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ANTICIPATING TRANSMUTATIONS OF COLLATERAL

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You represent a lender planning to make a loan that will be secured by specified personal property. You conduct the appropriate due diligence and prepare the necessary transaction documents to ensure that your client's security interest will be perfected and will be the first-priority security interest in the collateral. Assuming you do that correctly, what could go wrong? Actually, many things.

There might be a catastrophic global event, such as a war or pandemic, the risk of which we used to regard as remote. The economy might slide into a recession or the borrower might go into bankruptcy. There is the ever-present possibility that the borrower will be the victim of fraud and theft, or the perpetrator of such conduct. This article is about none of those things. It is, instead, about a type of legal problem: when something unexpected happens to the collateral, and that event jeopardizes the attachment, perfection, or priority of the client's security interest.

Some post-closing events rarely cause a problem. For example, debtors often sell, lease, or license the collateral, causing the security interest to attach to identifiable proceeds.[1] But Article 9 of the UCC, which governs security interests in most types of personal property, has both automatic attachment and automatic perfection rules to protect a secured party's interest in proceeds.[2] Moreover, the possibility that a security interest will attach to proceeds is something that transactional lawyers are likely to anticipate and to deal with in the transaction documents as best they can.

Accordingly, this article deals with other, less common and more subtle transmutations of collateral. Many of these transmutations involve a post-closing shift in the collateral's classification. Article 9 categorizes personal property into twelve, mutually exclusive classifications. The rules on attachment, perfection, priority, enforcement, and governing law all vary with the type of collateral involved. Unfortunately, the classifications of collateral are not static; collateral can transmute from one classification to another during the term of the secured obligation. Transactional lawyers need to plan ahead for these transmutations.

Other transmutations discussed in this article do not involve a classification shift, but nevertheless can cause a surprising loss of perfection or priority. For each transmutation discussed, this article indicates what the transactional lawyer representing the secured party might wish to include in the security agreement to help protect against the problems that the transmutation might cause.

GOODS

Article 9 has four mutually exclusive subclassifications of goods: consumer goods, equipment, farm products, and inventory.[3] How a particular good is classified depends, for the most part,[4] on how the debtor is using the goods. Consequently, if the debtor's use of the good changes, the classification can change.

1. Inventory Becomes Equipment

Consider a situation in which a secured party has a security interest in all of the debtor's inventory, and has perfected that security interest by filing a financing statement in the jurisdiction where the debtor is located. The debtor then takes an item of inventory off the showroom floor or out of the back storeroom and starts using the item for a business purpose other than sale or lease. For example, a debtor in the business of selling kitchen appliances takes a microwave oven out of the storerooms and puts it in the break room for use by employees. A used car dealer might take a care off the lot and use it as a loaner to customers who bring their own cars to the dealer for repair. Such an act converts the re-purposed good to equipment. That transmutation can affect attachment, perfection, or priority.

The transmutation could cause the security interest to de-attach from the item if the security agreement limits the collateral to inventory. Whether the agreement is so limited is not an issue of law but of contract interpretation.[5] A court might interpret a security agreement that describes the collateral as "all

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existing and after-acquired inventory" as encumbering only goods currently used as inventory,[6] not goods previously used as inventory or goods that are of a type that the debtor customarily uses as inventory. To guard against this risk, the secured lender to the car dealer could describe the collateral as "all existing and after-acquired inventory and vehicles." But when the items of inventory that might transmute are varied, simply adding a reference to one type of goods (such as "vehicles" or "appliances") might be insufficient. In such cases, the security agreement could define "inventory" so as to cover any property that is "of a type" that would otherwise fall within the meaning of that term. The following, which adds "of a type" to the Article 9 definition of "inventory," should work:

"Inventory" means all goods that are or are of a type that is:

(A) leased by Debtor;

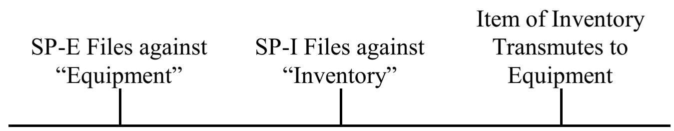
(B) held by Debtor for sale or lease or to be furnished under a contract of service;

(C) furnished by Debtor under a contract of service; or

(D) raw materials, work in process, or materials used or consumed in a business.

In general, a transmutation from inventory to equipment will not result in a loss of perfection achieved through the filing of a financing statement. The place to file as to both inventory and equipment is the same – in the jurisdiction where the debtor is located[7] – and even if the financing statement's indication of collateral is limited to "inventory," that indication will remain sufficient despite the collateral's transmutation to equipment.[8] However, in some cases the transmutation can cause the *method of perfection* to change. The example above of the used car dealer using a car as a loaner is such a case. The moment the car dealer re-purposes the car, causing the car to transmute to equipment, perfection by filing ceases to be effective. Instead, perfection can be achieved only through compliance with the certificate-of-title statute.[9] As a result, perfection will lapse the moment the transmutation occurs. There is no grace period. The only way to guard against this risk is to include in the security agreement a covenant by the debtor to either: (i) not convert any inventory to equipment; or (ii) send written notification to the secured party in advance of any such conversion, and thereby allow the secured party to maintain perfection by complying with the certificate-of-title statute. The secured party could then monitor the debtor's compliance with these covenants by periodically checking the odometer of each vehicle. Vehicles with a substantial increase in miles driven – more than would result from a occasional test drive – might have become equipment.

Even when there is no danger to perfection, transmutation of goods from inventory to equipment can affect priority. Consider, for example, a scenario in which, prior to the inventory lender's acquisition and perfection of a security interest in inventory, another secured party acquired a security interest in the debtor's existing and after-acquired equipment, and perfected that security interest by filing a financing statement covering equipment. Later, an item of inventory transmutes to equipment:



Under the first-to-file-or-perfect rule of § 9-332(a)(1), the security interest of the inventory financier in the transmuted goods will become junior to the security interest of the equipment financier. To guard against this risk, the inventory financier could, before extending credit to the debtor, insist that the equipment financier enter into an agreement subordinating its security interest in inventory that transmutes to equipment.[10]

2. Inventory Held for Sale Becomes Inventory Held for Lease

Goods held for lease are, like goods held for sale, inventory.[11] Therefore, when a debtor shifts from selling goods to leasing goods, the classification of the goods does not change. But the method of perfection might. If the debtor is a car dealer in the business of selling cars (or in the business of both selling and leasing cars), the way to perfect a security interest in the cars is by filing a financing statement.[12] However, if the debtor discontinues all sales practices and instead only leases cars, perfection by filing ceases to be effective and instead a security interest in the cars can be perfected only by compliance with the applicable certificate-of-title statute.[13] This scenario might sound far-fetched, but it essentially happened last year when a dealer in certificated goods – truck trailers – created a subsidiary to do all leasing transactions and transferred some of the goods to that subsidiary.[14] The court ruled that the security interest remained perfected, but that ruling was erroneous.[15]

The only way to protect against this risk is to include in the security agreement a covenant by the debtor either not to shift to an all-leasing business structure, either directly or through a subsidiary, or to send written notification to the secured party in advance of any such shift.

3. Goods Become Covered by a Document of Title

On occasion, a debtor delivers collateralized goods – most commonly inventory – to a professional bailee for storage or transport. If the bailee – a warehouseman or carrier – issues a negotiable document covering the goods, title to the goods becomes bound up in the document. This is not to say that the goods transmute into a document. The goods remain goods and whatever subclassification they had before delivery to the bailee is unlikely to be affected by either the bailee's possession or the issuance of the document. Nevertheless, the security interest in the goods is now vulnerable.

If the debtor duly negotiates the document to a holder,[16] the document holder's rights under Article 7 will potentially trump the secured party's security interest in the goods.[17] Specifically, if the secured party: (i) "entrusted" the goods to the debtor with the authority to store or sell them or with power to do so under other law; or (ii) "acquiesced" in the debtor's procurement of the document of title, the holder will take free of the secured party's security interest in the goods.[18]

Courts are not in complete agreement about what conduct of the secured party counts as "entrustment" or "acquiescence," and it is unlikely that any language in the security agreement can fully protect the secured party against the consequences of its own later conduct. Nevertheless, the risk of an entrustment or acquiescence can be reduced by including in the security agreement either: (i) a covenant by the debtor not to store the collateral with a bailee or to procure a negotiable document of title covering the collateral without the secured party's prior, written consent; or (ii) a declaration that the debtor has no authority to so.

4. Goods Become Real Property

Article 9 generally does not apply to a security interest in real property.[19] When ordinary building materials, such as lumber and sheet rock, are incorporated into an improvement on land, they cease to be goods for the purposes of Article 9.[20] Any Article 9 security interest that attached to the goods prior to their incorporation into the improvement no longer exists, and the secured party's interest in the goods, if any, will be determined by applicable real property law.[21] In all likelihood, if the secured party has no lien on the real property, the secured party retains no interest in the former goods at all.[22]

There is little that a secured party can do to protect itself against this risk. Fortunately, the likelihood that goods will become real property in this manner is usually small, and probably is limited to a narrow class of debtors (*e.g.*, builders) and a narrow class of goods (building materials). The one exception, for which the risk of this type of transmutation is higher, is a manufactured or mobile home that the debtor affixes to real property. Several states have statutes that expressly provide that when such a home is affixed to real property, and the certificate of title for the home is surrendered, the home becomes for all purposes an improvement to real property, and a separate security interest in the home no longer exists.[23] But even these situations do not present too much of a problem for secured parties because surrender of the certificate of title usually requires the signature of all secured parties,[24] and thus, absent forgery, cannot be done without the secured party's knowledge and participation.

5. Goods Become Fixtures

A far more likely transmutation occurs when goods become "fixtures." Fixtures are goods that become so related to real property that an interest in them arises under real property law.[25] This typically occurs when the goods are affixed to real property in a permanent or quasi-permanent manner. But unlike ordinary business materials, which cease to be goods when incorporated into an improvement on real property, fixtures retain their status as goods under Article 9. As a result, fixtures straddle the line between personal and real property, and are governed simultaneously by the legal regime applicable to each. Thus, a consensual lien in a fixture can arise under either personal property law (through Article 9) or real property law (through the law of mortgages).[26]

When goods subject to a perfected security interest become fixtures, the security interest remains perfected. This is apparently true even for security interests in a manufactured home perfected by compliance with a certificate-of-title statute,[27] provided the mobile home did not become real property upon surrender of the certificate of title. Hence, neither attachment nor perfection is jeopardized by what might be the debtor's unilateral action in converting goods into fixtures. Priority, however, is another matter.

The baseline rule is that a security interest in fixtures is subordinate to the conflicting interest of a real property claimant (other than the debtor).[28] There are three exceptions to this rule. First, the security interest will have priority if it is perfected by a "fixture filing" in the real property records before the interest of the real property claimant is recorded there.[29] Unfortunately, that rule does not enable the secured party to take priority over an earlier recorded mortgage and is unlikely to be of assistance if the transmutation to fixtures is unexpected.

Second, if the goods are encumbered by a purchase-money security interest ("PMSI") before they become fixtures and the secured party records a fixture filing before or within 20 days after the goods become fixtures, the PMSI generally has priority over the interest of a real property claimant.[30] To take advantage of this rule, the secured party – or its transactional lawyer – needs to inquire, at the time the time the deal is negotiated, whether the debtor plans to transmute the goods into fixtures and, if so, timely make the appropriate fixture filing. But this rule remains rather narrow and will not help the secured party retain priority after an unexpected affixation.

Third, a security interest in the goods that was perfected before the goods became fixtures has priority over a real property claimant's interest if the goods are: (i) factory or office machines; (ii) equipment *not* primarily used in the operation of the real property; or (iii) domestic appliances that are consumer goods.[31] The breadth of this exception is not entirely clear because the phrase in romanette (ii) – used in the operation of the real property – is not defined in the statute or explained in the comments. It seems likely, though, that many fixtures are used primarily in the operation of the real property, with the result that the baseline rule giving priority to the real property claimant often applies

To help guard against the loss of priority that can result when goods become fixtures, a transactional lawyer might wish to include in the security agreement a covenant by the debtor not to convert goods to fixtures without the secured party's prior written consent. Such a covenant could help in two ways. First, if the debtor complies with the covenant, the secured party could withhold consent unless circumstances were such that priority would be maintained, all prior real property claimants agreed to subordinate, or the debtor paid down the secured obligation. Second, because in many states status as a fixture is based in part on the intent of the person attaching the goods to the real property, a court might interpret the debtor's failure to obtain the secured party's consent as an intention that the goods not become fixtures.

6. Goods Cease to Be Fixtures

If a secured party has a security interest in fixtures and has perfected that security interest only by recording a fixture filing, perfection could be lost if the debtor removes the fixtures from the real property. That is because a fixture filing is typically made at the local level in the jurisdiction where the goods are located,[32] whereas the place to file a financing statement to perfect a security interest in goods that are not fixtures is usually in a centralized office in the jurisdiction where the debtor is located.[33] In short, either the state in which to file or the office within that state to file is likely to change instantaneously when the goods cease to be fixtures.

To protect against this risk, a transactional lawyer should, at the inception of the secured transaction, ensure that a financing statement is filed in the office designated by § 9-501(a)(2) in the jurisdiction where the debtor is located and that the financing statement indicates the collateral in terms broad enough to cover the goods.

7. Timber to Be Cut Is Cut

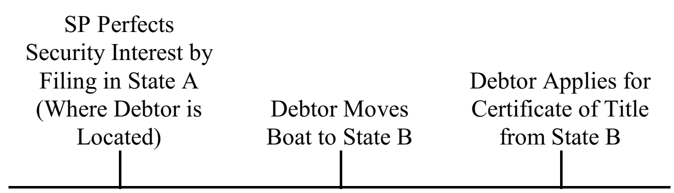
Article 9 treats as goods timber to be cut and removed from real property pursuant to a contract for sale.[34] To perfect an Article 9 security interest in such "timber to be cut," a financing statement must be filed in the real property records of the county where the timber is located.[35] But once the timber is cut, it ceases to be "timber to be cut," with the result that the proper place to file is now in the central filing office of the state in which the debtor is located.[36] This problem is essentially the same as what happens when fixtures are severed from real property.

To protect against this type of transmutation, a transactional lawyer should ensure that, at the inception of the transaction, a financing statement is filed in the office designated by § 9-501(a)(2) in the jurisdiction where the debtor is located and that the financing statement indicates the collateral in terms broad enough to cover cut timber.

8. Relocation of Equipment or Consumer Goods to a Different Jurisdiction

Every state has one or more a certificate-of-title statutes. But the goods to which these statutes applies varies considerably. All states issue certificates of title for cars and trucks. But only some of them issue certificates of title for trailers or for watercraft. When a debtor moves equipment or consumer goods from a jurisdiction that does not issue certificates of title for the goods to another jurisdiction that does, a secured party with a perfected security interest in the goods is at risk of losing perfection and priority.

For ease of analysis, let us start with the following hypothetical scenario. Lender has a security interest in Debtor's boat, perfected by a filed financing statement in the jurisdiction where the debtor is located.[37] The jurisdiction where the boat is principally located does not issue certificates of title for boats. The debtor then moves the boat to a state that does issue certificates of title for boats, and applies for a certificate of title:

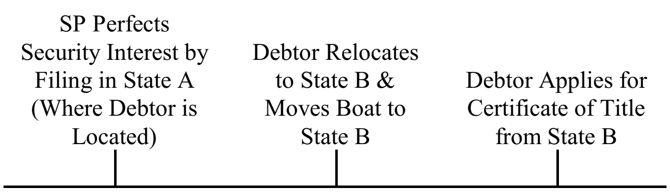


The moment the debtor filed an application for a certificate of title, the law governing perfection changed from State A to State B.[38] Nevertheless, pursuant to § 9-316(d) (as enacted in State B), even if Lender's security interest is not noted on the certificate of title, Lender's security interest remains perfected for four months. Consequently, Lender has four months to: (i) learn that the debtor had moved the collateral and obtained a certificate of title; and (ii) comply with State B's certificate of title law, presumably by having Lender's security interest properly noted on the certificate. If Lender fails to comply with State B's certificate-of-title statute during that period, it will lose perfection as to any purchaser for value, and this loss is retroactive to when State B's law started to apply.[39]

Unfortunately, even during this four-month period of continued perfection, the priority of Lender's security interest is vulnerable. Under § 9-337(1), a buyer of the boat – other than a person in the business of selling boats – will take free of Lender's security interest if the buyer gives value and receives delivery of the boat without knowledge of the security interest. Similarly, under § 9-337(2), a security interest that attaches and is perfected during this four-month period will have priority over Lender's security interest if the new secured party lacked knowledge of Lender's security interest.

To guard against this risk, a transactional lawyer should include in the security agreement a covenant by the debtor to not move collateral to a jurisdiction where it might be covered by a certificate of title, to send written notification to the secured party in advance of moving the collateral, or to include a reference to the secured party's security interest in any application for a certificate of title. None of those covenants will do much good if the debtor forgets about or ignores the covenant.

Unfortunately, the risk to the secured party can be even greater. Consider a scenario, perhaps more likely than the one discussed above, in which the debtor also relocates to the new state before applying for the certificate of title:



On these facts, a strict reading of § 9-316 suggests that perfection is lost immediately when Debtor applies for the certificate of title, not four months later. That is because the law governing perfection shifted from State A to State B when Debtor relocated, not later when Debtor applied for the certificate of title.[40] Although under § 9-316(a)(2) perfection normally continues for four months following a debtor's relocation to a new state, it is not clear that either that rule or § 9-316(d) applies on these facts, once the application for the certificate of title is filed.

Section 9-316(a)(2) applies only when a security interest is perfected pursuant to the law of the jurisdiction designated in § 9-301(1) or § 9-305(1). That was the case prior to filing the application for the certificate of title, but once the application was filed, the governing law was designated by § 9-303. Section 9-316(d) applies only if, when the goods become covered by a certificate of title in "this State," a security interest was perfected under the law of another state. But when the application for a certificate of title was filed, State B's law already governed perfection.[41]

This technicality might be regarded as a drafting glitch, and a court might conclude that Lender's security interest remains perfected for four months after Debtor's move, as the drafters of Article 9 no doubt intended. But the fact remains that a relocation of collateral from a non-titling jurisdiction to a titling jurisdiction is a transmutation for which transactional lawyers and their clients need to prepare.

9. Refinancing of a PMSI in Consumer Goods

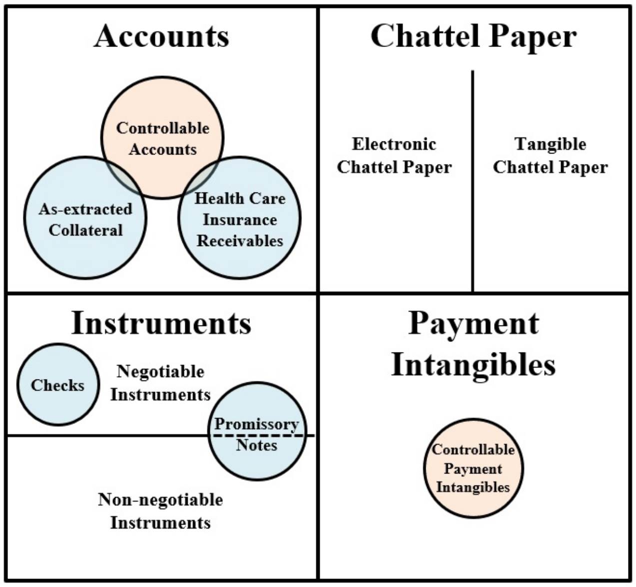
The original version of Article 9 was silent about whether purchase-money status was lost if the debtor and the secured party refinanced the secured obligation, such as by incurring additional indebtedness, adding collateral, extending the time for payment, or altering the interest rate. Revised Article 9 expressly provides that PMSI status is not lost when the purchase-money obligation is refinanced in any of these ways.[42] However, this rule applies only when the secured transaction is not a consumer-goods transaction. If the secured transaction is a consumer-goods transaction, the official text of Article 9 provides no guidance on whether a refinancing affects PMSI status.[43] Several states have dealt with this textual vacuum by enacting a non-uniform version of § 9-103 to make the new rule applicable to consumer-goods transactions.[44] In other states, the matter is left for courts to resolve.[45]

Loss of PMSI status can matter. A PMSI in consumer goods not covered by a certificate-of-title statute is automatically perfected.[46] If PMSI status is lost upon refinancing, automatic perfection ceases, instantaneously. If the secured party has not already filed a financing statement or taken possession of the goods, the security interest becomes unperfected the moment the refinancing occurs.

Transactional lawyers are unlikely to be involved in transactions giving rise to a PMSI in consumer goods. But the lawyers who advise sellers and lenders entering into such transactions – or advise financiers who lend to such sellers – should make sure their clients understand the risk and consequence of losing PMSI status and, in jurisdictions where PMSI status is lost on refinancing or the law is uncertain, that the clients consider filing a financing statement before refinancing a PMSI transaction.[47]

RECEIVABLES

Article 9 categorizes most receivables – that is, a right to payment of a monetary obligation – into one of four classifications: accounts, chattel paper, instruments, payment intangibles.[48] Three of these classifications currently have subclassifications, and two more subclassifications – "controllable accounts" and "controllable payment intangibles" – are included in the proposed amendments to the UCC, currently being finalized, that are designed to address issues arising from emerging technologies:



The distinctions depend largely on how the right to payment arose, what ancillary rights support the right to payment, whether the right to payment is in writing, and if it is in writing, what the writing says.

A security interest in all of these receivables can be perfected by filing.[49] But possession also works to perfect a security interest in written instruments and tangible chattel paper,[50] and control is an effective method for perfecting a security interest in electronic chattel paper.[51] These alternative methods of perfection are also critical to priority. A secured party or other purchaser[52] who acquires possession of an instrument or tangible chattel paper, or control of electronic chattel paper can take priority over or even free of a security interest perfected in a different manner.[53]

Unfortunately, receivables can transmute from one classification to another. When that happens, particularly when a receivable not subject to possession or control is converted into one that is, a secured party might find itself vulnerable to an unexpected loss of priority.

1. *Reification of an Account or Payment Intangible into an Instrument*

Consider a situation in which a secured party has a security interest in a debtor's accounts or payment intangibles, and that security interest is perfected by the only financing statement filed against the debtor. As long as the receivable remains outstanding and the financing statement remains effective, the priority of that security interest is fixed and cannot be altered by subsequent events. Well, unless the receivable transmutes into a different classification.

If the account debtor issues a negotiable instrument[54] or delivers a nonnegotiable instrument to the debtor, not in payment of the debt but as a memorialization or reification of it, the asset transmutes from an account or payment intangible into an instrument. This is unlikely to present an attachment problem,[55] and assuming it does not, it definitely presents no perfection problem.[56] But priority is another matter.

If the debtor transfers the instrument to a holder in due course, the holder will take free of the secured party's perfected security interest.[57] If the debtor transfers the instrument to a purchaser who took the instrument for value, in good faith, and without knowledge that the purchase violates the secured party's rights, the purchaser will have priority over the perfected security interest. The only ways to guard against these risks are to: (i) prevent the reification from occurring; (ii) ensure that the instrument indicates that it is subject to the secured party's security interest;[58] or (iii) take possession of the instrument. Covenants in the security agreement could address these matters.

2. *Reification of an Account or Payment Intangible into Chattel Paper*

Transmutation of an account or payment intangible into tangible chattel paper presents virtually the same problems as transmutation into in instrument. Priority is governed by different subsections of § 9-330, but the risk to priority and the methods to protect priority are the same.

INVESTMENT PROPERTY

Investment property – a type of personal property governed by both Articles 8 and 9 – includes several subclassifications. One such subclassification is a "security,"[59] which itself embraces two sub-subclassifications: certificated securities and uncertificated securities.[60]

A security interest in a security can be perfected either by filing a financing statement or by control.[61] But the choice matters because a security interest perfected by control has priority over a security interest perfected by some other method.[62] Or, looking at it from the other perspective, a secured party that perfects the first security interest in a security by filing a financing statement can lose priority to another secured party that later perfects by control. Even worse, a "protected purchaser" of the security can take free of the perfected security interest entirely.[63]

All this is reasonably straightforward except for one thing. Collateral can transmute into or out of a security.

1. General Intangibles Become a Security

Consider a situation in which a lender obtains a security interest in the borrower's membership interest in a limited liability company, a common practice because many borrowers grant a security interest in their membership interests in one or more subsidiaries formed as limited liability companies. Most LLC membership interests are general intangibles, and hence a security interest in them can be perfected only by filing a financing statement. But some membership interests are securities.

In general, LLC membership interests are securities only if the interests are "dealt or traded on securities exchanges or in securities markets."[64] However, to avoid the uncertainty associated with this test,[65] the company can elect to have its interests treated as securities. It does this by including in the company's operating agreement language stating that each membership interest in the company is a security, and thereby opting in to Article 8 of the UCC.[66]

Unfortunately, while the opt-in procedure can provide certainty that the membership interests are securities, opt-in status can change. An LLC operating agreement that did not include an opt-in clause when the loan was made and the security interest was granted could later be amended to add an opt-in clause. When that occurs, two risks arise.

First, a security interest in the membership interest might de-attach if the security agreement describes collateral as "general intangibles" and the agreement is interpreted to cover only property that is a general intangible, rather than property that was a general intangible at the time the debtor authenticated the agreement.[67] Second, even if the security interest survives the transmutation, a later secured party or protected purchaser who acquires control of the security could acquire priority over, or take free of, the security interest.

The best way to protect against this risk is to get the parties to amend the LLC operating agreement to provide that the secured party's consent is needed for all subsequent amendments (or at least any subsequent amendment opting into Article 8) to be effective. The statutes governing LLCs in at least a dozen states expressly permit an operating agreement to condition the effectiveness of an amendment on the approval of a person that is not a party to the agreement.[68]

If the state law that governs the operating agreement does not permit this type of restriction, then the best approach is to get a covenant from the relevant parties not to amend the agreement without prior notification to the secured party and assurance that the secured party will be given control of the security.[69]

2. A Security Becomes a General Intangible

The inverse of the prior problem can arise when an LLC membership interest was a security because the operating agreement opted into Article 8, the secured party perfected solely by control or by possession of the security certificate, and then the parties to the operating agreement amended the agreement by rescinding the opt-in election. In such a case, the membership interest would become a general intangible, filing would become the only permissible method to perfect, and the security interest would become unperfected.

Transactional lawyers can protect against this risk either by demanding that the operating agreement be amended to require the secured party's consent to future amendments, or by filing a financing statement as a back-up method of perfection.

OTHER

Federal law preempts Article 9's perfection rules with respect to security interests in aircraft,[70] ships,[71] registered copyrights,[72] and rolling stock.[73] To perfect a security interest in any of those types of property, filing in a specified federal office is required. Federal law does not preempt Article 9 with respect to perfecting a security interest in an unregistered copyright.[74] The only way to perfect a security interest in an unregistered copyright is to file a financing statement in the jurisdiction where the debtor is located.

1. Registration of an Unregistered Copyright

One implication of this limited federal preemption is that, when the debtor registers an unregistered copyright used as collateral, the method of perfection changes, and does so instantaneously. A security interest perfected under the UCC becomes immediately unperfected; there is no grace period.

To protect against this risk, particularly if the copyright is important collateral, a transactional lawyer might wish to explore whether the debtor would be willing to register the copyright before the secured loan is made. Then the secured party could perfect by filing in the Copyright Office and the collateral could not thereafter transmute because it is not possible to un-register a copyright.[75] If the debtor is not willing to register the copyright at that time, but the lender client is still willing to make the loan, then the transactional lawyer should include in the security agreement a covenant by the debtor to notify the secured party in advance of any planned registration of the copyright. The client should be advised that this might not insulate the client from preference risk if the debtor goes into bankruptcy within 90 days after the client re-perfects under federal law,[76] but it is the best that can be done.

CONCLUSION

This article has identified and discussed more than a dozen examples of how collateral can transmute in a way that might undermine attachment, perfection, or priority a security interest. These examples are no doubt not an exhaustive list, and readers are invited to submit others, for possible exploration in a follow-up article.

All the transmutations discussed present a risk. Transactional lawyers who represent secured lenders should, at the inception of a transaction, identify the potentially dangerous transmutations, do what they can in the transaction documents to protect the client from the effects thereof, and advise the client of the risks for which there is no adequate protection.

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Notes:

1. *See* § 9-102(a)(64) (defining "proceeds").

2. *See* § 9-315(a)(2), (c), (d).

3. *See* § 9-102(a)(23), (33), (34), (48) & cmt. 4a.

4. Because "consumer goods" are defined as goods "used or *bought for use* primarily for personal, family, or household purposes," § 9-102(a)(23) (emphasis added), goods "bought for" personal, family, or household purposes apparently remain consumer goods even if the debtor starts using them primarily for other purposes.

5. In all likelihood, the security agreement was drafted by or on behalf of the secured party. Traditionally, the maxim *contra proferentem*, pursuant to which agreements are interpreted against the drafter, is a rule of last resort, applicable only when all other interpretive devices fail to resolve an ambiguity. *See, e.g.*, Gardiner, Kamya & Assocs., P.C. v. Jackson, 467 F.3d 1348, 1353-54 (Fed. Cir. 2006); B.F. Goodrich Co. v. U.S. Filter Corp. 245 F.3d 587, 597 (6th Cir. 2001) (applying N.Y. law); Mesa Air Group, Inc. v. Dept. of Transp., 87 F.3d 498, 506 (D.C. Cir. 1996); Residential Mktg. Group, Inc. v. Granite Inv. Group, 933 F.2d 546, 549 (7th Cir. 1991) (applying Ill. law); Cal. Civ. Code § 1654. However, the maxim is not expressly so limited in the current Restatement, *see* RESTATEMENT (SECOND) OF CONTRACT § 206; *but see id.* cmt. a (indicating that the maxim is used only when other interpretive principles "are not decisive"), and the frequency and ardor with which some courts now resort to the maxim suggest that it might no longer be a rule of last resort, particularly with respect to a contract of adhesion. *See, e.g.*, Staffing Specifix, Inc. v. TempWorks Mgmt. Servs., Inc., 896 N.W.2d 115, 130-32 (Minn. Ct. App. 2017).

6. The term "inventory" is defined in Article 9 to include more than goods held for sale or lease. The term also includes raw material, work in process, and materials used up or consumed in a business. § 9-102(a)(48)(D). Of course, unless a security agreement incorporates that definition, either by restating it or by reference, a court need not interpret the term in the agreement consistently with the statutory definition. After all, the definitions in Article 9 purport merely to define words used in the Article itself, not words used in private agreements. *See e.g.*, § 9-102(a) (beginning "in this article . . .").

7. *See* § 9-301(1).

8. *See* § 9-507(b). One implication of this is that searchers interested in an item of property currently used as equipment should be concerned about a filed financing statement indicating the collateral as "inventory" if there is any chance that the item might once have been inventory.

9. *See* § 9-311(a)(2), (d). *See also id.* cmt. 4 ("If the debtor takes goods of this kind out of inventory and uses them, say, as equipment, a filed financing statement would not remain effective to perfect a security interest.").

10. A transmutation in the opposite direction – equipment becomes inventory – could also occur and present the same problem.

11. *See* § 9-102(a)(48)(A), (B).

12. *See* § 9-311(d).

13. *See id.*

14. *See* In re K&L Trailer Leasing, Inc., 630 B.R. 81 (Bankr. E.D. Tenn. 2021).

15. *See* Carl S. Bjerre & Stephen L. Sepinuck, *Spotlight*, Commercial Law Newsletter 16-17 (Sept. 2021).

16. *See* § 7-501.

17. *See* § 9-331(a).

18. *See* §§ 7-503(a), 2-403(2), (3).

19. *See* § 9-109(d)(11).

20. *See* § 9-334(a). As for what constitutes "ordinary building materials," see In re Vincent, 468 B.R. 802 (Bankr. E.D. Va. 2012) (because windows and siding are ordinary building materials, a creditor's alleged security interest in them did not continue after they were installed in the debtor's home); In re Adkins, 444 B.R. 374 (Bankr. N.D. Ohio 2011) (because windows are ordinary building materials, a creditor's security interest in windows did not continue after the windows were installed in home); Baker Constr. Co. v. City of Burlington, 2009 WL 3350747 (N.C. Ct. App. 2009), *review denied.*, 690 S.E.2d 529 (N.C. 2010) (underground water and sewer lines were ordinary building materials, not fixtures, and thus became

the real property in which they were installed). *But cf.* In re Hodgins, [2019 WL 4296859] (Bankr. E.D. Mich. 2019) (a security interest in siding survived installation of the siding on the debtors' property; the siding was a fixture); In re Ryan, [360 B.R. 50] (Bankr. W.D.N.Y. 2007) (bathtub installed in debtors' home was a fixture, not ordinary building materials, and thus security interest in the bathtub survived). Perhaps the distinction between ordinary building materials and other goods, including fixtures, is analogous to the difference between accessions and commingled goods. If the goods lose their separate identity upon installation – that is, if either they cannot be removed at all or the cost of removal (including damage to either the goods or the structure) exceeds the value of the removed goods – then the goods are better viewed as part of the real property, and not as fixtures.

21. *See* § 9-334 cmt. a.

22. This is particularly likely if the debtor is not the owner of the real property. *See* In re Pierce, [621 B.R. 434] (Bankr. S.D. Ind. 2020) (a creditor that financed the purchase by the debtor and her boyfriend of windows, siding, and gutters had no security interest provided by the boyfriend because once the goods were installed in the home owned solely by the debtor, the boyfriend had no rights in the goods).

23. *See, e.g.*, Kans. Stat. § 58-4214(a); Ky. Stat. § 186A.297(7) (as amended, April 8, 2022). *See also* Tenn. Stat. § 55-3-128(c) ("Recordation of the affidavit of affixation . . . shall be prima facie evidence that the manufactured home has become affixed to the real property as an improvement to real property").

24. Kans. Stat. § 58-4214(b); Ky. Stat. § 186A.297(2) (as amended, April 8, 2022). *See also* Tenn. Stat. § 55-3-128(1)(G) (requiring that the name and address of every secured party be disclosed with an affidavit of affixation).

25. *See* §§ 9-102(a)(41) (definition of fixtures); 9-102(a)(44) (definition of goods).

26. *See* § 9-334(a), (b). The official text of § 9-334(a) states that an Article 9 security interest "may be created in goods that are fixtures or may continue in goods that become fixtures." This language implies that whether the security agreement is entered into before or after the goods become fixtures is irrelevant. Louisiana, however, has a non-uniform version of § 9-334(a) that is substantially narrower. It provides that an Article 9 security interest can be created in *goods that are to become fixtures*, but not in goods *after they become fixtures*, *see* La. Rev. Stat. §§ 10:9-334(a), thus indicating that sequence does matter. To create and perfect a security interest in goods that already are fixtures, a creditor must apparently comply with real property law. The statute further provides that "a security interest in goods that become fixtures continues in the fixtures if the security interest was perfected by a fixture filing when the goods become fixtures," *Id.*, thereby conditioning continued attachment on perfection, and indeed on perfection through a fixture filing.

27. *See, e.g.*, Ark Real Estate Servs., Inc. v. 21st Mortg. Corp., [300 So. 3d 1210] (Fla. Ct. App. 2020) (a buyer of real property at a foreclosure sale did not thereby acquire ownership of a mobile home free and clear of an existing security interest perfected through notation on the certificate of title; there is no requirement that the security interest be re-perfected under real property law after the mobile home becomes a fixture); In re Trinity Homes, LLC, [2020 WL 4219171] (Bankr. N.D.W. Va. 2020) (a secured party with a security interest in a modular home that was later affixed to a concrete block foundation on real property might have retained its security interest even though the secured party did not have a deed of trust encumbering the real property); In re Riffe, [2018 WL 3788973] (Bankr. S.D.W. Va. 2018) (a security interest in a manufactured home, which was perfected through compliance with the state certificate-of-title statute, did not become invalid or unperfected when the manufactured home became affixed to real property). *Cf.* In re Sweeney, [556 B.R. 208] (Bankr. E.D.N.C. 2016) (because the debtor's manufactured home was not permanently affixed to the real property on which it was located, even though the home's wheels and axles had been removed, a security interest in the home originally perfected by having the lien noted on the certificate of title remained perfected).

28. *See* § 9-334(c).

29. *See* § 9-334(e)(1).

30. *See* § 9-334(d). This rule is limited somewhat if the mortgage is a construction mortgage. *See* § 9-334(h).

31. *See* § 9-334(e)(2).

32. *See* §§ 9-301(3)(A), 9-501(a)(1).

33. *See* §§ 9-301(1), 9-501(a)(2).

34. *See* § 9-102(a)(44). Article 2 does the same. *See* § 2-107(2).

35. *See* § 9-301(3), 9-501(a)(1)(A). It might also be possible to encumber timber to be cut under real property law. *See* Epstein v. Coastal Timber Co., Inc., [711 S.E.2d 912] (S.C. 2011) (although both Articles 2 and 9 treat timber to be cut as goods, and the latter provides that a security interest in the timber can be perfected by filing a financing statement, a recorded mortgage on the land – even one that does not specifically mention the timber – also encumbers the timber and, if recorded first, has priority).

36. *See* §§ 9-301(1), 9-501(a)(2) & cmt. 3.

37. The analysis is the same if the security interest is a PMSI that is automatically perfected under § 9-309(1).

38. §§ 9-301(1), 9-307(b), (c).

39. *See* § 9-316(e).

40. *See* § 9-316(a)(2).

41. For the same reason, § 9-337 does not apply if the debtor relocates before applying for a certificate of title in the new state.

42. *See* § 9-103(f).

43. *See* § 9-103(h).

44. *See, e.g.*, Fla. Stat. § 679.1031(6); Idaho Code § 28-9-103(f); Ind. Code § 26-1-9.1-103(f); Kan. Stat. § 84-9-103(f); La. Rev. Stat. § 10:9-103(f); Md. Code, Com. Law § 9-103(f); Neb. Rev. Stat. U.C.C. § 9-103(f); N.D. Cent. Code § 41-09-03(6); S.D. Codified Laws § 57A-9-103(f).

45. *See* In re Jett, 563 B.R. 206 (Bankr. S.D. Miss. 2017) (because the transformation rule, not the dual-status rule, should be applied to PMSIs in consumer goods, a bank's PMSI in the debtors' vehicle lost purchase-money status when the debtors and bank refinanced the debt and included in it two previously unsecured loans).

46. *See* § 9-309(1).

47. Because of the expense involved, secured parties are unlikely to want to routinely file a financing statement in transactions involving a PMSI in consumer goods. Nevertheless, there is a reason to do so beyond the potential loss of perfection upon refinancing. Without a filed financing statement, a buyer of the collateral can take free of the security interest. *See* § 9-320(b).

48. Commercial tort claims, deposit accounts, some types of investment property, and letter-of-credit rights also can or do consist of a right to payment.

49. *See* § 9-310(a).

50. *See* §§ 9-310(b)(6), 9-313(a).

51. *See* §§ 9-105, 9-310(b)(8), 9-314(a).

52. A secured party is a type of "purchaser." *See* § 1-201(b)(29), (30).

53. *See* §§ 9-330, 9-331.

54. *See* § 3-105(1) (defining "issue").

55. Even if the security agreement describes the collateral narrowly, so that a court would interpret the agreement to cover only receivables that are currently accounts or payment intangibles, rather than receivables that were originally accounts or payment intangibles, *cf. supra* notes 5-6 and accompanying text (discussing how a security interest in inventory might de-attach when an item of inventory transmutes to equipment), the security interest would likely attach to the instrument. That is because the instrument is probably proceeds of the receivable in its original form. *See* § 9-102(a)(64)(A), (B), (C) (defining "proceeds" to include whatever is received in exchange for the collateral, collected or distributed on account of the collateral, and rights arising out of the collateral).

The only reason to question this conclusion is because most proceeds arise when the original collateral has been transferred or dissipated, and the debtor has received something else of value in its place. Yet when a check or negotiable note is taken for an existing obligation, the obligation is not discharged; it is merely suspended. *See* § 3-310(b). So, the original receivable survives, albeit in a sort of limbo, when the instrument for it is issued. Nevertheless, proceeds are not limited to situations in which the original collateral is gone. For example, § 9-102(a)(64)(A) defines "proceeds" to include whatever is received from a license of collateral, and when a collateralized patent or copyright is licensed, the royalties due and received under the license are proceeds even though the patent or copyright remains and is still encumbered by the security interest. The key issue in determining the limits of the term "proceeds" is whether the property is such that the law should presume that the parties would expect the security interest to attach to it. That test would seem to be satisfied with respect to an instrument issued to memorialize an account or payment intangible.

56. If the instrument is proceeds, the security interest would be perfected under § 9-315(c) and (d)(1). If the instrument is not proceeds, the filed financing statement would remain effective to perfect under § 9-507(b). *See supra* note 8.

57. §§ 3-306, 9-331.

58. *See* §§ 3-302(a)(2)(v), 9-330(f).

59. *See* § 8-102(a)(15). *See also* § 9-102(b) (making the Article 8 definition applicable to Article 9).

60. *See* § 8-102(a)(4), (18).

61. *See* §§ 8-106(a)–(c), 9-106(a), 9-314(a), (c).

Control of a certificated security in bearer form requires that the secured party take delivery of the certificate. *See* § 8-106(a). Delivery of the certificate requires either that the secured party take possession of the certificate or that a third person other than a securities intermediary acknowledge that it holds the certificate on behalf of the secured party. *See* § 8-301(a).

Control of a certificated security in registered form may be accomplished in several ways. One is for the secured party to have possession of the certificate and have the certificate be either: (i) indorsed in blank or to the secured party; or (ii) re-registered in the name of the secured party. *See* §§ 8-106(b), 8-301(a). Another method is that the certificate be in the possession of a third party, other than a securities intermediary, who has acknowledged the secured party's security interest in the certificate and the certificate is either: (i) indorsed in blank or to the secured party; or (ii) re-registered in the name of the secured party. *See* §§ 8-106(b), 8-301(a). Finally, if a certificate in registered form is in the possession of the securities intermediary and registered in the name of the secured party, indorsed to the secured party, or payable in the name of the secured party, and not indorsed in blank or to the securities intermediary, the secured party also has control. §§ 8-106(b), 8-301(a).

Control of an uncertificated security occurs when: (i) the secured party becomes the registered owner of the security; (ii) another person, other than a securities intermediary, becomes the registered owner and acknowledges that it holds the uncertificated security on behalf of the secured party; or (iii) the issuer of the security agrees that it will comply with the instructions of the secured party regarding the security without further consent of the debtor. *See* §§ 8-106(c), 8-301(b).

62. *See* § 9-328(1).

63. *See* §§ 8-303, 9-331.

64. *See* § 8-103(c).

65. *See* § 8-103 cmt. 4.

66. *See* § 8-103(c). The following language suffices: "Each interest in [name of issuer] constitutes a 'security' within the meaning of Section 8-102(a)(15) of the Uniform Commercial Code as enacted by [state of organization of issuer]."

If the entity chooses to issue certificates, the certificates will often, but not always, contain similar language noting that the entity has elected to opt in under Article 8.

67. *See supra* notes 5-6 and accompanying text (discussing this issue when inventory transmutes to equipment). If the security interest remains attached, the transmutation will not affect the effectiveness of a filed financing statement. *See* § 9-507(b) (discussed *supra* note 8).

68. *See* Cal. Corp. Code § 17701.12(a); Del. Code tit. 6, § 18-302(e); D.C. Code § 29-801.09(a); Fla. Stat. § 605.0107(1); Idaho Code § 30-25-107(a); Iowa Code § 489.112(1); Minn. Stat. § 322C.0112(1); Neb. Rev. St. § 21-112(a); N.J. Stat. § 42:2C-13(a); N.D. Cent. Code § 10-32.1-15(1); Utah Code § 48-3a-114(1); Vt. Stat. tit. 11, § 4003(k); Wyo. Stat. § 17-29-112(a). *See also* Revised Uniform Limited Liability Company Act § 107(a) (2013) ("An operating agreement may specify that its amendment requires the approval of a person that is not a party to the operating agreement . . . . An amendment is ineffective if its adoption does not include the required approval."); Allen Benson and Stephen L. Sepinuck, *Restricting Amendment of a Debtor's LLC Operating Agreement*, 6 THE TRANSACTIONAL LAWYER 1 (Feb. 2016).

69. If the other members are not otherwise liable for the secured obligation, such a covenant could be supported by a "bad boy" guaranty, pursuant to which their liability for the secured obligation would be triggered if they breached the covenant.

70. *See* 49 U.S.C. §§ 44107, 44108 (requiring that notice be filed with the FAA Aircraft Registry to perfect a security interest in aircraft). *See also* In re AvCentral, Inc., 289 B.R. 170 (Bankr. D. Kan. 2003) (holding that a federal filing is necessary even though the debtor and the secured creditor both understood at the time they created the security interest that the debtor would not be operating the aircraft, but instead disassembling them and converting their components to inventory for sale).

While filing with the FAA is normally required to perfect a security interest in an airframe and its engines, a UCC filing might be necessary to perfect a security interest in accessions to the aircraft. Moreover, for aircraft of a certain size, it might be advisable to record the security interest with the International Registry of Mobile Assets, which is an online registry based in Dublin, Ireland established pursuant to the Cape Town Convention, which the United States has ratified.

71. *See* 46 U.S.C. §§ 31321–31330 (detailing how to create, perfect, and enforce security interests in vessels).

72. *See* 17 U.S.C. § 205(a). *See also* In re Nacio Systems, Inc., 410 B.R. 38 (Bankr. N.D. Cal. 2009); In re Peregrine Entertainment, Ltd., 116 B.R. 194 (C.D. Cal. 1990); In re Avalon Software, Inc., 209 B.R. 517 (Bankr. D. Ariz. 1997); In re AEG Acquisition Corp., 127 B.R. 34 (Bankr. C.D. Cal. 1991), *aff'd*, 161 B.R. 50 (9th Cir. BAP 1993). This is apparently also the view of the Copyright Office. *See* Statement of Marybeth Peters, Register of Copyrights, Before the House of Representatives Committee on the Judiciary, Subcommittee on Courts and Intellectual Property (June 24, 1999).

73. *See* 49 U.S.C. § 11301; In re California W. R.R. Inc., 303 B.R. 201 (Bankr. N.D. Cal. 2003).

74. *See* In re World Auxiliary Power Co., 303 F.3d 1120 (9th Cir. 2002).

75. The Copyright Office can, in limited circumstances, cancel a copyright registration. *See* 37 C.F.R. § 201.7. Filing a financing statement at the inception of the secured transaction could protect against this unlikely event.

76. Even if the debtor or the secured party files an assignment with the Copyright Office along with the registration documents, a court might conclude that registration and assignment are sequential, not simultaneous. Consequently, there might be a brief moment when the security interest is unperfected. That would render the security interest potentially avoidable as a preference if the debtor files for bankruptcy within the ensuing 90 days. *See* 11 U.S.C. § 547.

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Recent Cases

SECURED TRANSACTIONS

Attachment Issues

In re Community Home Financial Services Corp.,
32 F.4th 472 (5th Cir. 2022)
A secured party did not have a security interest in funds that the debtor's bankruptcy trustee recovered from the debtor's principal, who had stolen proceeds of collateral. The secured party had the burden to identify the proceeds by an appropriate method of tracing and its request that the court apply "equitable principles," without explanation or citation to pertinent case law, did not satisfy that burden.

Perfection Issues

In re Community Home Financial Services Corp.,
32 F.4th 472 (5th Cir. 2022)
A security interest in mortgage notes perfected through possession by a custodian that acknowledged it held the notes for the benefit of the secured party and the debtor, and that agreed to release the notes only upon the written request of both of them, remained perfected when the secured party assigned the secured loan. Pursuant to § 9-310(c), if a secured party assigns a perfect security interest, the security interest remains perfected without the filing of a financing statement. The custodial agreement did not alter that rule by providing that no party could assign or otherwise transfer the custodial agreement without the prior written consent of the other parties because that term dealt with assignment of the custodial agreement, not the security interest, and another term in the custodial agreement stated that the secured party could transfer its rights and duties to an assignee, who would then be deemed to be the lender under the custodial agreement.

Priority Issues

Unibank for Savings v. 999 Private Jet, LLC,
31 F.4th 1 (1st Cir. 2022)
An investment company that provided the funds for the purchase of an aircraft, and which sent a claim-of-lien letter to the FAA after learning that the company's president had fraudulently titled the aircraft in the name of another entity formed by the president, did not have priority over the bank that had acquired and perfected a security interest from a transferee of that entity. The claim-of-lien letter was in a suspense file, and hence was not properly recorded, and the bank did not have actual notice of it. Moreover, even if the transferee acquired the aircraft in a fraudulent transaction and, therefore, had only voidable title, the transferee had the power to transfer good title to a good faith purchaser for value, and the bank was such a purchaser.

Enforcement Issues

Seifert v. U.S. Bank,
2022 WL 1311177 (E.D. Cal. 2022)
Debtors had not stated a cause of action for breach of contract or conversion against a secured party that repossessed and sold their recreational vehicle because even if, as the debtors claimed, they were current in making payment on the secured obligation, the security agreement obligated the debtors to keep the vehicle in their possession and not attempt to sell it without the secured party's written permission, and the debtors had transferred possession of the vehicle to a broker for sale.

Langley v. East Coast Group Funding, Inc.,
2022 WL 1073413 (Conn. Super. Ct. 2022)
Because the retail installment contract between a buyer residing in Connecticut and a seller in New York provided that New York governed the transaction, the buyer could not have any claim against the seller's assignee for failure to comply with Connecticut's law regarding repossession and sale of the vehicle. Such matters were governed by the law of New York.

Liability Issues

CoFund II LLC v. Hitachi Capital America Corp.,
2022 WL 1101576 (3d Cir. 2022)
The secured lender to a factoring company was liable under an intercreditor agreement to the buyer of participations interests in the factor's transactions with its customers. The lender had agreed that any funds it received into a blocked account that were proceeds of the participant's share of factoring agreements would be held in trust for the participant and immediately turned over to the participant, but had instead used those funds to pay the factor's obligation to itself.

BANKRUPTCY

In re W Resources, LLC,
2022 WL 1117107 (5th Cir. 2022)
A lender that made a loan to the sole member of a limited liability company and received a mortgage from the company to secure "all obligations and liabilities of Mortgagor," did not have an allowable claim in the company's bankruptcy because the company did not have liability for the loan. Bankruptcy claims are fixed at the time the petition is filed, and parol evidence was not admissible to alter the terms of the mortgage.

In re CE Electrical Contractors, LLC,
2022 WL 1420094 (Bankr. D. Conn. 2022)
A reorganization plan that temporarily enjoined enforcement of a guaranty issued by the debtor's owner would not be confirmed over the creditor's objection. The plan also could not be crammed down because it proposed to modify the rights of a fully secured creditor by eliminating accrued default interest and an annual loan charge, and therefore did not provide the creditor with the liquidation value of its claim.

GUARANTEES & RELATED MATTERS

Amos Financial LLC v. Szydlowski,
2022 WL 1469354 (Ill. Ct. App. 2022)
Summary judgment was properly granted against the maker of a continuing guaranty in favor of the assignee of a later note by the borrower. Because the continuing guaranty covered "existing or hereafter arising" indebtedness of the borrower, it was irrelevant that neither the later note nor the allonges to it referenced the guaranty. Nor was it necessary for the guaranty to be expressly assigned because a secondary obligation follows the primary obligation. No citation to § 9-203(f).

LENDING, CONTRACTING & COMMERCIAL LITIGATION

Hall CA-NV, LLC v. Ladera Development, LLC,
2022 WL 943151 (D. Nev. 2022)
A contractually subordinated lender breached the intercreditor agreement by submitting a plan in the borrower's bankruptcy proceeding and by contesting the validity of the intercreditor agreement. The subordinated lender could not void the intercreditor agreement due to the senior lender's alleged misrepresentation that there were no prior mechanic's liens on the collateral – a luxury hotel – at the time the loans were made because the subordinated lender could not have justifiably relied on such a representation given that: (i) the subordinated lender had access to documents stating that work on the property had begun; and (ii) construction fences surrounded the property. Nor could the subordinated lender void the intercreditor agreement due to mistake because the mistake was one of law, not fact, it was not the product of someone in whom trust and confidence have been reposed, and it could have been avoided by the subordinated lender's ordinary care. However, the senior lender was not entitled to the proceeds of the subordinated lender's title insurance (which insured against the existence of mechanic's liens, whereas the senior lender's own title insurance did not), because even though the intercreditor agreement required the subordinated lender to release insurance proceeds awards "to be applied to the restoration of the Property or to payment of the indebtedness" owed to the senior lender, the policy was not issued to cover restoration of the property or the debt owed to the senior lender.

LCM XXII Ltd. v. Serta Simmons Bedding, LLC,
2022 WL 953109 (S.D.N.Y. 2022)
Lenders holding a small portion of first-lien debt stated a cause of action against the debtor for breach of the First Lien Term Loan Agreement by alleging that debtor entered into a restructuring transaction with lenders owning a majority of the loan, pursuant to which agreement the debtor would borrow approximately $1.1 billion, issue new notes to which the existing First Lien Term Loan would be contractually subordinated both in terms of payment and in lien priority, and use the loaned funds to acquire $1.5 billion of the existing loan owned by the majority of the lenders. Although the First Lien Loan Agreement expressly exempts "open market purchases" from a requirement that receipts be shared pro rata among all the first-lien lenders, the plaintiffs adequately alleged that the restructuring did not involve open market purchases because it was negotiated in private with a subset of the lenders, was not open to everyone, and was at a price not set by market forces. The plaintiffs did not, however, state a claim for breach based on the debtor's agreement with a majority of lenders to amend the First Lien Term Loan Agreement without the plaintiff's consent because even though the amendment subordinated the first-lien debt, it did not affect any of the plaintiff's so-called "sacred rights," for which their consent was required.

In re Pacific Links U.S. Holdings, Inc.,
2022 WL 1434225 (Bankr. D. Haw. 2022)
A company's guaranty of a 2019 restructuring of loans made in 2017 and 2018 to an affiliate, and the grant of a security interest to secure the guaranty, were avoidable transactions for less than reasonably equivalent value. Even if the guarantor indirectly benefitted from the earlier loans, those benefits were not in exchange for the later guaranty and security interest, and even if, after the restructuring, the guarantor continued to benefit from those earlier loans, that benefit was not reasonably equivalent to the $57 million in liability incurred. Even though the guarantor represented that it would substantially benefit from the 2019 transaction and the creditor's related one-year forbearance from collecting, that representation is not binding and the evidence established that it received only about $400,000 after that transaction, which amount is not reasonably equivalent to $57 million.

Berman v. Freedom Financial Network, LLC,
30 F.4th 849 (9th Cir. 2022)
Consumers who used a website were not bound by the arbitration clause included in the Terms & Conditions posted on the site. Although the site included a notice in fine print stating, "I understand and agree to the Terms & Conditions which includes mandatory arbitration," the hyperlinked terms were not reasonably conspicuous and the consumers' actions in clicking on large green "continue" buttons did not unambiguously manifest assent to those terms.

Whirlpool Corp. v. Cabri,
2022 WL 1421126 (D. Del. 2022)
The choice-of-forum clause in a domestic corporation's Omnibus Stock and Incentive Plan applied and could be enforced with respect to the corporation's claim to recover benefits paid under the plan to an employee of the corporation's Italian subsidiary, after the employee quit and immediately began working for a competitor, but it did not cover the corporation's claim to recover payments made under a different employee bonus plan, which lacked a choice-of-forum clause, or the corporation's claims for breach of contract and disclosure of trade secrets.

North American Leasing, Inc. v. NASDI Holdings, LLC,
2022 WL 1073544 (Del. 2022)
The parent company of a seller of two businesses gave timely notification to the buyer of a claim for indemnification arising from the parent's liability on a performance bond. The sales agreement required notification within a reasonable time after the indemnitee becomes aware of the existence of a potential claim, "but in any event before the later of the Termination Date or the survival period provided in Section 9.5 with respect to [the] particular representation or warranty to which the matter applies." Although notification was given after the Termination date, the entire "in any event" clause related solely to claims relating to a seller's representation or warranty, which came to an end on the Termination Date, except for a few that survived longer pursuant to § 9.5. No other interpretation would be reasonable, as there would be no reason why the parties would intend to cut off claims for indemnification arising from performance bonds before the bond termination date, or even before the claims come into existence.

Benbrook Economic Dev. Corp. v. National Bank of Texas,
2022 WL 1042926 (Tex. Ct. App. 2022)
Because the assignee of a promissory note, which had recorded an assignment of the deed of trust securing the note and had possession of the note, had also allowed the original payee to receive payments, full payment to the original payee might have satisfied the note and discharged the lien.

Momentum Commercial Funding, LLC v. Project Storm, LLC,
2022 WL 1322835 (E.D. Cal. 2022)
Because an equipment lessor's lease lacked an attorney's fees clause but its security agreement with the lessee contained such a clause, additional briefing was required on whether the attorney's fees incurred in connection with the lessor's efforts to enforce both agreements were recoverable.

■ ■ ■

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