Vague Terms in Collateral Description Bring Partial, Pyrrhic Victory to Secured Party

A recent federal court decision provides some valuable lessons on how to describe—and how not to describe—the collateral in a security agreement.

The case, *FSL Acquisition Corp. v. Freeland Systems*, LLC, 2010 WL 605701 (D. Minn. 2010), arose out of the purchase by Kardia Health Systems of the assets of Freeland Systems, LLC. Kardia paid about 40 percent of the $10 million purchase price up front and agreed to pay the balance

in two years. To secure the debt, Kardia gave Freeland a security interest in "(i) all Purchased Assets identified on the Bill of Sale [and] (ii) all renewals, substitutions, replacements, accessions, proceeds, and products of the Purchased Assets."

A recent federal court decision provides some valuable lessons on how to describe—and how not to describe—the collateral in a security agreement.

Court Disposes of Fraud Claim. Kardia defaulted and sued Freeland for fraud. Freeland responded by notifying Kardia that it proposed to sell certain software and customer lists that it claimed were part of the collateral. Kardia sought a preliminary injunction forbidding the sale.

The court ruled it unlikely that Kardia would prevail on its claim of fraudulent inducement. The court noted that if the software was as defective as Kardia now complained, why had Kardia used it and paid for it for more than one year without complaint? Moreover, Kardia had represented in the purchase agreement that it was a "sophisticated purchaser and had made its own investigation, review, and analysis" of the assets purchased. The court concluded that if the jury believed these assertions, it would be skeptical of Kardia's fraud claim. In the alternative, if the jury did not believe that Freeland had provided full access to relevant information, then Kardia would have to explain why it signed the agreement representing the opposite. Accordingly, the court rejected the alleged fraud as a basis for enjoining the sale.

Cross-References in Collateral Descriptions Are Okay. The court then moved to Kardia's alternative argument that the software and customer list were not adequately described in the security agreement, and hence were not part of Freeland's collateral. On this issue, the court ruled in part for each party. It concluded first that the collateral description was adequate to cover the software and customer lists generated prior to closing because these items were identified in the Bill of Sale that was referenced in the security agreement, and were thus "objectively determinable." This ruling was undoubtedly correct. Article 9 requires merely a "reasonable" description of the collateral, and there is no reason that the description in a security agreement cannot be through a cross-reference to another document.

But How Do You Categorize Customer Lists? However, the court then concluded the collateral description did not cover software and customer lists developed or acquired after the closing. Here is where the analysis gets particularly interesting. Recall that the security agreement covered "renewals, substitutions, replacements, accessions, proceeds, and products" of the original collateral. Freeland did not argue that the revised software or updated customer lists were "accessions" or "proceeds" of the original collateral, but it did argue that they were "products," "substitutions," or "replacements." The court rejected all three contentions.

Customer Lists are Not "Products" of Software. Even though Kardia could not have developed the new customers without the software purchased, the court ruled that updated customer lists were not "products" of described collateral. In contrast to milk, which is the product of a cow, the court stated that "[a] customer is not the product of software he uses, any more than a milk drinker is the product of the cow whose milk he drinks." This statement is, of course, slightly off the mark. Freeland was not suggesting that the *customers* were products of the software, it was arguing that Kardia's revised *customer lists* were products of the software used to generate business and licensed to customers. Still, the court's conclusion is probably correct. It is a stretch to say that a customer list is the product of the software licensed to customers.

Nor Are They "Substitutions" or "Replacements." The court then ruled that revised software and updated customer lists were not substitutions or replacements because, even though the old software and customer lists may have been superseded, they are not "displaced." Moreover, parol evidence indicated that the parties had discussed including in the collateral description "additions" to the purchased assets and "present and future general intangibles," but had rejected both.

As a result, Kardia was likely to prevail on the merits and the court enjoined the sale. Freeland was apparently permitted to sell the original software and the original customer lists, but that was likely a pyrrhic victory. Those items were two years old and were probably of very limited value.

Two Lessons from the Case. There are two lessons here for secured parties and their counsel. First, make sure you understand how the collateral may change in form and value when it is dynamic and evolving over time. The key point in time is not when the security interest is created, but when it is to be enforced. Items such as customer lists and software can become obsolete—and therefore valueless—very quickly.

Second, if after-acquired property is to be covered, make that clear. It is very risky to rely on the terms used by FSL Acquisitions—"renewals," "substitutions," "replacements," "accessions," and "products"—or upon other similarly

unclear terms such as "additions" or "profits."

Many of these terms have no obvious meaning. A "renewal" probably covers an agreement to extend the maturity of a collateralized promissory note or lease, but what does it mean with respect to equipment or inventory? "Substitutions" and "replacements" probably cover new equipment that replaces old, but it may not if the debtor continues to use or even simply retains the old equipment.

More about "Accessions." "Accessions" is a defined term in Article 9, but nothing requires that parties express themselves in their private contracts in the same manner that the law speaks. *See* UCC § 9-102(a)(1). There is no reason that the court must look to the Article 9 definitions when interpreting a security agreement. Indeed, the security agreement in this case referred to "accessions ... of" the original collateral, as if the accessions were things attached to collateralized goods. This is probably consistent with prevailing practice. But Article 9 uses the term quite differently. When goods are physically united with other goods in such a manner that their identity is not lost, Article 9 refers to the original collateral as accessions to the "other goods," not the other goods as accessions to the original collateral. *See* UCC § 9-335(b) & Comment 3. Thus, if the term "accessions" was added to a description of the collateral and was imbued with the meaning given by Article 9, the term would add nothing to the scope of the collateral.

A Closer Look at "Products." Article 9 does not define the term "products," but Comment 4(c) to UCC § 9-104 does refer to "products of crops or livestock" and old Article 9 expressly referred to eggs as the products of chickens, milk as the product of dairy cows, and suggested that sap, maple syrup, and maple sugar are all products of maple trees. *See* UCC § 9-109(3) & Comment 4 (repealed). Thus, it appears that products include goods that are produced—perhaps through natural processes—by other goods. Honey is the product of bees and apples are the product of an apple orchard. Less clear is whether the quarters in a coin-operated arcade game are products of the game machine or whether lumber is the product of the saws and planes of a lumber mill. The court in *FSL Acquisitions* did say that "widgets are the product of widget factories," but this statement was dicta and not something on which creditors should pin their hopes.

References to "Profits" and "Additions" Can Be Ambiguous. The term "profits" probably does not mean revenue in excess of expenses. In all likelihood it is instead a derivation of the French phrase *profit à prendre*, a real estate term that means a right to enter another's land and remove something of value, such as by mining, logging, or hunting. It is not clear what it means when the collateral is personal property. The court in *FSL Acquisitions* made much of the fact that the security agreement did not include "additions" to the collateral, implying that the word means after-acquired property of the same type as the described collateral. That is certainly a possible meaning of "additions," but it could just as easily refer to property physically added to the collateral, as a new wing might be an addition to an existing building. For example, equipment comprised of robots and conveyors in an automated production line might be added onto by an addition of packaging machines. Such an addition may also qualify as an accession (or, more properly, as other goods to an accession), but it may not if the new machines are appended without being "physically united."

Parting Thought: Don't Rely Too Much on Vague Terms. There is no harm in including these vague terms in the collateral description. They occasionally can cover something valuable and important to the secured party. The harm comes in *relying* on these vague terms to cover the property the secured party needs to be included in the collateral. Remember also that the security agreement is likely to be interpreted against the drafter, which is typically the secured party, so any question about coverage will usually be decided against the creditor.

This article was written by Stephen L. Sepinuck, a Professor at Gonzaga University School of Law. Professor Sepinuck is the former chair of the UCC Committee of the American Bar Association and currently the ABA Advisor to the Joint Review Committee for Article 9 of the UCC.

CLARKS' SECURED TRANSACTIONS MONTHLY (ISSN 0895-5492) is published monthly by A.S. Pratt & Sons, 805 15th St. NW, Third Floor, Washington, DC 20005.