be inequitable to allow the bank to go unpaid when it had refused to subordinate its interest, there had been no change in operator, and the new lender knew of the bank’s security interest.

Nelson v. Project Spokane, LLC,
[2020 WL 3470311](#) (D. Mont. 2020)

A secured party with a junior security interest was entitled to a preliminary injunction prohibiting the secured parties with senior security interests from disposing of the collateral while the junior secured party's action for subordination is litigated. The debtor had promised that the junior secured party would have a first-priority lien and the senior secured parties, one of whom was the CEO of the debtor and the other was owned by the CEO, were allegedly alter egos of the debtor and might be bound by promissory estoppel to the debtor's promise.

Enforcement Issues

Russell v. Santander Consumer USA, Inc.,
[2020 WL 3077944](#) (E.D. Wis. 2020)

A repossession company and its company's agent were liable to the debtors under the Fair Debt Collection Practices Act and both of them and the secured party were liable to the debtors under the Wisconsin Consumer Act for breaching the peace during a repossession. Although the agent ceased repossession efforts and withdrew when one of the debtors objected and allegedly threatened the agent with a gun, the agent then contacted police and repossessed the vehicle while the debtor was in custody. Even assuming that a secured party need not pursue judicial remedies after the debtor objects to a repossession, waiting merely 30 minutes to try again is not long enough to calm emotions and reduce the threat of violence.

D2 Mark LLC v. ORE VI Investments, LLC,
[2020 WL 3432950](#) (N.Y. Sup. Ct. June 23, 2020)

A secured party's planned public sale of the equity in an entity that indirectly owned a hotel, valued in excess of \$400 million, would be stayed for 30 days. The debtor had demonstrated a likelihood that the sale, on 36 days' notice, would not be conducted in a commercially reasonable manner. Although consultants for the secured party had: (i) contacted 700 potential bidders; (ii) created a virtual data room with over 100 documents relating to the collateral, which 115 entities had signed nondisclosure agreements to access; and (iii) advertised the sale in the Wall Street Journal for a week and in a trade magazine, only two of the 115 entities had submitted documentation proving the financial ability to bid, and the 36 days' notice was probably unreasonably short during a global pandemic, given that the hotel was closed for 27 of those days, making inspection impossible.

Hanna v. Ivy Funding Co.,
[2020 WL 4220445](#) (N.D. Tex. 2020)

The debtor's claims against the secured party arising from an altercation with a repossession agent during repossession and for repossessing the collateral after the secured obligation had

been paid off were subject to arbitration. Although the debtor's claims against the repossession company were, pursuant to the debtor's agreement with the secured party, subject to arbitration at the option of the repossession company, the repossession company had not elected to arbitrate those claims. Accordingly, those claims would be stayed pending arbitration of the claims against the secured party.

Liability Issues

GlobalTranz Enterprises, Inc. v. PNC Bank,
[2020 WL 3469114](#) (Del. Super. Ct. 2020)

A secured party that allegedly either acquiesced in or encouraged the debtor to use the services of a freight broker without disclosing the debtor's poor financial condition to the broker, and which then realized the benefit of those services when the debtor's assets were sold off, had no unjust enrichment liability to the broker. Only in unusual circumstances is a secured party liable in unjust enrichment to an unsecured creditor of the debtor. The freight broker began providing services to the debtor years before the secured party allegedly spearheaded the debtor's breakup, and therefore the broker could not allege that the secured party initiated the transaction. Mere acquiescence to the transactions is insufficient to upend Article 9's priority rules, and the freight broker's services were not necessary to preserve the collateral.

LENDING, CONTRACTING & COMMERCIAL LITIGATION

Crystal Foods Corp. v. B & K Equipment Co.,
[2020 WL 2893432](#) (Ind. Ct. App. 2020)

A contract for the sale and installation of an underground tank, which provided that "[n]o . . . warranties are either expressed or implied, including the warranty of merchantability and fitness for a particular purpose," disclaimed only warranties associated with a sale of goods, not with the services provided, and thus did not entitle the seller/installer to summary judgment on a breach of contract claim for installing inappropriate backfill.

Maslowski v. Prospect Funding Partners, LLC,
[2020 WL 2893376](#) (Minn. 2020)

A litigation funding agreement did not violate Minnesota's public policy against champerty and hence was enforceable. Due to changes in the legal profession and in society, the ancient prohibition against champerty is no longer necessary.

Raffel Systems, LLC v. Man Wah Holdings Ltd.,
[2020 WL 3211684](#) (E.D. Wis. 2020)

The owner of a patent had standing to bring an infringement action even though the owner had granted a security interest in the patent and the secured party had perfected by filing with the Patent and Trademark Office. The grant of the security interest was not an "assignment" within the meaning of the Patent Act and did not transfer title to the patents.

Cambridge Valley Machining, Inc. v. Hudson MFG LLC,
[2020 WL 3610244](#) (N.D.N.Y. 2020)

Email messages from a managing member of a buyer of goods, asking if the seller needed anything further from the buyer to reach production targets and whether the seller was confident that it would be able to meet release schedules, did not constitute demands for adequate assurance of future performance because the messages made no reference to the U.C.C., did not track the language of § 2-609, and did not contain any clear statement that, absent assurances, the buyer would withhold performance. Consequently, the seller did not repudiate the contract by failing to provide assurances.

Barnes v. Routh Crabtree Olsen PC,
[2020 WL 3527088](#) (9th Cir. 2020)

A judicial foreclosure of a residential deed of trust was not a form of debt collection regulated by the Fair Debt Collection Practices Act because applicable state law does not permit a deficiency judgment and thus the plaintiff and its attorneys were merely enforcing the lien on the collateral, not seeking payment of the debt.



Describing Collateral by Quantity, Formula, or Procedure

Stephen L. Sepinuck

For a security interest to attach to personal property as collateral, Article 9 of the Uniform Commercial Code generally requires the debtor to authenticate a security agreement “that provides a description of the collateral.”¹ But the description need not be specific; the baseline rule is that the description need only “reasonably identif[y]” the collateral.² Article 9 then provides six safe harbors: that is, six methods of describing the collateral that Article 9 designates as reasonably identifying the collateral.³ Unfortunately, despite the statutory text, two of these methods might not provide the full measure of assurance that they appear to provide, and transactional lawyers should think twice before relying on a literal interpretation of either of them. This article explains why.

Background

The safe harbors in question are contained in § 9-108(b)(4) and (5), which deal respectively with a description by “quantity” or by “computational or allocational formula or procedure.” Both paragraphs were derived from former § 9-115(3), and it is useful to compare the relevant text under the current and former versions of Article 9:

Current § 9-108(b)(4)–(6)	Former § 9-115(3)
<p>... a description of collateral reasonably identifies the collateral if it identifies the collateral by: ...</p> <p>(4) quantity;</p> <p>(5) computational or allocational formula or procedure; or</p> <p>(6) ... any other method, if the identity of the collateral is objectively determinable.</p>	<p>A description of investment property collateral in a security agreement or financing statement is sufficient if it identifies the collateral by specific listing, by category, by quantity, by computational or allocational formula or procedure, or by any other method, if the identity of the collateral is objectively determinable.</p>

There are two things to note about how revised Article 9 altered the rule in former § 9-115(3). First, former § 9-115(3) applied only to investment property, whereas revised § 9-108(b)(4) and (5) apply to any type of collateral, including all types of goods and receivables.

Second, former § 9-115(3) authorized a description by quantity or by computational or allocation formula only if “the identity of the collateral is objectively determinable.” In contrast, revised § 9-108 moved that condition to its own safe harbor in § 9-108(b)(6); the requirement that the identity of the collateral be “objectively determinable” is conspicuously omitted from paragraphs (4) and (5). As a result, the language

and structure of § 9-108(b)(4) and (5) indicate that a description by quantity or by computational or allocational formula is sufficient regardless of whether the collateral is objectively determinable.

There are no cases interpreting the paragraphs but at least one treatise appears to have accepted this proposition, stating without citation to anything other than the statutory text that “[f]ive tons of gravel” is a sufficient description.⁴

Analysis

But not so fast. It is important to remember the purpose of the collateral description in a security agreement. A security

agreement does not merely create *contract rights* against the debtor, it also transfers *property rights* in the collateral to the secured party. Hence, the security agreement needs to identify what the collateral is, so that the secured party can enforce its rights in the collateral – such as by repossessing or disposing of the collateral – after default.⁵

This is not to say that all descriptions by quantity, formula, or procedure are ineffective. Some such descriptions do work. For example, “all inventory financed by [secured party]” is likely sufficient.⁶ But that is because such a description probably makes the identity of the collateral objectively determinable. The parties – and, if necessary, a court – can usually look to other documents to determine what inventory of the debtor the secured party financed. If, however, such documentation does not exist or is not available, then the description is probably not effective.⁷

There is a way to interpret the text of § 9-108(b) consistently with this approach: that is, as requiring that the description make the identity of the collateral objectively determinable. Treat the last clause of paragraph (6) as modifying all the previous paragraphs. This could be done simply by reading the subsection as if it were tabulated as follows:

Proposed Interpretation of § 9-108(b)(4)–(6)

. . . a description of collateral reasonably identifies the collateral if it identifies the collateral by: . . .

- (4) quantity;
- (5) computational or allocational formula or procedure; or
- (6) . . . any other method,

if the identity of the collateral is objectively determinable.

This is not the most literal reading of the subsection,⁸ but it nevertheless gives meaning to all the words while avoiding unworkable results. Under this interpretation, a description of collateral by quantity, formula, or procedure will be effective only if it makes the identity of the collateral objectively determinable.

To understand the effect of this interpretation, and why it makes sense, let’s consider the following three descriptions of collateral:

1. “Debtor’s three most recently purchased computers.”
2. “30% of the Debtor’s \$100,000 certificate of deposit issued by Bank.”
3. “The first \$5,000 received from [a specified account debtor or all account debtors].”

The first description should work in most cases because extrinsic evidence is likely to be available to determine which

three of Debtor’s computers were purchased most recently. However, if the debtor purchased multiple computers when purchasing the third most recent, the description would suffer a latent ambiguity as to which computers it covers. In such a case, which computers may the secured party repossess and sell after default?

The second description is similar. The certificate of deposit is easily divisible, and because it is unlikely that Bank will honor only a fraction of its obligation thereon, determining which 30% is collateralized is unlikely to matter. However, if the debtor were indebted to Bank and the Bank had setoff rights, a problem would arise as to whether the setoff rights applied to the collateralized portion, the non-collateralized portion, or to both ratably.⁹

The third description is also probably fine because it should be relatively easy to determine the first \$5,000 received. However, if the debtor received a total of more than \$5,000 when that threshold was achieved, and some of the receipts were later dissipated, it might be impossible to determine whether the receipts that remain are the ones that are collateralized or noncollateralized.¹⁰ Absent application of some tracing principle, such as the lowest intermediate balance rule commonly used to trace cash proceeds of collateral deposited into a deposit account, it would not be possible to identify with assurance whether the secured party’s collateral was the retained receipts or the dissipated funds.

Let’s now consider three additional descriptions of collateral that are even more problematic:

4. “600 bushels of wheat stored in the silo on Debtor’s farm.”
5. “30% of Debtor’s equipment.”
6. “Half of Debtor’s Toyota RAV4.”

The fourth description at first blush appears to be sufficient, assuming there is only one silo on Debtor’s farm. After all, Article 2 of the U.C.C. allows goods to be identified to a contract for sale through reference to “an undivided share in an identified bulk of fungible goods,”¹¹ and the description of wheat in the silo above is such a reference. Because identification is the time when the buyer starts to get *property rights* in the goods to be sold – as distinguished from mere contract rights against the seller¹² – it is tempting to think that the description would be sufficient to transfer property rights under Article 9.¹³

On the other hand, the description does not specify which bushels in the silo are encumbered. That might be a problem if, for example, the silo contained more than 600 bushels of wheat when Debtor authenticated the security agreement but Debtor later removed some bushels from the silo. Were the bushels that were removed part of the collateral or were they unencumbered bushels?

Even in the absence of such a tracing problem, other provisions in Article 9 – those dealing with commingled goods – suggest that there can be no security interest in less than all of the grain in the farmer’s silo. Article 9 defines “commingled goods” as “goods that are physically united with other goods in such a manner that their identity is lost on a product or mass.”¹⁴ The comments make clear that this includes not merely goods whose original form is altered in the commingling process – as occurs when flour and eggs are combined to make cake – but also goods such as ball bearings that are intermixed with and become indistinguishable from other like goods.¹⁵ Article 9 then states that “[a] security interest does not attach to commingled goods as such,” but that a security interest may attach to the resulting product or mass.¹⁶ This suggests that it is impossible to obtain a security interest in commingled goods – as distinguished from the resulting product or mass – once the goods have been commingled. Indeed, a previously created security interest in goods is “lost,”¹⁷ when the goods are commingled, and instead the security interest attaches to the entire product or mass.¹⁸ It would be strange indeed if Article 9 permitted a security interest in commingled goods to attach after the commingling while prohibiting a security interest that attached before the commingling to remain. Because of this, it seems unlikely that a security interest could attach to “600 bushels of wheat” in a silo containing more than that amount.¹⁹

The fifth description – “30% of Debtor’s equipment” – likely does not involve commingled or fungible goods, but is even more problematic. Putting aside the ambiguity of whether the fraction is intended as a measure of value or amount, it provides no guidance on which items of equipment are collateral and which items are not. The collateral is not objectively determinable and neither the secured party nor a court could point to any item of equipment and say with any assurance whether it is or is not part of the collateral.

The sixth description involves a single item that is not readily divisible at all. Which part of Debtor’s RAV4 is collateral? May the secured party repossess the engine and drive chain but not the chassis? To ask the question is to reveal the absurdity of the answer. The concept of a security interest in less than all of an indivisible whole is simply unworkable.²⁰ A court so inclined might choose to interpret the collateral description as covering the entire vehicle, but with recovery limited to half the vehicle’s value.²¹ But a transactional lawyer should not rely on such judicial beneficence, and hence the effectiveness of a description of collateral in this manner cannot be assured.

Conclusion

A strict reading of § 9-108(b)(4) and (5) indicates that a description of collateral by quantity or by a computational or allocational formula or procedure is sufficient. The provisions are drafted as safe harbors, and neither of them purports to

incorporate the requirement in former § 9-115(3) that the collateral be “objectively determinable.” Nevertheless, transactional lawyers should be reluctant to rely on these provisions if the identity of the collateral is not objectively determinable. Such a description would fail its basic function of identifying the property in which the debtor is purporting to transfer rights to the secured party. In short, because these safe havens leave the security agreement exposed to destructive forces, a transactional lawyer should be reluctant to seek refuge in them.

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Notes:

1. U.C.C. § 9-203(b)(3)(A).
2. U.C.C. § 9-108(a).
3. U.C.C. § 9-108(b)(1)–(6).
4. [11 Part I Lawrence’s Anderson on the Uniform Commercial Code § 9-108:10.](#)
5. *See, e.g., Sanders v. Comerica Bank*, [274 S.W.3d 861](#), 863 (Tex. Ct. App. 2008); U.C.C. § 9-108 cmt. 2 (“[t]he test of sufficiency of a description under this section . . . is that the description do the job assigned to it: make possible the identification of the collateral described.”).
6. *See Liberty Sav. Bank v. Webb Crane Serv., Inc.*, [2005 WL 1799300](#) (D. Colo. 2005) (relying on § 9-108(b)(5)). Several courts validated similar descriptions under former Article 9. *See, e.g., Coseo v. Alpena Sav. Bank*, [612 F.2d 276](#), 277 (6th Cir. 1980); *In re McCallister*, [215 B.R. 217](#) (Bankr. N.D. Ala. 1996); *Villa v. Alvarado State Bank*, [611 S.W.2d 483](#) (Tex. Ct. App. 1981). *See also In re Estate of Wheeler*, [410 P.3d 483](#) (Colo. Ct. App. 2013) (the description of collateral in a commercial lease as “all property now owned or hereafter acquired by [tenant] which shall come in or be placed upon the premises” was sufficient to cover the personal property at tenant’s jewelry store); *In re Murphy*, [2013 WL 1856337](#) (Bankr. D. Kan. 2013) (a cardholder application that provided for a security interest in “goods purchased on your Account” was sufficient); *In re Thrun*, [2013 WL 2585636](#) (Bankr. W.D. Wis. 2013) (customer’s signed Consumer Lending Plan with credit union providing that credit union would have a security interest in “all goods, property, or other items purchased under this Plan . . . either now or in the future” was sufficient to cover motor vehicle purchased with an advance under the plan); *In re Dalebout*, [454 B.R. 158](#) (Bankr. D. Kan. 2011) (language in cardholder agreement granting the issuer a security interest in “the merchandise purchased on your account,” together with

language on the charge slip providing for a security interest in “any goods, described in this charge slip,” was sufficient). *But see* In re Cunningham, [489 B.R. 602](#) (Bankr. D. Kan. 2013) (relying on § 9-108(e)(2) to reach a result contrary to that in *Murphy* with respect to the same creditor and the same contract language); In re Shirel, [251 B.R. 157](#) (Bankr. W.D. Okla. 2000) (ruling similarly to *Cunningham* under former Article 9).

Although it is questionable whether the description referred to in the text involves a computational or allocational formula or procedure, perhaps the process of looking to which items are financed by the secured party is a “procedure” for identifying the encumbered property.

7. *Cf.* Van Diest Supply Co. v. Shelby Cty. State Bank, [425 F.3d 437](#) (7th Cir. 2005) (because a supplier’s security agreement covered only the portion of the debtor’s inventory acquired from the supplier, but that portion was not segregated or otherwise readily matched, such as through use of a universal product code, to the transactions giving rise to its proceeds, the proceeds of the inventory were deemed not to be “identifiable” under former § 9-306(2), the predecessor to current § 9-315(a)(2)).

8. Because the numbered paragraphs of subsection (b) are separated by semicolons but the last clause in paragraph (6) is separated by a comma, the last clause is more properly regarded as modifying only paragraph (6). Moreover, no other provision of Article 9 is tabulated in the manner suggested. That is, no section contains language after a numbered or lettered provision, but which language is not itself numbered or lettered, that modifies one or more previously numbered or lettered provisions. Indeed, such tabulation would violate the Uniform Law Commission’s rules. *See* Uniform Law Commission, *Drafting Rules for Uniform and Model Acts*, Rule 405(f), (g) (2012) (“Do not include in the last item of a tabulation language intended to qualify all the items. Place language intended to qualify all provisions in a tabulated series in the text immediately preceding the series”; “Do not place a trailing sentence or phrase after a tabulation. If the language is not a part of the tabulated series, place it before the tabulated sentence or draft it as a separate subsection, paragraph, or other subdivision.”).

9. Section 9-340 preserves a depository bank’s setoff rights with respect to a deposit account. If, however, the certificate of deposit were an instrument, and therefore not a deposit account, a possibility expressly recognized in § 9-102 comment 12, § 9-340 would not apply. Section 9-404(a)(2) also deals with setoff rights by allowing an account debtor to reduce its obligation by the amount of any claim against the debtor that accrued before the account debtor received notification of the assignment. However, “account debtor” is defined as a person obligated on an account, chattel paper, or general intangible, § 9-102(a)(3), and does not include someone obligated on an

instrument. Hence, § 9-404 would also not apply if the certificate of deposit were an instrument. *See* § 9-404 cmt. 5.

The problem in determining which portion of the certificate of deposit is subject to Bank’s setoff rights is a bit like the problem that arises when a guaranty covers some fraction – such as half – of a debt. Do the debtor’s payments reduce the guaranteed portion or the unguaranteed portion? Instead, a transactional lawyer should draft the guaranty so as to cover the entire debt, but cap liability at a specified amount. *See* Stephen L. Sepinuck, *Suggestions for Drafting Guaranties*, [7 The Transactional Lawyer 1](#), 2 (Oct. 2017). *See also* Chapel Real Estate Co. v. Burris, [64 N.E.3d. 1069](#) (Ohio Ct. App. 2016) (resolving competing interpretations of a guaranty of the full performance of the tenant’s obligations under a two-year lease “for the term of one (1) year only”).

10. The description also suffers from another problem. By identifying the collateral as “receipts,” rather than receivables, the security agreement postpones the time attachment will occur. This would present a problem if the debtor seeks bankruptcy protection. The Bankruptcy Code prevents a security interest from attaching to property that a debtor acquires postpetition, unless the property is proceeds (or products, offspring, or profits) of prepetition collateral. 11 U.S.C. § 552(a), (b). If the receivables are not collateral, the security interest would not attach to post-petition receipts.

11. *See* U.C.C. § 2-105(4).

12. *See* U.C.C. § 2-401(1).

13. *See* Colorado Nat’l Bank-Longmont v. Fegan, [827 P.2d 796](#) (Kan. App. 1992), in which, in return for a loan, the Fegans granted a bank a security interest in crops growing or to be grown. When the Fegans experienced financial hardship, they leased their land to their farm manager under a crop-share lease, with one-third of the crop to be paid as rent to the Fegans. The Kansas Court of Appeals ruled that the bank had a security interest in one-third of the crops because the Fegans had only a one-third interest in the crops. The decision is only marginally helpful, however. That is because the security interest encumbered all of the debtors’ rights in the crops and because, by the time the litigation occurred, the parties were really fighting about the proceeds of the crops, not the crops themselves.

14. U.C.C. § 9-336(a).

15. U.C.C. § 9-336 cmt. 2.

16. U.C.C. § 9-336(b).

17. U.C.C. § 9-336 cmt. 3.

18. U.C.C. § 9-336(b).

19. There is a contrary argument. Comment 3 to § 9-336 states that, once collateral becomes commingled goods, “no security interest in the original collateral can be created thereafter except as *part of* the resulting product or mass” (emphasis added). Read in isolation, the phrase “part of” suggests that a secured party could take a security interest in less than all of the product or mass that results from commingling. Under such a reading, it would be possible to take a security interest in 600 bushels of wheat stored in the silo on Debtor’s farm. But the sentence as a whole is referring to a security interest in the original collateral – which is only part of the resulting product or mass – and that security interest unquestionably attaches to the whole product or mass. Thus, it is not clear that the comment is really suggesting that, after commingling, it is possible to create a security interest in an unsegregated portion of the product or mass.

20. Article 9 provides that a security interest automatically extends to “whatever is acquired” upon the sale of the collateral. See U.C.C. §§ 9-102(a)(64) (defining “proceeds”); 9-315(a)(2) (providing that a security interest extends to identifiable proceeds). One of the reasons for this broad definition of proceeds – and for not requiring a rough equivalence of value between the original collateral and its proceeds – is to avoid the problems associated with a security interest in less than all of a single item of property.

21. See U.C.C. § 1-103(a), which provides that the U.C.C. is to be construed and applied liberally to promote its underlying purposes. Of course, there is a difference between interpreting the U.C.C. and interpreting a security agreement. Section 1-103(a) refers to the former, not to the latter. On the other hand, a court might choose to interpret § 9-108 as to not invalidate an agreement if the agreement’s meaning is evident.



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