

THE TRANSACTIONAL LAWYER

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THE GOLDEN RULE OF DRAFTING

Scott J. Burnham

I once asked my students, “What is the Golden Rule of Drafting?” One wise guy offered, “Draft unto others as you would have them draft unto you.” That’s not bad advice, but the traditional rule is “Never change your language unless you wish to change your meaning and always change your language if you wish to change your meaning.”

There was a great example of violation of the Golden Rule in the Power of Attorney (POA) that Stephen Sepinuck analyzed in the previous issue of this newsletter.¹ The POA granted the agent authority “to do and perform all acts concerning my property.” The contingency clause, however, stated:

If _____ is unable to serve as my attorney-in-fact, I appoint _____ to serve as my successor attorney-in-fact **for property management.**

When I first read that provision, I wondered if the successor’s powers were more restricted than the powers of the original agent. For example, does “property management” include the right to buy and sell property? The drafter could have made clear that the successor had the same powers as the original agent by using the same language that was used in the grant to the original agent:

If _____ is unable to serve as my attorney-in-fact, I appoint _____ to serve as my successor attorney-in-fact **to do and perform all acts concerning my property.**

Here’s another example from my files:

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Buyer is responsible for removal of any hazardous material (e.g., asbestos) or correction of any hazardous condition that affects Seller’s performance of services. Services will be delayed until Buyer corrects the hazardous condition; Seller shall not be liable to Buyer as a result of such delays.

Buyer is responsible for two things: (i) removal of any hazardous material; and (ii) correction of any hazardous condition. The provision provides for what happens if services are delayed for one of them – correction of any hazardous condition. What happens if services are delayed for removal of any hazardous material? The use of different language suggests a different result.

And one more:

The MOU and Order(s) placed hereunder shall be subject to Company’s standard **Telecommunications Service Provider Purchase and License Agreement**, a copy of which has been previously provided to Customer and is incorporated herein by this reference, until Customer signs the **Company Telecommunications Service Provider and License Agreement**.

Subject to the terms and conditions contained herein, Company agrees to apply a total discount of XX% to the list price of all Company products ordered by Customer upon execution of the **Telco and Service Provider Agreement**.

The document referred to is initially the “Telecommunications Service Provider Purchase and License Agreement.” It then becomes the “Company Telecommunications Service Provider and License Agreement.” By the end of the provision, it is the “Telco and Service Provider Agreement.” If these are all the same document, why not call it by the same name?²

The Golden Rule is frequently violated when the drafter uses a word string and then omits something from the string. For example, a Shareholder’s Agreement begins by stating that a shareholder may not “sell, transfer, assign, pledge, encumber or otherwise dispose of or convey (by operation of law or otherwise)” shares of the corporation. By the end of the agreement, the tired drafter states that “If a Shareholder proposes to transfer shares” What if the Shareholder proposes to sell, assign, pledge, encumber, or otherwise dispose of or convey the shares?

There are two solutions to this problem. One is to use the cut and paste feature of your word-processing program to make sure the same string is replicated throughout the agreement. The other, which the drafter of this agreement may have thought he or she did, is to use a definition.³ Here, the drafter could define the string as a “transfer” and then use the defined term throughout. Here’s a tip to make sure your defined term is always used correctly. Use the find and replace feature of your word-processing program to find the defined term and replace it with the definition. If the sentence reads correctly, you have a successful definition.

In conclusion, contract drafters should eschew the advice their high school English teacher gave them to use a thesaurus to add variety to their language. In drafting, variety can be fatal.⁴ If you mean the same thing, use the same language.

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Notes:

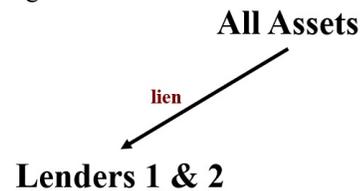
1. Stephen L. Sepinuck, *Know Your Audience*, [11 THE TRANSACTIONAL LAWYER 1](#), 4 (August 2021).
2. For these and other examples, see SCOTT J. BURNHAM, *DRAFTING AND ANALYZING CONTRACTS* ch. 15 (4th ed. 2016). See also STEPHEN L. SEPINUCK & JOHN F. HILSON, *TRANSACTIONAL SKILLS: HOW TO STRUCTURE AND DOCUMENT A DEAL* 152 (2d ed. 2019).
3. “Using defined terms does more than save space and make written agreements more readable. It also helps prevent error, such as might occur if the written agreement used slightly different words in different places to refer to the same concept.” Sepinuck & Hilson, *supra* note 2, at 17.
4. See, e.g., In re Sheed, [607 B.R. 470](#) (Bankr. E.D. Pa. 2019) (a loan modification agreement that used four different but similar, undefined terms – “arrearages,” “mortgage payment arrearages,” “payment arrearages,” and “arrearage payments” – was ambiguous); *Moniuszko v. Karuntzos*, [2014 WL 4657134](#) (Ill. Ct. App. 2014); *Middleton v. First Nat’l Bank*, [399 S.W.3d 463](#) (Mo. Ct. App. 2013) (because Addendum A to a deposit agreement between a bank and its customers referred to both the Deposit Agreement and “this form,” the latter reference was to Addendum A itself; because that reference indicated that the customers were not bound unless they signed “this form,” and they had signed the Deposit Agreement but not Addendum A, they were not bound by Addendum A). *But cf.* *City of Wayne Retirees Ass’n v. City of Wayne*, [2019 WL 5199361](#) (Mich. Ct. App. 2019) (a collective bargaining agreement that used the phrases “for the life of this agreement” and “for the duration of this agreement” was not ambiguous; the terms were used interchangeably and no distinction in meaning was intended).

DESCRIBING THE COLLATERAL IN SPLIT-COLLATERAL DEALS

*Stephen L. Sepinuck
& John F. Hilson*

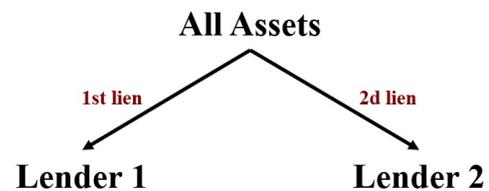
Many commercial financing arrangements involve multiple lenders to a single debtor or group of related debtors. This might be due to a need to spread the risk (*i.e.*, the total amount owed by the borrower would represent too much exposure for any one lender’s loan portfolio), due to regulatory limitations,¹ or because some lenders offer different terms with respect to different types of loans or different types of collateral. Whatever the reason, there are numerous ways to structure financings.

For example, the lenders could, collectively, make one loan secured by a single lien.

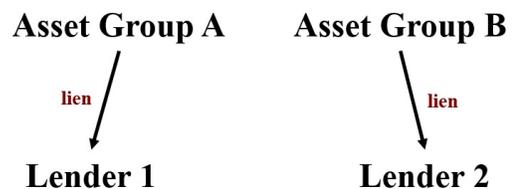


Between themselves, the lenders could share the same priority as to payment or they could create an intramural hierarchy of payment.²

Alternatively, the lenders could make separate loans secured by separate liens on all of the borrower’s assets.

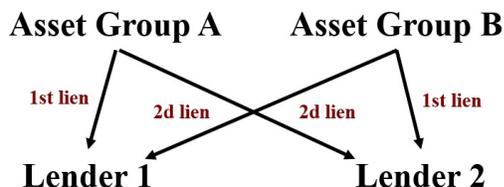


In other structures, the lenders divide the collateral between themselves. Thus, they might each take a lien on separate assets, with neither having a lien on the other’s collateral.³



Or, they might each obtain a lien on all of the borrower’s assets but have differing priorities with respect to different groups of those assets. In other words, Lender 1 might have a first lien on

the assets in Group A and a second lien on the assets in Group B, while Lender 2 has a first lien on the assets in Group B and a second lien on the assets in Group A.



The use of each structure raises its own set of issues,⁴ although in all of the them the lenders would be wise to have an intercreditor agreement (or terms in the credit agreement dealing with the lenders’ relative rights and obligations). Several years ago, an ABA task force published a wonderful report and model intercreditor agreement applicable to the second structure.⁵ Any transactional lawyer working on such a deal would be wise to review that report. But one important topic that report did not discuss, at least not in detail, was how to properly describe the collateral in transactions structured in either of the last two ways. That is the purpose of this article: to provide guidance on describing the collateral in a split-collateral deal of the type depicted in the last diagram.

In many split-collateral deals, one lender⁶ makes a term loan secured by a first lien on the borrower’s long-term assets (e.g., real property, equipment, intellectual property), while another lender makes a revolving loan secured by a first lien on the borrower’s rotating assets (e.g., inventory and receivables). But to some extent every deal is unique and the division of assets requires careful thought. And, regardless of how the assets are divided, there are invariably complexities. That is because, as the borrower conducts its business, assets (or their values) can be expected to shift from one group to the other. For example, the borrower might sell inventory and use the proceeds to buy new equipment. Or the borrower might start licensing its patents, and in that process generate receivables. What follows is a list of four things that a transactional lawyer should do in connection with the description of collateral in the intercreditor agreement for a split-collateral deal.

1. Avoid Overlapping Definitions

Although it might seem obvious, it is imperative to make sure that all items of priority collateral fall into one – and only one – of the two groups. In other words, no item of collateral should be in both Asset Group A and Asset Group B,⁷ and no item should be in neither group. Unfortunately, it is often easier to state this as a principle than to do it. Because assets transmute from one type to another, transactional lawyers need to account for that possibility in the intercreditor agreement. As a result, it is common in many such agreements to define Asset Group A as containing one or more classes of property –

equipment, for example – unless that property is identifiable proceeds of property in Asset Group B. The agreements then do the reverse in defining Asset Group B. This process often leads to mental gymnastics and, on occasion, an unbreakable circularity.

Consider for example, the following two definitions taken from a draft intercreditor agreement that one of us reviewed last year. Some words are colored to make it easier to correlate each point below to the relevant language in the definitions.

“A Priority Collateral” shall mean all Collateral not constituting B Priority Collateral including, without limitation, the following:

- (1) all Accounts and other rights to payment arising in a credit-card, debit-card, prepaid-card or other payment-card transaction (other than Accounts and receivables arising under agreements for sale of B Priority Collateral described in clauses (1) through (4) of the definition of such term to the extent constituting identifiable proceeds of such B Priority Collateral);
- (2) all Payment Intangibles (other than any Payment Intangibles constituting identifiable proceeds of B Priority Collateral described in clauses (1) through (4) of the definition of such term);
- (3) all Inventory;
- (4) all Equipment;
- (5) all real property interests (including Fixtures) over which a Lien has been granted pursuant to the terms of the A Documents and has not been granted pursuant to the terms of the B Documents;
- (6) all cash, Deposit Accounts, Securities Accounts and Commodity Accounts (other than any identifiable proceeds of B Priority Collateral described in clauses (1) through (4) and (8) of the definition of such term);
- (7) solely to the extent evidencing, governing, securing or otherwise relating to any of the items constituting A Priority Collateral under clauses (1) through (6) above, (i) all General Intangibles, (ii) Instruments, (iii) Documents, (iv) licenses from any governmental authority to sell any Inventory, (v) Chattel Paper, and (vi) commercial tort claims to the extent not directly arising from the B Priority Collateral;
- (8) all books and records to the extent relating to any of the foregoing; and
- (9) all products and proceeds of the foregoing.

Notwithstanding the foregoing, the term “A Priority Collateral” shall not include any assets referred to in clauses (1) through (4) of the definition of the term “B Priority Collateral.”

“B Priority Collateral” shall mean:

(1) all Intellectual Property and **all real property interests (including Fixtures) over which a Lien has been granted pursuant to the terms of the B Documents and has not been granted pursuant to the terms of the A Documents;**

(2) all Investment Property (other than Investment Property constituting A Priority Collateral under clause (6) of the definition of such term);

(3) all commercial tort claims to the extent not directly arising from the A Priority Collateral and any other commercial tort claims not constituting A Priority Collateral;

(4) all insurance policies relating to B Priority Collateral;

(5) except to the extent constituting A Priority Collateral under clause (6) or (7) of the definition of such term, all Documents, all General Intangibles, all Instruments and all Letter-of-Credit Rights;

(6) all collateral and guarantees given by any other Person with respect to any of the foregoing, and all Supporting Obligations (including Letter-of-Credit Rights) with respect to any of the foregoing;

(7) all books and records to the extent relating to any of the foregoing; and

(8) all products and proceeds of the foregoing.

Notwithstanding the foregoing, the term “B Priority Collateral” shall not include any assets referred to in clauses (1) through (4) and (9) of the definition of the term “A Priority Collateral.”

The first thing to note is that the definition of A Priority Collateral begins (the language in brown) “all Collateral not constituting B Priority Collateral including.” But what if some property expressly included in the language that follows does constitute B Priority Collateral? Is that property excluded or not? The result is a bit like saying “all mammals, including snakes.” Snakes are not mammals, so it is unlikely that they are covered.⁸

Second, each definition excludes things that the other purports to cover, with the result that there appear to be circles of paradox, such as one might find in an Escher drawing. And even if some of the circularities can be broken and paradox avoided with careful reading, the definitions are still mind-numbingly complex. Three examples illustrate this problem, but feel free to skip this part of the article if you are not yet fully caffeinated because there is no way to make it easy to follow.

A. Payment Intangibles (the words in red). Clause (2) of the definition of A Priority Collateral includes payment intangibles except those constituting proceeds of B Priority Collateral described in clauses (1) through (4) of that definition.

However, the language at the beginning of the definition of A Priority Collateral excludes all B Priority Collateral. So, there is a bit of an internal conflict in the definition of A Priority Collateral. As a result, it is unclear if the definition of A Priority Collateral includes payment intangibles that fall within the definition of B Priority Collateral under clause (5), because payment intangibles are a subset of general intangibles.

To make matters worse, the closing paragraph of the definition of B Priority Collateral appears to exclude payment intangibles because they are A Priority Collateral under clause (2) of that definition, but the opening paragraph of the definition of A Priority Collateral appears to exclude them because they are B Priority Collateral.

B. Real Property (the words in blue). Clause (5) of the definition of A Priority Collateral includes real property if a lien on it has been granted under the A Documents and if a lien on it has not been granted under the B Documents. Clause (1) of the Definition of B Priority Collateral does the reverse; it includes real property if a lien on it has been granted under the B Documents and a lien on it has not been granted under the A Documents. So, what if the same piece of real property is covered (or is later covered) by the A Documents and the B Documents? Does that mean the intercreditor agreement does not specify which lender’s lien has priority on it?⁹

Now consider equipment that becomes a fixture on real property on which a lien is granted pursuant to the B Documents (and no lien is granted on the real property pursuant to the A documents). The equipment is A Priority Collateral under clause (4) of the definition of that term and B Priority Collateral under clause (1) of the definition of that term. However, the last clause of each definition would appear to exclude the fixture because it is priority collateral for the other lender.¹⁰

C. Books & Records (the words in green). Each definition includes books and records “to the extent” relating to other collateral in that definition. But what if, as is likely, the debtor’s books and records deal with all of the debtor’s assets, and thus relate to both A Priority Collateral and B Priority Collateral. The last clause of each definition would appear to then exclude the books and records. This result, which is no doubt contrary to what the lenders intend, would be avoided if the phrase “to the extent” allowed for the books and records to somehow be allocated to the assets to which they relate. But that might not be possible.¹¹

The advice for transactional lawyers from the analysis above of this pair of definitions should be obvious. One of the asset groups should be defined without reference to the other, and the other should be defined simply as all assets that are not in the first group. Under such an approach, the definitions above might have been drafted as follows:

“A Priority Collateral” means all Collateral not constituting B Priority Collateral and all books and records relating thereto.

(a) Except as provided in paragraph (b), “B Priority Collateral” means:

- (1) all Intellectual Property;
- (2) all real property interests (including Fixtures) over which a Lien has been granted pursuant to the terms of the B Documents;
- (3) all Securities;
- (4) all commercial tort claims to the extent: (i) relating to loss of or damage to any B Priority Collateral or (ii) not relating to loss of or damage to any Collateral;
- (5) all insurance policies, and all claims thereunder, to the extent: (i) relating to loss of or damage to any B Priority Collateral; or (ii) not relating to loss of or damage to any Collateral;
- (6) all General Intangibles (other than Payment Intangibles and governmental licenses to sell Inventory);
- (7) all Supporting Obligations with respect to any of the foregoing;
- (8) all books and records to the extent relating to the foregoing; and
- (9) all identifiable proceeds of the foregoing.

(b) “B Priority Collateral” does not include identifiable proceeds of Accounts, Payment Intangibles, Inventory, or Equipment unless such Accounts, Payment Intangibles, Inventory or Equipment are identifiable proceeds of B Priority Collateral.

Note, this revised version allows for both lenders to have a lien on books and records that relate to both groups of collateral. It also omits from the B Priority Collateral all documents, instruments, and payment intangibles that are not proceeds of other B Priority Collateral because it was not clear why some of those things were included in the original draft.¹²

2. Allocate Non-obvious Collateral

As noted above, in many split-collateral deals, one lender makes a term loan secured by a first lien on the borrower’s real property, equipment, intellectual property, and their proceeds. The other lender makes a revolving loan secured by a first lien on the borrower’s inventory, receivables, and their proceeds. But that common structure fails to allocate some assets of the borrower that might be or become very significant.

For example, and particularly relevant during the current pandemic, this split does not deal with business interruption insurance. Unlike property insurance – a claim under which would typically be proceeds of one type of collateral (real property; equipment) or the other (inventory) – business interruption insurance is really not proceeds of anything: it is

payment for something that was expected but never occurred.¹³ In one recent case, the court saw it differently. The court awarded the proceeds of business interruption insurance to the inventory and accounts lender, partly on the theory that the insurance claim arose from the loss of (*i.e.*, absence of) accounts, and hence was proceeds of accounts.¹⁴ But regardless of whether that decision is correct or a good interpretation of the parties’ intercreditor agreement, it might not be what all lenders want or expect.

3. Consider Reallocating Some Collateral

In some transactions, there are or will be receivables that arguably should not be priority collateral for the inventory and accounts lender, but instead should be reallocated to the term loan lender. For example, the right to a federal income tax refund – a type of payment intangible – might be primarily attributable to cost recovery with respect to (*i.e.*, depreciation on) equipment. Or it might arise from an uninsured casualty to fixed assets. A transactional lawyer representing a term lender should be cognizant of these possibilities and consider suggesting a more nuanced approach for dealing with tax refunds than simply lumping them in with all other payment intangibles. Unfortunately, the matter can be very difficult to address because it is not always easy to attribute or allocate a tax refund to specific assets, particularly if the right to the refund arises from the carryback of current losses.¹⁵

Another asset that perhaps should be reallocated is personal property extracted from real property: minerals, oil, gas, and the proceeds thereof. If the term loan lender has priority in the real property but the revolving loan lender has priority in inventory and accounts, which of them should have priority in the as-extracted collateral? Note, “as-extracted collateral” is a defined term under Article 9 and includes not merely the extracted goods themselves but also accounts arising from the sale of the extracted goods at the wellhead or minehead, provided that the debtor had an interest in them before extraction.¹⁶ Unless the traditional split of collateral were altered, the revolver lender would have the first lien on as-extracted collateral. But that might not be appropriate given that the as-extracted collateral is arguably a kind of proceeds of the real property. Indeed the value of the real property might decrease as minerals, oil, and gas are extracted from it.

Finally, there might be property the law would classify one way¹⁷ but that the lenders might think of in another. Consider a borrower that owns and operates heavy machinery. The parties might think of the machinery as equipment, and might finance it as such, even though the borrower frequently leases the machinery to others on a short-term basis (*i.e.*, when not needing it for the borrower’s own operations). As a result, the machinery might be – or might, after the loans are made, become – inventory. The transactional lawyer should consider this possibility and question which lender should have priority in the receipts and receivables under such leases.

4. Deal with Hybrid Collateral

Some assets of the borrower might fairly be regarded as partly term collateral and partly rotating collateral. For example, the franchise fees due to a franchisor arise in part from a license of the franchisor's intellectual property (which might be priority collateral for the term lender) and payment for services (which might be priority collateral for the revolving lender). Which lender should have the prior lien on those fees? If they should each have priority in some portion of the fees, the intercreditor agreement should specify an allocation methodology, particularly if the franchisor's contracts with its franchisees simply call for a total amount and make no allocation.

Similarly, a borrower who has an insurance or tort claim for damage to collateral in both Asset Group A and Asset Group B might settle the claim for a lump sum, without specifying what portion of the total is for which class of assets. As long as both lenders have a lien on all of the assets, neither should have a problem claiming the total settlement as identifiable proceeds.¹⁸ But that does not resolve the question of which lender's lien has priority and to what extent. The transactional lawyer should consider this issue at the inception of the transaction.

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Notes:

1. See 12 C.F.R. § 32.3.
2. The latter arrangement – in which there is a payment hierarchy – could be created through a separate agreement among the lenders or through a so-called “last out” participation agreement, by which the original lender transfers a portion of the loan to a participant that agrees to accept payment only after the original lender is paid in full with respect to the portion of the loan retained by the original lender.
3. This structure is somewhat uncommon and might be restricted to situations in which the collateral is real property.
4. A transaction involving a single lien and an intramural hierarchy of payment, which is sometimes referred to as a “uni-tranche” loan, can affect the lenders' right to post-petition interest if the borrower goes into bankruptcy. So, a transactional lawyer using that structure needs to be aware of that risk and, to the extent appropriate, deal with it. See Stephen L. Sepinuck, *The Dangers of Uni-tranche Loans & the Rule of Explicitness*, [3 THE TRANSACTIONAL LAWYER 3](#) (Oct. 2013). It is also important in that structure to provide rules on how

collective decisions are made and to define and protect each lender's “sacred rights.” See Stephen L. Sepinuck, *Lender's “Sacred Rights” under Credit Agreement Did Not Prevent Lender from Becoming a Sacrificial Lamb*, [10 THE TRANSACTIONAL LAWYER 1](#) (Aug. 2020).

In the second structure, it is usually imperative to cap the principal amount of the obligation secured by the first lien, sometimes appropriate to cap the principal amount of the obligation secured by the second lien, and generally advisable to at least consider whether the first lien's priority should be conditioned on no loss of perfection.

5. *Report of the Model First Lien/Second Lien Intercreditor Agreement Task Force*, [65 BUS. LAW. 809](#) (2010).

6. Although this article refers to each of the two lenders in the singular, many of these transactions are syndicated such that there are multiple lenders in each group.

7. As discussed below, it might be appropriate to make an exception to this principle for the borrower's books and records because they might not already be divided or be readily divisible by the asset groups.

8. See Stephen L. Sepinuck, *“Including without Limitation,”* [9 THE TRANSACTIONAL LAWYER 4](#) (Feb. 2019).

9. This result might be avoided by a close reading of the two definitions. Because neither definition covers it pursuant to the numbered paragraphs, it would apparently be A Priority Collateral under the opening clause of the definition of that term (“all collateral not constituting B Priority Collateral”). However, the real question is whether that is the result the parties intend.

10. Note that the limiting language in paragraph (5) of the definition of A Priority Collateral dealing with which documents create a lien on the real property does not appear in paragraph (4), which appears to cover all equipment, regardless of whether the equipment is a fixture.

11. These clauses have several additional problems that are unrelated to the split-collateral nature of the deal. For example, clause (1) of the definition of A Priority Collateral has a dangling modifier: a modifying phrase after a list, making it ambiguous whether the modifier applies only to the last item or to all the items. Specifically, the phrase “arising in a credit-card, debit-card, prepaid-card or other payment-card transaction” appears after two things: “Accounts” and “other rights to payment.” Presumably the modifier is intended to apply only to the latter but better drafting would avoid the ambiguity.

There is a similar problem in clause (1) of the definition of B Priority Collateral. The phrase “over which a Lien has been granted . . .” appears after a reference to both intellectual

property and real property. Again, the modifying phrase is probably intended to limit only the latter of the two.

Clause (1) of the definition of A Priority Collateral refers first to accounts and “other rights to payment” and then in a parenthetical refers to accounts and “receivables.” If the terms “other right to payment” and “receivables” are intended to be synonymous, then the wording should be changed. *See* Scott J. Burnham, *The Golden Rule of Drafting*, 11 THE TRANSACTIONAL LAWYER 1 (Oct. 2021). If a different meaning is intended, that difference is opaque.

The definitions improperly use the phrase “to the extent” in several places to mean “if,” but the phrase does not appear where it is needed: in clause (4) of the definition of B Priority Collateral. Presumably, that clause is intended to cover insurance policies only “to the extent” they relate to B Priority Collateral, not all of a policy if a tiny fraction of it covers B Priority Collateral.

Clause (3) of the definition of B Priority Collateral refers to commercial tort claims “arising from” A Priority Collateral, but it is not clear that tort claims ever arise from property. Such claims might, however, “relate to” property. Consequently, “relate to” would be a more appropriate phrase to use.

12. There is another thing worth noting about this language. These definitions are designed to be included in an intercreditor agreement, not in a security agreement with the borrower. Although a security agreement generally needs to refer to “after-acquired” property for such property to be included in the collateral, *see* U.C.C. § 9-204(a), the absence of such a reference in an intercreditor agreement should not matter. Similarly, although a reference to “commercial tort claims” is an insufficient description in a security agreement, *see* U.C.C. § 9-108(e)(1), there is no reason to think that such language is insufficient in an intercreditor agreement. Finally, although the uniform version of Article 9 does not govern consensual liens on insurance policies or insurance claims (unless the claims are proceeds of other collateral), *see* U.C.C. § 9-109(d)(8), it is possible to obtain a consensual lien on insurance policies and claims under the common law.

13. In this sense, business interruption insurance is a bit like payments the federal government makes to a farmer for taking arable land out of production. Those payments are not proceeds of crops because the crops never existed. *See* *In re Kingsley*, [865 F.2d 975](#) (8th Cir. 1989); *In re Schmaling*, [783 F.2d 680](#) (7th Cir. 1986). *Cf.* *In re Connelly*, [41 B.R. 217](#) (D. Minn. 1984) (payment to farmer upon delivering grain into government storage under price-support system were not payments from a “disposition,” and thus were not “proceeds” because the farmer still owned the grain and had merely “pledged” it to the program).

14. *See* *In re PES Holdings, LLC*, [625 B.R. 822](#) (D. Del. 2021).

15. *Cf.* *In re Somerset Regional Water Resources, LLC*, [949 F.3d 837](#) (3d Cir. 2020) (a debtor-in-possession financing order that provided for the sole member of the debtor to “assign to Lender any rights or interest in the 2015 Federal tax refund due to him individually, but attributable to the operating losses of the Debtor” was ambiguous as to whether it covered a refund of 2014 taxes attributable to a carryback of 2015 losses; after considering parol evidence, the trial court did not err in ruling that, because the parties understood that the entirety of any refund generated on account of the 2015 operating losses was to be the collateral, the refund was collateral).

16. *See* U.C.C. § 9-102(a)(6).

17. Many transaction documents expressly incorporate the UCC’s definitions for terms such as “inventory” and “equipment,” so that the law’s meaning of those terms becomes the contractual meaning as well.

18. *Cf.* Stephen L. Sepinuck, *Identifying What Portion of a Settlement Payment Is Proceeds of Collateral*, [10 THE TRANSACTIONAL LAWYER 4](#) (Oct. 2020).



PEB Update

The [June issue](#) of this newsletter described recent activity by the Permanent Editorial Board for the UCC, including four draft commentaries released in March. Since then, the PEB has released four additional draft commentaries for public comment.

In June, the PEB released a draft commentary on [Application of UCC Sections 9-406 and 9-408 to Transfers of Interests in Unincorporated Business Organizations](#). In the works since 2011, this commentary explains why Article 9 does not override most restrictions on transfer of an interest in an unincorporated entity. The commentary begins by noting that Article 9 applies to security interests that secure an obligation and to sales of *payment intangibles*, but not to sales of *general intangibles*. If an interest in an unincorporated business is a general intangible, the inapplicability of Article 9 to a sale of the interest means that neither of Article 9’s rules that override many restrictions on transfer – § 9-406 and § 9-408 – will apply. As a result, the restriction on transfer will be enforceable (assuming nothing in the law outside of the UCC renders it unenforceable). The commentary then notes that, if the interest in an unincorporated entity is a “security” within the meaning of Article 8, then neither § 9-406 nor § 9-408 will apply because neither of those provisions deals with a restriction on the assignment of a security. The commentary then explains that

§ 9-406 and § 9-408 override some restrictions on transfer in an agreement between the debtor and an account debtor. In this context, it is the unincorporated entity that is the “account debtor,” not the other owners. So, unless the entity itself is a party to the agreement that purports to restrict transfer – and rarely is the entity a party to its own formation documents – § 9-406 and § 9-408 will not apply. Finally, even if the entity is a party to the agreement, § 9-406 and § 9-408 will have no effect on any restriction on transfer that is enforceable by the other owners. The upshot of all this is that Article 9 will rarely override a contractual restriction on transfer of an interest in an unincorporated entity.

Also in June, the PEB released a draft commentary on [Proceeds of Collateral](#). The commentary rejects judicial decisions that treat proceeds as a type of collateral distinct from other types of collateral, such as accounts. The commentary explains that “proceeds” is a description of the origin of the property, not a separate type of property, and that all types of personal property can be proceeds.

In August, the PEB released a draft commentary on [Perfection of a Security Interest in Intangible Money and Related Choice-of-Law Rules](#). The draft commentary is a thoughtful and measured response to, among other things, El Salvador’s new law recognizing Bitcoin as a medium of exchange. The commentary explains that Article 1’s decades-old definition of “money” was premised on the understanding that money is tangible – paper and coins – and that it would not make sense to treat an intangible medium of exchange as “money” under any of the four provisions of Article 9 that refer to “money”: §§ 9-312(b)(3), 9-313(a), 9-301(2), and 9-301(3)(C). Public comments on this draft commentary are due by October 4.

Finally, in September, the PEB released a draft commentary on [Injunction against a Noncomplying Disposition under Section 9-610 of the Uniform Commercial Code](#). The draft commentary rejects the reasoning of several recent New York court rulings that require a debtor to show irreparable injury to enjoin a secured party’s planned, noncomplying disposition of collateral. The commentary notes that § 9-625(a) authorizes courts to enjoin actions that do not comply with Part 6 of Article 9, and it is not appropriate to deny an injunction merely because an award of money damages against the secured party would be available and collectible. Public comments on this draft are due by November 7.



Recent Cases

SECURED TRANSACTIONS

Scope Issues

In re Shoot the Moon, LLC,
[2021 WL 4144933](#) (Bankr. D. Mont. 2021)

Eighteen transactions by which a financier, in return for immediate cash, purportedly purchased the debtors’ future receivables until the financier received a specified amount, were really secured loans. The documents granted the financier a perfected security interest in virtually all of the debtors’ assets, not merely the receivables purchased, which is not typical of a sale of receivables. The filed financing statements identified each debtor as a “debtor,” rather than as a “seller.” The financier obtained a personal guaranty of the debtors’ payment and performance obligations and the guaranty contained a waiver of any requirement that the financier proceed against the “collateral” before demanding payment from the guarantor. The financier obtained an affidavit of confession of judgment “for a debt due.” The parties discussed the transactions as “loans” with “terms” and “balances,” and rolled funds from one transaction to the next. Finally, the financier retained a right of recourse against the debtors and the debtors commingled funds from the receivables allegedly sold with other funds.

NextEngine Inc. v. NextEngine, Inc.,
[2021 WL 4026759](#) (C.D. Cal. 2021)

The restructuring of a financing transaction through which the debtor “assigned” patents and trademarks to a holding company, which then gave an exclusive license back to the debtor, was not a true assignment but merely a security interest. The agreements referred to the intellectual property as “collateral,” prohibited the holding company from transferring the IP prior to default, required the lender to notify the debtor before any sale of the IP and give the debtor reasonable opportunity to purchase the IP at a higher bid, required that any proceeds of the sale be applied toward satisfaction of the debt, and provided that the holding company’s rights to the IP terminated upon full payment of the debt. Therefore, the holding company’s assignee did not have standing to bring an infringement claim against the debtor.

Attachment Issues

Polk 33 Lending, LLC v. Schwartz,
[2021 WL 3662868](#) (D. Del. 2021)

A DIP Credit Agreement that included “all commercial tort claims” in the description of collateral was insufficiently specific to encumber subsequently arising tort claims against an insider. Consequently, the secured party had no interest in the claims, did not acquire them in a foreclosure, and had no standing to prosecute them.

First Dakota National Bank v. Gregg,
[2021 WL 4202543](#) (S.D. 2021)

A man who contracted to feed cattle owned by his parents-in-law, in return for payment based on the cattle's weight, and then represented to a bank that he was the owner of cattle, did not have rights in the cattle and therefore did not grant a security interest in the cattle to the bank. The parents-in-law were not estopped from claiming ownership because the doctrine of estoppel requires that there be a representation or concealment of material fact. Even though the parents-in-law had allowed the man to appear to be the owner of the cattle by giving him possession and not filing a caretaker financing statement under § 9-505, those acts are insufficient to serve as the basis for estoppel. Moreover, the parents-in-law marked the cattle with their exclusive brand and attached to each left ear a separately numbered orange tag.

In re Lane,
[2021 WL 3438347](#) (Bankr. D.N.M. 2021)

An individual who signed a promissory note and security agreement as corporate secretary of a limited liability company had actual authority to do so because she was one of two managers of the company and the company's operating agreement, which had been provided to the lender, states that each manager has the authority to borrow money for the company and to encumber the company's assets. However, there was a genuine issue of fact as to whether the individual had acted outside the scope of her authority because the company claimed that the loan was not used for the company's benefit. There was a factual issue about whether the individual had apparent authority to execute the documents on behalf of the company because apparent authority requires due diligence by the third party and the opinion letter provided to the lender had red flags suggesting that it might not be a bona fide letter. Specifically, (i) the letter contained no opinions, only "representations"; (ii) the letter stated that the individual is authorized to execute loan documents on behalf of another entity but did not include a statement that she was authorized to execute the loan documents on behalf of the company, even though the letter names the company as one of the borrowers; (iii) the letter contained numerous typographical and grammatical errors, which are uncommon in letters prepared by law firms; (iv) the letter did not contain the customary components of an opinion letter, including a salutation, the name of the firm's client, the scope of the investigation conducted, the assumptions made, a statement regarding the governing state law, or any qualifications or limitations; and (v) the letter included a representation that, according to the borrowers' projected revenues, they will have the ability to repay the loan, which is highly unusual in attorney opinion letters.

McGowen, Hurst, Clark & Smith, P.C. v. Commerce Bank,
[2021 WL 3817792](#) (8th Cir. 2021)

A bank that made a personal loan to an individual shareholder in an Iowa professional corporation did not obtain a security interest in the individual's shares because the borrower could not make a voluntary transfer of shares unless the transfer was authorized by the shareholders, which it was not, and the transfer was either to the corporation itself or to an individual licensed in Iowa to practice the same profession that the corporation is authorized to practice. Although the individual executed an acknowledgment of the pledge on behalf of the corporation, he lacked actual or apparent authority to do so.

Enforcement Issues

Quality Leasing Co. v. Atomic Dog, LLC,
[2021 WL 3674705](#) (S.D. Ind. 2021)

Summary judgment could not be granted on an equipment lender's action against a debtor for nonpayment because material facts were in dispute about whether the lender breached one financing agreement by paying the supplier before it was permitted to do so. The agreement, which provided for the lender to pay the second draw to the supplier "within thirty (90) [sic] days of the first draw or when requested by the vendor at completion & installation of the equipment," was ambiguous and would be interpreted to prevent the lender from unilaterally paying the second draw before delivery and installation. Nevertheless, evidence was conflicting as to whether the debtor later authorized the lender to pay the second draw before delivery. Because the parties had provided briefing on whether a breach by the lender with respect to one transaction – if any such a breach occurred – excused the debtor's failure to make payment with respect to other financed items, summary judgment would also not be granted on the lender's claims with respect to the other loans.

Stifano v. Slaga,
[2021 WL 3627522](#) (Cal. Ct. App. 2021)

A secured party conducted an acceptance of collateral – a certificated interest in a two-member limited liability company – even though the proposal omitted the amount due, failed to indicate that the debtor had only 20 days to respond, and phrased the proposal in the future tense. The debtor's attempt to pay the secured obligation 23 days later was too little and too late. The debtor was not entitled to any distributions after default but prior to the secured party's acceptance of the collateral because the pledge agreement stated that, "[p]rovid[ed] that [the debtor] is not in default . . . , [he] shall be entitled to vote the Certificate and receive any distributions that may be declared respecting the Certificate." The negative implication of that language was that the debtor was not entitled to distributions after default.

Tribble v. Surface Preparation Systems, Inc.,

[2021 WL 3729948](#) (D. Or. 2021)

A Wisconsin limited liability company that purchased substantially all of the debtor's assets with knowledge of a perfected security interest was bound by the Oregon choice-of-forum clause in the security agreement between the debtor and the secured party.

Liability Issues

In re Argon Credit LLC,

[2021 WL 4026682](#) (Bankr. N.D. Ill. 2021)

The individuals whose consumer loans were used as collateral by the originator stated causes of action against the assignee of a secured party for violation of California's Financing Law ("CFL") and the California Fair Debt Collection Practices Act. The individuals claimed that the originator violated the CFL by lending under a name and from an address other than those on its license, and by failing to properly post the license online, and that these violations invalidated the obligation to pay interest and possibly the obligation to repay principal, and that the assignee's debits of the individuals' checking accounts was therefore improper.

BANKRUPTCY

In re RTI Holding Co.,

[2021 WL 3409802](#) (Bankr. D. Del. 2021)

Shareholders who did not assent to the debtor's prepetition merger and were entitled to payment based on an appraisal of the value of their shares, did not have a general unsecured claim but a claim subordinated under § 510(b). Regardless of whether they were shareholders on the petition date, their payment right arose from their equity interests.

GUARANTIES & RELATED MATTERS

Wilmington Trust v. Patel,

[2021 WL 355083](#) (N.D. Tex. 2021)

The guarantors who agreed to be unconditionally liable for a \$5.5 million loan to the borrower following a "Springing Recourse Event" were liable. The guaranty agreement defined such an event to mean the creation of any lien on the collateral – a hotel operated by the borrower – or any transfer of an interest in the borrower, and one mechanic's lien and two consensual liens on the collateral had been created, and the guarantors had transferred their membership interest in the borrower. The fact that the two consensual liens were incurred in an attempt to keep the hotel afloat during the pandemic did not mean that enforcement of the guaranty violated public policy. Nor did it matter that one of those liens had been

released when the obligation it secured was paid off. The guarantors' liability was triggered by the creation of the lien, regardless of whether the creditor suffered any damage from it. Although the transferee of the guarantors' interest in the borrower disputed whether the transfer was valid and had declared the transfer void, the guaranty agreement defined "transfer" to include "the entry of any agreement" to transfer, and there was no dispute that the guarantors had entered into such an agreement.

LENDING, CONTRACTING & COMMERCIAL LITIGATION

In re Weinstein Company Holdings LLC,

[997 F.3d 511](#) (3d Cir. 2021)

Even though investment contracts were listed on a 2,000-page schedule of Assumed Contracts that accompanied the sale of the debtor's film producer's assets, they were not included in the sale, and the purchaser assumed no duties under the contracts, because language in the asset purchase agreement limited the contracts being assumed to "executory contracts" and the investment contracts were undisputedly not executory.

Commerce Park Realty, LLC v. HR2-A Corp.,

[2021 WL 2677257](#) (R.I. 2021)

Although the loan agreements for two commercial loans made by Massachusetts lenders selected Massachusetts law to apply, Rhode Island had a materially greater interest in the transactions than did Massachusetts because the borrowers were located in Rhode Island, the primary collateral was Rhode Island real property, the loan agreements were executed in Rhode Island, and the purpose of the loans was to finance a Rhode Island development. Because application of Massachusetts law – which effectively has no limit on permissible interest rates – would violate fundamental policy of Rhode Island, Rhode Island law governed that issue. Under Rhode Island law, the loans were usurious because even though the borrowers certified that they had received the statutorily required "pro forma methods analysis performed by a certified public accountant licensed in the state of Rhode Island indicating that the loan is capable of being repaid," there was no evidence that such analysis had actually been conducted. Although after default the borrowers signed a waiver of claims in connection with a forbearance agreement, that waiver was ineffective to waive the usury defense because it was made in response to a threat of foreclosure, and hence was coercive.

In re Shoot the Moon, LLC,

[2021 WL 4144933](#) (Bankr. D. Mont. 2021)

Transactions structured as a sale of future receivables but which were really secured loans, were usurious under Montana law. Although the transaction documents include a New York choice-of-law clause and the financier is located in New York, Montana law applies because applying New York law would

violate a fundamental policy of Montana and Montana has a materially greater interest in determining the issue due to the fact that the debtors are Montana entities owned and operated by Montana citizens working out of a Montana office and the extremely high cost of the loans contributed to the debtors' financial demise, which resulted in financial losses for numerous Montana citizens. Because the loans were usurious, the financier was liable for twice the amount of interest charged. The financier also had preference liability for payments made prepetition.

Agrifund, LLC v. Heartland Co-op,

[8 F.4th 660](#) (8th Cir. 2021)

A co-op that helped finance a farmer's operations but had contractually subordinated its loan to the secured loan of an agricultural financier, and which had received a notification from the financier stating that any proceeds of the farmer's crops should be sent to the financier, was not a holder in due course of a check that the farmer provided to pay off the co-op's loan and which was derived from proceeds of crops. Although the co-op did not know that the check came from crop proceeds, the farmer's payment to the co-op was for the full outstanding debt due, rather than a smaller, more typical monthly payment. It would have taken minimal effort for the co-op to confirm, either with the farmer or the financier, whether the financier had been fully paid, and thus the co-op did not accept the payment without notice. The co-op also failed to exercise reasonable commercial standards of fair dealing, and therefore did not act in good faith. Because the co-op did not qualify as a holder in due course, it was liable in conversion to the financier.

Audax Credit Opportunities OffShore Ltd. v. TMK Hawk Parent, Corp., [2021 WL 3671541](#) (N.Y. Sup. Ct. 2021)

A minority of first-lien lenders stated causes of action against a majority for breach of contract by engaging in a transaction with the debtor by which the majority loaned an additional \$120 million on a super-priority basis and exchanged their portion of the first-lien debt – \$307.5 million – for super-priority debt. The refinancing transaction, taken as a whole, had the effect of modifying the waterfall in the credit agreement even though the text of the waterfall clause was unchanged. Moreover, an amendment to the credit agreement that prevented lenders from suing each other, and instead permitted them to direct the administrative agent to sue but only if lenders posted cash in an amount the agent determined in its sole discretion, violated public policy and was unenforceable. Although no-action clauses are generally enforceable because they reflect an ex ante agreement to sacrifice certain individual rights for the salutary purpose of benefitting the venture as a whole, the amendment in this case was not at the inception of the transaction but instead imposed later by a subset of lenders without notice to prevent these plaintiffs from suing these defendants in connection with this transaction: a sort-of preemptive self-pardon. However, the

minority did not state claims for: (i) breach of the duty of good faith, because the facts alleged were no different than those in the breach of contract claim; (ii) tortious interference with contract against the equity sponsors, because they had an economic justification for agreeing to the refinancing; or (iii) violation of the New York Voidable Transactions Act by transferring senior liens with intent to hinder, delay, or defraud, because the debtor's chief executive office is in Massachusetts, and hence the New York act does not apply.

Hom v. Petrou,

[2021 WL 3361063](#) (Cal. Ct. App. 2021)

Lenders who had a security interest in a lessee's lease of real property and who were the prevailing parties on tort claims brought by the landlord were entitled to attorney's fees pursuant to a clause in the lease even though they were non-signatories to the lease. The lenders were third party beneficiaries of the lease, which contained two pages specifying the rights of secured lenders. The language of the attorney's fees clause covered "any dispute aris[ing] from this Lease or the tenancy hereby created," and was not limited to disputes between the lessor and the lessee.

Gourlay v. Buchner,

[2021 WL 3832364](#) (Md. Ct. App. 2021)

Even though the subordination agreement between a lender and a credit seller stated that it was solely for the benefit of the parties, and "not for the benefit of Borrowers, Guarantors or any other party," the guarantor had standing in an action brought by the seller to assert the clause prohibiting the seller from seeking or receiving payment until the borrower's obligation to the lender was paid in full. Because the subordination agreement was executed contemporaneously with all the other transaction documents, it had to be read together with them.

Tennenbaum Living Trust v. TGLT S.A.,

[2021 WL 3863117](#) (S.D.N.Y. 2021)

Entities holding a minority of convertible subordinated notes failed to state a cause of action against the debtor for nonpayment after the debtor involuntarily converted all the notes into equity pursuant to an amendment to the indenture agreed to by the majority of noteholders. The indenture originally gave each holder a voluntary right to convert to equity and a right to institute an action to enforce the right to payment, neither of which could be impaired without the consent of the affected noteholder. It also included a mandatory conversion to equity if the debtor proceeded with an IPO, but that provision could be amended by a majority of the noteholders. The amendment altered the mandatory conversion provision in the indenture, but that did not affect the noteholders' rights under the voluntary conversion term because voluntary conversion was always limited by mandatory conversion. The amendment also did not impair the noteholders' right to sue to collect the debt

for the same reason: that right was always subject to mandatory conversion.

Perkins v. Advance Funding, LLC,
[2021 WL 4059861](#) (D.N.J. 2021)

The arbitration clauses in several Sale and Assignment Agreements, by which a tort plaintiff purportedly sold portions of his right to proceeds of his lawsuit, were unenforceable because the clauses did not clearly and unambiguously indicate that the individual was choosing to arbitrate disputes rather than have them resolved in a court of law. Although the clauses provided that any claim arising out of the agreements “shall be settled by final binding arbitration,” and set forth certain procedural requirements for such arbitration, they did not, as required by New Jersey law, explain what arbitration is or indicate how arbitration is different from a proceeding in a court of law.



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**Center for Law,
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Working together for the common good

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