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ATTACHING AND PERFECTING A SECURITY INTEREST IN ESCROWED ASSETS

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Consider a situation in which Buyer purchases a business from Seller. Pursuant to the Purchase and Sale Agreement, the purchase price will be adjusted post-closing based on some facts not known or knowable at that time. Perhaps the price will be adjusted up or down based on EBITDA of the business during a specified period. Perhaps the price will be adjusted based on the amount or collectability of receivables outstanding on the closing date. Whatever the reason for the adjustment, a portion of the purchase price is put in escrow awaiting final determination of which party is entitled to the funds.

Now consider a real property developer that is selling condos, time-shares, or single family residences in a development that has yet to be completed. Buyers make down payments that are refundable if the development is not completed by a specified date. Those down payments are escrowed.

In both of these situations, each of the two parties has contingent rights to the escrowed funds. One or both of those parties might have a secured creditor that wishes to have a security interest in those rights. Indeed, the secured creditor might even be the source of the funds. Is such a security interest an interest in the funds themselves (most likely a deposit account) or is it in a party's contingent rights in the escrow contract (likely a general intangible) or in a party's contingent right to payment from the escrow agent (likely either an account or general intangible)?[1] That matters because a security interest in a deposit account as original collateral can be perfected only by control,[2] whereas a security interest in an account or general intangible can generally be perfected only by filing a financing statement.[3] The priority rules applicable to the security interest also vary depending on how the property is classified.

There is no clear answer to this classification question under either Article 9 or the cases interpreting it. That is because the law governing who owns escrowed assets is rather muddled. This article, which expands on a 2012 article in this newsletter,[4] concludes that the classification of collateral held in escrow depends in part on the nature of the escrowed asset and in part on whether the transaction is documented as a security interest in the escrowed asset or as a security interest in the debtor's rights against the escrow agent.

Before delving into escrow arrangements, however, it is useful to explore a different common situation in which ownership is shared: a lease of goods. Doing so provides context and a useful comparison for analyzing escrows.

A BRIEF DIGRESSION – LEASES OF GOODS

Consider a situation in which a business granting a security interest in its assets is a lessee of goods under a true lease. The lessor remains the titleholder of the leased goods but the lessee also has property rights in the goods, specifically the right to possess and use them.[5] Indeed, depending on the terms of the lease, the lessee might have a greater share of the economic rights in the goods than the lessor has.[6]

If the collateral is regarded as the lessee's interest in the lease, then the collateral would be a general intangible and the only way to perfect the security interest would be by filing a financing statement. If, however, the collateral is regarded as the lessee's interest in the goods, then the collateral would be goods – most likely, equipment.[7] In such a case, the way to perfect the security interest would depend on other facts. In most cases, perfection would be by filing a financing statement but, if the goods were in the possession of a bailee, perfection could also be achieved by the bailee's acknowledgment that it holds possession for the secured party's benefit.[8] More significantly, if the goods were subject to a certificate of title statute, the only way to perfect the security interest would be through compliance with that statute.[9]

There are no known cases that treat a lessee's interest in goods as general intangibles. That is not surprising. If a

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debtor's limited rights in property, rather than the property itself, was what controlled how the property was classified, then all personal property would be treated as a general intangible if anyone other than the debtor shared property rights. If a married couple jointly owned a brokerage account, then each would have a general intangible rather than investment property. If a debtor had previously granted a security interest in goods, the debtor's residual rights would be a general intangible rather than the goods, with the result that there could never be competing security interests in the same collateral.

Clearly, that is not how Article 9 works. It expressly provides for the possibility of multiple security interests in the same collateral.[10] It also expressly contemplates that a secured party can have a security interest in fixtures or crops even though a person other than the debtor might own the real property to which the fixtures are attached or on which the crops are grown, and also have an ownership interest in the fixtures or crops.[11] And the comments expressly reject the notion that a security interest in less than all of the rights associated with chattel paper is anything other than chattel paper.[12]

Indeed, if the existence of a co-owner at the time of attachment meant that the collateral was necessarily a general intangible, then secured parties would frequently have no way of knowing how to classify the collateral. Almost any personal property that does not appear to be a general intangible would be one if someone else – secretly – had an ownership interest in the property. As a result, secured parties would have no assurance how to perfect or what priority rule would govern a dispute among multiple secured parties.

In sum, the mere fact that the debtor owns less than all of the property to which a security interest attaches does not affect how the property is classified under Article 9.

ESCROWED ASSETS

Although *incomplete* ownership does not affect the classification of property, *indirect* ownership generally does. For example, a debtor's interest in a partnership or limited liability company is a general intangible.[13] This is so regardless of what type of property the entity owns, in part because the debtor has no ownership interest in that property. Accordingly, when a debtor contributes property to such an entity, the debtor exchanges whatever the contributed property was – securities, realty, funds, goods – for a general intangible. The same is true for the debtor's beneficial interest in a trust.[14]

Consequently, the question with respect to escrowed property is whether the escrow transfers ownership of the escrowed property to the escrow agent. Put more generally, is an escrow a bailment – a delivery of possession or custody for safekeeping or other purposes – or is it a trust?

In a traditional trust, the trustee acquires title to the trust res. In an escrow arrangement, like a bailment, the opposite is generally true.[15] If the escrow involves a deed to real property that identifies an escrow beneficiary, not the escrow agent, as the grantee, then the law is reasonably clear that the escrow arrangement does not transfer title to the real property (or ownership of the deed itself).[16] If the escrowed property is goods – for example, a painting escrowed in connection with a sale transaction contingent on verification of the painting's provenance – then it is likely that title to the painting also does not shift: it remains with the seller, although the buyer acquires some rights to the painting by its identification to the contract for sale.[17]

Even when the escrow involves funds, title apparently remains with the transferor,[18] although the escrow agent is occasionally referred to as a "trustee" with fiduciary duties.[19] As a result, the escrowed funds become part of the transferor's bankruptcy estate if the triggering event has not yet occurred when the bankruptcy petition is filed.[20]

CASE LAW

Unfortunately, there are not many judicial decisions that deal with a security interest in escrowed assets. Those that have done so involved escrowed funds and are not fully consistent. Some expressly or implicitly look through the escrow structure to determine what type of property the parties to the escrow own. Others expressly or implicitly treat the parties as owning an interest in the escrow itself.

Cases Looking through the Escrow

In *In re Tuscany Energy, Inc.*,[21] The debtor owed $5 million to Armstrong Bank, which had a security interest in substantially all of the debtor's assets, including the debtor's deposit accounts. A few weeks before the debtor filed for bankruptcy protection, the debtor transferred $200,000 from one of its deposit accounts at another bank to its bankruptcy counsel, partly for prepetition services and partly as a retainer for postpetition services.[22] The issue was whether Armstrong Bank retained a prior security interest in the retainer.

The court began its analysis by noting that a retainer provided to a law firm remains the client's property but the firm has a security interest in the retainer.[23] The court then characterized this as "a possessory security interest in money."[24] The court then concluded that the law firm's security interest was perfected by possession under § 9-313(a). In contrast, Armstrong Bank had no security interest at all because the law firm had taken free of the bank's security interest under § 9-332(b).[25] The court then added that even if Armstrong Bank did still have a security interest in the retainer, that interest was not perfected because the only way to perfect a

security interest in a deposit account is through control and Armstrong Bank did not have control of the deposit account.[26]

The court's analysis is beset with errors.[27] Nevertheless, in analyzing what property the debtor owned, the court implicitly looked through structure and focused on what property the law firm held on the debtor's behalf. There was no hint or suggestion that the debtor's property was some right against the law firm, which would be a general intangible.

In re Harbour East Development, Ltd.,[28] involved a real estate developer's rights in forfeited deposits made by buyers in connection with contracts to purchase real property. The developer had, before construction began, contracted to sell condominiums in a planned luxury project. The buyers had paid 20% of the purchase price money into escrow, which the escrow agent placed in a deposit account. When the developer filed for bankruptcy, $550,000 of the escrowed deposits had been forfeited by the buyers, and the developer's mortgagee claimed an interest in those funds.

The court ruled the mortgagee's interest was governed by real property law, not by Article 9.[29] Nevertheless, the court added that, if Article 9 applied, the mortgagee's interest was perfected despite the absence of a filed financing statement because the escrow agent had possession of the funds on behalf of the mortgagee and money, when deposited into a bank account, is still money.[30] The court was clearly wrong in treating deposits as "money."[31] Under § 1-204(b)(24), "money" is limited to cash or legal tender; it does not include a deposit account or a right to receive payment. The fact remains, however, that the court looked through the escrow structure to determine what the collateral was.

In re LDM Development Corp.,[32] is a case decided under old Article 9. In connection with the debtor's sale of real property, the debtor was required to leave about $11,000 of the sale proceeds with the escrow agent to protect the title company from liability for a mechanic's lien on the real property. A couple loaned the debtor about $10,500 and the debtor executed a security agreement that described the collateral as "escrow deposit in sum of $10,800 held by Gibraltar Title Agency, LLC." The couple did not file a financing statement. The mechanic's lien was later discharged with other funds and, in the debtor's bankruptcy, the couple sought relief from the stay to access the escrowed funds.

The debtor claimed that the collateral was a contingent right to payment under the escrow agreement, which was a general intangible.[33] The couple claimed that the collateral was money and that their security interest was perfected by possession because they had provided notice to the escrow agent, which they claimed was a bailee.[34]

The court refused to treat the deposited funds as an escrow, concluding that it was a security arrangement.[35] The court then ruled that the arrangement did not transform the debtor's rights into a general intangible. Instead, those rights were contingent rights to the funds themselves, which the court concluded was money.[36] The court then ruled that the couple was a junior secured party with a security interest perfected by notice to the escrow agent, as bailee.[37]

The decision is deeply flawed. First, there is no explanation as to why an arrangement cannot be both an escrow and a security arrangement. Second, the court made the same mistake that *Tuscany Energy* and *Harbour East Development* did in treating a deposit account as money.[38] Still, the court was clear that the debtor's indirect interest in the funds provided to the escrow agent did not convert the debtor's property into a general intangible.

Cases Focusing on the Escrow

In *D & M Land Co. v. Branch Banking & Trust Co.*,[39] the debtor entered bankruptcy with a contract to sell real property. The buyer had paid a $65,000 earnest money deposit that was held in escrow. During the bankruptcy case, the sale failed to close and the debtor's principal lender claimed that the escrowed funds were part of its collateral in which it had the most senior security interest. The district court affirmed the bankruptcy court's ruling that the deposit was both proceeds of the real property (on which the lender had a deed of trust) and a general intangible.[40] Accordingly, the lender was entitled to the funds. There was no discussion, perhaps because no one raised the issue, that the collateral should be regarded as a deposit account, rather than as a general intangible.

In re E-Z Serve Convenience Stores, Inc.,[41] is another case involving a retainer provided to a law firm. At the time of the debtors' bankruptcy petition, the debtors owed the CIT Group about $17 million. The debt was secured by substantially all of the debtors' personal property. One of those assets was a $790,000 retainer that the debtors had provided to their law firm, about $400,000 of which had not been earned by the firm.[42] The firm later used about half of that for postpetition services and, after the case was converted to Chapter 7, sought permission to remit the balance to the trustee free and clear of liens.[43] CIT objected, claiming a perfected security interest in the funds.

The court first ruled that, under North Carolina law, the retainer was a "security retainer," which meant that the debtors retained a property interest in the retainer funds.[44] The court then proceeded to analyze how to classify the debtors' rights under Article 9. Specifically, whether the debtors' interest in the retainer was money, a deposit account, or a general intangible.

The court properly rejected the trustee's argument that the interest was money because there the retainer was neither paper currency nor coins.[45] The court then ruled that the debtors'

interest in the retainer was not a deposit account because a deposit account must be maintained with a bank. Although the retainer funds were held in a deposit account, that deposit account was the law firm's deposit account, not the debtors'. As the court phrased it, the debtors had an interest in only the unearned portion of the retainer, which was simply an entry on the law firm's books reflecting an interest in an unsegregated trust account.[46] Instead, the debtor's interest was a general intangible.[47]

The decision is the most thoughtful of all the cases bearing on the issue. Still, it does not fully explain the shift in focus that occurred when the court went from concluding that the debtors had an ownership interest in the "retainer funds" to their having an ownership interest in rights against the firm. The court also did not discuss – because it did not need to – whether the analysis or result would be different if the escrowed funds had not been commingled with other funds.

In *In re Vienna Park Properties*,[48] the debtor had established, in connection with its purchase of 300 condominiums, an escrow account to provide funds needed to maintain the properties while the properties remained under the seller's management. At the end of that period, the balance was to be distributed to the debtor. The escrow was initially funded with $2.5 million, of which $500,000 came from the debtor and the remainder from its lender. The debtor granted the lender a security interest in its "rights to receive funds now or hereafter deposited in the Escrow Account in accordance with the Escrow Agreement." The lender did not file a financing statement.

In the debtor's bankruptcy, the debtor argued that the escrow was a general intangible, and therefore the lender's security interest was unperfected. The lender argued that the collateral was money and that the security interest was perfected by the escrow agent's possession on the behalf of the lender.[49]

The court concluded that the funds held in the escrow account were unquestionably "money" within the meaning of § 1-201,[50] but because the debtor did not have an unencumbered present right to these funds at the time it granted the security interest, merely a contingent contractual right to receive any funds remaining in the escrow account, the most the debtor could transfer at the time of the security agreement was a contingent right to receive an uncertain amount of money in the future. This, the court concluded, was a general intangible.[51] Critical to the court's reasoning was the fact that the lender was not a party to the escrow agreement and claimed a security interest only in the debtor's rights under the escrow agreement.[52]

In *In re Allen*,[53] the debtor borrowed funds to purchase a condominium, not yet built, from a developer. The funds were put in escrow and the debtor purported to grant a security interest in his rights under the Purchase and Escrow Agreement to the lender. The lender filed a financing statement.

In the debtor's bankruptcy, it became necessary to determine what the collateral was and whether the lender's security interest was perfected. Despite twice referring to the collateral as the escrowed "funds,"[54] the court ruled that the debtor's contingent right to the escrowed funds was a general intangible, and the lender's security interest was perfected by the filed financing statement.[55]

Overall Weight of Authority

With the exception of *E-Z Serve Convenience Stores*, none of these decisions is particularly persuasive. Most of the courts start off in the wrong direction by equating a deposit account with "money," which is simply wrong. Money is a defined term that is limited to paper currency and coins.[56] Although that error has no direct bearing on the central question of whether the debtor owns the escrowed property or merely a claim against the escrow agent, it does little to inspire confidence in the courts' decision making.

Perhaps more to the point, none of the decisions delves into what the debtor's rights are. The cases that look through the escrow to the underlying assets do not really explain their reason for doing so. And the discussion in *Tuscany Energy* about the classification of the collateral is pure dicta. The cases that treat the debtor's rights as a general intangible do not really explain why an escrow arrangement should be regarded as indirect ownership of the escrowed property rather than as shared ownership (with the other party to the escrow arrangement) of property placed with a bailee. In each case, the court seems more to be announcing a decision that comports with its underlying assumptions and understanding about what an escrow is rather than explaining what makes the most sense, what is most consistent with the common law of escrow, or what works best under Article 9.

Still, the cases might not be as inconsistent as they at first appear. In both *Vienna Park Properties* and *Allen*, the security agreement described the collateral as an indirect ownership right. Specifically, the former referred to the debtor's "rights to receive funds now or hereafter deposited in the Escrow Account" and the latter referred to the depositor's rights in the escrow agreement. In contrast, in *LDM Development*, the security agreement described the collateral as the escrowed assets, by referring to the "escrow deposit." There is nothing inherently wrong in holding a secured party to its bargain: that is, to limiting the collateral to the debtor's escrow rights rather than to the escrowed property, if that is what the security agreement provides.

IMPLICATIONS OF TREATING THE COLLATERAL AS ESCROW RIGHTS

As explained in the 2012 article on this subject, describing the collateral as rights under the escrow agreement rather than as the escrowed property might affect whether the security interest remains attached to the escrowed assets after the escrow is terminated and what qualifies as proceeds of the collateral.[57]

Consider, for example, a debtor who owns a valuable painting and who delivers the painting to an escrow agent in connection with a contract for sale. If a creditor obtained and perfected a security interest in the painting before the escrow was created, the creditor's security interest would likely have priority over the buyer's rights unless the buyer qualified as a buyer in ordinary course of business or the secured party expressly or implicitly authorized the sale to the buyer free and clear.[58] If the creditor obtained and perfected a security interest in the painting after the escrow is created, one is tempted to think that the secured party's rights would be subordinate to the buyer's rights, which were earlier in time. In other words, the secured party could acquire a security interest only in the debtor's residual rights in the goods. However, that might not be correct. Pursuant to § 9-201(a), a security agreement is effective according to its terms as against purchasers of the collateral. Unless the buyer could take free of the security interest under some provision of Article 9, the buyer would apparently take subject to the security interest.

Regardless of the timing, however, if the sale goes through, the amounts the buyer pays would undoubtedly be proceeds of the painting,[59] and the security interest would attach to those proceeds.[60] If the sale does not go through, the security interest in the painting would remain.

In contrast, if a creditor obtained and perfected a security interest in the debtor's rights under the escrow agreement, the results are less clear. If the sale falls through and the painting is returned to the debtor, is the painting proceeds of the escrow contract? Perhaps,[61] but that conclusion is far from certain. Similarly, if the sale goes through, the funds that the buyer pays are undoubtedly proceeds of the *painting* but whether they are proceeds of the debtor's interest in the *escrow agreement* is less certain. The funds do not seem to be "acquired upon the sale, lease license, exchange, or other disposition" of the escrow agreement,[62] but they might be "distributed on account of" or "aris[e] out of" the escrow agreement.[63]

ADVICE TO TRANSACTIONAL LAWYERS

Escrowed Goods

When goods are escrowed, it is clear that the escrow agent does not acquire title to or ownership of the goods. Instead, title remains with the party depositing the goods into escrow, although the other party to the escrow arrangement might have begun to acquire ownership rights in the goods based on the parties' underlying contract. Despite clarity on that point, a lawyer representing a secured creditor of one of the parties to the escrow has a choice to make: whether to treat the collateral as the goods or as rights under the escrow agreement. This choice can have several consequences:

- Encumbering the escrowed goods directly could affect whether the other party to the escrow takes free of the security interest if the escrow closes as planned.
- What constitutes identifiable proceeds of the collateral might depend on whether the collateral is the goods or the debtor's interest in the escrow agreement.

With these consequences in mind, in most cases a lawyer representing a creditor of one of the parties to the escrow should disregard the escrow structure and draft the security agreement as creating a security interest in the goods themselves. Of course, if the debtor is not the party depositing the goods into escrow, the security agreement should expressly extend to the debtor's after-acquired rights in the goods, as the debtor's rights in the goods will expand if the escrowed transaction closes.

To perfect the security interest, the lawyer should file a financing statement covering the goods or get the escrow agent to acknowledge that it holds possession for the secured party's benefit,[64] unless the goods are covered by a certificate of title statute[65] or by a federal filing system for aircraft, documented vessels, or rolling stock.[66] In such a case, compliance with the certificate of title statute or with federal law is necessary to perfect.

Escrowed Funds

When dealing with escrowed funds, the transactional lawyer needs to be aware that the law is unclear whether the escrow agent acquires ownership of the funds.[67] This uncertainty is significant because perfecting a security interest in a party's rights in the escrow agreement requires filing a financing statement covering either general intangibles or the rights under the escrow agreement, whereas perfecting a security interest in escrowed funds requires control.[68]

Given the uncertainty, transactional lawyers might wish to draft the security agreement to cover both the escrowed funds and debtor's rights under the escrow agreement, and then perfect the security interest by both getting control of the deposit account and filing as to the rights in the escrow agreement.

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Notes:

1. If the collateral is a right to payment from the escrow agent, classification of the right might depend on which party is granting a security interest. The seller's right to payment, even though contingent, would be an account. *See* U.C.C. § 9-102(a)(3) (defining "account" to include a right to payment for property sold, whether or not earned by performance). In contrast, the buyer's right to a partial refund would be a general intangible and, more specifically, a payment intangible.

2. *See* U.C.C. § 9-312(b)(1).

3. *See* U.C.C. § 9-310(a). A security interest created by the sale of a payment intangible is automatically perfected. *See* U.C.C. § 9-309(3). If the 2022 UCC Amendments were in effect in the relevant jurisdiction, a security interest in a controllable account or controllable payment intangible could be perfected by control. *See* U.C.C. §§ 9-107A, 9-310(b)(8), 9-314(a), 12-105 (2022).

4. *See* Stephen L. Sepinuck, *Taking a Security Interest in Escrowed Assets*, 12 The Transactional Lawyer 2 (Apr. 2012).

5. *See* U.C.C. § 2A-103(1)(j) (defining "lease" to mean a transfer of the right to possession and use of the goods).

6. The lessor must have retained some economic rights in the goods because, if the lessor did not, the transaction would be a financed sale structured as a lease. *See* U.C.C. § 1-203(b)(1).

7. Of course, a lessee might have rights under a lease in addition to the right to possession and use of the goods. For example, the lessor might have made warranties in connection with the transaction, *see* U.C.C. §§ 2A-210 *through* 2A-213, or might have a right to renew the lease or purchase the goods. Some of these rights might be proceeds of the goods, *see* U.C.C. § 9-102(a)(64)(D) (defining "proceeds" to include a claim for nonconformity or infringement of rights in the collateral), so that a security interest in the goods would extend to those rights, *see* U.C.C. § 9-315(a)(2). But other rights under the lease might not be proceeds of the goods. For that reason, a creditor taking a security interest in the lessee's interest in the goods might also want a security interest in the lessee's rights under the lease.

8. *See* U.C.C. § 9-313(c)(1). Most lessees of equipment want possession of the leased goods so that they can use the goods in their business, and thus are unlikely to deliver possession of the goods to a bailee. However, a lessee might allow an affiliate to possess and use the goods, in which case the affiliate would be a bailee that could acknowledge holding possession for the benefit of a secured party.

9. *See* U.C.C. § 9-311(b).

10. *See, e.g.*, U.C.C. §§ 9-110(4), 9-322(a), 9-324, 9-325, 9-326(b), 9-327, 9-328, 9-329, 9-337(2), 9-338(a) (each referring to a "conflicting" security interest).

11. *See* U.C.C. §§ 9-334(d), (e), (f), (i).

12. *See* U.C.C. § 9-102 cmt. 5d.

13. *See, e.g.*, Trapp v. Hancuh, 530 N.W.2d 879, 887 (Minn. Ct. App. 1995); Newcombe v. Sundara, 654 N.E.2d 530 (Ill. App. Ct. 1995); In re Larson, 1993 WL 367106 (Bankr. D.N.D. 1993); In re Hartman, 102 B.R. 90, 93 (Bankr. N.D. Tex. 1989).

14. *See, e.g.*, In re 3PL4PL, LLC, 619 B.R. 441, 461-63 (Bankr. D. Colo. 2020) (law firm's trust account); 1989 WL 1684534, at *2 (Bankr. S.D. Iowa 1989); In re Cowsert, 14 B.R. 340, 343 (Bankr. S.D. Fla. 1981) (land trust); Wambach v. Randall, 484 F.2d 572, 575 (7th Cir. 1973).

15. *See also* Restatement (Third) of Trusts § 5 cmt. k ("A person who, as agent, receives funds for a principal is an agent-trustee . . . if title to the money is received . . . ; but the person is an agent-bailee if mere possession but no title is received.").

16. *See, e.g.*, In re NTA, LLC, 380 F.3d 523, 529-30 (1st Cir. 2004) (relying on Miquel v. Belzeski, 797 F. Supp. 636, 641 (N.D. Ill. 1992)).

17. The escrow aside, the buyer would have "a special property and insurable interest" in the painting under U.C.C. § 2-501(a) because the painting was undoubtedly identified to the contract at the time the contract was made.

18. *See, e.g.*, In re Mushroom Transp. Co., 282 B.R. 805, 817 (E.D. Pa. 2002) ("under an express trust, the trustee obtains legal title to the property . . . [i]n contrast, under an escrow agreement, the depositor retains legal title to the escrow funds."), *aff'd in part and rev'd in part*, 382 F.3d 325 (3d Cir. 2004); In re Royal Business School, Inc., 157 B.R. 932, 940-42 (Bankr. E.D.N.Y. 1993).

19. *See, e.g.*, In re Cannon, 277 F.3d 838, 850-51 (6th Cir. 2002) (referring to a lawyer who held escrowed funds for a client as having only legal title to the funds, which were held in trust); In re J & J Record Distrib. Corp. 80 B.R. 53, 55 (Bankr. E.D. Pa. 1987), *aff'd*, 84 B.R. 364 (E.D. Pa. 1988).

20. *See, e.g.*, In re Missionary Baptist Found. of Am., Inc., 792 F.2d 502 (5th Cir. 1986); *but cf.* In re Royal Business School, Inc., 157 B.R. at 942 (only the transferor's contingent interest becomes part of the transferor's bankruptcy estate).

In contrast, the funds do not become part of the transferee's bankruptcy estate unless the triggering event occurred prepetition. *See, e.g.*, Missionary Baptist Found, 792 F.2d at 506; NTA, LLC, 380 F.3d at 529-30; In re Newcomb, 744 F.2d 621 (8th Cir. 1984).

21. 561 B.R. 910 (Bankr. S.D. Fla. 2016).

22. *Id.* at 913.

23. *Id.* at 915.

24. *Id.*

25. *Id.* at 916.

26. *Id.*

27. The court made at least three errors in its analysis: (i) treating a deposit account as money (indeed, the court treats the law firm as having a security interest in money while simultaneously concluding that, if the bank had a security interest, that security interest would be in a deposit account); (ii) concluding that the law firm took the funds free of a bank's security interest despite also concluding that the debtor remained the owner of the funds held as retainer; and (iii) concluding that the bank's security interest was unperfected without considering the possibility that the deposit account was identifiable cash proceeds of collateral in which the bank had a perfected security interest. *See* Carl S. Bjerre and Stephen L. Sepinuck, *Spotlight*, Commercial Law Newsletter 9, 10-11 (spring, 2017).

A subsequent decision in the same case is no better. *See* In re Tuscan Energy, LLC, 581 B.R. 681 (Bankr. S.D. Fla. 2018).

28. 2011 WL 3035287 (Bankr. S.D. Fla. 2011).

29. *Id.* at *3-6.

30. *Id.* at *7-8.

31. Nevertheless, the court's conclusion about perfection might have been correct. *See infra* note 68.

32. 211 B.R. 348 (Bankr. D. Minn. 1997).

33. *Id.* at 350.

34. *Id.*

35. *Id.* at 351-52.

36. *Id.* at 352.

37. *Id.* at 353-55.

38. Numerous other courts make the same mistake. *See, e.g.*, In re EAS Graceland, LLC, 2021 WL 1941658 (Bankr. W.D. Tenn. 2021) (a law firm's interest in a $35,000 retainer received from the debtor was perfected by possession).

39. 431 B.R. 133 (E.D.N.C. 2010).

40. *Id.* at 136-37.

41. 299 B.R. 126 (Bankr. M.D.N.C. 2003).

42. *Id.* at 128.

43. *Id.*

44. *Id.* at 130.

45. *Id.* at 131.

46. *Id.*

47. *Id.* at 131-32.

48. 976 F.2d 106 (2d Cir. 1992).

49. *Id.* at 114.

50. *Id.* at 116.

51. *Id.* at 117.

52. *Id.*

53. 888 F.2d 1299 (10th Cir. 1989).

54. *Id.* at 1301, 1302.

55. *Id.* at 1302.

56. *See* 12 The Transactional Lawyer at 3.

57. U.C.C § 1-201(b)(24).

58. *See* U.C.C. §§ 9-315(a)(1), 9-320(a). If the escrow agent was a merchant in the business of selling goods of this kind and the secured party was aware of the agent's possession of the good but did nothing, the secured party might be deemed to have "entrusted" the good to the agent so as to allow the agent to sell the secured party's rights to a buyer in ordinary course of business. *See* U.C.C. §§ 2-403(2), (3), 9-320 cmt. 3, ex. 2.

59. *See* U.C.C. § 9-102(a)(64)(A).

60. *See* U.C.C. § 9-315(a)(2).

61. *See* U.C.C. § 9-102(a)(64)(C) (including as proceeds "rights arising out of collateral").

62. *See* U.C.C. § 9-102(a)(64)(A).

63. *See* U.C.C. § 9-102(a)(64)(B), (C).

64. *See* U.C.C. § 9-313(c).

65. *See* U.C.C. § 9-311(a)(2), (d). *See also* U.C.C. §§ 9-313(b), 9-316(d) (providing for perfection by possession of goods covered by a certificate of title in only very limited circumstances).

66. *See* 49 U.S.C. §§ 44107, 44108 (requiring that notice be filed with the FAA Aircraft Registry to perfect a security interest in aircraft); 46 U.S.C. §§ 31321–31330 (detailing how to create, perfect, and enforce security interests in vessels documented with the U.S. Coast Guard); 49 U.S.C. § 11301 (dealing with perfection on a security interest in rolling stock).

67. The escrow agent might acquire custody and control of the funds but not nominal ownership of them. Moreover, even if the escrow agent qualifies as a transferee that, under U.C.C. § 9-332(b), takes the funds free of a security interest granted by the depositor, the security interest might attach to the escrow agent's deposit account as property of the depositor that is proceeds of original collateral.

68. If the escrowed assets are funds in the deposit account maintained in the escrow agent's name, the escrow agent would have control under § 9-104(a)(3). Consequently, the secured party could have control if the escrow agent agreed to serve as the secured party's agent. This point is now made expressly in § 9-104(a)(4), which was added by the 2022 U.C.C. Amendments, but was likely the law prior to the amendments. *See* § 1-103(b).

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PEB Draft Report on Choice-of-Law Issues under the 2022 UCC Amendments

The October issue of this newsletter advised readers that the Permanent Editorial Board for the UCC was in the process of preparing a report on the complex choice-of-law issues that are likely to arise from the fact that the 2022 Amendments to the UCC are effective in some but not all states. A draft of that report is now available on the PEB's web site. Comments on the draft are welcome. They are due by January 15, 2024 but submitting them a few days in advance of the PEB's meeting on December 11, 2023 is preferred.

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Recent Cases

SECURED TRANSACTIONS

Scope Issues

In re Legacy Cares, Inc.,
2023 WL 8100081 (Bankr. D. Ariz. 2023)
A transaction by which an investor provided a "capital contribution" to an entity that used the funds to purchase equipment and, pursuant to the entity's operating agreement, allegedly had title to the equipment until the investment was repaid over a 20-year period, created a security interest if the investor actually had title. Because the investor never perfected its security interest, the security interest was avoidable using the strong-arm powers of the bankruptcy trustee for the debtor that acquired the equipment.

Travelers Casualty & Surety Co. v. Vázquez-Colon,
2023 WL 6377492 (D.P.R. 2023)
A general agreement of indemnity, which provided that "in the event of a default, Indemnitors assign, convey and transfer" specified property to the surety company, did not effect a transfer until a default occurred. Because that date was not in the record before the court, the court could not determine on summary judgment whether the surety's interest had priority over the interest of taxing authorities.

Attachment Issues

In re K & L Trailer Sales and Leasing, Inc.,
2023 WL 7401457 (Bankr. E.D. Tenn. 2023)
A bank's security agreement that described the collateral as a "purchase money security interest in all new trailers" covered all trailers and was not limited to trailers that were purchase-money collateral. Instead of modifying the property constituting collateral, the phrase "purchase money" designated the type of security interest. Therefore, it did not matter that the bank was unable to show that the funds it loaned were used to buy the trailers at issue. The bank's security interest had priority over another bank's security interest pursuant to the banks' intercreditor agreement.

Perfection Issues

In re D'Angelo,
2023 WL 7154023 (Bankr. W.D. Pa. 2023)
A security interest in the debtor's membership interests in a limited liability company was unperfected even though the secured party had possession of the membership certificates. The membership interests were not "securities" because the membership interests were not "dealt in or traded on securities exchanges or in securities markets" and there was no express agreement under § 8-103(c) to treat the interests as securities governed by Article 8. Consequently, the membership interests were general intangibles and the only way to perfect the security interest was by filing of a financing statement, which the secured party did not do.

In re City of Chester,
2023 WL 7274750 (Bankr. E.D. Pa. 2023)
An indenture trustee's security interest in revenues "payable to or received by" a city from a casino and racetrack was a security interest in payment intangibles, not money, and was perfected by a filed financing statement, either pursuant to the State Debt Act or U.C.C. Article 9. However, the security interest did not attach to post-petition revenues pursuant to § 552(a) because the revenues were not proceeds of prepetition collateral. The revenues were not "special revenues" excepted from § 552(a) by § 928(a) because they were not special excise taxes.

Wulco, Inc. v. The O'Gara Group, Inc.,
2023 WL 7292951 (Ohio Ct. App. 2023)
A Second Lien Agent's security interest in the debtor's deposit account was perfected by its control agreement with the debtor, the First Lien Agent, and the depositary bank. It did not matter that the debtor retained the right to direct the disposition of funds from the deposit account because the test of control is not whether the debtor has retained powers but whether the secured party has obtained the requisite power. Nor did it matter that the control agreement initially made the First Lien Agent (which

was subsequently paid off) the "control agent" because the agreement provided for the control agent to shift upon notification to the bank and, even though no such notification had been sent, it could have been done unilaterally at anytime.

Tri-State Elec. Contractors, LLC v. Consolidated Elec. Distribs., Inc., 2023 WL 6211989 (W.D. Okla. 2023)

A secured party's filed financing statement amendment, which added a new debtor name following the debtor's merger, was effective but was not itself a new financing statement and therefore did not extend the effective period of the initial financing statement beyond five years. The security interest became unperfected when the initial financing statement lapsed. Accordingly, the secured party did not have a secured claim in the debtor's dissolution proceeding (no discussion of why a loss of perfection resulted in a loss of the security interest but other creditors apparently did have a perfected security interest in the interpleaded funds).

Priority Issues

Sentinel Insurance Co. v. Head to Toe Therapy Inc., 2023 WL 8002848 (D. Ariz. 2023)

A secured party that had a perfected security interest in the debtor's assets and that was added as a loss payee on the debtor's casualty insurance policy after a casualty had priority in the insurance proceeds of collateral over an earlier-named loss payee who did not claim an interest in the insured property.

Enforcement Issues

Interflow Factors Corp. v. Hilton Holdings, LLC, 2023 WL 6631907 (Tex. Ct. App. 2023)

An account debtor that received the debtor's written instruction to pay a factor that purchased some of the debtor's accounts until the factor provided written notification withdrawing the instruction, but which thereafter paid the debtor pursuant to the debtor's request, did not discharge its obligation and had to pay the factor. Even if the factor had not bought the right to payment from the account debtor, the Factoring Agreement purported to grant the factor a backup security interest in all of the debtor's accounts, that language was effective, and the security interest constituted an "assignment" for the purposes of § 9-406. Although the debtor and the factor later entered into an agreement for the factor not to collect the debtor's accounts, that agreement did not estop the factor from pursuing the account debtor because: (i) the account debtor was not informed of that agreement; (ii) the account debtor began paying the debtor before that agreement was made; and (iii) § 9-406 preempts principles of equity inconsistent with the section's terms.

AmeriFactors Fin. Group, LLC v. Dunham Price Group, LLC, 2023 WL 7579908 (La. Ct. App. 2023)

The trial court did not err in refusing to overturn the jury's verdict that a factor had no breach of contract claim against an account debtor that refused to pay the factor after it instead paid the debtor's subcontractors. Although the account debtor had, before paying the subcontractors, received an instruction to pay the factor directly and had signed an agreement for each factored account verifying the validity of the account, disclaiming any disputes or setoff rights, and waiving any defense to payment, there was sufficient evidence to support the jury's determination that there was no breach of contract. Even if the verification agreements were valid contracts, it would be an absurd result if those agreements required the account debtor to pay the factor and those funds did not go toward paying the subcontractors. The trial judge did not err in refusing to give the jury an instruction about the validity of a waiver of defenses under § 9-403(b) because that provision deals with a waiver in an agreement between a debtor and an account debtor, not in an agreement between a secured party and an account debtor.

Edwards v. The Superior Court of Santa Clara County, 2023 WL 7919628 (Cal. Ct. App. 2023)

The trial court did nor err in ordering arbitration of the debtor's claims against the assignee of the right to payment of her credit card obligation, and its collection agent, for failing to send a required notification and for attempting to collect a time-barred debt. The debtor's contract with the credit card issuer contained an arbitration clause and the issuer's sale of the receivable carried with it rights incident thereto, including the right to arbitrate. The buyer's subsequent five-year "lease" of the receivables to the assignee was not for the purposes of collection only because the assignee had the obligation to service the account, not merely to collect on it, and was not obligated to turn over the proceeds of collection to the buyer. As a result, Article 9 applied to the lease of the receivable and the assignee had standing to enforce the debtor's obligation, including the arbitration clause.

Overland Bond & Investment Corp. v. Calhoun, 2023 WL 8177123 (Ill. Ct. App. 2023)

A secured party that sued two debtors on their secured obligations, and thereby exercised its contractual right to choose between arbitrating and litigating the parties' "disputes," was not entitled to arbitrate the debtors' counterclaims based on the secured party's alleged failure to conduct a commercially reasonable disposition by using a "kill switch" to remotely disable but never retrieve the debtors' vehicles, thereby failing to mitigate damages. The counterclaims were part of the same "disputes" brought by the secured party even though they might relate to different claims or causes of action.

American Greenfuels Rockwood (Tennessee), LLC v. Aik Chuan Construction PTE. Ltd., 2023 WL 8018271 (S.D.N.Y. 2023)

A lender that had a deed of trust on the debtor's unfinished renewable diesel energy facility that encumbered both the real property and the equipment and technology associated with the facility did not violate Part 6 of Article 9 by conducting a foreclosure of all the collateral with only limited advertising, at which the secured party bought the property with a small credit bid. The secured party complied with real property law and, pursuant to § 9-604(b)(2), the remaining provisions of Part 6 do not apply. No discussion of the fact that § 9-604(b)(2) is limited to fixtures.

Liability Issues

Wintrust Specialty Fin. v. Pinnacle Commercial Credit, Inc., 2023 WL 7167597 (D.N.J. 2023)

A bank that, in connection with its purchase of an equipment loan from the originator and in compliance with information provided by the originator, wired funds to a fraudster's bank account rather to the debtor's bank account was entitled to recover the amount of the loss from the originator pursuant to a clause in the parties' agreement that required the originator to indemnify the bank for all expenses, injury and damage that the bank incurs, pays or suffers as a result of the originator's acts. The amount of the loss was the amount of the wire transfer less the profit from the equipment loan, which the bank later funded.

Oasis Capital, LLC v. Neason, Yeager, Gerson, Harris & Fumero, P.A., 2023 WL 6534497 (S.D. Fla. 2023)

A secured creditor stated claims for malpractice and breach of contract against its law firm for failing to obtain the consent needed for the creditor to acquire a security interest in the debtor's subsidiaries and for failing to file the financing statement needed to perfect the security interest that the creditor did obtain.

BANKRUPTCY

Avoidance Powers

In re Senior Care Centers, LLC, 2023 WL 7137097 (Bankr. N.D. Tex. 2023)

The debtor's prepetition repayment of bridge loans was not a constructively fraudulent transfer. Although the loans were structured as loans to the debtor's indirect parent, the funds were initially wired directly to the debtor and the evidence established that the funds were constructively re-loaned by the parent to the debtor, rather than an infusion of equity. Consequently, the debtor had liability to repay the resulting debt and received reasonably equivalent value when it discharged that liability by making payment. Even if the funds were an infusion of equity in the debtor by the indirect parent, the debtor still received reasonably equivalent value because the debtor received the loaned funds.

Discharge and Dischargeability

In re Shurley, 2023 WL 6969221 (5th Cir. 2023)

The debtors' obligation on a secured loan from a bank that, after advising them to take out a receivables loan, did not request a new UCC search and therefore did not find a recently filed financing statement covering all the debtors' business assets, was dischargeable. The obligation was not nondischargeable under § 523(a)(2) because the bank did not reasonably or justifiably rely on the debtors' misrepresentation that there were no other liens on the collateral. The obligation was not nondischargeable under § 523(a)(6) because the debtor genuinely believed that the loans were secured by different collateral.

GUARANTIES & RELATED MATTERS

In re Meade, 2023 WL 6618810 (Bankr. C.D. Ill. 2023)

A lender had an allowable claim in the bankruptcy of two guarantors. The guaranties were not voidable due to the parties' mutual mistake in believing that the lender had the senior security interest in the collateral. The priority of the security interest did not relate to a material feature of the loan agreement. No discussion of which party bore the risk of such a mistake.

LENDING, CONTRACTING & COMMERCIAL LITIGATION

Contract Formation

Land v. IU Credit Union, 2023 WL 6985790 (Ind. 2023)

A credit union did not modify its agreement with a member to include an arbitration clause. The member's Account Agreement specified that its terms were subject to change at any time and a later Disclosure Agreement specified that the credit union could "modify the terms and conditions applicable to the Services from time to time" by sending notice to the member via email and that the member would be deemed to have received any such notice three days after it is sent." Thereafter the credit union sent – by both email and regular mail – an Addendum requiring arbitration of all disputes but permitting members to opt out of the addendum by sending written notice to the credit union within 30 days. The notice sent by email was likely not effective because the subject line used was the same language as that for monthly accounts statements, indicating only that a new electronic statement was available through the online platform, and the body of the message said nothing about the Addendum, although a link in the email would have directed the member to her monthly account statement, the first page of which referenced the addendum in bold, all-capital letters and directed her to review the updated terms at the end of the statement. In contrast, the notice sent by regular mail, which consisted of a two-page monthly account

statement, the first page of which noted the Addendum in bold, all-capital letters and directed her to review the updated terms, which were included, was effective as an offer. However, the mere fact that the Addendum stated that silence would constitute acceptance did not make it so. There was no definite and substantial reliance by the member on the proposed new term, nothing in the Account Agreement or Disclosure Agreement suggested that silence and continued use of the member's checking accounts would result in acceptance of any future modification to those original contracts, nothing on the Addendum itself conditioned continued use of the checking accounts on acceptance of the Addendum, and there was no course of dealing that made silence an acceptance of proposed new terms.

Edmundson v. Klarna, Inc.,
2023 WL 7238741 (2d Cir. 2023)
A consumer who contracted to use the defendant's "buy now, pay later" service that allows shoppers to buy products in four installments without incurring interest had agreed to the defendant's terms of service, which included a mandatory arbitration clause. Once the consumer elected to pay on GameStop's website using the defendant's service, the interface displayed, under the schedule of payments, the words, "By continuing, I accept Klarna Services terms." This phrase, which was bolded and in a black font on a white background, was a hyperlink to the then-current terms of service. To continue with the purchase after entering her payment information, the consumer was instructed to review the payment plan. During that process, the screen displayed the phrase "I agree to the payment terms" directly above a button marked "Confirm and Continue." The phrase "payment terms" was underlined, bolded, and served as a hyperlink to the terms of service. The consumer later logged into the defendant's app, where she again clicked a button that stated, "By clicking 'Sign in' I approve Klarna's User Terms," which was an underlined hyperlink to the terms of service. In each situation, the hyperlink was reasonably clear and conspicuous such that a reasonable internet or smartphone user would be on inquiry notice of the terms and the consumer objectively and unambiguously manifested assent to the terms.

Contract Interpretation

In re Walters,
2023 WL 7287942 (Bankr. W.D. Okla. 2023)
A mortgage on the debtors' home did not secure their obligation on eight subsequent loans despite a clause in the mortgage providing for the property to secure "All present and future debts from Mortgagor to Lender, even if this Security instrument is not specifically referenced, or if the future debt is unrelated to or of a different type than this debt," because the agreement for each of the eight subsequent loans stated that "[t]he Cross-collateralization clause on any existing or future loan, but not including this Loan, is void and ineffective as to this Loan." The future-advances clause in the mortgage was a cross-collateralization clause.

Breach

Generation Next Fashions Ltd. v. JP Morgan Chase Bank,
2023 WL 6812984 (S.D.N.Y. 2023)
A foreign seller of goods to a domestic buyer in a documentary collection transaction governed by the ICC's Uniform Rules for Collection (URC), Publication No. 522 had no breach of contract claim against the collecting bank in connection with the buyer's failure to pay. The collecting bank's duty was to deliver the title documents upon the buyer's acceptance of the goods. Because the buyer's agent accepted the goods before they were shipped, the collecting bank properly delivered the documents and discharged its obligations. The collecting bank had no contractual duty to collect payment or to advise the seller or the remitting bank of the reason for nonpayment. Although Article 26 of URC 522 contains a provision entitled "Advice of Non-Payment and/or Non-Acceptance," that provision applies only if the buyer refuses to accept the goods, in which case the collecting bank should attempt to understand the reasons for non-acceptance. The seller also had no claim against the collecting bank for breach of fiduciary duty, conversion, negligence, tortious interference with contract, bailment, fraud, or civil conspiracy.

Dzielak v. Whirlpool Corp.,
83 F.4th 244 (3d Cir. 2023)
A manufacturer of washing machines did not breach an express warranty when selling machines with the "Energy Star" logo, pursuant to a license from the EPA, after the EPA revised the criteria, which the machines did not satisfy. By using the logo, the manufacturer might have expressly warranted that the manufacturer was authorized to display the logo, but such a warranty was not breached because the EPA permitted the manufacturer to continue using the logo temporarily after the criteria changed. Even if, by using the logo, the manufacturer expressly warranted that the machines were more energy efficient than most items sold in the same category, that warranty was also not breached because the machines consumed 46.1% less water and 34.3% less energy, corresponding to 92-93% of the water and energy savings needed to qualify under the revised criteria. The manufacturer did not, by using the logo, expressly warrant that the machines satisfied the revised criteria because the ordinary consumer would not understand that technical meaning, and even if trade usage applied, the revised criteria could not have immediately changed the nature of the warranty made by using the logo because a reasonable purchaser would still have had doubts about whether that meaning changed immediately, given the lengthy comment period on the new criteria and the time needed to test products.

Top Priority Transit LLC v. Cape Auto Pool, Inc., 2023 WL 8042629 (Mo. Ct. App. 2023)

The trial court properly awarded summary judgment against a buyer of a vehicle on its claim against the dealership that sold the vehicle for breach of the warranty of title. Although the seller delivered a salvage title, that was good title because the transfer was rightful and the vehicle was unencumbered. However, the court erred in awarding summary judgment to the seller on the buyer's claim for fraud because there was a factual dispute about whether the seller had informed the buyer of the vehicle's history.

Remedies

Wintrust Specialty Fin. v. Pinnacle Commercial Credit, Inc., 2023 WL 7167597 (D.N.J. 2023)

A bank that, in connection with its purchase of an equipment loan from the originator and in compliance with information provided by the originator, wired funds to a fraudster's bank account rather to the originator's bank account was entitled to recover the amount of the loss from the originator pursuant to a clause in the parties' agreement that required the originator to indemnify the bank for all expenses, injury and damage that the bank incurs, pays or suffers as a result of the originator's acts. The amount of the loss was the amount of the wire transfer less the profit from the equipment loan, which the bank later funded.

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