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PROVIDING FOR THE APPOINTMENT OF A RECEIVER

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Two recent court decisions provide object lessons on how to draft – or how not to draft – a clause in a mortgage providing for the appointment of a receiver after default. Before discussing those cases, and the drafting advice that can be gleaned from them, it is useful to canvas the law relating to the appointment of a receiver.[1]

BACKGROUND ON THE LAW

State Law

Mortgagees[2] of commercial real property – particularly income-generating real property – typically have a lien not only on the real property but also on the rents and other income that the property generates.[3] If the mortgagor defaults, the mortgagee often wants a receiver to take control of the property during the foreclosure process to ensure that the property continues to operate as a going concern and to ensure that the income the property generates is used for operational purposes, to maintain the property, or to pay the mortgage debt.

Traditionally, courts could exercise their broad equitable powers to appoint a receiver prior to judgment, but only if the remedy at law was inadequate. Courts would decline to appoint a receiver unless the mortgagee could establish that the value of the real property was insufficient to satisfy the mortgage debt or the mortgagor was committing fraud or waste. In an effort to expand their right to the appointment of a receiver, mortgagees responded by including a term in the mortgage expressly providing for the appointment of a receiver upon default.

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Some jurisdictions have not been particularly receptive to such clauses.[4] Because the appointment of a receiver has traditionally been subject to the court's equitable discretion, some court's regarded such clauses as usurping a judicial function. Others viewed such clauses as trying to expand the court's equitable jurisdiction by authorizing an equitable remedy even though the remedy at law was adequate. Accordingly, in such jurisdictions, a clause in a mortgage providing for the appointment of a receiver is potentially relevant but not by itself sufficient; the mortgagee still has to demonstrate that the legal remedies are inadequate.

Other jurisdictions, however, treat such a clause as a sufficient basis for appointing a receiver, but nevertheless regard the matter as remaining within the discretion of the trial court. As a result, a court may or may not appoint a receiver.[5] Still other jurisdictions go further, and treat such a clause as binding on the court or very close to it.[6]

Moreover, the law on the effect of these clauses continues to develop. The Restatement (Third) of Property states that a mortgagee "is entitled to the appointment of a receiver" to take possession of the real estate if the mortgagor is in default and the mortgage contains either a mortgage on the rents or a provision authorizing appointment of a receiver upon default.[7] The Uniform Assignment of Rents Act provides similarly.[8] At least four states – Michigan, Nevada, New Mexico and Utah – have enacted that rule.[9] The even more recent Uniform Commercial Real Estate Receivership Act provides states with the option of entitling a mortgagee to the appointment of a receiver if the mortgage so provides,[10] and at least two additional states – Connecticut and Tennessee – have enacted that option.[11]

The upshot of this is that, in several states, courts are required to appoint a receiver for commercial real property if the debtor defaults and the mortgage contains a clause providing for the appointment of a receiver upon default. In other states, such a clause can be a persuasive factor in a court's decision as to whether to appoint a receiver. In no jurisdiction is such a clause likely to create a problem for the mortgagee.

Federal Law

When litigation occurs in federal court, the rules are potentially different. Even in a diversity case, the appointment of a receiver is regarded as a procedural matter governed by federal law.[12] This is because a receivership is an ancillary remedy that does not affect the ultimate resolution of the case.[13]

Federal courts do not treat a contractual clause providing for the appointment of a receiver as binding.[14] Instead, they weigh numerous factors,[15] including whether: (i) the property is inadequate security for the outstanding debt; (ii) there is imminent danger of the property being lost, concealed, injured, diminished in value, or squandered; (iii) the likelihood of success on the merits; and (iv) whether the harm to the plaintiff caused by a denial of the appointment would be greater than the injury to those opposing the appointment. Although the lists of factors that courts regularly cite do not include the existence or absence of a contractual clause providing for the appointment of a receiver, federal courts do acknowledge that such a clause is relevant.[16]

One important implication of this is that even if under applicable state law the mortgagee would be entitled to the appointment of a receiver upon default, there will be no automatic entitlement if the proceeding is commenced or removed to federal court.

THE CASES

The Right "to apply"

In *SKW-B Acquisitions Seller C, LLC v. Stobba Residential Associates, L.P.*,[17] a Pennsylvania state court case, the debtor borrowed $24 million and secured the debt with a mortgage on a condominium complex. The mortgage included an assignment of rents and a clause providing that, upon default, the lender may "apply for the appointment of a receiver, trustee, liquidator or conservator of the Property, without notice and without regard for the adequacy of the security for the Debt and without regard for the solvency of Borrower."[18] After the debtor defaulted, the lender sued and moved for the appointment of a receiver. The trial court denied the motion and the lender appealed.

The appellate court acknowledged that, under Pennsylvania law, a contract can entitle a mortgagee to the appointment of a receiver.[19] But it ruled that the language in the mortgage did not do that. Authorizing the lender to "apply for the appointment of a receiver" did not, according to the court, entitle the lender to the appointment of a receiver upon request, it merely acknowledged the lender's right to seek an appointment. Accordingly, the decision on whether to appoint a receiver remained in the discretion of the trial court.[20] Other courts have ruled similarly.[21]

This might seem like a rather technical reading of the contractual language. After all, the clear import of the clause in the mortgage was to entitle the lender to have a receiver appointed without having to satisfy the standard normally required for such equitable relief. Nevertheless, the clause was not well drafted. On its face, the clause purported to grant a permission – to apply for the appointment of a receiver – that the lender already has as a matter of law. There is no need for an agreement to do that.[22]

This is not to say that there is only one way draft the clause properly. Courts have enforced clauses stating that, upon default, a mortgagee "shall be entitled . . . to the appointment of a receiver,"[23] or that states both that the mortgagee has a "right to apply" for the appointment of a receiver after default and that the borrower "hereby consents" to the appointment.[24]

"To the extent permitted by law"

In *Leonite Capital LLC v. Founders Bay Holdings*,[25] a lender moved in federal court for the appointment of a receiver pursuant to a term in a Pledge and Security Agreement providing that "[t]o the extent permitted by applicable law, . . . [the lender] may have a receiver appointed as a matter of right."[26] The court denied the motion. In so doing, it wrote that even if the debtor's consent to the appointment were controlling, the agreement did not evidence ironclad consent or alter the standard for appointment of a receiver. Instead, the language merely indicated that the parties contemplated that the appointment of a receiver would be governed by "applicable law."[27]

The case is a reminder of the maxim that often less is more. By adding the phrase "to the extent permitted by law," the drafter weakened the clause, making the clause essentially pointless. That raises the question of when, if ever, the phrase "to the extent permitted by law" would be desirable. After all, it is typically not necessary for a contract term to defer to the law. If the law makes a clause ineffective, it will do so regardless of whether the clause subjects itself to such authority.

The answer is that the phrase "to the extent permitted by law" can function as a sort of savings clause. For example, a drafter might be concerned that, in the absence of such language, if there were some circumstances when the clause would be unenforceable, a court might throw out the clause entirely rather than enforce the clause to the extent the law permits. That concern is perhaps most applicable to an indemnification clause that requires one party to reimburse another for a loss or expense suffered. There are situations when indemnification would be contrary to law (*e.g.*, reimbursing the indemnitee for losses suffered by the indemnitee's own gross negligence or willful misconduct). Incorporating the phrase "to the extent permitted by law" signals to the court that the drafter is not trying to overreach and that the clause should be enforced to the maximum extent permissible.[28]

But that concern really does not apply to a term providing for the appointment of a receiver after default. Such a clause will either be enforceable or not, depending on applicable law. There is no danger that the court would declare the clause invalid because in some situations it might not be enforceable.

DRAFTING ADVICE

Two additional points are worth bearing in mind when drafting a clause providing for the appointment of a receiver after default.

First, if the request for a receiver is likely to be made in a jurisdiction that treats a contractual clause as binding, the drafter might wish to include a term waiving each party's right to commence an action in or remove an action to federal court. That would ensure that the state law, not federal law, applies to the appointment issue.

Second, because it is often desirable to have a receiver appointed quickly, before the debtor can damage or divert collateral, the clause providing for the appointment should state that the debtor waives the right to notification of the request and the right to a hearing. At least in some jurisdictions, such a clause is enforceable.[29]

The following clause reflects all the advice discussed above, other than the possible need to have both parties waive the right to sue in or remove to federal court.

> ***Entitlement to a Receiver.*** Upon and during an Event of Default, Lender is entitled to the appointment of one or more receivers to take possession of and administer for the benefit of Lender all or any part of the Collateral, and to collect all rents, issues, and profits thereon and other income therefrom, without regard to: (i) whether the Collateral is adequate or inadequate security for the outstanding debt, (ii) whether there is imminent danger that the Collateral will be lost, concealed, or transferred or is likely to diminish in value; or (iii) any other legal requirement for such appointment. Borrower hereby consents to the appointment of a receiver and hereby waives all rights to notification of the request therefor, to a hearing on the request, and to any requirement that a bond be posted.

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Notes:

1. This article focuses on the appointment of a receiver to take possession and control of real property. A secured creditor might additionally or alternatively wish to have a receiver appointed to take control of personal property collateral, particularly income-generating collateral. Appointment of a receiver for such a purpose is likely to be governed by the same principles and rules as those discussed in this article, although statutes dealing with real property might not apply. *See* Uniform Assignment of Rents Act (discussed *infra* notes 8-9); Uniform Commercial Real Estate Receivership Act (discussed *infra* notes 10-11). *Cf.* UCC §§ 9-601 (providing that a secured party has the rights provided by the agreement of parties); 9-604 (providing that a secured party may proceed under real property law if collateral includes both real and personal property).

2. This article uses the term "mortgage," and the correlative terms "mortgagee" and "mortgagor," but the discussion is equally applicable to alternative security devices such as deeds of trust or deeds to secure debt.

3. Such income might be in the form of rent (if the property is leased), membership fees or license fees (such as from the operation of a country club or golf course), ticket sales (such as from the operation of ski resort), room charges (from the operation of a hotel or motel), food and beverage charges (from the operation of a bar or restaurant), or Medicare or Medicaid reimbursement (from the operation of a nursing home or hospice). *Cf.* MB Fin. Bank v. Royal Tee, LLC, 2017 WL 776083 (Ill. Ct. App. 2017) (the trial court that appointed a receiver in connection with a mortgagee's action to foreclose on a golf course erred in not authorizing the receiver to manage the golf course business; the applicable statute authorizes the receiver to collect "profits," not merely "rents," and without the authority to manage the golf course business, the receiver would have no income to pay expenses associated with maintaining the property).

4. *See, e.g.*, Dart v. Western Sav. & Loan Ass'n, 438 P.2d 407 (Ariz. 1968) (appointment of a receiver for mortgaged real property was error, despite a clause purporting to require it, because the mortgagee was oversecured); Chromy v. Midwest Fed. Sav. & Loan Ass'n, 546 So. 2d 1172 (Fla. Ct. App. 1989) (it was error to appoint a receiver for mortgaged real property, despite a clause purporting to require it, without evidence of waste); Gage v. First Fed. Sav. & Loan Ass'n, 717 F. Supp. 745 (D. Kan. 1989) (refusing to appoint a receiver for mortgaged real property, despite a clause purporting to require it, without evidence of fraud, waste, or irreparable injury, relying on a case dealing with a contractual clause entitling a mortgagee "to make application for and obtain the appointment of a receiver"); Barclays Bank, P.L.C. v. Davidson Ave. Assocs., Ltd., 644 A.2d 685 (N.J. Super. Ct. 1994) (notwithstanding a provision in the loan documents entitling a mortgagee to the appointment of a receiver, appointment is subject to the careful review and exercise of sound discretion by the chancery judge).

5. *See, e.g.*, Barclays Bank v. Superior Court, 137 Cal. Rptr. 743 (Cal. Ct. App. 1977) (if a clause in a mortgage authorizes the appointment of a receiver, a court may, but need not, appoint a receiver for the property without proof that the mortgage debt is undersecured; "the express agreement of the mortgagor is an equity that should not ordinarily be ignored"); Riverside Props. v. Teachers Ins. & Annuity Ass'n, 590 S.W.2d 736 (Tex. Ct. App. 1979) (same). *See also* Ariz. Rev. Stat. § 33-702(B)

(legislatively overruling *Dart*, cited *supra* note 4, by authorizing the appointment of a receiver for mortgaged property regardless of the adequacy of the security).

6. *See. e.g.*, CFS-4 II, LLC v. Greco, 2016 WL 5386451 (Pa. Super. Ct. 2016) (effectively treating appointment of a receiver pursuant to a clause in a mortgage as required); U.S. Bank v. Gotham King Fee Owner, LLC, 2013 WL 2149992, at *2-3 (Ohio Ct. App. 2013) (pursuant to a term in the agreement, the mortgagor waived its right to oppose appointment of a receiver); Bank of America Nat'l Trust & Sav. Ass'n v. Denver Hotel Ass'n, 830 P.2d 1138 (Colo. Ct. App. 1992) (trial court did not abuse its discretion in appointing a receiver for a mortgaged hotel without regard to the adequacy of the collateral or the insolvency of the debtor because the mortgage entitled the mortgagee to the appointment of a receiver); Fleet Bank v. Zimelman, 575 A.2d 731, 734 (Me. 1990) ("there is no reason not to enforce the unambiguous language of the mortgage, entitling the Bank to the appointment of a receiver").

7. RESTATEMENT (THIRD) OF PROPERTY: MORTGAGES § 4.3(b) (1997).

8. Uniform Assignment of Rents Act § 7(a)(1)(A) (2005) ("An assignee is entitled to the appointment of a receiver for the real property subject to the assignment of rents if . . . the assignor is in default and . . . the assignor has agreed in a signed document to the appointment of a receiver in the event of the assignor's default").

9. *See* Mich. Stat. § 554.1057(1); Nev Stat. § 107A.260(1); N.M. Stat. § 56-15-7(A); Utah Stat. § 57-26-107(1).

10. See Uniform Commercial Real Estate Receivership Act § 6(b)(2) (2015), which provides two bracketed alternatives for dealing with a mortgage clause purporting to entitle a mortgagee to the appointment of a receiver upon default. Under the first, a mortgagee is entitled to appointment of a receiver; under the second, appointment of a receiver would be justified but would remain subject to the court's discretion.

11. *See* Conn. Stat. § 52-624(b); Tenn. Stat. § 29-40-106(2). Nevada and Utah have also enacted this provision, *see* Nev. Stat. § 32.260(2); Utah Stat. § 78B-21-106(2), and in so doing each essentially reconfirmed its enactment of a similar rule in its codification of the Uniform Assignment of Rents Act. Four other states adopted the alternative of making appointment of a receiver permissible but not required if the mortgage provides for such appointment. *See* Ariz. Stat. § 33-2605(b); Fla. Stat. § 714.06(2); Mich. Stat. § 554.1016(2); Wis. Stat. § 55-21-6(2). Oddly, one of those states is Michigan, which as noted above enacted the Uniform Assignment of Rents Act. It thus appears that the Michigan legislature disregarded the Legislative Note to § 6 of the Uniform Commercial Real Estate Receivership Act, and in so doing might have implicitly repealed part of the Assignment of Rents Act.

12. *See, e.g.*, Canada Life Assur. Co. v. LaPeter, 563 F.3d 837, 842-43 (9th Cir. 2009); National P'ship Inv. Corp. v. National Housing Dev. Corp., 153 F.3d 1289, 1291 (11th Cir. 1998); Aviation Supply Corp. v. R.S.B.I. Aerospace, Inc., 999 F.2d 314, 316 (8th Cir. 1993); PNC Bank v. Dumard Holding, LLC, 2021 WL 5925957, at *2 (W.D. Mich. 2021); Goureau v. Lemonis, 2021 WL 4847073, at *4 (S.D.N.Y. 2021); Midwest Bank v. Goldsmith, 467 F. Supp. 3d 242, 245-47 (M.D. Pa. 2020); Winfield Solutions, LLC v. W S Ag Ctr., Inc., 2020 WL 8613974, at *4 (W.D. Wis. 2020); Holy Hops, Inc. v. Beer Church Hospitality Group, Inc., 2019 WL 11626481, at *3 (N.D. Ill. 2019); McGirr v. Rehme, 2018 WL 3708357, at *8-9 (S.D. Ohio 2018); ACA Fin. Guaranty Corp. v. City of Buena Vista, Virginia, 298 F. Supp. 3d 834 (W.D. Va. 2018); U.S. Bank v. Pendleton Westbrook SPE, LLC, 2016 WL 6808141, at *3 (D. Me. 2016); U.S. Bank v. Lakeview Retail Property Owner LLC, 2016 WL 2599145, at *1 (S.D. Miss. 2016); Paradise v. USPLabs, LLC, 2016 WL 11505594, at *2 (C.D. Cal. 2016); Am. Bank & Trust Co. v. Bond Int'l Ltd., 2006 WL 2385309, at *7 (N.D. Okla. Aug. 17, 2006); World Fuel Services Corp. v. Moorehead, 229 F. Supp. 2d 584, 596 (N.D. Tex. 2002). *See also* Fed. Rule of Civ. Proc. 66.

13. *See National P'ship Inv. Corp.*, 153 F.3d at 1291.

14. *See, e.g.*, Bank of Am. v. Florida Glass of Tampa Bay, Inc., 2016 WL 6778877 (M.D. Fla. 2016) (although mortgages contained provisions for appointment of a receiver in the event of default, none would be appointed because the mortgagee did not persuasively demonstrate fraudulent conduct on the part of mortgagor, imminent danger to the collateral, the inadequacy of legal remedies, or a probability of greater harm from denial of the motion than from granting it); PNC Bank v. Presbyterian Retirement Corp., 2014 WL 6065778, at *4 (S.D. Ala. 2014) (contractual consent is merely one non-dispositive factor in the overarching equitable inquiry under Rule 66); U.S. Bank v. Grayson Hospitality, Inc., 2014 WL 7272842 (E.D. Tex. 2014) (a secured lender was not entitled to the appointment of a receiver for hotel properties owned by the debtors despite a clause in the mortgages providing for a receiver upon default); Federal Nat'l Mortg. Ass'n v. Mapletree Investors. L.P., 2010 WL 1753112, at *3 (E.D. Mich. Apr. 30, 2010) (advance consent is a strong but not binding factor in determining whether to appoint a receiver); Sterling Sav. Bank v. Citadel Dev. Co., Inc., 656 F. Supp. 2d 1248, 1259-65 (D. Or. 2009) (contractual consent to the appointment of a receiver is not dispositive and does not reduce the burden on the party seeking a receiver to produce evidence that appointment is warranted); D.B. Zwirn Special Opportunities Fund, L.P. v. Tama Broad., Inc., 550 F. Supp. 2d 481, 491 (S.D.N.Y.2008) (the existence of a contractual provision providing for the appointment of a receiver does not dispose of the court's inquiry); Gage v. First Fed. Sav. & Loan Ass'n, 717 F. Supp. 745, 750 (D. Kan. 1989) (the appointment of a receiver is an extraordinary legal remedy

and is not automatic because of a clause in the mortgage agreement; the mortgagee must go through the normal legal channels to obtain a receiver). *But cf.* Am. Bank & Trust Co. v. Bond Int'l Ltd., 2006 WL 2385309, at *7 (N.D. Okla. 2006) (suggesting that appointment of a receiver was required because the loan documents provided for it).

15. *See* Wilmington PT Corp. v. Tiwana, 2020 WL 13158288, at *2-3 (E.D.N.Y. 2020) (identifying seven factors); Comerica Bank v. State Petroleum Distributors, Inc., 2008 WL 2550553, at *4 (M.D. Pa. 2008) (identifying nine factors); Brill & Harrington Investments, 787 F. Supp. 250, 253-54 (D.D.C. 1992) (identifying eight factors).

16. *See* Wilmington PT Corp. v. Tiwana, 2020 WL 13158288, at *3 (citing *Greystone Bank v. Tavarez*, 2010 WL 11651639, at *2 (E.D.N.Y. 2010) (in turn citing cases)).

17. 2023 WL 2293902 (Pa. Super. Ct. 2023).

18. *Id.* at *2.

19. *Id.*

20. *Id.* Nevertheless, the appellate court held that the trial court had erroneously concluded that there was no evidence that the borrower had improperly diverted rents received from tenants and subject to the lender's mortgage. Accordingly, the trial court's order not to appoint a receiver would be vacated and the case remanded for further consideration. *Id.* at *7.

21. *See, e.g.*, Sterling Sav. Bank v. Citadel Dev. Co., Inc., 656 F. Supp. 2d 1248, 1260 (D. Or. 2009) (noting that contractual consent to the mere application to a court to appoint a receiver is different from consent to the actual appointment of a receiver). *See also* Comerica Bank v. State Petroleum Distributors, Inc., 2008 WL 2550553 (M.D. Pa. 2008) (a clause in a security agreement providing that, after default, the secured party may "[p]ersonally or by agents, attorneys, or appointment of a receiver, enter upon any premises where Collateral may be located" did not provide for consent to the appointment of a receiver).

22. *See* Stephen L. Sepinuck, *When to Contract for Remedies*, 3 THE TRANSACTIONAL LAWYER 3 (June 2013).

23. *See* Wells Fargo Bank v. InSite Dunmore (O'Neil), LLC, 2015 WL 5074421, at *1 (Pa. Ct. Comm. Pl. 2015) ("Lender, as a matter of right and . . . without any showing of insolvency, fraud or mismanagement on the part of [borrower], . . . shall be entitled to the appointment of a receiver or receivers for the protection, possession, control, management and operation of the Property"); Metropolitan Life Ins. Co. v. Liberty Center Venture, 650 A.2d 887, 891 (Pa. Super. Ct. 1994) ("If an Event of Default shall have occurred and be continuing, Mortgagee, upon application to a court of competent jurisdiction, shall be entitled, without notice and without regard to the adequacy of any security for the repayment of the indebtedness evidenced by the Note and/or secured by this mortgage or the solvency of any party bound for its payment, to the appointment of a receiver(s) to take possession of and to operate the Property (or any portion thereof) and to collect the Rents and Profits.").

24. *See, e.g.*, MSCI 2006-IQ11 Logan Boulevard L.P. v. Greater Lewistown Shopping Plaza, L.P., 2017 WL 485958, at *2 (M.D. Pa. 2017), (lender may apply for and the borrower "consents, to the extent permitted by applicable law, to the appointment of a receiver"); City Nat'l Bank v. 728 Market St. L.P., 2012 WL 781185 (Pa. Ct. Comm. Pleas 2012) ("Lender shall have the absolute and unconditional right to apply to any court having jurisdiction and obtain the appointment of a receiver or receivers of the Property. Borrower irrevocably and unconditionally consents to such appointment and agrees that the Lender shall have the right to obtain such appointment (i) without notice to Borrower or any other Person; (ii) without regard to the value of the Property or any other collateral securing the Obligations.").

25. 2023 WL 2306739 (D. Del. 2023).

26. *Id.* at *1. It is not clear from the court's opinion what the collateral was or what property the requested receiver was to administer. The underlying transaction was a sale of a Senior Secured Convertible Promissory Note, so perhaps the request was to have a receiver take control of the debtor itself.

27. *Id.* at *4.

28. Another situation in which the phrase might be useful is in a clause excluding consequential damages in a contract for the sale of goods. Such a clause is prima facie unconscionable with respect to personal injury in a case involving consumer goods. *See* UCC § 2-719(3). If, in a contract for the sale of goods, a clause excluding consequential damages included the phrase "to the extent permitted by law," a court might be more inclined to enforce the clause with respect to consequential damages other than personal injury. However, no case can be found where such a clause had that effect. *Cf.* Constructora Mi Casita S de RL de CV v. NIBCO Inc., 2017 WL 3438182 (N.D. Ind. 2017) (dealing with a sales contract that contained such language in a clause limited consequential damages but deciding the case on another basis); Henson v. Western Star Truck Sales, Inc., 2005 WL 1313825 (Ky. Ct. App. 2005) (same).

29. *See* U.S. Bank v. Gotham King Fee Owner, LLC, 2013 WL 2149992, at *3 (a provision in a mortgage agreement whereby the mortgagor waives his or her entitlement to notice of the appointment of a receiver for the mortgaged property is valid and enforceable). *See also* GE Life and Annuity Assur. Co. v. Fort Collins Assemblage, Ltd., 153 P.3d 703, 705 (Colo. Ct. App. 2001) (the absence of language authorizing appointment on an ex parte basis made the case distinguishable from an earlier case, with the result that the trial court erred in appointing a receiver on an ex parte basis); Fortress Credit

Corp. v. Alarm One, Inc., 511 F. Supp. 2d 367 at 371-72 (S.D.N.Y. 2007) (indicating that a receivership order can be issued ex parte if the agreement so provides, but nevertheless declining to do so).

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A Texas Take on Ag Liens

Scott J. Burnham

Many transactional attorneys are not familiar with agricultural liens. They are, indeed, a strange creature. Although an ag lien is a lien on a crop, which is a farm product as defined in UCC Article 9, an ag lien should not be confused with a security interest in farm products. A security interest is generally created consensually pursuant to Article 9. An ag lien, on the other hand, is a lien created pursuant to other state statutes. But unlike many other liens arising by operation of law, an ag lien is not dependent on possession.

Although they are not Article 9 security interests, ag liens are governed by Article 9. However, not all the provisions of Article 9 apply to them. Because they are not security interests, a provision of Article 9 that applies to them refers to either a "security interest or agricultural lien" or only to an "agricultural lien;" a provision that refers only to a "security interest" does not apply to an agricultural lien.

Ag liens do not fit comfortably into the Article 9 framework. Part of the problem is that many of the older ag lien statutes have not been revised in light of revisions to Article 9 in the 1990s. For example, ag lien filing systems might differ from Article 9 filing systems with respect to the jurisdiction for filing, the office within that jurisdiction for filing, and the contents of the document that is to be filed. To better accommodate ag liens, the drafters of Revised Article 9 created a model provision that would have made "production-money security interests" part of Article 9. The model provision, which is similar to § 9-324(b) dealing with PMSIs in inventory, gives priority to a properly perfected production-money security interest over an earlier non-production-money security interest in crops, provided advance notification of the production-money financing is given. Several states have enacted statutes based on this model.

With respect to priority, Article 9 generally treats ag liens the same as it treats security interests, with the result that the first-to-file-or-perfect generally has priority. However, this rule is subject to an exception if the ag lien statute provides otherwise. Many ag lien statutes do provide for ag liens to have priority. This allows a farmer who has granted a security interest in crops to obtain additional credit in order to purchase goods and services necessary to plant, grow, or harvest the crop – seed, fertilizer, labor, and the like. Facilitating the farmer's ability to obtain additional credit seems to be the policy behind ag liens.

Unfortunately, ag liens do not always provide the protection that the lien claimant needs, as a recent case decided by the Texas Court of Appeals illustrates. In that case, a lender loaned money to the Garys, obtained a security interest in their cotton crop, and perfected that security interest by filing a financing statement with the Secretary of State. After the Garys defaulted on this loan, a bank loaned money to the Garys to enable them to obtain seeds and chemicals to plant and fertilize their crops. The bank also obtained and perfected a security interest in the Garys' crops. A dispute then arose over priority in the proceeds of the crops, with the bank claiming priority on grounds that it had a PMSI. The trial court ruled for the bank, reasoning that the bank had a PMSI in the seeds and fertilizer, the crop was the proceeds of the seeds and fertilizer, and that the bank therefore had priority under § 9-324(a), which deals with PMSIs in goods other than inventory or livestock.

A majority of the appellate court reversed and determined that the bank did not have a PMSI. "The very term 'purchase money security interest' denotes that the security interest must be taken in the items actually purchased," the court explained. "The Bank's loan to the Gary's did not enable them to purchase a crop; it enabled them to produce one." It also determined that the crop was not the proceeds of the seeds and fertilizer because "[t]he crop was not the result of the sale, lease, license, exchange, or disposition of the seed." The dissent acknowledged that this result is in line with "the work of learned writers, commentary, and authority from neighboring states," but respectfully "tilted at the windmill" of the prevailing view, sympathizing with a bank that had enabled a farmer to plant a crop the sale of which would repay the loan the lender made.

The case left me wondering: Why didn't the bank assert an ag lien? This question led me to explore the Texas ag lien statutes. Chapter 128 leapt right out at me, with the straightforward caption: Agricultural Chemical and Seed Liens. It is a fairly modern statute, having been enacted in 1995. The statute is very clear about a seller or service provider's right to an ag lien when it sells seeds and chemicals on credit. It requires the creditor to give notice of the lien to the debtor and, if the creditor wishes to perfect, to file a notice of claim with the Secretary of State; certain information, however, is required that is not required for the filing of a financing statement, and the filing must be signed, so filing a standard UCC financing statement would probably not be sufficient. Moreover, the statute does not provide for a lender to obtain the ag lien, as would the model statute for production-money security interests. Consequently, the bank was not entitled to an ag lien under the statute.

Even if the bank had an ag lien, there would have been an additional problem. The statute provides that "[a] lien created under this chapter has the same priority as a security interest perfected by the filing of a financing statement on the date the notice of claim of lien was filed." Therefore, the first-to-file-or-perfect rule would apply and the lien would be junior to a security interest in the crops perfected by an earlier-filed financing statement. So, in Texas, unlike most jurisdictions, the ag lien does not create a superpriority.

Therefore, the Texas bank was limited to obtaining a security interest in the crop, and its only hope, having not bargained for subordination, was to argue that its security interest had a superpriority as a PMSI, and that attempt failed. So, while they may have been tilting at windmills, the trial court and the dissent expressed a view that was in line with the policy behind ag lien statutes in most jurisdictions - but not in Texas.

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Notes:

1. *See* § 9-102(a)(34)(A).

2. *See* § 9-102(a)(5). Cf. § 9-333 (providing a priority rule for possessory liens).

3. *See* § 9-109.

4. *See, e.g.*, §§ 9-308(c), 9-310(a), (c), 9-315(a)(2), 9-317(a)-(c), 9-322(a), 9-338, 9-501(a), 9-507(a), 9-509(c), 9-515(c), 9-601(e), (f), 9-608(a), 9-615(a), (g), 9-617(c)(2), 9-622(a)(3).

5. *See, e.g.*, §§ 9-302, 9-308(b).

6. *See, e.g.*, § 9-315(a)(2) & cmt. 9.

7. *See* Scott J. Burnham, A*gricultural Liens Under Revised Article 9*, 63 MONT. L. REV. 91 (2002).

8. *Id.* at 97-101.

9. *See* the 1998 NCCUSL Annual Meeting draft Appendix II.

Enactment of the model provision would not have fully replaced ag liens because an ag lien can secure: (i) the price of goods or services, or (ii) rent on the real property, but the model provision deals only with the former.

10. *Compare* § 9-324(b) *with* Model § 9-324A, which provides in part:

> **Priority of Production-Money Security Interests and Agricultural Liens.**
> (a) Except as otherwise provided in subsections (c), (d), and (e), if the requirements of subsection (b) are met, a perfected production-money security interest in production-money crops has priority over a conflicting security interest in the same crops and, except as otherwise provided in Section 9-327, also has priority in their identifiable proceeds.

11. Idaho, Maine, Mississippi, North Carolina, Vermont, Wisconsin, and Wyoming have adopted some form of Model § 9-324A. *Agrifund*, *infra* note 15 at *4, notes that Texas had not adopted this provision.

12. *See* § 9-322.

13. *See* § 9-322(g). Somewhat oddly, while the priority of ag liens is the same as the priority for security interests unless the ag lien statute provides otherwise, possessory statutory liens have priority over Article 9 security interests unless the statute provides otherwise. *See* § 9-333.

In addition to providing for the priority between an ag lien and a security interest, ag lien laws also generally provide for the priority between one ag lien and another. *See* Scott J. Burnham, *Agricultural Liens Under Revised Article 9*, 63 MONT. L. REV. 91, 110-111 (2002).

14. *See* Jason Finch, *The Making of Article 9 Section 9-312(2) Into Model Provision Section 9-324A: The Production Money Security Interest: Finally a Sensible "Superpriority" for Crop Finance*, 5 DRAKE J. AGRIC. L. 381 (2000); Steve H. Nickles, S*etting Farmers Free: Righting the Unintended Anomaly of UCC Section 9-312(2)*, 71 MINN. L. REV. 1135 (1987).

15. Agrifund, LLC v. First State Bank of Shallowater, 2022 WL 17547812 (Tex. Ct. App. 2022).

16. *Id.* at *3.

17. *Id.* (citing the § 9-102(a)(64)(A) definition of "proceeds").

18. *Id.* at *5.

19. *Id.*

20. While I thought this might affect the issue of priority, it would apparently not change the issue as to whether crops are the proceeds of seeds, which the court analyzed with reference to cases involving farm products. Official Comment 9 to § 9-315 provides:

> **Proceeds of Collateral Subject to Agricultural Lien.** This Article does not determine whether a lien extends to proceeds of farm products encumbered by an agricultural lien. If, however, the proceeds are themselves farm products on which an "agricultural lien" (defined in Section 9-102) arises under other law, then the agricultural-lien provisions of this Article apply to the agricultural lien on the proceeds in the same way in which they would apply had the farm products not been proceeds.

21. Tex. Agric. Code ch. 128.

22. *Id.* § 128.006.

23. *Id.* §§ 128.010, 128.016.
24. *Compare id.* § 128.013 *with* UCC § 9-502.
25. *Id.* §§ 128.014, 128.015.
26. *Id.* § 128.026.
27. *See* § 9-322.

■ ■ ■

Recent Cases

SECURED TRANSACTIONS

Attachment Issues

In re Financial Oversight and Mgmt. Bd. for Puerto Rico, 2023 WL 2589708 (D.P.R. 2023)

The preamble of a Trust Agreement for municipal bonds, which provided that the issuer "has pledged and does hereby pledge to the Trustee the revenues of the [issuer's electric generation and transmission system] . . . to the extent provided in this Agreement" was not an independent grant of a security interest that expanded on the more specific terms later in the Trust Agreement. The later terms of the Trust Agreement, which granted a security interest in "Revenues," which term was defined to mean "all moneys received by the [issuer] in connection with or as a result of its ownership or operation of the System," covered only receipts deposited into specified accounts and, therefore, the bonds were not secured by receivables. The bondholders could have no present security interest in Revenues for electricity not yet generated because such Revenues are a mere expectancy, not property to which a security interest could attach. Although § 928 of the Bankruptcy Code permits the bondholders' security interest to attach to special revenues acquired post-petition, that merely permits the security interest to attach to any Revenues deposited in the specified accounts prior to confirmation of a plan of adjustment. The bondholders do not have a security interest in the issuer's covenants relating to future Revenues because those covenants are promises by the issuer, not property to which a security interest can attach.

In re Las Martas, Inc., 2023 WL 2024889 (Bankr. D.P.R. 2023)

A secured creditor with a perfected security interest in the debtor's milk quota – a license to produce milk for the fresh milk market – and accounts receivable, but no security interest in the debtor's cows, did not have a security interest in the debtor's milk. The milk was not proceeds of the quota. Consequently, the creditor's security interest in accounts receivable did not, as a result of § 552, extend to receivables generated post-petition.

In re First to the Finish Kim ad Mike Viano Sports, Inc., 2023 WL 2435702 (Bankr. S.D. Ill. 2023)

A lender whose initial 1992 security agreement properly indicated the debtor's corporate name continued to have an attached security interest even though the debtor was involuntarily dissolved in 1994, reincorporated in 1999 with the same name except that it used "Inc." instead of "Incorporated," and then in 2014 executed a new security agreement that used the original name. There was only one business throughout the entire period and the minor change in the debtor's name – "Inc." instead of "Incorporated" – was a misnomer that did not affect the efficacy of the security agreement.

Perfection Issues

In re Creason, 2023 WL 2190623 (Bankr. W.D. Mich. 2023)

A financing statement filed against an individual dentist that incorrectly identified the debtor as an organization, listed the dentist's name as "Paul Kevin Creason dba Dr Paul Creason Family Dentistry," and was apparently not disclosed in response to a search of the dentist's name, was unlikely to be effective to perfect.

Priority Issues

Markel Insurance Co. v. Origin Bancorp, Inc., 2023 WL 2589231 (N.D. Tex. 2023)

A bank with a perfected security interest in the debtor's accounts had priority in the proceeds of accounts over the issuer of surety bonds that later obtained and perfected a security interest in the debtor's accounts relating to bonded projects. It did not matter that language in the debtor's agreement with the surety declared that all monies due or becoming due under any bonded project "are trust funds . . . for the benefit of and for payment of all obligations" owed to the surety. That generic, ritualistic language was insufficient to create a trust relationship that would override creditor priority rules. Read in context, the agreement created a debtor-creditor relationship, not a fiduciary relationship.

In re Atrium of Racine, Inc.,
2023 WL 2530355 (Wis. 2023)
Bondholders' security interest in the assets of a senior-living facility had priority over the claims of residents to a refund of their entrance fees. The residents were unsecured creditors. Although the mortgage was expressly subject to Permitted Encumbrances, which include liens to secure entrance fees, there never were any such liens. The term in the mortgage merely contemplated the possibility that a lien for entrance fees could take priority over the bondholders' mortgage; it did not create a lien, much less accord it priority over the mortgage. There was no basis for imposing a constructive trust on the proceeds of the facility for the benefit of the residents; their entrance fees had not been held in a segregated account and treating the sale proceeds as traceable to their entrance fees would disrupt the statutory priority of the bondholders' lien.

Liability Issues

Clark v. Boat Holdings, LLC,
2023 WL 2505891 (E.D. Mich. 2023)
A buyer of substantially all of the assets of the debtor – a boat manufacturer – at a disposition by the secured party might have successor liability for products liability even if there were no continuity of ownership. Continuity of ownership is not required under the more relaxed requirements for successor liability in the products liability context.

BANKRUPTCY

Property of the Estate

In re Miami Metals I, Inc.,
2023 WL 2242049 (S.D.N.Y. 2023)
Transactions by which customers of the debtor purported to lease precious metals to the debtor were sales because the debtor was obligated to return a like amount of the same metal, not the specific goods provided. As a result, the metals were property of the estate and a creditor with a perfected security interest in the debtor's inventory had priority in the metals. It did not matter that some of the metals were delivered before the customers signed the debtor's Standard Terms because that document unambiguously superseded all preexisting agreements between the parties and governed the parties' dealings going forward.

In re Urban Commons 2 West LLC,
648 B.R. 530 (Bankr. S.D.N.Y. 2023)
A prepetition escrow agreement did not prevent the escrowed assets – proceeds of insurance for water damage to a hotel – from becoming part of the bankruptcy estate of the debtor that owned the hotel. The agreement purported to require the consent of four parties to release the funds but provided no mechanism for dealing with an inability to obtain that consent. Accordingly, either the agreement should be interpreted as including an implied term authorizing any party to seek a judicial determination of the parties' rights, in which case the funds were property of the debtor's estate subject to the senior lender's lien, or the agreement failed to create a true escrow because release of the funds was not conditioned on an event, in which case the funds remained the property of the debtor as the grantor.

Claims & Expenses

In re Latex Foam International, LLC,
2023 WL 2403757 (D. Conn. 2023)
An oversecured creditor was entitled to post-petition interest at the contractual default rate, which was 3% higher than the non-default rate. The contractual rate presumptively applies, absent equitable considerations, and the debtor had defaulted by filing a bankruptcy petition. Equity did not require otherwise. There was no evidence of creditor misconduct, even though the creditor had purchased the loan at a discount and even though the creditor had refused to provide post-petition financing. The additional 3% was not a penalty. And the unsecured creditors would not be unduly harmed.

Discharge, Dischargeability & Dismissal

Moody National Bank v. Shurley,
2023 WL 2368023 (W.D. Tex. 2023)
The bankruptcy court did not err in concluding that the debtor's bank loan was not rendered nondischargeable by § 523(a)(2)(B) due to the debtors' misrepresentation that there were no prior liens on the collateral. Section 523(a)(2)(B) requires reasonable reliance. There was evidence that the bank's loan officer advised the debtors to get a receivables loan to make payroll and the bank maintained the deposit account into which the loaned funds were deposited. Moreover, given the red flags, the bank should have updated its lien search, conducted on August 31, before entering into the loan commitment on September 28.

Avoidance Powers

In re Quorum Health Corp.,
2023 WL 2552399 (Bankr. D. Del. 2023)
Section 546(e) preempts state law and prevents creditors, not merely the bankruptcy trustee, from avoiding a transfer made by or to a financial participant in connection with a securities contract. Accordingly, the trustee of a litigation trust could not avoid a spin-off dividend as a fraudulent transfer. However, claims for unjust enrichment and receipt of an illegal dividend, which sought to impose liability for the same transaction but not to avoid the transfer, were not barred by § 546(e).

Other Bankruptcy Matters

In re Roberson Cartridge Co.,
2023 WL 2393809 (Bankr. N.D. Tex. 2023)

A term in a security agreement providing that, upon default, the debtor's voting rights as the sole member of a manager-managed LLC immediately ceased and vested in the secured party did not affect the authority of the debtor, as the manager, to file a bankruptcy petition for the LLC. A term in the security agreement requiring the secured party's consent to "any action that results in a liquidation or dissolution of the Company" was against public policy and void to the extent that it purported to waive or condition the LLC's right to seek bankruptcy protection. Although the loan was convertible into equity in the LLC, the secured party had not exercised that conversion right and therefore had no ownership interest in the LLC that could be used to support such a blocking right.

In re S-Tek 1, LLC,
2023 WL 2529729 (Bankr. D.N.M. 2023)

The debtor was not entitled to a structured dismissal that would include a sale of assets free and clear of liens under § 363(f) because that would, without the secured party's consent, alter the priority rules that would otherwise apply. The secured party had a security interest in all of the debtor's existing and after-acquired accounts. Although § 552(a) generally prevents a security interest from attaching to collateral acquired post-petition, the court had previously granted the secured party a security interest in accounts acquired post-petition as part of the cash collateral orders. Upon dismissal, § 552(a) would no longer prevent the secured party's security interest from attaching to after-acquired accounts. And while it might be possible for a new lender with a PMSI to gain priority in accounts, that is not possible in this case because the debtor's accounts arise from the provision of services.

GUARANTIES & RELATED MATTERS

Legal Recovery Associates LLC v. Brenes Law Group, P.C.,
2023 WL 2253138 (S.D.N.Y. 2023)

Although a lawyer's guaranty of a loan to his law firm provided that the guaranty was "unconditional" and waived any defense to payment that the firm might have, the court should not strike the lawyer's affirmative defenses arising from the lender's alleged lack of good faith in refusing to provide payoff information so as to prevent the firm from obtaining alternative financing. A reasonable person would be justified in expecting a lender to disclose the amount the lender believes is owed when the borrower seeks to pay off the debt. Under New York law, a lender's conduct after a guaranty is signed may discharge a guarantor's obligation despite broad waiver language. However a defense of undue influence was wholly conclusory, was waived in the guaranty, and, thus, should be stricken.

LENDING, CONTRACTING & COMMERCIAL LITIGATION

ADE Middle Market Debt Funding LLC v. Marblegate Asset Mgmt. LLC, 2023 WL 2394680 (N.Y. App. Div. 2023)

Minority lenders stated a claim for breach of contract against the majority lenders for directing the collateral agent to conduct, and against the collateral agent for conducting, a public sale of the collateral, credit bidding the debt of all of the lenders, and then selling the collateral as a going concern to an entity owned by the majority lenders, effectively siphoning the collateral to the majority lenders in violation of the pro rata sharing provisions of the credit agreement. Under those provisions, each minority lender was entitled to a pro rata interest in the collateral purchased. Instead, the sale resulted in a marked diminution of the minority lenders' interests in comparison to what the majority lenders received. The minority lenders also stated a claim against the majority lenders for breach of the covenant of good faith by alleging that they secretly designed the transaction so as to defeat the minority lenders' contractual expectations of pro rata treatment, concealed the transaction from them until it could be revealed as a fait accompli, withheld information necessary for them to effectively participate in the process, and improperly structured the foreclosure process to preclude effective participation by third parties, including the minority lenders, thereby undermining the minority lenders' reasonable economic expectations under the Credit Agreement. The minority lenders did not state a claim for breach of fiduciary duty against the majority lenders because the majority lenders had no such duty.

Ormsby v. Nexus RVs, LLC,
2023 WL 2536326 (N.D. Ind. 2023)

A couple that negotiated the purchase of an RV directly from the manufacturer, but ultimately for tax reasons provided the funds for their son's LLC to purchase the RV, had no claim for breach of implied warranty or revocation of acceptance against the manufacturer. Even if the dealer that conducted the sale was the agent of the manufacturer, the couple had not argued that the LLC was their agent, and thus lacked privity of contract with the manufacturer. Moreover, no one had advised the manufacturer that the sale would be to the LLC, so even if the dealer was the manufacturer's agent, the dealer had acted outside the scope of the agency by selling the RV to the LLC. Consequently, the LLC also had no claim against the manufacturer. There were also no claims for breach of express warranties made during the initial negotiations with the manufacturer because whatever was said during those discussions with the couple could not have been part of the basis of the bargain in the sale to the LLC. In sum, by structuring the transaction as they did, the couple might have gained the benefit of avoiding sales taxes but lost the rights they might have enjoyed as buyers or as contracting parties who wisely put to paper the terms they wanted.

Bernhardt v. Bernhardt,
2023 WL 2607753 (Tex. Ct. App. 2023)
A term in a couple's agreement incident to divorce, which was incorporated into the divorce decree, entitling the former husband to a setoff on the amount he owed to his former wife if his interests in several businesses or vehicles was "foreclosed upon by the lien holder," did not apply after the former husband voluntarily sold the property in an "informal foreclosure" to avoid a forced sale by the secured party.

Corso v. Concordia Healthcare USA, Inc.,
2023 WL 2631496 (D. Del. 2023)
A document labeled as a "Promissory Note" and provided in connection with the sale of a business was not a promissory note because the principal amount varied depending on the future earnings of the business, and thus was not a sum certain. Accordingly, Delaware's three-year limitations period for breach of contract applies, not the state's six-year period for actions on a promissory note. The claims for installments due in 2014-2017 were all untimely; the claims for amounts due in 2018-2020 were not, unless the debt had been accelerated. Although the plaintiff had attempted to accelerate the debt in 2015 and 2016, those attempts were unsuccessful because the defendant was not then in default. Letters sent by the plaintiff's lawyer in 2017 and 2020 also did not accelerate the debt because they stated that if the defendant did not cure the default within a specified time, the plaintiff "will exercise his right to accelerate."

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