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IDENTIFYING WHAT PORTION OF A SETTLEMENT PAYMENT IS PROCEEDS OF COLLATERAL

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Some judicial decisions *create* problems for transactional lawyers. They can do this by misinterpreting the law or by imposing an explicitness requirement for a specific type of contractual term.[1] Other judicial decisions *reveal* problems for transactional lawyers. They typically do this by addressing how an agreement, as governed by applicable law, applies to unanticipated events. In such cases, the result might not be what the lawyer or the parties intended.

Three recent cases reveal a significant problem for transactional lawyers who draft security agreements. This article identifies the problem through a simple hypothetical scenario, a brief discussion of the applicable law, and a short description of the three cases. The article then explores several ways in which transactional lawyers who represent secured parties might deal with the problem, analyzing the benefits and drawbacks of each approach.

The Hypothetical

> Lender acquires a security interest in some assets of Debtor. Thereafter, the assets are damaged or destroyed. Debtor asserts one or more claims against a third party for the lost value to the collateral. The claim or claims might sound in tort or contract, or might be asserted under an insurance policy. Debtor also seeks recompense for other injury (*i.e.*, for damage to property that is not part of the lender's collateral, for lost business, or for personal injury). Debtor and the third party then enter into a settlement agreement, pursuant to which the third party promises to pay Debtor a specified sum to fully settle the claim or claims. The agreement does not purport to apportion the sum due to the various claims asserted. Does Lender have a security interest in all or any portion of the settlement agreement or the proceeds thereof?

Background on the Law

An Article 9 security interest automatically extends to identifiable proceeds of collateral.[2] For this purpose, "proceeds" is defined broadly, and includes, to the extent of the value of collateral, claims arising out of, or insurance payable by reason of, loss of or damage to the collateral.[3] But Article 9's guidance on when proceeds are "identifiable" is rather limited. It states merely that if the proceeds are not goods, they are identifiable to the extent that the secured party identifies the proceeds by a method of tracing permitted under other law.[4] The official comments indicate that the "lowest intermediate balance rule" is one appropriate tracing principle,[5] but that rule applies principally to deposit accounts and would not be relevant to the above Hypothetical.

The Cases

Three recent cases suggest that *none of* Debtor's right to payment under the settlement agreement is identifiable proceeds of the original collateral. In each of those cases, the secured party saw its collateral damaged or destroyed yet was denied an interest in the replacement value the debtor received in exchange.

In *In re Aerogroup International, Inc.*,[6] THL Corporate Finance, Inc. ("THL") had a security interest in the debtors' intellectual property. After the debtors filed for bankruptcy protection, they entered into an agreement to sell the bulk of their assets to GBG USA Inc. ("GBG"). The agreement included a license of the debtors' trademarks and related intellectual property, thereby allowing GBG to design, manufacture, and import products bearing the debtors' trademarks and to sell those products through specified distribution channels.

Prior to court approval, GBG purported to terminate the agreement, claiming that various conditions had not been satisfied. The debtors commenced an adversary proceeding against GBG, asserting claims for breach of contract, breach of the implied covenant of good faith, promissory estoppel,

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fraudulent misrepresentation, and equitable estoppel. A few months later, the parties reached a settlement agreement pursuant to which GBG would pay a specified amount and the parties would release their claims against each other. The debtors sought court approval for the agreement, and in so doing asked that the proceeds (less attorney's fees and expenses) be paid to their DIP financier, which everyone agreed had a lien on the debtors' commercial tort claims.

THL objected, not to the settlement, but to the proposed order regarding the distribution of settlement proceeds. THL claimed that the settlement amount included value attributable to the debtors' intellectual property and associated goodwill, assets on which THL held a first-priority lien. In essence, THL argued that a portion of the settlement payment was proceeds of collateral in which it held a first-priority security interest.

The court overruled THL's objection. In so doing it did not explain why the debtors' claims against GBG – which appear to be contract claims – were commercial tort claims on which the DIP financier had a security interest. In fact, no one appears to have discussed the difference between tort and contract claims. The court also did not discuss how or why GBG's breach damaged the debtors' intellectual property so as to make some portion of the claims against GBG – and later, the settlements of those claims – proceeds of the intellectual property. What the court did rule was that, even if some portion of the settlement payment was for a loss to the value of the debtors' intellectual property, and thus proceeds of THL's collateral, it was not "*identifiable* proceeds."[7]

In re Montreal, Maine & Atlantic Railway, Ltd.,[8] a First Circuit decision from April of this year, involved a secured party, Wheeling & Lake Erie Railway Co. ("Wheeling"), that had a security interest in the debtor's existing and after-acquired accounts and payment intangibles. This security interest later attached to the debtor's contract claims against a shipper of oil that had allegedly mislabeled the oil, an action that allegedly contributed to catastrophic damages resulting from a 2013 freight train derailment in Quebec. The secured party did not, however, have a security interest in the debtor's tort claims arising from the accident. During the debtor's bankruptcy, the estate representative entered into a global settlement of all the claims. Over Wheeling's objection, the bankruptcy court approved the settlement, but, in so doing, stated that neither its order nor the settlement agreement limited Wheeling's ability to contend or the estate representative's ability to contest whether Wheeling's security interest attached to any portion of the settlement.[9]

When the issue later came to a head, the bankruptcy court ruled against Wheeling for two reasons. First, the court held that the estate representative had not used Wheeling's collateral when entering into the settlement because the estate did not have any cognizable non-tort claims against the shipper. Second, even if the estate had such a claim, Wheeling had not carried its burden of proving the claim's value.[10] The district court affirmed. Although that court determined that the estate did have non-tort claims against the shipper – claims that the estate representative released as part of the settlement – the court agreed that Wheeling had not proven that those claims had any value.[11] The First Circuit affirmed. Wheeling had not proven that its collateral – the contract claims – had value.[12] The court added that it took no position on whether Wheeling's entitlement to a portion of the settlement "depended on its ability . . . to trace its collateral to identifiable proceeds."[13] Reading between the lines, however, it seems likely that the court would have been at least skeptical that any portion of the global settlement was identifiable proceeds of Wheeling's collateral.

The final case, *In re JMF Cab, Inc.*,[14] was decided less than a week after the First Circuit's decision in *Montreal, Maine & Atlantic Railway.* It involved a bank with a security interest in the debtor's taxicab medallion, an asset that the court referred to as, "in former times," the crown jewel of the bank's collateral.[15] Before filing for bankruptcy, the debtor and other taxicab companies sued Uber for unfair competition and civil conspiracy. During the debtor's bankruptcy, a global settlement was reached (although a separate agreement was reached with each bankrupt owner, or its trustee, to facilitate court approval of the settlement), under which the estate was to receive about $70,000 in exchange for releasing all claims against Uber.

The bank claimed that the rights under the settlement agreement were proceeds of the medallion. Everyone in the case agreed that the value of Boston taxi medallions had collapsed in the wake of the rideshare revolution, and the debtor's claims against Uber sought damages for the lost value of the debtor's medallion. And the court acknowledged that, "[t]o the extent the bank can establish that the settlement funds are compensation for damage to the medallion, they would be proceeds of the bank's collateral."[16] Nevertheless, the court ruled against the bank. The court noted that nothing in either the complaint or the settlement agreement apportioned the settlement amount among the theories of harm or causes of action asserted, or provided any methodology for doing so.[17] It is unclear whether the court ruled that the debtor's rights under the settlement agreement were not proceeds of the medallion at all or merely not "identifiable" proceeds. But either way the ruling is clear. Absent some way to determine what portion of the settlement is attributable to the collateral, the secured party gets nothing.

Each of the cases has a slightly different focus. *Aerogroup* based its decision on a conclusion that the debtors' right to payment under the settlement agreement, even if proceeds of the secured party's interest in a portion of the debtors' claim, was not "identifiable" proceeds. *Montreal, Maine & Atlantic Railway* concluded that the secured party had not proven that the claim on which it had a security interest was valuable, and hence had not shown that the settlement was proceeds of that claim at all. However, the court also hinted that identifiability would be a problem even if the secured party had shown that its collateral had value. *JMF Cab* can be read consistently with either of those decisions. The court either concluded that the debtor's right to payment under the settlement agreement was not proceeds of collateral or it concluded that the lack of an apportionment or methodology for making an apportionment, rendered the proceeds portion not identifiable. Despite these differences, each of the cases suggests that the Lender in the Hypothetical will not have a security interest in all or any portion of the debtor's right to payment under the comprehensive settlement.

There is some contrary authority. One court apportioned a \$1.9 million settlement between two secured parties based on their relative interests in the debtor's total \$23 million claim. Specifically, the secured party that had priority in the debtor's claim for damage to equipment was entitled to 39.78% of the settlement amount because 39.78% of the total claim was for damage to equipment, while the remainder of the claim was for lost contracts, future profits, and goodwill.[18] But given:

(i) the three cases discussed above,

(ii) the possibility that a different debtor's damages might not be easy to establish, and

(iii) the possibility that different claims might have different chances of success, so that it would not be appropriate to apportion the total settlement based solely on the relative amount claimed

transactional lawyers should plan for the possibility that a settlement might not yield identifiable proceeds of a client's collateral.

Possible Solutions to the Problem

There are several ways that a transactional lawyer could, when drafting a security agreement on behalf of the prospective secured party, deal with the possibility that a settlement might not result in identifiable proceeds. Unfortunately, each has potential problems.

Expand the Collateral. First, the security agreement could be drafted to cover all of the debtor's existing and after-acquired personal property, including future claims of all kinds. This approach, if it worked, would make all of the claims collateral. As a result, the entire settlement would be proceeds of collateral, and there would arguably be no problem of apportionment or identifiability.

But there are at least two problems with this approach. First, taking a security interest in all the debtor's property might simply be inconsistent with the deal. Recall that the Hypothetical stated that Lender acquired a security interest in "some" of Debtor's assets. Not every financing arrangement involves a security interest in everything the debtor owns. Moreover, even if a creditor had a security interest in all of the debtor's assets, another creditor might have or acquire a senior security interest in some after-acquired property[19] or might have or acquire a senior lien on property outside the scope of Article 9.[20] The apportionment problem arises not only when the creditor's security interest encumbers less than all of the debtor's claim, but also when the security interest encumbers the whole claim but has priority in only a portion of it.[21]

Second, while it is possible to draft a security agreement to encumber all future *contract* claims, it is not possible to draft a security agreement so that it will encumber all future *tort* claims.[22] Article 9 requires that commercial tort claims be described with some particularity; describing them simply as "commercial tort claims" will not be effective.[23] It is nigh impossible to describe with particularity claims that do not yet exist.[24] In addition, Article 9 does not allow a security interest to attach under an after-acquired property clause to a commercial tort claim.[25] Thus, to encumber a commercial tort claim that arises after the debtor authenticates the security agreement and which is not proceeds of other collateral, the debtor and secured party must amend the security agreement. The initial security agreement could obligate the debtor to do that or authorize the secured party to do it unilaterally, but the debtor might breach that obligation and the secured party might neglect to update the agreement.[26]

Encumber Future Settlement Rights. A second approach is to describe the collateral to include all of the debtor's rights under all future settlement agreements. The theory underlying this approach is that the debtor's right to payment under a settlement agreement is a contractual right – which Article 9 would classify as a payment intangible – not a commercial tort claim. Hence Article 9's rules that inhibit the creation of a security interest in an after-acquired commercial tort claim would not apply.

Unfortunately, there are also two problems with this approach. First, if the secured party has a security interest in after-acquired settlement rights, but not in the claims settled, then the settlement rights would be after-acquired collateral but not proceeds of collateral. As a result, if the debtor goes into bankruptcy, the attachment of the security interest to a prepetition settlement might be an avoidable preferential transfer,[27] and attachment of the security interest to a post-petition settlement would be prevented by the Bankruptcy Code.[28]

Second, a series of badly reasoned cases have ruled that Article 9's limits on after-acquired commercial tort claims also apply to settlements of such claims.[29] These decisions are unsupported by the text of Article 9 and are patently wrong.[30] But they remain an obstacle, at least until the Permanent

Editorial Board for the U.C.C. – which is charged with monitoring the law of commercial transactions and authorized to issue commentary to correct misinterpretations of the Code[31] – clarifies the law, and courts follow that clarification.

Obtain a Right to Approve Settlements. A third approach is to obtain a contractual right to approve the settlement of any claim that constitutes collateral. Article 9 does not provide for such a right but does allow a debtor to grant the secured party additional rights.[32] It is under this rule that secured parties frequently contract for the right to vote the debtor's equity in a subsidiary. Although Article 9 refers to the exercise of such additional contractual rights only "[a]fter default," there is no reason to think that the parties lack the freedom to contract for additional pre-default rights. Unless some other rule of law intervenes, the parties should be free to require the secured party's consent to the settlement of any claim that constitutes collateral. Armed with this right, the secured party could withhold consent to any settlement that does not expressly identify what portion of any settlement payment is attributable to the portion of the claim that constitutes the secured party's collateral.

But this approach too has its problems. First, it is possible that a court might find that such a contractual right impermissibly interferes with judicial process, encourages litigation by impeding settlement, or otherwise violates public policy. That risk seems small, but should be investigated before this approach is tried. Second, the debtor could disregard the contractual term and enter into a settlement without the secured party's consent. If the counter-party had no knowledge of the term in the security agreement, it is likely that the settlement would be binding.

Still, the term might be useful if the debtor is the subject of a bankruptcy proceeding. In that setting, court approval of any settlement is likely to be required,[33] at which point the secured party can object to any settlement that violates its rights. Recall that in *Aerogroup*, the secured party did not object to the settlement itself, merely to the proposed order regarding the distribution of settlement proceeds. That might have been a tactical mistake. In *Montreal, Maine & Atlantic Railway*, the secured party did object to the settlement, but the bankruptcy court ruled that the claim constituting the secured party's collateral had no value. If the claim has value, and if the security agreement expressly grants the secured party the right to consent to any settlement, a bankruptcy court will be hard pressed to approve a settlement over the secured party's objection if the settlement does not identify how much of the settlement payment is attributable to the secured party's claim. Doing so, and then later ruling that no portion of the settlement payment is identifiable proceeds, would seem to strip the secured party of its property rights in violation of law.

Of course, if the debtor's business regularly generates claims that the debtor routinely settles – and many debtors regularly settle accounts with their account debtors – restricting the debtor's freedom to settle all claims might be inappropriate. In such a case, the agreement could be drafted to require the secured party's consent to settle only claims that exceed a threshold dollar amount or settlements outside the ordinary course of business.

The following is a simple version of a clause requiring the secured party's consent to settlement of claims:

> ***Settlement of Claims***. Debtor may not [outside the ordinary course of Debtor's business] settle any Claim for less than the full amount asserted without the prior, written consent of Secured Party. For the purpose of this paragraph, "Claim" means any alleged right to payment, whether arising in contract, tort, or unjust enrichment, arising under a policy of insurance, or arising out of a violation of the law, if the Secured Party has a security interest in the right to payment [and the right to payment is for an amount in excess of $------].

Conclusion

Because none of these three approaches is sure to work, transactional lawyers should consider combining them. Draft the description of collateral as broadly as possible, thereby increasing the likelihood that all later-arising claims are proceeds of collateral, expressly cover after-acquired payment intangibles (*i.e.*, rights under later created settlement agreements), and include a provision requiring the secured party's consent to the settlement of any claim. A more complete solution to the problem might not be possible.

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Notes:

1. For brief articles discussing cases that misinterpret the law – most commonly the Uniform Commercial Code – see the *Spotlight* column, which since 2006 has been a regular component of the Commercial Law Newsletter, published by the ABA Business Law Section. Copies of the newsletter (or for older issues, just the column) and an index of the cases "spotlighted" are available on the web page of Gonzaga's Center for Law, Ethics & Commerce. *See also infra* note 30.

For discussion and criticism of many rules of explicitness, see Stephen L. Sepinuck, *Gotcha!: Caught in the Explicitness Trap*, 8 THE TRANSACTIONAL LAWYER 1 (June 2018), reprinted in BUSINESS LAW TODAY (Aug. 15, 2018).

2. *See* U.C.C. § 9-315(a)(2).

3. *See* U.C.C. § 9-102(a)(64)(D), (E).

4. *See* U.C.C. § 9-315(b)(2).

5. *See* U.C.C. § 9-315 cmt. 3.

6. 2019 WL 2120735 (Bankr. D. Del. 2019).

7. *Id.* at *6.

8. 956 F.3d 1 (1st Cir. 2020).

9. *Id.* at 5.

10. *See id.* at 6 (describing the bankruptcy court ruling).

11. Wheeling & Lake Erie Ry. Co. v. Keach, 606 B.R. 1, 12, 14-15 (D. Me. 2019).

12. 956 F.3d at 7-12.

13. *Id.* at 11-12.

14. 614 B.R. 648 (Bankr. D. Mass. 2020).

15. *Id.* at 649.

16. *Id.* at 652.

17. *Id.*

18. *See* Bayer Cropscience LP v. Texana Rice Mill, Ltd., 2018 WL 1378641 (E.D. Mo. 2018). *See also* In re PES Holdings, LLC, 2020 WL 1047768 (Bankr. D. Del. 2020) (determining the relative priority of multiple interests in the debtor's business interruption insurance proceeds and multiple claims to the debtor's property damage insurance proceeds, but not being called upon to determine what portion of the insurance proceeds was for business interruption and what portion was for property damage).

19. *See, e.g.*, § 9-324(a), (b) (providing that a purchase-money security interest in equipment or inventory can, under specified circumstances, have priority over another security interest that would otherwise have priority under the first-to-file-or-perfect rule).

20. For example, another creditor might have or acquire a lien on the debtor's real property, and the debtor's claim might seek recompense for damages to both real and personal property.

21. An insurance claim might include amounts for damage to or loss of personal property, as well as amounts for lost business generally. The latter is not proceeds of any Article 9 collateral. However, as long as the secured party had a security interest in the entire policy, there would be no apportionment or identifiability problem with respect to any settlement of the insurance claim. Such a security interest would not be governed by Article 9, *see* U.C.C. § 9-109(d)(8), but it is still possible to create such a security interest. *See* In re PES Holdings, LLC, 2020 WL 1047768. *Cf.* Stephen L. Sepinuck, *Beware: The "Loss Payee" Need Not Be Paid Following Loss*, 3 THE TRANSACTIONAL LAWYER 5 (Dec. 2013).

22. The discussion that follows of the rules that impede the creation of a security interest in tort claims apply only to commercial tort claims. Article 9 does not apply to a security interest in a tort claim that is not a commercial tort claim, unless that claim is proceeds of other collateral. *See* U.C.C. § 9-109(d)(12). *See also* U.C.C. § 9-102(a)(13) (defining "commercial tort claim").

23. *See* U.C.C. § 9-108(e)(1). There might also be a similar problem with respect to perfection of a security interest in commercial tort claims. Unless the financing statement covers "all assets" or "all personal property," *see* U.C.C. § 9-504(2), an indication of collateral in a financing statement using the phrase "commercial tort claims" might not be sufficient. *See* Shirley Medical Clinic, P.C. v. Commissioner of Internal Revenue, 446 F. Supp. 2d 1028 (S.D. Iowa 2006) (a financing statement indicating that the collateral includes "any lawsuit due or pending" was inadequate to perfect a security interest in a commercial tort claim).

24. A security agreement might describe commercial tort claims by indicating the nature of the claim. For example, it might refer to "all commercial tort claims for intentional interference with business relations." However, it is unclear if that qualifies as a sufficient description under Article 9.

25. *See* U.C.C. § 9-204(b)(2). *See also* Waltrip v. Kimberlin, 79 Cal. Rptr. 3d 460 (Cal. Ct. App. 2008) (an after-acquired property clause is ineffective to cover later-arising commercial tort claims); The Epicentre Strategic Corp.– Michigan v. Perrysburg Exempted Village Sch. Dist., 2005 WL 3060104 (N.D. Ohio 2005) (the rule of § 9-204(b) means that a commercial tort claim must exist when the debtor authenticates the security agreement for the claim to be encumbered by the security interest).

26. *See* Helms v. Certified Packing Corp., 551 F.3d 675 (7th Cir. 2008) (a lender's security interest did not attach to commercial tort claims pursuant to the terms of the security agreement because even though the security agreement gave the lender permission to amend the schedule of collateral to include commercial tort claims upon receiving notification of the claim from the debtor, the secured party failed to make such an amendment).

27. *See* 11 U.S.C. § 547(b).

28. *See* 11 U.S.C. § 552(a), (b).

29. *See* Mantle v. North Star Energy & Construction LLC, 441 P.3d 841 (Wy. 2019) (because of the heightened requirements for describing a commercial tort claim in a security agreement, a security interest covering after-acquired "general intangibles" is insufficient to encumber the debtor's rights under an

agreement settling a commercial tort claim); DB NPI Century City, LLC v. Legendary Investors Group No. 1, LLC, 2019 WL 2082039 (Cal. Ct. App. 2019) (even though a lender's security agreement covered after-acquired general intangibles, the security interest did not attach to the debtor's rights under an agreement settling a commercial tort claim that arose after the security agreement was authenticated; because a security interest cannot attach under an after-acquired property clause to a commercial tort claim, it cannot attach to the rights under a settlement agreement relating to such a claim); Bayer Cropscience LP v. Stearns Bank, 837 F.3d 911 (8th Cir. 2016) (a bank with a perfected security interest in the debtor's commercial tort claim had priority in the debtor's rights under an agreement settling that claim over another lender with an earlier security interest in the debtor's existing and after-acquired general intangibles because § 9-108(e) requires a heightened description for a commercial tort claim and attachment of a security interest in a payment intangible arising from the settlement of a commercial tort claim would undermine the requirement of § 9-108(e)). *See also* In re American Cartage, Inc., 656 F.3d 82 (1st Cir. 2011) (a security agreement's after-acquired property clause cannot encompass commercial tort claims that did not exist when the security agreement was entered into; while the right to a tort recovery can be proceeds of other collateral, the commercial tort claim itself – and hence standing to pursue the claim – cannot be proceeds of other collateral); In re Zych, 379 B.R. 857 (Minn. Ct. App. 2007) (a creditor's security interest does not attach to a commercial tort claim that was neither described in the security agreement nor existing when the security agreement was executed, even though the commercial tort claim might be proceeds of other collateral).

30. *See* Carl S. Bjerre & Stephen L. Sepinuck, *Spotlight*, Commercial Law Newsletter 9, 11-12 (Fall 2016) (criticizing *Bayer Cropscience*); Stephen L Sepinuck & Kristen Adams, *Spotlight*, Commercial Law Newsletter 12, 14-15 (Winter 2011) (criticizing *American Cartage*); Stephen L Sepinuck & Kristen Adams, *Spotlight, 5-6* (Special December 2007 ed.) (criticizing *Zych*).

31. The agreement, between the Uniform Law Commission and the American Law Institute creating the PEB and describing its authority is available on the PEB's web page.

32. *See* U.C.C. § 9-601(a).

33. *See* 11 U.S.C. § 363(b).

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Recent Cases

SECURED TRANSACTIONS

Scope Issues

In re Roberts,
2020 WL 5531507 (Bankr. D.N.M. 2020)

An oral, five-year lease of farming equipment for $35,000 per year with an option to purchase at the end of the lease term for $1 was a true lease, not a sale and secured transaction, because the lessee had the option to terminate the lease at any time. The right to terminate was not illusory and would result in no penalty or forfeiture to the lessee.

Attachment Issues

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.

In re Ojeda,
2020 WL 5746801 (Bankr. M.D. Fla. 2020)

A lender that financed the construction of the debtor's in-ground swimming pool did not acquire a security interest in the pool because the pool was neither a good nor a fixture. The pool was constructed with ordinary building materials, such as rebar, concrete, and plaster, and was not moveable after it was completed.

Patterson Dental Supply, Inc. v. Aesthetic Dentistry of Charlottesville, P.C., 2020 WL 5733208 (W.D. Va. 2020)

The bankruptcy court did not err in concluding that dental equipment was sold to a dental services corporation, rather than to the individual dentist who owned the corporation. Although the installment sale contract identified the dentist as the buyer at the beginning and on the signature line, it listed the corporation's address throughout, identified the corporation as the buyer in an attached schedule to the agreement, and contained a personal guaranty, which would make sense only if the corporation was the purchaser. Moreover, the corporation had remitted the monthly payments due under the agreement, paid the property taxes on the equipment, and depreciated the equipment for tax purposes. Accordingly, the equipment became part of the corporation's bankruptcy estate, and the seller's security interest was unperfected because the filed financing statement identified only the dentist as the debtor.

Betts v. USAA General Indemnity Co.,
2020 WL 5650711 (Ark. Ct. App. 2020)
A lender with a security interest in a vehicle was entitled to receive and retain the portion of the insurance proceeds covering sales tax and title fees when the vehicle was totaled, even though the secured party was not named a loss payee on the insurance policy. The security agreement covered "all proceeds from insurance."

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 five years after the debtor changed its name, and four years after the secured party filed 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 financing statement never lapsed. Although the gap in perfection as to collateral acquired more than four months after the name change 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 orders and sale order, so as to allow the secured party to credit bid at a pending sale of the collateral.

Enforcement Issues

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 the 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.

Perez-Sorlano v. Credit Acceptance Corp.,
2020 WL 4607779 (Mass. Super. Ct. 2020)
A debtor's class action against a secured party for allegedly sending a disposition notification and an explanation of deficiency that did not comply with Article 9 was subject to the arbitration clause in the parties' retail installment contract, which covered any dispute "arising out of or in any way related to this Contract." It did not matter that the notification and explanation were required by Article 9, rather than by the agreement, because the action was "related to" the contract. The debtor's claims would not exist in the absence of the contract. Moreover, the contract defined "dispute" to include claims based on violations of law.

Kaufman v. Prospect Funding LLC,
2020 WL 5105813 (Cal. Ct. App. 2020)
An arbitrator exceeded his authority in ruling that a lawyer and the lawyer's firm had agreed to be bound by an arbitration clause in a litigation funding agreement between the lawyer's client and a litigation financier. Although the lawyer signed an acknowledgment that "all disputes arising out of this transaction will be resolved via arbitration per the Sale and Repurchase Agreement," that language indicated that the client was bound to arbitrate, not that the lawyer had assented to arbitrate. Although a lawyer's signature approving a document for the client's signature might signify an intent to be bound if the document imposes duties on the lawyer, the litigation funding agreement imposed no duties on the lawyer and neither the lawyer nor the firm received any consideration for the purported agreement to arbitrate.

Kleeberg v. Eber,
2020 WL 4586904 (S.D.N.Y. 2020)
Even though a state court had ruled that a proposed acceptance of collateral in full satisfaction of the secured obligation was "commercially reasonable," that did not prevent the beneficiaries of a trust that was the indirect owner of the debtor from bringing a breach of trust action against the secured party, who was both a trustee and a beneficiary of the trust. The plaintiffs' claim for breach of fiduciary duty arose out of the creation of the security interest and the later acceptance of collateral, not from the judge's ruling. Although the trust agreement expressly authorized trustees to make loans secured by trust assets, the agreement did not expressly grant trustees the right to foreclose on the collateral and keep it for themselves, and thus the agreement did not create an exception to the duty of undivided loyalty. Even though the acceptance of collateral was completed pursuant to Article 9, that was not a bar to unwinding the transaction if it resulted from a breach of fiduciary duty.

Liability Issues

WIHC LLC v. Nextgen Laboratories, Inc.,
2020 WL 5032055 (D. Haw. 2020)
An agreement to settle a claim for misappropriation of confidential client information and trade secrets, pursuant to which one defendant would pay $500,000 up front, pay $4 million through 18 monthly installments, and provide a security interest in its assets to secure the $4 million debt, and an individual defendant would guaranty the debt, was enforceable even though, shortly after the agreement was reached and announced to the court, the defendant's parent company took out loans and caused a number of liens to be recorded against the defendant's assets. The settlement agreement did not

require that the security interest have first priority or that the collateral be otherwise unencumbered. If those were terms the plaintiff wanted or intended, they should have been incorporated into the agreement. Although there was some merit to the plaintiff's argument that an implied condition precedent to the agreement was that the collateral be worth an amount equal to the settlement obligation, it was foreseeable that the defendant's assets would be subject to encumbrances as part of its ongoing business, the parties could have addressed this issue in the settlement agreement, and the guaranty mitigated the plaintiff's risk.

BANKRUPTCY

In re Vetsch,
2020 WL 5188122 (Bankr. W.D. Wash. 2020)
The debtor's contingent interest in an inter vivos trust that was established by his parents and was revocable on the date of the bankruptcy petition was not property of the estate because the debtor's rights were subject to complete divestment. Although the debtor's distribution rights became fixed during the 180-day period after the petition, when the debtor's mother died, the rights were not included in the bankruptcy estate under § 541(a)(5)(A) because the rights were not acquired by bequest, devise, or inheritance given the inter vivos nature of the trust. Even if the distribution rights were provisionally included in the estate under § 541(a), they would have been excluded by § 541(c)(2) due to the spendthrift provision in the trust documents. The relevance of the spendthrift provision is determined on the petition date, and thus it did not matter that, after the debtor's mother died, the debtor became entitled to a share of the trust res.

In re Tribune Company,
2020 WL 5035797 (3d Cir. 2020)
A bankruptcy court may cram down a reorganization plan even though the plan does not comply with an otherwise enforceable subordination agreement, provided the plan does not discriminate unfairly. Unfair discrimination is rough justice and courts should ordinarily compare the recovery percentages of the dissenting and preferred classes, and ask if the difference in recovery is material. However, if that is difficult, as it was here, the court may compare the dissenting class's desired recovery to its actual recovery under the plan. In this case, that difference – 34.5% vs. 33.6% – was not material, and hence not unfair.

LENDING, CONTRACTING & COMMERCIAL LITIGATION

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.

In re National Collegiate Student Loan Trusts Litigation,
2020 WL 5049402 (Del. Ch. Ct. 2020)
The granting clauses in indentures relating to the securitization of student loans were absolute assignments by the trusts. The trusts' retention of bare legal title to facilitate their servicing responsibilities did not mean that the trusts had conveyed a mere security interest. The backup grant of a security interest did not belie the absolute nature of the assignments. Moreover, because the noteholders have no recourse against the trusts if the notes are not repaid, the unmistakable intent that the grants was to create more than a mere security interest. The granting clauses included tort claims against various service providers.

Pharmacy Corp. of America/Askari Consolidated Litigation,
2020 WL 5369191 (D. Del. 2020)
A term in an LLC operating agreement that required consent of members holding at least 75% of the membership interests for "the granting or incurrence of any . . . security interest" on a substantial portion of the assets of the company did not apply to a decision to increase a secured working capital loan from $10 million to $64 million because increasing the secured obligation did not "grant[] or "incur[]" a security interest in any existing collateral or new property.

Palma v. South Florida Pulmonary & Critical Care, LLC,
2020 WL 5539818 (Fla. Ct. App. 2020)
Individual physicians who were departing members of a limited liability company and who signed promissory notes as co-makers in connection with the renewal of a loan to the LLC, were accommodation parties because the LLC, not the physicians, received the loan proceeds. The fact that the LLC paid the physicians salaries and bonuses did not render the physicians direct beneficiaries of the loans. Accordingly, the note holder had no cause of action against the physicians under theories of unjust enrichment or contribution for a pro rata share of the balances due under the notes when the physicians terminated their membership interests in the LLC.

First Security Bank v. Buehne,
2020 WL 5580498 (Kan. Ct. App. 2020)
Because a commercial promissory note contained a term by which the maker "waive[d] any applicable statute of limitations to the full extent permitted by law," because such a waiver does not violate public policy of Kansas, and because the makers were not prejudiced by the delay, the holder's action on the note, brought more than seven years after default, was not barred by the statute of limitations establishing a five-year limitations period.

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COMMERCIAL LAW AMICUS INITIATIVE UPDATE

CLAI Wins First Two Cases

In June, the Idaho Supreme Court issued its decision in *State v. Dix*, 465 P.3d 1090 (Idaho 2020), reversing a decision below that misinterpreted U.C.C. § 2-403. In so doing, the court wrote that it "agree[d] with the reasoning in the *amicus curiae* brief filed by Commercial Law Amicus Initiative." *Id.* at 1095.

In September, the Nebraska Supreme Court issued its decision in *First State Bank Nebraska v. MP Nexlevel, LLC*, 2020 WL 5581733 (Neb. 2020), ruling that a secured party with a security interest in accounts to secure an obligation is an "assignee" within the meaning of § 9-406. In its analysis of the matter, the court rejected several contrary decisions by other courts and adopted much of the analysis presented by CLAI in its *amicus curiae* brief.

These successes mean that CLAI now has a perfect 2-0 record, a record CLAI is eager to expand on. If you know of a case in which CLAI might be able to assist a court in faithfully interpreting and applying the Uniform Commercial Code, other commercial statutes, or related common law, please contact Professor Stephen L. Sepinuck, CLAI's Executive Director, at sepinuck@gonzaga.edu.

CLAI is a tax-exempt charitable organization under § 501(c)(3) of the Internal Revenue Code. All its work is performed by volunteers and CLAI does not accept financial contributions from anyone who: (i) is a party in a judicial proceeding in which CLAI is involved; (ii) controls or is employed by a party in such a proceeding; (iii) represents a party in such a proceeding; or (iii) is employed by or associated with a law firm that represents a party in such a proceeding.

For more information about CLAI, visit its web site at amicusinitiative.org.

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