The Transactional Lawyer

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GONZAGA UNIVERSITY SCHOOL OF LAW

The Enforceability of Default Interest

Stephanie J. Richards

Many loan agreements provide for a higher interest rate after the borrower defaults. Such default rates of interest are of course subject to usury statutes and, if grossly excessive, can be struck down as unconscionable. However, in several jurisdictions, default interest rates are limited in another manner: courts regard them as a form of liquidated damages for the borrower's breach. Consequently, courts can strike down the increase in an interest rate as an unenforceable penalty.

Traditionally, liquidated damages compensate the non-breaching party for the breach. While a default interest rate does recompense the lender for the increased costs of administering a defaulted loan, which would seem to be an element of damages, it is also designed to compensate the lender for the increased risk of nonpayment, which is less clearly a proper measure of contract damages. Nevertheless, an increasing number of states view default interest rates as a form of liquidated damages,[1] which means that the increase will be enforceable only if it is a reasonable estimate of the lenders' actual or anticipated loss.[2]

There is no clear guidance about how much of an increase in default interest is permissible. Relevant factors include:

- the amount of the increase;
- the initial rate of interest;
- the nature of the breach (*e.g.*, whether a monetary or non-monetary default);
- the borrower's solvency;
- the extent to which the debt is secured; and,
- whether the lender is seeking both default interest and a late payment fee.

The following chart displays the increases in interest rates that courts have permitted and invalidated.

State	Largest Increase Permitted	Smallest Increase Invalidated
California	5%[3] (6% → 11%)	5%[4]
Colorado	29.75%[5] (6.25% → 36%)	
Connecticut	12.05%[6] (11.95% → 24%)	11%[7] (13% → 24%)
Delaware	14%[8] (10% → 24%)	
Illinois	5%[9] (6.25% → 11.25%)	
Kansas	6%[10] (18% → 24%)	
Massachusetts	5%[11] (14.25% → 19.25%)	4%[12] (16% → 20%)
Minnesota	5%[13] (5.04% → 10.04%)	
New Jersey	6%[14] (9% → 15%)	3%[15] (12% → 15%)
New York	15%[16] (10% → 25%)	
Ohio	2%[17] (12.25% → 14.25%)	
Virginia		1.614%[18] (16.386% → 18%)

As this chart illustrates, lenders must be very careful in selecting a default interest rate. Even a rather small increase in the interest rate after default might not withstand scrutiny.

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Notes

1. *See, e.g.*, Garrett v. Coast & S. Fed. Sav. & Loan Assn., 511 P.2d 1197 (1973); Inland Bank & Trust v. Knight, 927 N.E.2d 777 (Ill. Ct. App. 2010); Raisin Mem'l Trust v. Casey, 945 A.2d 1211 (Me. 2008); Art Country Squire, L.L.C. v. Inland Mort. Corp., 745 N.E.2d 885 (Ind. Ct. App. 2001) Citicorp Vendor Fin., Inc. v. WIS Sheetmetal, Inc., 206 F. Supp. 2d 962 (S.D. Ind. 2002).

2. RESTATEMENT (SECOND) OF CONTRACTS § 356(1) (1981); St. Jude Med., Inc. v. Medtronic, Inc., 536 N.W.2d 24, 28 (Minn. Ct. App. 1995); In re DWS Investments, Inc., 121 B.R. 845, 849, n.7 (Bankr. C.D. Cal. 1990).

3. First Century Plaza, LLC, v. Nguyen, 2012 WL 6691880 at *7 (Cal. Ct. App. 2012).

4. California Bank & Trust v. Shilo Inn, 2012 WL 5605589, at *4 (D. Or. 2012).

5. In re K & J Properties, Inc., 338 B.R. 450 (Bankr. D. Colo. 2005); *see also* In re Wood Family Interests, Ltd., 135 B.R. 407, 409 (Bankr. D. Colo. 1989) (permitting an increase upon default from 11.5% to 24%).

6. Southridge Real Estate Partners, L.P. v. Rosenberg, 2015 WL 5135353, at *1 (Conn. Super. Ct. 2015); *see also* Lasalle Nat. Bank v. Freshfield Meadows, LLC, 2004 WL 3105965 (Conn. Super. Ct. 2004) (upholding an increase from 11.95% to 24%).

7. Three Sixty Five Cherry, LLC v. Twelve Willard, LLC, 2013 WL 388190, at *7 (Conn. Super. Ct. 2013).

8. River Bank Am. v. Tally-Ho Assocs., L.P., 1991 WL 35719 (Del. Super. Ct. 1991).

9. Inland Bank & Trust v. Knight, 927 N.E.2d 777 (Ill. App. 2010); *see also* In re Kimbrell Realty/Jeth Court, LLC, 483 B.R. 679 (Bankr. C.D. Ill. 2012) (permitting an increase from 6.55% to 10.55% upon default).

10. Wagnon v. Slawson Expl. Co., 874 P.2d 659 (Kan. 1994); *see also* TMG Life Ins. Co. v. Ashner, 898 P.2d 1145 (Kan. App. 1995).

11. In re White, 88 B.R. 494 (Bankr. D. Mass. 1988).

12. In re 201 Forest Street LLC, 409 B.R. 543 (Bankr. D. Mass. 2009) (the additional 10% compounded late charge effectively made the default rate 41%); *see also* In re White, 88 B.R. 498 (increase from 16.5% to 48% was an unenforceable penalty).

13. In re Bowles Sub Parcel A, LLC, 792 F.3d 897 (8th Cir. 2015).

14. MONY Life Ins. Co. v. Paramus Parkway Bldg., Ltd., 834 A.2d 475 (N.J. Super. Ct. App. Div. 2003); *see also* Norwest Bank Minnesota v. Blair Rd. Assocs., L.P., 252 F. Supp. 2d 86 (D.N.J. 2003) (enforcing an increase from 7.88% to 10.88%).

15. In re Timberline Prop. Dev., Inc., 136 B.R. 382, 387 (Bankr. D.N.J. 1992); *see also* MetLife Capital Fin. Corp. v. Washington Ave. Assocs. L.P., 732 A.2d 493 (N.J. 1999) (invalidating an increase from 9.55% to 15% but permitting an increase to 12.55%).

16. AXA Inv. Managers UK Ltd. v. Endeavor Capital Mgmt. LLC, 890 F. Supp. 2d 373 (S.D.N.Y. 2012); *see also* Citibank v. Nyland (CF8) Ltd., 878 F.2d 620 (2d Cir. 1989) (permitting an increase from 13.5% to 17.5%); In re 785 Partners LLC, 470 B.R. 126 (Bankr. S.D.N.Y. 2012) (permitting an increasefrom 5% to 10%). Interest rates as high as 25% are consistently held to be reasonable under New York law. *See* In re Route One W. Windsor Ltd. P'ship, 225 B.R. 76, 89 (Bankr. D.N.J. 1998); Emery v. Fishmarket Inn of Granite Springs, Inc., 570 N.Y.S.2d 821 (N.Y. Sup. Ct. App. Div. 1991).

17. Cardinal Fed. Sav. & Loan Ass'n v. Michaels Bldg. Co., 1987 WL 17783, at *3 (Ohio Ct. App. 1987)); *see also* LTV Corp. v. Gulf States Steel, Inc. of Alabama, 969 F.2d 1050, 1063 (D.C. Cir. 1992) (permitting an increase from 16.75% to 18.75%).

18. FNB Se. v. Dean, 2009 WL 10291356 (Cir. Ct. Va. 2009).

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Liquidated Damages, Alternative Performance, and Ensuring the Enforceability of Contingent Charges and Fees

Stephen L. Sepinuck

An article in the October 2014 issue of this newsletter[1] discussed the case of *White Winston Select Asset Funds, LLC v. InterCloud Systems, Inc.*,[2] in which a federal district court, applying New York law, ruled that a signed Term Sheet for a loan was not a binding preliminary agreement, and hence the prospective borrower was not obligated for either a $500,000 break-up fee or the prospective lender's expenses after the borrower obtained funding elsewhere. In a clear win for lenders, the U.S. Court of Appeals for the Third Circuit recently reversed that ruling.[3] The circuit court rejected the somewhat formalistic analysis and terminology used by the district court and expressly noted that, even though the Term Sheet did not purport to impose on the prospective lender a duty to lend, it did bind the prospective borrower to pay the break-up fee and expenses.

The one slight negative for prospective lenders is that the court left open the possibility that the break-up fee constitutes an unenforceable penalty. The circuit court remanded that issue to the district court, noting that the distinction between a valid liquidated damages clause and an invalid penalty is a legal question, the resolution of which requires due consideration of the nature of the contract and the circumstances, and that the burden is on the party seeking to invalidate the clause.

While remand on this issue was appropriate, it was also unfortunate. In a well-drafted Term Sheet, the language providing for a break-up fee is neither a liquidated damages clause nor a penalty. More generally, it is possible to structure many contingent fees and charges so that they are immune from the scrutiny to which courts subject liquidated damages clauses. Before discussing that, a brief review of liquidated damages and alternative performance is in order.

Liquidated Damages & Penalties

Historically, the common law has been hostile to contractual penalties. Perhaps this is because a penalty often has an *in terrorem* effect, which is at odds with the common law's compensatory goal.[4] Consequently, penalties are unenforceable.[5] A contractual clause fixing unreasonably large damages in the event of breach operates as a disguised penalty, and is also unenforceable. While the law's hostility to liquidated damages clauses has abated some, it is still generally true that, to be enforceable, a liquidated damages clause must fix damages at an amount that is reasonable in light of the anticipated or actual loss and the anticipated difficulty in proving loss.[6]

Contracting parties occasionally seek to avoid judicial scrutiny of liquidating damages clauses by structuring the clause as an incentive to perform rather than by imposing a disincentive to breach. For example, an agreement to construct a building might call for a $10,000 bonus or premium if the builder completes the work on time. However, this is not economically different from an agreement with a $10,000 higher price and a $10,000 penalty for failing to complete performance on time. Accordingly, courts can and do scrutinize premiums and bonuses, but perhaps not with the same zeal they use when scrutinizing a clause purporting to liquidate damages.[7]

Alternative Performance

Contracting parties also occasionally structure an incentive or disincentive as an alternative performance. For example, instead of imposing a $10,000 penalty on a builder for not completing construction on time, the agreement could give the builder the option of either completing the work on time or paying $10,000.

There is at least one important difference between a clause liquidating damages and clause providing for alternative performance. A liquidated damages clause does not prevent a court from awarding specific performance,[8] but a true alternative performance most likely does.[9] That said, however, distinguishing a liquidated damages clause – which might be an unenforceable penalty if not a reasonable estimate of actual or anticipated harm – from a provision that calls for alternative performance can be extremely difficult. This is ably demonstrated by a recent California decision.

In *McGuire v. More-Gas Investments, LLC*,[10] three individuals purchased two pieces of real property from More-Gas Investments. One purchase agreement called for a price of $1.05 million and required More-Gas to either: (i) obtain within two months the consent of neighboring lot owners not to build within 900 feet of an access road to be constructed along the north side of the property; or (ii) refund $80,000 of the purchase price. The other agreement called for a purchase price of $2 million and provided that, by a specified date, either: (i) More-Gas must complete the process for subdividing the property, or (ii) the buyers would have the option of either selling the property back to More-Gas for $2.5 million or receiving a refund of $250,000.

More-Gas did not obtain the neighbor's consent with respect to the first piece of property or complete the subdivision with respect to the second. The buyers sued and the trial court ruled that the provisions of both agreements were liquidated damages clauses that constituted unenforceable penalties.

The appellate court reversed. It ruled that the trial court failed consider a third possibility. Instead of being a valid liquidated damages clause or an invalid penalty, each clause might have provided for alternative performance. Quoting an earlier opinion involving a cell phone provider's early termination fee, the court noted that "[a] contractual provision that merely provides an option of alternative performance of an obligation does not impose damages" and hence is not subject to scrutiny as a potentially invalid penalty.[11] The court hastened to add, however, that a clause purporting to provide for alternative performance can be used to mask what is in reality a penalty. Moreover, the form of the clause or language used is not controlling; instead the substance of the arrangement controls.[12] If the agreement provides one party with "the power to make a realistic and rational choice," it is a valid term providing for alternative performance; if, on the other hand, it "realistically contemplates no element of free rational choice," the provision is a penalty.[13]

With respect to the first purchase agreement at issue, the court observed that More-Gas could either secure the neighbors' consent to the building restriction and keep the $80,000 or decline to obtain that consent and refund $80,000 to the buyers. Viewed in this manner, the agreement could, therefore, be understood to provide for alternative performance. Because the trial court did not consider whether, at the time of contracting, this was a realistic and rational choice, the trial court's decision had to be reversed and the case remanded.

The same analysis applied to the second agreement. While an obligation to repurchase for $500,000 more than the original purchase price might seem excessive or penal, no evidence had been presented about what it would cost More-Gas to complete the subdivision process. Without that evidence, it was impossible to determine whether the agreement provided More-Gas with a realistic and rational choice.[14] On remand, the issue reportedly remains unresolved and is set for trial later this year.

A transactional lawyer can draw two conclusions from this case. First, that the distinction between liquidated damages and alternative performance is about as clear as mud. The determination will be based on the economic reality of the transaction, not by the words used in the agreement, and a transactional lawyer drafting an agreement simply cannot be sure how a court might later interpret it. Second, and more important, the distinction might not be significant. The same facts and evidence used to distinguish a valid liquidated damages clause from an invalid penalty will likely be used to distinguish liquidated damages from alternative performance. In other words, a clause that requires a breaching party to pay damages in an amount that is a reasonable estimate of the counter-party's anticipated or actual harm probably also provides that party with a realistic and rational choice between performance and breach.[15] Thus, it is not clear that the doctrine of alternative performance is materially different from the traditional test for evaluating a liquidated damages clause.

Contingent Charges and Fees

Fortunately, all the uncertainty inherent in the distinction among liquidated damages, penalties, and alternative performance can be often avoided. If an agreement conditions one party's duty to pay a specified amount on some event or condition other than that party's breach, so that the duty arises when there is no breach, the duty to pay simply cannot be either liquidated damages or a penalty. The amount of the payment therefore need not be reasonable.[16] If this seems like a mere drafting trick, rest assured that the law on this point is well settled.[17] Moreover, clauses of this nature are ubiquitous, including, for example.

- A fee imposed on a depositary bank's customer for drawing a check on insufficient funds, presenting a check that is later dishonored, or falling under the daily minimum balance.[18]
- Severance benefits for an at-will employee.
- A fee for early termination of an agreement.[19]
- A charge by an internet service provider for exceeding a data usage limit.
- A charge by a phone company for exceeding the number of minutes allotted.

In none of these cases has the party with the duty to pay breached the agreement. A depositor does not promise not to bounce a check or maintain a minimum balance. An employer makes no promise of continued employment to an at-will employee. The customer of an

ISP or phone company makes no promise not to exceed specified limits on usage. Consequently, each of these fees or charges is simply not subject to avoidance as a penalty,[20] although a court can refuse to enforce it if the court determines that the clause is unconscionable.[21]

Not all fees and charges can readily be structured in this manner. For example, a late-payment fee imposed by a lender or credit card issuer is necessarily tied to the breach of the promise by the borrower or cardholder to make timely payment. Consequently, the fee will be subject to scrutiny and treated as either liquidated damages or a penalty. Similarly, a term in a loan agreement calling for higher interest after default – which also necessarily arises upon the borrower's breach – is a form of liquidated damages. If the increase in the interest rate is excessive, it too is subject to avoidance as a penalty.[22] In many other cases, however, the transactional lawyer can help ensure that a fee or charge will not be invalidated as a penalty simply by not including a corresponding covenant.

Conclusion

Returning to the break-up fee in *White Winston*, if the Term Sheet did not include a promise by the prospective borrower not to seek funding elsewhere, the borrower's decision to obtain funding elsewhere was not a breach. Consequently, the break-up fee could not be liquidated damages for breach, merely a contingent fee, and there would be no basis for invalidating the fee as a penalty. As long as the fee was not unconscionable, it should be enforceable.

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Notes

1. Stephen L. Sepinuck, *Term Sheets, Letters of Intent, and Preliminary Agreements: Ensuring Recovery of Expenses*, 4 THE TRANSACTIONAL LAWYER 2 (Oct. 2014).

2. 2014 WL 4105492 (D.N.J. 2014).

3. White Winston Select Asset Funds, LLC v. Intercloud Systems, Inc., 2015 WL 4620827 (3d Cir. 2015).

4. *See* E. ALLAN FARNSWORTH, CONTRACTS § 12.18 at 815 (4th ed. 2004). A penalty can also discourage an efficient breach.

5. *See* RESTATEMENT (SECOND) OF CONTRACTS § 356(1). *See also id.* § 355 (denying punitive damages for breach of contract).

6. *Id.* at § 356(1); U.C.C. § 2-718(1). *Cf.* Cal. Civ. Code § 1671(b) (amended in 1977 to make liquidated damages clauses in non-consumer transactions valid "unless the party seeking to invalidate the provision establishes that the provision was unreasonable under the circumstances existing at the time the contract was made."

A clause fixing damages at an unreasonably low level is not an unenforceable penalty, but can be unconscionable. RESTATEMENT (SECOND) OF CONTRACTS § 356 cmt a.

7. *See* RESTATEMENT (SECOND) OF CONTRACTS § 356 cmt. c.

8. *See* RESTATEMENT (SECOND) OF CONTRACTS § 361.

9. *See* FARNSWORTH, *supra* note 4 at § 12.6, n.8.

10. 163 Cal. Rptr.3d 225 (Cal. Ct. App. 2013).

11. *Id.* at 235 (*quoting* Cellphone Termination Fee Cases, 122 Cal. Rptr. 3d 726 (Cal. Ct. App. 2011)).

12. *Id.*

13. *Id.* (*quoting* Garrett v. Coast & Southern Fed. Sav. & Loan Ass'n, 511 P.2d 1197 (Cal. 1973)).

14. *Id.* at 242. Because the buyers had elected to put the property back to the seller at $500,000 premium over the original purchase price, rather than to receive a $250,000 refund of the purchase price, the court did not compare and contrast these alternatives. It is fairly easy to see why the partial refund might be an alternative performance. It is less clear why a duty to repurchase for a $500,000 premium over the purchase price is really an alternative performance. Such an alternative would make the contract a losing proposition for the seller, which would not seem to be a realistic and rational choice.

15. *See* RESTATEMENT (SECOND) OF CONTRACTS § 356 cmt. c (indicating that "the relative value of the alternatives may be decisive").

16. *But cf.* Grand Prospect Partners, L.P. v. Ross Dress for Less, Inc., 182 Cal. Rptr. 3d 235 (Cal. Ct. App. 2015), which involved a lease of retail space in a shopping center to a retailer of off-price apparel and home fashion. The lease contained two co-tenancy conditions: (i) the duty to pay rent was abated if Mervyn's did not occupy 76,000 square feet of retail space in the shopping center on the commencement date of the lease; and (ii) the tenant could terminate the lease

if Mervyn's non-occupancy continued for 12 months. Mervyn's filed for bankruptcy protection and closed its stores prior to the commencement date of the lease. The tenant therefore paid no rent for the first year and then terminated the lease. The landlord sued, claiming the co-tenancy conditions were unenforceable penalties. The trial court agreed but the appellate court reversed in part. In concluded that the right to terminate was not a penalty but the rent abatement clause was. In doing so, the court noted that a prior decision ruled that a failed condition can operate as an unenforceable penalty. *Id.* at 254-55 (citing Fox Chicago Realty Corp. v. Zukor's Dresses, Inc., 122 P.2d 705 (Cal. Ct. App. 1942)). What the court failed to notice or appreciate, however, was that the condition in the cited case was actually a party's breach of a covenant. The landlord in *Grand Prospect Partners* did not promise to lease space to Mervyn's.

17. *See, e.g.,* Berens and Tate, P.C. v. Iron Mountain Information Management, Inc., 747 N.W.2d 383 (Neb. 2008) ("permanent withdrawal" fee for removing records from storage was not a liquidated damages provision or a penalty because there was no breach; consequently the reasonableness of the fee was irrelevant); Majestic Cinema Holdings, LLC v. High Point Cinema, LLC, 662 S.E.2d 20 (N.C. Ct. App. 2008) (the term in commercial lease providing for rent to abate if fewer than 15,000 square feet of retail space were not open for business was not a liquidated damages clause because there was nothing to indicate the term serves as a recovery for breach of contract; consequently there was no need to consider if the term constituted an unenforceable penalty).

18. *See, e.g.*, Best v. U.S. Nat'l Bank of Oregon, 714 P.2d 1049 (Or. Ct. App. 1986); *Jacobs v. Citibank*, 462 N.E.2d 1182 (N.Y. 1984); Hoffman v. Security Pacific Nat'l Bank, 176 Cal. Rptr. 14 (Cal. Ct. App. 1981) (all ruling that the fee a bank charges its checking account customers for writing a check drawn on insufficient funds could not be an invalid penalty because the customer had no duty to refrain from writing such a check). *See also* Perdue v. Crocker National Bank, 702 P.2d 503, 515 (Cal. 1985) (expressly agreeing with this portion of the *Hoffman* decision).

19. *See, e.g.*, Mahlum v. Adobe Sys. Inc., 2015 WL 124663 (N.D. Cal. 2015) (appeal pending); Jaquez v. Protection One Alarm Monitoring, Inc., 2014 WL 962601 (Cal. Ct. App. 2014).

20. A fee for repaying a loan before maturity would similarly not be subject to analysis as liquidated damages or a penalty if the borrower made no promise not to repay early, and hence is not in breach by making an early payment. *See, e.g.,* Hunt v. Stalians, 2014 WL 1008085 (Cal. Ct. App. 2014). However, the "perfect tender in time rule" apparently survives in many jurisdictions, so that a borrower would be breaching by making early prepayment unless the loan agreement authorized the borrower to do so. *See, e.g.*, Megan W. Murray, *Prepayment Premiums: Contracting for Future Financial Stability in the Commercial Lending Market*, 96 IOWA L. REV. 1037, 1042-43 (2011). *See also* MONY Life Ins. Co. v. Paramus Parkway Bldg., Ltd., 834 A.2d 475, 481-83 (N.J. Super. Ct. App. Div. 2003) (upholding a prepayment premium as a reasonable and permissible liquidated damages clause); Norwest Bank Minnesota v. Blair Road Assocs., 252 F. Supp. 2d 86 (D.N.J. 2003). *Cf.* RESTATEMENT (THIRD) OF PROPERTY (MORTGAGES) § 6.1 (rejecting the "perfect tender in time" rule).

21. *See, e.g,* Perdue v. Crocker National Bank, 702 P.2d 503 (Cal. 1985).

22. *See* Stephanie J. Richards, *The Enforceability of Default Interest*, 5 THE TRANSACTIONAL LAWYER 1 (Oct. 2015).

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An Avoidable Trap for Credit Card Issuers

Allen Benson

A recent decision by the federal District Court for the District of Massachusetts poses a significant impediment to banking institutions that wish to set off a consumer's deposit account balance against the consumer's debt on a credit card issued by the institution. Banks, savings and loan associations, and credit unions that issue credit cards should carefully review and revise their credit card agreements in light of this decision to ensure that they give the issuer the right to effect setoff.

Background

The Truth in Lending Act prohibits, subject to some exceptions, a credit card issuer from offsetting a cardholder's indebtedness arising in connection with a consumer credit transaction against funds of the cardholder held on deposit with the issuer.[1] The regulations promulgated thereunder clarify that this prohibition does not alter or affect the right of the issuer to "[o]btain or enforce a consensual security interest in the funds."[2]

However, the Official Staff Interpretation of the regulation places a hurdle on the issuer's path toward obtaining such a security interest by requiring that the consumer: (i) be aware that granting a security interest is a condition to opening the account (or to receiving more favorable terms) and (ii) "specifically intend to grant a security interest in the deposit account." The Interpretation then identifies the following three "indicia" of such awareness and intent:

> A. Separate signature or initials on the agreement indicating that a security interest is being given.
>
> B. Placement of the security agreement on a separate page, or otherwise separating the security interest provisions from other contract and disclosure provisions.
>
> C. Reference to a specific amount of deposited funds or to a specific deposit account number.[3]

The Decision

In *Martino v. American Airlines Federal Credit Union*,[4] the plaintiff claimed that the credit union violated the Truth in Lending Act by effecting setoff against her deposit account to cover outstanding amounts due on her credit card. The credit union argued that, because the Card Agreement granted the credit union a security interest in the cardholder's deposit accounts maintained with the credit union, the setoff prohibition was inapplicable.

The cardholders did not sign the Card Agreement; however, the plaintiffs had signed the credit card application thereby acknowledging that any use of the card would bind them to terms of the Card Agreement. The Card Agreement was sent to the cardholders on a later date in a joint mailing with the credit card. Page two of the Card Agreement contained a paragraph granting the credit union a security interest in all of the cardholders' deposit accounts maintained with the Credit Union. The "Security Agreement" paragraph was distinguished from other text on the page in that the font was bold and the paragraph was surrounded by a box.

The court ultimately determined that the application and Card Agreement were not sufficient to grant the credit union a consensual security interest in the cardholders' deposit accounts. In its application of the Official Staff Interpretation, the court stated: "compliance with one of the three indicia is *necessary but not sufficient* to establish that the security interest was affirmatively agreed to and specifically intended to be granted." (emphasis added).[5] In other words, the indicia are relevant evidence of, but not conclusive proof that, the applicable standard has been satisfied: that the consumer specifically intended to grant the security interest. The court further noted: "the lack of any signature or other acknowledgment of receipt of the Agreement is a significant obstacle to the validity of this security agreement."[6]

The *Martino* decision effectively imposes conditions to attachment of a security interest well beyond those in Article 9 of the UCC.[7] To deal with this, prudent counsel for an issuer of consumer credit cards should review and, if necessary, revise the credit application or credit card agreement to ensure that one or both of them demonstrates the cardholder's intent to grant a security interest.

The best solution would be to include the grant of a security interest in the credit card agreement and to have the cardholder sign not only the agreement but also the clause containing the granting language. Unfortunately, the reality is that cardholders rarely sign the credit card agreement. Instead, they are advised that using the card constitutes assent to the credit card agreement. This works as a matter of contract law, but does not satisfy the higher standard in the Official Staff Interpretation.

Cardholders do, however, frequently sign the credit card application. Accordingly, the application should include language expressly granting the issuer a security interest in deposit accounts to secure any amount later owing on the card. The following should suffice:

> ***Security Interest***. I hereby grant [Issuer] a security interest in all the deposit accounts that I maintain with [Issuer], whether now or in the future, to secure all obligations I incur by using the card or pursuant to the credit card agreement. I understand that this means that [Issuer] may debit any or all of those deposit accounts without prior notification to me to satisfy all or part of such obligations.

This language should be made conspicuous, separated in some way from the remainder of the text, and should be accompanied by a place for a separate signature. For applications completed and submitted on-line, the applicant should be required to signify assent twice: once to the security interest and once more generally to the entire application.

One final point is in order. The credit card agreement – which follows later and becomes binding through the cardholder's use of the card – must not supersede the terms of the application. Accordingly, the credit card should either not contain a merger clause or, if it does contain such a clause, the language should make clear that the application is part of the agreement. The following language should work:

> ***Entire Agreement***. Any credit card application submitted by [you] [cardholder] to [us] [issuer] in connection with the issuance of the card is part of this Agreement. This Agreement (including any such credit card application) contains the entire understanding of the parties with respect to the subject matter hereof. There are no promises, conditions, understandings, or representations not included in this Agreement (including the credit card application).

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Notes

1. 15 U.S.C. § 1666h.

2. 12 C.F.R. § 226.12(d)(2), *to be re-codified at* 12 C.F.R. § 1026.12(d)(2).

3. Official Staff Commentary on Regulation Z, 2006 WL 3947402, at *1.

4. 2015 WL 4920015 (D. Mass. 2015).

5. *Id.* at *8.

6. *Id.*

7. *But cf.* U.C.C. § 9-109(d)(13) (Article 9 does not apply to a security interest in a deposit account in a consumer transaction).

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Recent Cases

SECURED TRANSACTIONS

Attachment Issues

In re Smith,
2015 WL 4594096 (Bankr. E.D.N.C. 2015)
A bank that refinanced the debtor's manufactured home loan and obtained a deed of trust that described the collateral as the property listed on the prior *deed*, not the property listed on the prior *deed of trust*, has a lien only on the debtor's real property, not the debtor's manufactured home, because the home was not a fixture. The manufactured home does not have a permanent foundation, has no block or curtain wall (only a faux stone curtain wall applied to wire mesh around its base), and is still registered with the state Division of Motor Vehicles as a motor vehicle.

Perfection Issues

In re SemCrude, L.P.,
2015 WL 4594516 (D. Del. 2013)
The security interests of the debtor's oil suppliers were unperfected because even though the law of the suppliers' states created an automatically perfected security interest, the law of the jurisdiction where the debtor was located governs. It did not provide for automatic perfection, and the suppliers did not file a financing statement in the state where the debtor is located.

Enforcement Issues

Chao Xia Zhang v. Layer Saver LLC,
2015 WL 4467063 (N.D. Ill. 2015)
The buyer of the debtor's "patent rights" at a public sale conducted by the debtor's secured party was not entitled to an injunction prohibiting the debtor from further use of those rights absent evidence that a patent had been issued because an inventor's inchoate rights after making an application for a patent but before the patent is issued do not entitle the inventor to injunctive relief against an infringer.

Liability Issues

Macquarie Bank Ltd. v. Knickel,
2015 WL 4385677 (8th Cir. 2015)
A secured party that, after it foreclosed on the debtor's oil and gas leases in apparent satisfaction of the secured obligation, used the debtor's trade secrets that had also been pledged as collateral, was liable for misappropriation of those trade secrets.

Veleron Holding, B.V. v. Morgan Stanley,
2015 WL 4503580 (S.D.N.Y. 2015)
The investment bank that entered into an Agency Disposal Agreement with a secured party that authorized the investment bank to sell the publicly traded stock collateral in the event of default could be liable for insider trading – but not for market manipulation – for selling the stock short after learning of a default and the likelihood that the secured party would instruct it to sell the collateral, thereby causing the stock price to fall. Genuine issues of fact remained as to whether the information was non-public and confidential.

Amegy Bank v. Deutsche Bank Alex.Brown,
2015 WL 4718885 (11th Cir. 2015)
Sufficient evidence supported the jury's verdict that a broker colluded with its customer to violate the rights of a lender with a security interest in the customer's stock, and hence was not shielded by § 8-115 from liability for conversion, because there was evidence from which the jury could infer that the broker knew that the customer's conduct – redeeming a partnership interest in exchange for stock in the corporate general partner and then immediately liquidating the stock – was an effort to violate the secured party's rights and there was evidence that the broker provided substantial assistance to the debtor by setting up a margin account, personally picking up the certificate from the debtor's office, selling the stock without reviewing the certificate, and wiring the proceeds to the debtor's bank account the next day.

Sourcing Management, Inc. v. Simclar, Inc.,
2015 WL 4587974 (N.D. Tex. 2015)
A judgment creditor stated a cause of action that the transfer of all of the debtor's assets, allegedly valued at $44 million, at a collusive private disposition under Article 9 with respect to a $9 million secured obligation, was both an actually fraudulent and constructively fraudulent transfer. Because the complaint alleged that the property disposed of was worth substantially more than the secured obligation, it was not excluded from the definition of "assets" under the UFTA. The creditor also stated a claim against the buyer for successor liability as a mere continuation of the debtor by alleging that the buyer entered into a collusive agreement to avoid the debtor's debts, that the buyer informed the debtor's customers that it was merely operating under a "new legal name," that the buyer retained many of the same employees, continued operations in the same location, and used the same telephone numbers, and that the debtor's shareholders became members of the buyer.

BANKRUPTCY

Property of the Estate

In re Alco Stores,
2015 WL 4529780 (Bankr. N.D. Tex. 2015)
State money transmitter statutes, which impose an express trust in favor of the distributor of stored value cards on the sale proceeds attributable to the cards, result in a floating trust only on the proceeds and the assets commingled with the proceeds, not on all the assets of the retailer. Because the commingled assets of the retailer no longer exist – *i.e.*, the bank account into which the proceeds of stored value cards had been deposited was fully dissipated – the distributor's trust corpus was exhausted. As a result, the distributor had no interest in the retailer's other assets and had merely an unsecured claim against the retailer's bankruptcy estate.

In re Dryden Advisory Group, LLC,
2015 WL 4596335 (Bankr. M.D. Pa. 2015)
The debtor's prepetition factoring of its accounts was a sale, not a loan, because: (i) the agreement described the transaction as a sale; (ii) the agreement required the debtor to hold proceeds of the factored accounts "in trust and safekeeping," indicating that the proceeds would not be commingled with the debtor's other assets; (iii) the agreement gave the factor the right to demand payment directly from the account debtor; and (iv) the factor had the risk that the account debtors would not be able to pay (although the debtor had the risk that the account debtors had a defense to payment). Therefore, the accounts were not property of the debtor's bankruptcy estate.

Avoidance Powers

In re C.W. Mining Co.,
2015 WL 4717709 (10th Cir. 2015)
Because the § 547(c)(2) preference defense refers to the ordinary course of business or financial affairs *of* the debtor and the transferee, not *between* the debtor and the transferee, the first transaction between the debtor and a creditor can qualify for the defense. Although a new debt that is large, unprecedented for the debtor, and undertaken only because the debtor is sliding into bankruptcy might not qualify for the defense, the debtor's incurrence of $805,000 in debt to purchase used equipment to permit it to change its operations from a continuous-mining method to a longwall system, thereby increasing its mining capacity by a factor of four to five, was in the ordinary course of its business.

Other Bankruptcy Matters

In re Talbut,
2015 WL 5145598 (Bankr. N.D. Ohio 2015)
Although the term in the operating agreement for a LLC giving the LLC the option to purchase a member's interest in the event the member files a bankruptcy petition was an unenforceable *ipso facto* clause, another term giving the LLC a right of first refusal before any transfer of a membership interest was enforceable. Consequently, the bankruptcy trustee for one member would not be permitted to sell the debtor's membership interest absent evidence that the trustee had complied with the right of first refusal.

LENDING & CONTRACTING

InterDigital, Inc. v. Wistron Corp.,
2015 WL 4537133 (D. Del. 2015)

A clause in a patent license agreement providing that the parties "irrevocably consent to exclusive jurisdiction and venue of the state and federal courts in the state of Delaware" bound the defendant to the plaintiff's choice of a Delaware state court as the forum and operated as a waiver of the right to remove to federal court.

Solaria Corp. v. United States,
2015 WL 5116760 (Fed. Cl. 2015)

A prospective borrower did not state a claim for breach of contract against a government corporation that had entered into a commitment letter for a $30 million loan because the letter expressly permitted the corporation to terminate its obligations if, "in its sole judgment, [it] is not satisfied with the results of its due diligence investigation," and the investigation raised several concerns. The prospective borrower also did not state a claim for breach of the duty of good faith even though it alleged that the corporation cancelled the loan for political embarrassment – that is, the corporation did not want the circumstances of the loan to be publicized and contrived false reasons to terminate it – because the commitment letter expressly authorized the corporation to terminate based on its sole judgment, and the duty of good faith does not impose obligations inconsistent with an agreement's express terms.

Proficio Bank v. Wire Source, LLC,
2015 WL 5126335 (D. Utah 2015)

A partial owner of a limited liability company which, in connection with a loan to the LLC, represented and warranted that, to its knowledge, all the LLC's accounts "which have been reported" to the lender are genuine, and that the LLC "is solvent" did not make any representations or warranties about future events. Although the document also stated that the representations are "continuing and irrevocable" for as long as the LLC was indebted to the lender, this language did not expand the representations and warranties to future events; it merely set the time in which the owner was required to stand by its representations and warranties.

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