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TRAPS TO AVOID WHEN INCORPORATING UCC DEFINITIONS INTO AN AGREEMENT

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Many credit agreements and security agreements contain definitions for dozens of words and phrases used in the agreement. Many then supplement their catalogue of definitions with a term that incorporates the UCC definition or meaning of other words and phrases. The following is a typical example.

> **Each term used but not defined herein has the meaning ascribed to it in the UCC [as enacted and in effect in _____].**

Unfortunately, this relatively simple and useful term can result in unintended and undesirable consequences for five related reasons. This article explains why and suggests a way to expressly incorporate UCC definitions while avoiding the undesirable consequences.

1. Too Many Notes

The first problem is that the UCC contains more than 300 definitions.[1] Some of these give a precise meaning to many commonplace words and phrases that might be found in a credit or security agreement. Examples include "purchase," "request," "send," and "receive."[2] Unless the person drafting an agreement has catalogued every defined word or phrase, and carefully ensured that the UCC definition is appropriate for every use of that word or phrase in the agreement, the drafter who incorporates all UCC definitions is essentially flying blind. Or, to use a better metaphor, is hoping to make a savory meal using every herb and spice in the pantry. Maybe it will work, but the risk of creating something distasteful is high.

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In sum, there are too many UCC definitions for a transactional lawyer to be aware of and deal with. So, something less than the wholesale adoption of all the UCC definitions is needed.

2. It Is Our Choices That Show What We Truly Are

The second problem is that the UCC contains multiple – and different – definitions for some words commonly used in credit agreements and security agreements. For example, "account" is defined differently in Articles 4 and 9.[3] In Article 9, the term means a right to payment, usually for property sold or leased or services provided; in Article 4, "account" means a bank account. "Instrument" is defined differently in Articles 3 and 9: the Article 3 definition is limited to negotiable instruments, and is therefore much narrower than the Article 9 definition.[4] The term "goods" is defined differently in Articles 2, 2A, 7, and 9.[5] The Article 9 definition differs from the others by excluding general intangibles, and might therefore be narrower.[6]

As should be obvious, these differences can matter. If a security agreement describes the collateral to include "accounts, instrument, and goods," the scope of the collateral would be quite different depending on which UCC definition was incorporated. For this reason, an agreement that incorporates UCC definitions needs to specify which competing definition for the same word or phrase applies.

3. I Don't Think That Word Means What You Think It Means

A third problem arising from the incorporation of UCC definitions is that the UCC defines some words in a manner that is likely to be inconsistent with how the words are used in a credit or security agreement. For example, § 2A-103(1)(r) defines "lien" to exclude a security interest. That definition is intended to apply to one UCC provision for which a technical and narrow meaning of the word was desired.[7] But that definition is patently inconsistent with the general understanding and usage. Most lawyers understand that the broad term "lien" includes judicial liens, statutory liens, and consensual liens. Consequently, a credit or security agreement is unlikely to use the word "lien" in the narrow sense that it is used in Article 2A. For example, such an agreement might define "default" to include the creation of any "lien" on the collateral. In this context, the obvious intent is that the creation of a consensual lien – that is, a security interest – would be a default.

Another example of a term defined in a manner inconsistent with prevailing usage is the word "accession." Section 9-102(a)(2) defines "accession" to mean "goods that are physically united with other goods in such a manner that the identity of the original goods is not lost." That definition, in isolation, is not problematic. But when context and the official comments are considered, a problem is revealed. Many security agreements define the collateral to include accessions *to* the original, identified collateral. In other words, it is common for contracting parties to use the word "accessions" in the description of collateral to pick up additional property. However, § 9-335 comment 3 makes it clear that it is the original, identified collateral that becomes an "accession"; the comment refers to the property with which the original collateral is united as "other goods." This meaning is consistent with how the statutory text uses the word "accession."[8]

Accordingly, it would be problematic if a security agreement adopted the Article 9 definition of "accession" and then provided that the security interest attaches to accessions to the original, identified collateral. If, as Article 9 indicates, "accessions" are the original, identified collateral, then an accession to the original, identified collateral adds nothing.

4. What We Have Here Is a Failure to Communicate

Putting aside the problems identified above about the large number of definitions, the existence of competing definitions for the same word or phrase, and the existence of definitions that are inconsistent with prevailing usage, there is an even more basic issue of determining what UCC provisions the agreement incorporates. The typical term quoted at the beginning of this article purports to incorporate into the agreement "the meaning ascribed to" a word or phrase in the UCC, and thus is apparently not restricted to formal, statutory definitions. But the breadth of that language is unclear.

At one end of the spectrum are the provisions in the UCC that specify what a word or phrase placed within quotation marks "means." These are clearly definitions and would no doubt be incorporated by the typical language quoted above.

Other UCC provisions use different language to explain the meaning of a quoted word or phrase. For example, § 2-106 specifies when goods and conduct are "conforming," when "'[t]ermination' occurs," and when "'[c]ancellation' occurs." Despite the absence of the word "means," these provisions are also definitions and would be incorporated by the typical clause. Next are the UCC provisions that state a word or phrase in quotation marks "includes."[9] These entries are, strictly speaking, not definitions; they are non-exhaustive descriptions.[10] Still, they would almost assuredly be incorporated by the typical clause.

Moving further along the spectrum are the provisions of the UCC that explain the meaning of a word or phrase that is not in quotation marks. For example, § 1-204 indicates the circumstances in which a person gives value. Sections 8-106, 9-104, 9-105, 9-106, and 9-107 provide rules on when a secured party has control of various types of collateral. These provisions might or might not be "definitions,"[11] but they unquestionably ascribe meaning to words and phrases and would therefore also seem to be incorporated by the typical clause.

Then there are terms used in the UCC that are not defined in the statutory text but are explained in the official comments. For example, comment 26 to § 9-102 contains a sort of stealth definition for the word "assignment," a word used extensively in Part 4 of Article 9.[12] After some courts misunderstood what the word means, and hence misapplied the rules in Part 4,[13] the Permanent Editorial Board issued a new Commentary explaining why the courts were wrong and amending the comments.[14] But still there is no statutory definition.

Finally, there are the words and phrases that are not expressly defined or explained in the statutory text or the comments, but might nevertheless have some meaning ascribed to them in the UCC, perhaps in official comments that provide examples. Whether the typical clause would incorporate the ascribed meaning of these terms is far less clear. That lack of clarity is further complicated by the fact that the UCC might not use any given word or phrase consistently throughout. Consider, for example, the undefined phrase "original collateral." That phrase appears in three places in § 9-315, as well as in more than 20 official comments throughout Article 9.[15] While traditional principles of statutory construction would suggest that the phrase has the same meaning each place it appears, this particular phrase appears to have three different meanings, depending on the context in which it is used: (i) the first collateral; (ii) the immediately preceding collateral; or (iii) any preceding collateral. Even solely within the text of § 9-315 the term apparently means different things in different places.[16]

So, clarity is needed about whether the agreement is incorporating only definitions or also other ascribed meanings, and if only definitions, whether they are limited to those that appear in the statutory text.

5. We're Not in Kansas Anymore

The Uniform Commercial Code is neither uniform nor a code. It is not a code because it is not law; it is merely a model for states, territories, and tribes to adopt as they see fit. It is not uniform because states, territories, and tribes have enacted versions that deviate from the official text in numerous ways. Some of these variations have even altered statutory definitions.[17] As a result, a lawyer drafting an agreement that

will incorporate UCC definitions needs to specify what version of the UCC is to be the source of those definitions.

Many agreements deal with this by specifying the version of the UCC as enacted in a specified jurisdiction. That certainly works but it is not necessary. A term in an agreement adopting UCC definitions is not a choice-of-law clause; it is instead an incorporation by reference of another document. Contract law permits parties to incorporate other documents in their agreement, and those other documents need not be created by the parties. So, there is no reason that the parties cannot by agreement adopt the definitions in the official text of the UCC.

If the lawyer nevertheless wishes to adopt the definitions in a version of the UCC enacted in a particular jurisdiction, then the lawyer should ascertain whether that jurisdiction has enacted a non-uniform version of any of the relevant definitions.

6. Always in Motion Is the Future

Things change. Among them are laws, which get enacted, repealed, and amended. Even the official text of model and uniform laws get revised. If an agreement incorporates the definitions in the UCC as enacted by a specified jurisdiction, or the official text issued by the ALI and ULC, the agreement should indicate clearly whether it is the definitions as they exist when the agreement is executed or the definitions as they are from time to time amended. It is common in a choice-of-law clause to refer to the law as it is amended from time to time. But as noted above, a term incorporating UCC definitions is not a choice-of-law clause. More to the point, it seems unlikely that the parties would really wish to effectively cede to a legislature or a UCC Drafting Committee the authority to change the meaning of their agreement. Such a change would likely cause the agreement to no longer mean what at least one of the parties intends or desires.

If the prospect of future changes to definitions seems unlikely, note that the Drafting Committee for the UCC and Emerging Technologies is currently in the process of drafting amendments to the UCC. These amendments are likely to add new definitions and change some existing definitions, including the existing definitions of "money," "chattel paper," and "deposit account." So, there is more than a small chance that the official text will change within the next year and that enacted versions will be amended soon thereafter.

SUGGESTED APPROACH

Because of the problems identified above, transactional lawyers should strongly consider selective, rather than wholesale, incorporation of UCC definitions and meanings. This gives the transactional lawyer control of precisely what is incorporated, and hence avoids most of the interpretive problems discussed above. One way to do this is to cut and paste the language of the desired definitions into the agreement. This approach has the benefit of making the agreement self-contained. A reader will not need to access the UCC to determine what the agreement means.

But this cut-and-paste approach has three drawbacks. First, it makes the agreement longer. Second, it might not work with respect to words and phrases that are defined in reference to other defined words. For example, the UCC defines "equipment" as goods that are not consumer goods, farm products, or inventory.[18] It defines "general intangibles" as personal property that is not any of the other principal types of property defined in Article 9.[19] If an agreement restated either of those definitions but did include the definitions for each of the other referenced terms, the definition would be hollow. Third, this approach incorporates the statutory text but arguably not the explanatory comments or the cases interpreting the statutory text.

A slightly different approach is to narrow the typical clause so that it incorporates the definitions of only those words and phrases that are capitalized in the agreement itself.[20] This too gives the transactional lawyer control over what definitions are incorporated and thus avoids the problems associated with incorporation on a wholesale basis. The other problems created by the typical clause can be avoided by specifying the version of the UCC that is incorporated. The following clause should work:

> **Each capitalized term that is not defined herein but is defined in the UCC has the meaning ascribed to the term in the official text and comments of the UCC as of the date hereof. If the UCC ascribes more than one meaning for a term, the meaning contained in Article 9 of the UCC applies.**

One drawback to this approach is that it leaves many terms undefined. In other words, the typical clause at the beginning of this article would potentially incorporated hundreds of definitions whereas this clause would likely incorporate only one or two dozen. But, as this article has attempted to show, the typical clause arguably creates more uncertainty and interpretive problems than it removes. Moreover, the clause suggested does not make the UCC irrelevant to the meaning of non-capitalized words and phrases. Because usage of trade is relevant to the interpretation of all agreements, anyone looking for guidance about what a non-capitalized word or phrase means might still conclude that the UCC meaning applies.[21]

A second drawback to this approach is that it requires the drafter to carefully ensure that each defined term is properly capitalized every time it is used. That is because any use of the term without capitalization creates ambiguity about whether the definition applies to that usage.*22* But such care is required with respect to all definitions of capitalized terms, not merely

definitions that incorporate a meaning ascribed by the UCC. So, this is something for which transactional lawyers already should be on guard.

Whatever approach the transactional lawyer takes, the lawyer should understand the benefits and drawbacks of that approach, and the interpretive problems that can arise. Be careful out there.

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Notes:

1. *See* U.C.C. §§ 1-201(b), 1-202(b), 1-303(a)–(c), 2-103(1), 2-104, 2-105, 2-106, 2A-103, 3-103(a), (b), 4-104(a), (b), 4A-103(a), 4A-104, 4A-105(a), (b), 5-102(a), 7-102(a), 8-102(a), (b), 9-102(a); 9-103(a), 9-210(a), 9-321(a), 9-333(a), 9-336(a), 9-503(h), 9-611(a), 9-616(a), 9-619(a).

2. *See* §§ 1-201(b)(29), (30) (defining "purchase" and "purchaser," respectively), (36) (defining "send"), 1-202(2) (defining "receives" in connection with a notice or notification), 9-102(a)(36) (defining "send"), 9-210(a)(1) (defining "request").

3. *See* UCC §§ 4-104(a)(1); 9-102(a)(2).

4. *See* UCC §§ 3-104(b), 9-102(a)(47).

5. *See* UCC §§ 2-105(1), 2A-103(1)(h), 7-102(a)(7), 9-102(a)(44). Other words or phrases defined differently in different UCC sections include "buyer in ordinary course of business," *see* UCC §§ 1-201(b)(9), 2A-102(1)(a), "commercial unit," *see* UCC §§ 1-205(6), 2A-103(1)(c), "good faith," *see* UCC §§ 1-201(b)(20), 5-102(a)(7), and "issuer," *see* UCC §§ 5-102(a)(9), 7-102(a)(8), 8-201(a).

6. It is worth noting that the Article 2 definition of "goods" relates primarily to the scope of the Article, and hence primarily to the relative rights of a buyer and seller, with only a few sections affecting rights of third parties. *See, e.g.*, § 2-403. In contrast, the Article 9 definition is not relevant to the scope of that Article. Instead, it is relevant to such matters as the method for perfecting a security interest in the property – a security interest in goods can be perfected by possession but a security interest in general intangibles cannot be, *see* § 9-313(a) – and priority. Given that the definitions serve very different purposes, it should not be surprising if the definitions have different meanings.

The issue can come up with respect to such things as printed tickets to a show or concert. Because the tickets are moveable – that is, they have mass – they would seem to be goods, at least for the purposes of Article 2. However, with respect to tickets to events that have not yet occurred, the tickets' value is not as physical objects, but in their ability to be used for admission. In other words, their value lies in the incorporeal right that they represent. *Cf.* In re Anderson, 584 B.R. 861 (Bankr. N.D. Ind. 2017) (tickets to Notre Dame football games were not "tangible personal property" within the meaning of the Indiana state exemption statute). That makes them seem more like general intangibles. Unfortunately, the interpretation of Article 9 is complicated by the fact that the Article 9 definition of "goods" excludes "general intangibles," *see* § 9-102(a)(44), and the definition of "general intangibles" excludes "goods," *see* § 9-102(a)(42), and that there is no ordering principle to determine which definition controls over the other. Presumably, the proper classification should be based on where the value lies and how the commercial world treats the type of property involved. Tickets for past events – I still have my ticket stub to Game 6 of the 1986 World Series – in contrast, no longer have value as a right to attend. If they have value at all, it is as memorabilia, and hence they should be treated as goods under Article 9.

7. *See* § 2A-307(2); *see also* § 2A-103 cmt.

8. *See* UCC § 9-335(a) (providing that a security interest "continues" in collateral that becomes an accession, implying that it is the original, identified collateral that is the accession).

9. *See* UCC § 1-201(b)(1),(7), (13), (22), (37), (43). *See also* § 2A-103(1)(v). In contrast, 20 paragraphs in § 9-102(a) begin by stating what a quoted word or phrase "means" and then add one or more express inclusions or exclusions. *See* § 9-102(a)(2), (3), (8), (10), (11), (12), (26), (29), (32), (40), (42), (44), (45), (47), (51), (53), (57), (59), (71), (76).

10. This is so even though the caption for § 1-201 is "General Definitions" and UCC § 1-107 provides that section captions are a part of the UCC.

11. The section caption for § 2-106 indicates that these are definitions. In contrast, the caption for each of the other sections mentioned does not label the section as a definition.

12. *See also* § 9-307 cmt. 2 (defining "chief executive office").

13. *See, e.g.*, Durham Capital Corp. v. Ocwen Loan Servicing, LLC, 777 F. App'x 952 (11th Cir. 2019); IIG Capital LLC v. Archipelago, LLC, 829 N.Y.S.2d 10 (N.Y. App. Div. 2007).

14. *See* PEB Commentary No. 21 (March 11, 2020).

15. *See* UCC §§ 9-101 cmt. 4a, 9-102 cmts. 5, 8, 13a, 13d, 9-104 cmt. 2, 9-109 cmt. 16, 9-207 cmt. 7, 9-312 cmt. 5, 9-315 cmts. 2, 4, 5, 6, 7, 9-322 cmts. 6, 8, 9, 9-322 cmt. 9, 9-324 cmt. 8, 9-327 cmt. 4, 9-336 cmts. 3, 5, 9-509 cmt. 4, 9-607 cmt. 3.

16. Section 9-315(c) states that "[a] security interest in proceeds is a perfected security interest if the security interest in the original collateral was perfected." In that context, the term "original collateral" means the immediately preceding collateral.

To understand why the term cannot mean the first collateral in that subsection, consider a situation in which a secured party has a security interest in inventory but mistakenly files as to accounts. The inventory is sold, generating accounts. The accounts are then paid by check. The security interest in the first collateral (the inventory) was not perfected by filing but the security interest in the accounts was perfected – not by virtue of § 9-315(c), but due to the filed financing statement. When the accounts are paid, there is no reason that § 9-315(c) should not apply to the checks.

The phrase also cannot mean any preceding collateral in subsection (c) because the idea is to preserve continuity of perfection. Consider a situation in which a secured party perfects a security interest in inventory by filing. The debtor sells inventory for cash and uses the cash to buy equipment. Two years later, the debtor trades the equipment for another item of equipment. The security interest in the cash was perfected under § 9-325(c) and (d)(2). As a result, the security interest in the initial item of equipment was perfected for 20 days, but no longer because § 9-315(d)(1)(C), (2), and (3) were not satisfied. If "original collateral" in § 9-315(c) meant any preceding collateral, the security interest in the second item of equipment would be perfected (at least for 20 days), but there is no reason that it should be.

Section 9-315(d)(1) on the other hand, provides for continuous perfection in proceeds if, among other things, "a filed financing statement covers the original collateral." That rule makes sense only if "original collateral" means any preceding collateral. To understand why the term "original collateral" in this provision cannot mean the first collateral, consider a situation in which a secured party acquires a security interest in a deposit account as original collateral and perfects by control. The secured party also files an authorized financing statement covering "inventory." The debtor uses funds from the deposit account to buy inventory. The debtor then sells the inventory on open account. If "original collateral" in § 9-315(d)(1)(A) meant the first collateral – the deposit account – the security interest in the account would become unperfected 20 days after it attached, but that would make no sense.

The term also cannot mean the immediately preceding collateral. Consider a situation in which a secured party obtains a security interest in inventory and perfects by filing as to "inventory." The debtor trades some inventory for an item of equipment. Three months later, the debtor trades the item of equipment for a new item of equipment. If the phrase "original collateral" mean the immediately preceding collateral, the security interest in the second item of equipment would be perfected for only 20 days. But that is not the way § 9-315(d) is intended to work. If it was intended to work that way, § 9-315(d)(2) would cut off perfection in all second-generation proceeds, not merely second-generation proceeds acquired with cash proceeds (*i.e.*, the word "cash" would not have been included).

17. For example, Kentucky has a non-uniform definition of "farm products" that includes "interests in horses" even if the debtor is not engaged in a farming operation. *See* Ky. Rev. Stat. § 355.9-102(1)(ah).

18. *See* UCC § 9-102(a)(33).

19. *See* UCC § 9-102(a)(42).

20. Alternatively, the drafter could eliminate the general clause entirely and instead create a separate clause for each desired definition. For example the definition section of the agreement might include a subsection that states: "In this Agreement . . . 'Equipment' means 'equipment,' as that term is defined in the UCC."

21. *See, e.g.*, In re 3P4PL, LLC, 619 B.R. 441, 457 (Bankr. D. Colo. 2020) (treating each of the terms "investment property, goods, documents, inventory, equipment, general intangibles, accounts, chattel paper [and] instruments" in a security agreement's description of collateral as meaning what Article 9 defines those terms to mean); Figueroa Tower I, LP v. U.S. Bank, 2019 WL 1467953, at *11-12 (Cal. Ct. App. 2019) (treating the Article 9 definition of "general intangibles" as applicable to a Deed of Trust that used but did not define the term); Porter Capital Corp. v. Horne, 2016 WL 4197328 (N.J. Super. Ct. 2016) (looking to the Article 9 definitions of collateral types to determine the meaning of terms undefined in a security agreement); In re Wiersma, 324 B.R. 92 (9th Cir. BAP 2005) (security interest attached to debtor's contract claim because it was a "general intangible" and thus fell within the description of the collateral), *rev'd in part*, 483 F.3d 933 (9th Cir. 2007). *But cf.* In re Eaddy, 2016 WL 745277, at *5-6 (Bankr. S.D. Ind. 2016) (suggesting that the term "accessions" in a security agreement need not have the meaning ascribed to it in § 9-335 because that definition is relevant only "to determine the priority of competing lienholders").

22. *See* CFIP Master Fund, Ltd. v. Citibank, 738 F. Supp. 2d 450, 463-64 (S.D.N.Y. 2010) (refusing to determine on a motion for summary judgment whether the uncapitalized word "subordination" was imbued with the definition of the capitalized term). *See also* Erie Indemnity Co. v. Estate of Harris, 99 N.E.3d 625 (Ind. 2018) (struggling to determine whether the phrase "others we protect" in an insurance policy meant the same thing as the defined term "OTHERS WE PROTECT"); Republic Bank of Chicago v. 1st Advantage Bank, 999 N.E.2d 9, 17 (Ill. Ct. App. 2013) (refusing to interpret the word "guaranty" as meaning what the capitalized term was defined to mean).

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Recent Cases

SECURED TRANSACTIONS

Attachment Issues

In re S-Tek 1, LLC,
2021 WL 6101680 (Bankr. D.N.M. 2021)

A security agreement covering "the following described property, whether now owned or hereafter acquired . . . All Goods, Furniture Equipment, Inventory, Accounts, Account Receivables [sic], General Intangibles, Contract Rights, and other personal property owned by Debtor as of the Effective Date of this Agreement," did encumber after-acquired accounts receivable, While the reference to property "owned by Debtor as of the Effective Date of this Agreement" might have been unnecessary, it did not render the collateral description ambiguous. However, because the security agreement did not cover the debtor's claim against a broker for negligent misrepresentation – a commercial tort claim – either as original or after-acquired collateral, it did not attach to the debtor's rights under a settlement of that claim. A secured party cannot make an end run around the limitations on security interests in a commercial tort claim by acquiring a security interest in amounts payable or paid as a result of a settlement of such a claim.

In re Caribbean Motel Corp.,
2022 WL 50401 (Bankr. D.P.R. 2022)

A mortgage that provided for a lien on the rents and "fruits" of a by-the-hour motel was insufficient to create a security interest in the room proceeds.

Nutrien AG Solutions, Inc. v. Dykes,
2021 WL 6139506 (S.D. Ala. 2021)

A supplier of agricultural products had a perfected security interest in a tenant farmer's share of the crops grown and their proceeds. There was no question that value was given and that the tenant had authenticated a security agreement that described the collateral. Although the supplier had not informed the landlord of its security interest, the supplier had no duty to do so and, as an institution that engages in financial and credit lending activities, was prohibited by federal law from making such a disclosure. Moreover, the supplier's filed financing statement gave the landlord constructive notice of the supplier's security interest. Accordingly, the supplier did not collude with the tenant to perpetrate a fraud on the landlord, and therefore the tenant had sufficient property rights in the crops for the supplier's security interest to attach.

Perfection Issues

In re NRP Lease Holdings, LLC,
20 F.4th 746 (11th Cir. 2021)

It was unclear under Florida law whether a financing statement that incorrectly used an abbreviation in the debtor's name was nevertheless effective. Under the rules of the filing office, when a debtor's name is entered into the search engine, an alphabetical list with twenty names is displayed. If the debtor's name is found, it will appear at the top of the list. If the debtor's name is not found, the nearest match is at the top of the alphabetical list. Buttons labeled "previous" and "next" can be used to display additional, alphabetized search results. In this case, the filed financing statement would be disclosed by clicking the "previous" button. Because of the uncertainty, the issue will be certified to the Florida Supreme Court.

Priority Issues

The Cortland Savings and Banking Co. v. Platinum Rapid Funding Group, Ltd., 2021 WL 6141520 (Ohio Ct. App. 2021)

A buyer of future receivables that received $869,250 through a series of wire transfers from the seller's deposit account took free of a security interest in the deposit account claimed by the depositary bank, whether as original collateral or as proceeds, unless the buyer acted in collusion with the seller to violate the bank's rights. Under Article 9, a "deposit account" does not "contain" funds; it is simply the monetary obligation of the depositary bank to the depositor.

Rice v. Downs,
2021 WL 6111750 (Cal. Ct. App. 2021)

Even if a payment that a law firm received from a limited liability company owned by a client was, in effect, a distribution to the client, the firm did not have to disgorge the payment in favor of a judgment creditor who obtained a charging order against the client's LLC interest because the firm had, apparently, previously perfected security interest in the client's LLC interest. There was no equitable basis for the trial court to override the firm's priority, if the firm in fact had a security interest covering the LLC interest and the distribution, and had the present right to collect.

Enforcement Issues

Stream TV Networks, Inc. v. SeeCubic, Inc.,
2021 WL 5816820 (Del. Ch. Ct. 2021)

The debtor was not likely to prevail on appeal of a summary judgment upholding the validity of a friendly foreclosure, by which the debtor transferred all its assets to a newly formed entity controlled by the debtor's secured creditors in return for a release from the secured obligation, some shares in the new entity, and a right of the debtor's minority shareholders to swap

their shares in the debtor for shares in the new entity. Although Delaware law generally requires stockholder approval of a sale of substantially all of a corporation's assets, that requirement does not apply to a transfer by an insolvent corporation. Accordingly, the debtor was not entitled to a stay, pending appeal, prohibiting the new entity from transferring assets.

Liability Issues

In re Bailey Tool & Manufacturing Co.,
2021 WL 6101847 (Bankr. N.D. Tex. 2021)

A factoring company was liable for $18 million in compensatory and punitive damages for breach of contract, fraudulent misrepresentation, tortious interference with business, willful violation of the automatic stay, and violation of Texas law protecting homesteads. The factor, almost immediately after entering into a factoring agreement with a business experiencing cash-flow problems: (i) refused to advance funds in the manner promised based on the assertion that the business was "over-advanced," a concept not defined in the agreements and problematic in light of the due diligence conducted; (ii) charged fees, expenses, and penalties without any transparency; (iii) exercised excessive control over the business by insisting on what vendors, employees, and expenses were paid; and (iv) coerced the owner of the business to transfer the equity in his homestead by misrepresenting that the factoring company would resume making advances if the owner did so.

Borowsky v. Brooks,
2021 WL 5816395 (Ariz. Ct. App. 2021)

Summary judgment was properly granted against the debtor on his breach of contract claim against an individual who allegedly funded the secured party's loan to the debtor. The individual was not a party to or mentioned in the loan agreement, and the parol evidence rule barred evidence that the individual was a partner of the secured party.

Cornerstone Community Credit Union v. Lee & Mason Financial Services, Inc., 2021 WL 5862499 (Conn. Super. Ct. 2021)

A credit union that loaned funds to enable an individual to purchase a vehicle from a dealer that never transferred title to the individual or had the credit union's interest noted on the certificate of title, had no claim against the insurance broker through which the credit union had purchased an Ultimate Loss Insurance policy. The broker was not the insurance company and could have no liability for breach of contract for failing to make payment under the policy. Moreover, the loss was not covered by the policy because the policy defined a covered loan as one for which a security interest was created and in this case no security interest was created because the individual never obtained rights in the car.

Flastar Bank v. Keiter, Stephens, Hurst, Gray & Shreaves,
2022 WL 135396 (E.D. Va. 2022)

A bank with a security interest in the debtor's portfolio of illiquid bonds stated a claim for fraud against the accounting firm that misrepresented the debtor's financial condition, leading to a loss in excess of $10 million. The complaint alleged that the audited financial statement contained false statements of material fact made recklessly, due to "woefully deficient" audits that were conducted without checking the debtor's stated values for the illiquid assets. The bank did not state a cause of action for aiding and abetting the debtor's fraud because there was no allegation that the accounting firm had actual knowledge of the debtor's fraud. The bank also did not state a claim for negligent misrepresentation because even though the complaint stated that the accounting firm had reason to know that the bank would rely on the audited financial statements, there were no writings identifying the bank as an intended beneficiary of the financial statements, as is required under Michigan law for a claim of negligence against an accountant.

BANKRUPTCY

Discharge, Dischargeability & Dismissal

In re The Hertz Corp.,
2021 WL 6068390 (Bankr. D. Del. 2021)

Unsecured noteholders, who were treated as unimpaired in the debtors' confirmed Chapter 11 reorganization plan, were entitled to contractual make-whole payments only if the payments were not the economic equivalent of unmatured interest. Because the debtors were solvent, the noteholders were entitled to post-petition interest but only at the federal judgment rate, not the contract rate.

Discharge, Dischargeability & Dismissal

In re Arnett,
2021 WL 5985328 (Bankr. M.D. Ala. 2021)

Because a debtor cannot, prepetition, waive the right to file for bankruptcy protection or the dischargeability of a debt, a representation in a car title pawn transaction that the debtor did not intend to file a bankruptcy petition was not enforceable. Such a representation is functionally indistinguishable from a stipulation that the debt is nondischargeable. Even though one of the debtors in these cases filed less than six hours after rolling over a title pawn transaction and the other filed within two days of doing so, the debtors' plans were proposed in good faith. Their actions were the only way to save their cars, given the predatory interest rates of 133% and 206%, respectively, that the creditor charged.

GUARANTIES AND RELATED MATTERS

CP III Rincon Towers, LLC v. Cohen, 2022 WL 61318 (S.D.N.Y. 2022)

A term in a guaranty agreement providing that any voluntary or involuntary "transfer" of the collateral without the lender's prior approval, a term defined to include the creation of any lien, was not triggered by the imposition of several mechanic's liens. The guaranty also had a term triggering recourse upon the creation of a voluntary lien, which would be rendered meaningless if the term regarding transfer were interpreted to include involuntary liens. Such an interpretation would also render largely meaningless another term allowing the borrower to challenge the amount or validity of labor and material charges, and was inconsistent with the parties' course of dealing, pursuant to which the original lender took the position that the mechanic's liens did not trigger guarantor liability. Guarantor liability was also not triggered by a term requiring the lender's consent to any indebtedness in excess of $250,000 because the loan agreement contemplated that the borrower would incur the obligations to the mechanic's lienors by requiring the borrower to renovate the real property serving as collateral.

LENDING, CONTRACTING & COMMERCIAL LITIGATION

Adventure Motorsports Reinsurance, Ltd. v. Interstate National Dealer Services, 2021 WL 5893247 (Ga. 2021)

Under Georgia law, a court could not decline to enforce an arbitrator's award based on manifest disregard of the law in the absence of evidence that the correct law was communicated to the arbitrator and the arbitrator knowingly and intentionally chose to ignore the law. Because the arbitrator in this case never expressed during the hearing or in the arbitration award that the correct law should be ignored, at most there was evidence that the arbitrator made a mistake.

Stroudwater Associates v. Kirsch, 2021 WL 5815910 (D. Me. 2021)

Lenders' claim for specific performance of the debtor's promise to provide access to its books and records would not be dismissed. The debtor failed to explain why monetary damages would be an adequate remedy. The lenders' claim against the debtor's principals for breach of fiduciary duties would not be dismissed based on the lenders' commitment in intercreditor agreements not to seek to enforce the debt before the senior lender was paid. The claim was not an effort to collect the debt, but an effort to hold the principals liable for misstating the debtor's income in an effort to protect their incentive compensation. Nor could the claim be dismissed based on the lack of a fiduciary duty to creditors because there was an allegation that the debtor was insolvent and the directors of an insolvent corporation do owe a fiduciary duty to the corporation's creditors.

United States v. Mendez, 2021 WL 5898185 (S.D. Fla. 2021)

The right to payment of a law firm that successfully recovered the proceeds of stolen property for corporate entities owned by a man convicted of bank fraud and whose assets were subject to forfeiture to the federal government was not entitled to priority over the federal government. The firm had no security interest in – and hence was not a bona fide purchaser of – the recovered proceeds.

Gito, Inc. v. Axis Architecture, P.C., 2021 WL 5858467 (Pa. Super. Ct. 2021)

An agreement for architectural services to a school board that provided that neither party could assign the agreement without the consent of the other did not prevent the school board from assigning its claim for breach of contract to the contractor as part of a settlement with the contractor. A contractual term prohibiting assignment of "the agreement" prohibits a delegation of duties, not an assignment of rights, and did not prohibit the assignment of post-contract performance claims for damages.

TitleMax of Delaware, Inc. v. Weissmann, 2022 WL 200974 (3d Cir. 2022)

The application of Pennsylvania's usury laws to out-of-state lenders that made secured vehicle loans to Pennsylvania residents does not violate the dormant Commerce Clause. Even though the loan process occurs outside Pennsylvania and the loans are made by checks drawn on a bank outside the state, the Pennsylvanian debtors make payment from within the state, the collateral is located and registered in Pennsylvania, and the collateral might be repossessed in Pennsylvania. Moreover, the state has a strong interest in prohibiting usury and its usury laws do not impose any burden on the out-of-state lender that they do not also put on in-state lenders.

AB Stable VIII LLC v. Maps Hotels and Resorts One LLC, 2021 WL 5832875 (Del. 2021)

An entity that contracted to buy15 hotel properties was not liable for breach when it pulled out of the deal because the seller breached a covenant to conduct business "only in the ordinary course of business, consistent with past practice in all material respects" by closing hotels, laying off or furloughing thousands of employees, and implementing other drastic changes in response to the pandemic, without the buyer's consent. It did not matter whether the seller's actions were reasonable or similar to what other businesses did because the response was not "consistent with past practice," and the buyer had not consented to the changes. Although the contract's Material Adverse Event provision allocated pandemic risk to the buyer, the ordinary course covenant contained no exception for material adverse events.

In re Grail Semiconductor,
2022 WL 194384 (Bankr. E.D. Cal. 2022)

A draft intercreditor agreement that, after the subordinating creditors signed, the senior creditor modified to add the name of its wholly-owned subsidiary through which the senior creditor provided financing, was merely a counter-offer to which the subordinating creditors objected, albeit without informing the senior creditor. There was insufficient evidence for the court to determine whether the counter-offer was accepted by a method other than by signature. Even if the intercreditor agreement was a binding contract, it was ambiguous because it described the senior creditor as a "second priority" creditor and the subordinating group as"third priority" creditors, but also stated that the second and third priority creditors were to be paid "concomitantly" and "pari passau."

Rochester MSA Building Co. v. UMB Bank,
2022 WL 110295 (D. Minn. 2022)

The inclusion of a receivership remedy in loan agreements for charter schools will be afforded some weight in the court's decision, but the factors normally relevant to the granting of such an equitable remedy still apply, and the burden remains on the creditor, because: (i) the borrowers did not in the agreements consent to a receivership outright; they agreed merely not to "oppose, contest, or challenge" the appointment of a receiver and that the indenture trustee was "entitled to . . . *apply* . . . for the appointment of a receiver" (emphasis added by the court); and (ii) the parties conditioned the availability of receivership on specified events of default but the borrowers do not concede that such a default occurred. The equitable factors did not justify the appointment of a receiver because: (i) the existence of a default was contested; (ii) there was no claim that fraudulent conduct had occurred or was likely to occur; (iii) despite claims of mismanagement, there was no showing of imminent danger that collateral will be concealed or lost, or will diminish in value; (iv) appointment would add an expense when the borrowers were already paying for a business manager appointed by the indenture trustee; and (v) appointment created a risk of reduced revenue due to community misconception of the borrowers' financial condition.

Ladder Capital Finance LLC v. 1250 North SD Mezz LLC,
2022 WL 109000 (N.Y. Sup. Ct. 2022)

Because a loan agreement provided that, if the lender violates an obligation to act reasonably, the borrower will not be entitled to monetary damages and its only potential remedies will be to seek injunctive or declaratory relief, the borrower had no claim against the lender for breach of contract for unreasonably refusing to consent to change in management, improperly accelerating the debt, conducting a commercially unreasonable public auction in poor weather conditions, and refusing to allow the borrowers to pay off the loans. Because the agreement provided that no modification or waiver would be effective unless in a writing signed by the party against whom enforcement was sought, the borrower also had no promissory estoppel claim based on the lender's alleged promise not to seek a deficiency if the lender purchased the collateral at a public sale. The term in the agreement restricting amendment and waiver prevented the borrower from reasonably relying on the alleged promise.

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COMMERCIAL LAW AMICUS INITIATIVE UPDATE

In December, the Commercial Law Amicus Initiative ("CLAI") won its third case when the Ohio Court of Appeals reversed a trial court's summary judgment and ruled in *The Cortland Savings and Banking Co. v. Platinum Funding Group, Ltd.*, 2021 WL 6141520 (Ohio Ct. App. 2021), that a transferee of funds from a deposit account takes free of a security interest in the deposit account – whether claimed as original collateral or as proceeds – unless the transferee acts in collusion with the debtor to violate the rights of the secured party. In doing so, the court rejected the faulty analysis of *In re Tusa-Expo Holdings*, Inc., 811 F.3d 786 (5th Cir. 2016), and noted that a deposit account does not "contain" funds. Instead, deposits are a loan to the bank, and a deposit account is merely the depositor's right to payment from the bank. The decision brings CLAI's record as *amicus curiae* to 3-0.

Also in December, CLAI filed a brief before the Texas Supreme Court urging review and reversal of *HHH Farms, LLC v. Fannin Bank*, 2021 WL 5263701 (Tex. Ct. App. 2021), a case involving substantially the same issue as that presented in *Cortland Savings*.

In January, CLAI filed a brief before the Kentucky Supreme Court urging it to affirm the decision in *Versailles Farm, Home and Garden LLC v. Haynes*, 2021 WL 519722 (Ky. Ct. App. 2021), but on slightly different grounds, and to clarify that, even if an initial security agreement lacks a future advances clause: (i) the security interest can secure a later indebtedness if the transaction documents for the later debt so provide; and (ii) the priority of the security interest securing the later indebtedness is the same as the priority of the security interest securing the initial secured obligation.

Anyone who wants to review either brief may obtain a copy at CLAI's website: amicusinitiative.org. If you are aware of a case that you think CLAI should participate in as *amicus curiae*, please contact any of CLAI's officers:

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