A Cautionary Tale

Stephen L. Sepinuck

This is a story about caution, perhaps excessive caution. The story is true but, in the interest of caution, the names were changed. Actually, the facts have been altered too, out of more caution. Still, there is a nugget of truth. I swear.

Four Bs Barbeque, LLC ("Four Bs") is a Delaware entity that owns and operates Four Bs BBQ restaurants, mostly in the Midwest. It also is a franchisor, with a dozen franchisees operating a total of 20 Four Bs BBQ restaurants, again mostly in the Midwest.

Four Bs wishes to expand to other geographic areas and has approached Bank for a loan. The loan is to be secured by all of Four Bs’ personal property, which Four Bs claims is currently unencumbered. Bank searched for UCC financing statements filed against Four Bs in Delaware and in every other state in which Four Bs operates. Of course, assuming that Four Bs had never been located in a state other than Delaware, it was not necessary to search anywhere other than Delaware. Bank was simply being cautious.

Although Four Bs has no secured debt, two dozen financing statements were disclosed in response to Bank’s searches. All of these financing statements list a franchisee as the debtor. The franchisees are all registered entities and each has a name quite different from Four Bs’ name, but the secured parties that filed those financing statements – in an abundance of caution – provided as an additional name for the franchisee the name under which it operates: “Four Bs Barbeque.” Although that name lacks the “LLC” designation that is part of Four Bs’ name, and the comma before that designation, the search logic used by each of the filing offices where the financing statements were filed ignores such designations and all punctuation. Consequently, the financing statements were disclosed in response to a search for financing statements filed against “Four Bs Barbeque, LLC.”

Although Bank can safely ignore any of these financing statements filed in a state other than Delaware, Bank cannot ignore the financing statements filed in Delaware. That is because even though each of these financing statements clearly relates to a franchisee, not to Four Bs, each such financing statement would be effective to perfect a security interest that the filer has in the personal property of Four Bs (assuming such personal property comes within the collateral description in that financing statement). The fact that these financing statements each has a slight error in the name of Four Bs (each omits “, LLC”) would not render them ineffective because each was disclosed in response to a search against Four Bs’ correct name. Moreover, each of those financing statements could be effective to perfect a security interest that the filer later acquires in the personal property of Four Bs, and to give that security interest priority over Bank’s security interest perfected by a later filing. In short, Bank needs to contact each of the filers and get each to either: (i) clear up the public record; or (ii) subordinate to Bank’s security interest any security interest it has or later acquires in the personal property of Four Bs.

Unfortunately, Article 9 itself gives Bank and Four Bs little leverage in this process. There is a process by which a debtor that did not authorize the filing of a financing statement may demand that a secured party file a termination statement, and if the secured party fails to do so, the debtor may. However, each of the filed financing statements was, presumably, authorized by the franchisee that was also listed as the debtor. It is highly doubtful that Four Bs could use this procedure to demand or file a termination statement. The filer of each such financing statement would undoubtedly refuse a request to file a termination statement because doing so would render its security interest in the property of the franchisee unperfected. Moreover, Bank could not rely on a termination statement filed by Four Bs after such a refusal by the filer because Four Bs’ authorization to do so under these circumstances would be far from certain. Moreover, if Four Bs did so at Bank’s insistence, Bank might incur tort liability to the filer. In short, Article 9’s rules for filing termination statements were not designed
for financing statements that identify multiple debtors if a security interest continues in the personal property of one of the listed debtors.

Article 9 does contain rules for amending a filed financing statement, and such an amendment could include deleting a debtor’s name. However, it contains no rule mandating the filing of an amendment. So, that process too is at the mercy of the filer. Bank and Four Bs might have some leverage though. Each of the filed financing statements that lists “Four Bs Barbeque” is a cloud on the title to the personal property of Four Bs. In other words, it is defamation of title, a tort recognized in most jurisdictions. However, as of the date of this newsletter, the laborious process of contacting all the filers has just begun. It remains to be seen whether Bank and Four Bs will be successful in getting amendments filed or subordination agreements.

**Concluding Thoughts**

Bank could, in the exercise of reasonable commercial judgment, conclude that the filers are currently creditors of the franchisees, not of Four Bs. It could also conclude that the risk that any of them will later become a creditor of Four Bs and acquire a security interest in its assets is remote, and that Bank therefore need not be concerned about any of the filings. But Bank and its lawyers should not be faulted for their caution in this matter. Banking requires the assessment and minimization of risk, and there is some risk here, even though it is probably minimal.

Those who drafted the financing statements filed against the franchisees, however, are not so blameless. Although Article 9 makes it clear that listing a debtor’s trade name, in addition to its correct name, is neither necessary nor effective, these drafters nevertheless chose to include that information. This was not an abundance of caution, this was an overabundance – a useless act that will cause problems for unrelated parties and probably a bit of a hassle for the secured parties of record.

Of course, it is often only in hindsight that one can distinguish an abundance of caution from an overabundance. And it is probably tilting at windmills to suggest that transactional lawyers refrain from drafting that which is unnecessary. Moreover, so some might argue, it is better to include the debtor’s trade name and avoid any doubt about whether a financing statement is effective to perfect, given that the small risk of tort liability can probably be dealt with by later amending the financing statement. So, how is this problem to be prevented from recurring?

**A cautious franchisor should include in the franchise agreement a clause prohibiting the franchisee (at least one located in the same jurisdiction as the franchisor) from authorizing the filing of any financing statement that includes as a name of the debtor either: (i) the franchisor’s name; or (ii) any other name that would cause the financing statement to be disclosed in response to a search of the franchisor’s correct name. That might not prevent this problem, but at least it should help ensure that the franchisees will assist the franchisor in resolving it.**

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**Notes:**

1. This is not a takeoff on Five Guys, the makers of burgers; it is a nod to the division winning Boston Red Sox and their corps of killer B’s: Benintendi, Betts, Bogaerts, and Bradley. Congratulations to the Bosox for winning the most games in a regular season in the history of the team!

2. Under Article 9 of the UCC, a registered entity is “located” in the state in which it is registered. U.C.C. § 9-307(e). This is true regardless of where it has its offices or conducts its business. It is therefore difficult for a registered entity to relocate. While a registered entity can reincorporate in a different state (and even convert from one type of registered entity to another in the process), such a transaction normally involves a merger and the transfer of assets from the initial entity to the new entity. See U.C.C. § 9-316 cmt. 2. However, with respect to any such reincorporation or entity conversion, it is important to check applicable state law on whether it results in a new entity. For example, Delaware law allows a corporation to convert to a limited liability company and provides that, upon doing so, the new entity “shall, for all purposes of the laws of the State of Delaware, be deemed to be the same entity as the corporation.” Del. Code Ann. tit. 8, § 266(h). See also Del. Code Ann. tit. 6, § 18-214(g) (dealing with foreign entities converting into Delaware LLCs). Some state statutes are unclear on this point. See, e.g., Ohio Rev. Code. § 1705.391 (providing that “[t]he converting entity is continued in the converted entity” but also providing that “[t]he converted entity exists, and the converting entity ceases to exist”).

3. In general, to perfect a security interest, a financing statement must be filed in the state where the debtor is located, see U.C.C. § 9-301(1), and a registered entity such as Four Bs is located in the jurisdiction under whose
law it is organized, U.C.C. § 9-307(e). While a fixture filing
should be made in the jurisdiction where the fixtures are
located, rather than where the debtor is located, see U.C.C.
§ 9-301(3)(A), such a fixture filing would be in the office
designated for the filing of real property records – typically a
county office – not the state-wide office where financing
statements are filed. See U.C.C. § 9-501(a).

4. See, e.g., IACA, Model Administrative Rule
503.1.3(b), (c) (2015) (referring to such designations as
“ending noise words”).

5. See supra note 3. A financing statement filed in an
incorrect location is ineffective to perfect, and a perfected
security interest of another creditor will have priority
even if the creditor knows of the incorrectly filed
financing statement. See U.C.C. § 9-322 cmt. 4, ex. 2.

On the off chance that Four Bs relocates to a state in
which such a financing statement has already been filed,
see supra note 2, the filed financing statement would be
effective to perfect a security interest of the filer against
Four Bs, but whether it would be effective as of the date it
was filed, so as to give the filer’s security interest
priority over Bank’s, is less clear. When U.C.C.
§ 9-322(a)(1) speaks, for the purposes of priority, about
the first to file or perfect, it is implicitly referring to an
effective filing. The filing outside of Delaware was not
effective when made because Four Bs was not located
there. Although U.C.C. § 9-322 comment 4 indicates that
a financing statement that was unauthorized at the time it
was filed – and hence ineffective when filed – can
nevertheless be effective to ensure priority (if later
authorized), a reasonably diligent searcher should find
such a filed financing statement. Even a very cautious
searcher should not be expected to search for filings in
states in which the debtor is not located, just because
the debtor might later relocate to such a state.


7. See U.C.C. § 9-332(a)(1) & cmt 4 (indicating that a
financing statement that was unauthorized when filed is
still effective to ensure priority from the time of filing if
it is later authorized).

An easier approach would be for Bank to set up an
estoppel against the filers. To do this, Bank would send
each filer a letter stating that: (i) Bank is in the process
of providing secured credit to Four Bs; (ii) Bank
understands that the filer has identified Four Bs in its
filing but that the filer’s debtor is actually a franchisee;
and (iii) if the filer has or intends to acquire a security
interest in the assets of Four Bs it should notify Bank
immediately. However, it is uncertain whether this
approach would estop any of the filers from providing
credit to Four Bs in the future and obtaining a security
interest with priority over Bank’s security interest.


10. See U.C.C. § 9-509(d)(2).

11. See U.C.C. § 9-512. Subsection (e) makes
ineffective an amendment that deletes all debtors,
implying that an amendment that deletes less than all of
the debtors listed would be effective.

12. See Restatement (Second) of Torts §§ 623A,
624. Several jurisdictions have codified this cause of
action. See, e.g., Tex. Bus. & Com. Code § 9.5185(a);
Wis. Stat. § 706.13(1). See also U.C.C. § 9-625(b),
(e)(4) (providing for compensatory and statutory damages
for failure to file a statutorily required termination
statement). Such claims are difficult to win, however.

See, e.g., Quintanilla v. West, 534 S.W.3d 34 (Tex. Ct.
App. 2017); Fischer v. Bar Harbor Banking & Trust Co.,
857 F.2d 4 (1st Cir. 1988) (because the bank possessed
the qualified privilege of a rival claimant to the property,
the plaintiff has the burden of showing that the bank did
not have a good faith belief in the possible validity of its
claim to have a successful defamation of title); First
Security Bank of Bozeman v. Tholkes, 547 P.2d 1328
(Mont. 1976) (no claim that filing of financing statement
constituted slander of title in absence of averment of
special damages). But cf. Primary Residential Mortgage,
(affirming judgment awarding damages for slander of
title).

13. No doubt the security agreement between Bank and
Four Bs would prohibit Four Bs from granting a security
interest to anyone else, especially the prior filers, but of
course Four Bs could violate that covenant.

14. See U.C.C. § 9-503(b)(1), (c). See also § 9-506 cmt.
2 (“Searchers are not expected to ascertain . . . trade
names . . . by which the debtor may be known and then
search under each of them.”).
Prize Announcement

Congratulations to Michael Avidon, of Moses & Singer LLP, for winning the Explicitness Prize.

The June issue of this newsletter included an article entitled Gotcha!: Caught in the Explicitness Trap, which discussed various rules of explicitness in contract law. At the end of the article, readers were invited to submit information about additional rules of explicitness, with a prize to the first person who submitted a message describing what, in the sole judgment of the editors of the newsletter, is the worst of these rules of explicitness.

Mike reminded us that UCC § 5-103(c) makes a general waiver of liability and general limitations on remedies ineffective to vary obligations imposed by Article 5. As Mike put it, “[p]uty the issuing bank whose letter of credit reimbursement agreement simply and clearly states that the bank is entitled to be fully reimbursed for all payments that it makes under a letter of credit, whether or not legally obligated or permitted to honor, so long as the bank acted in good faith and without gross negligence. The statute and Official Comment 2 may get thrown in its face if the bank acted improperly in any respect under the letter of credit and the well-represented applicant does not wish to reimburse it.”

A new Gonzaga Bulldogs baseball cap is on its way to Mike. Go Zags!

Recent Cases

SECURED TRANSACTIONS

Attachment Issues

Jipping v. First National Bank Alaska,
2018 WL 4001719 (9th Cir. 2018)
Although the debtor’s first security agreement with a bank granted the bank a security interest in the debtor’s deposit accounts and expressly stated that the security interest would “continue in effect even though all or any part of the Indebtedness is paid in full,” because that secured obligation was paid off and the debtor’s subsequent security agreement with the bank did not list deposit accounts as collateral and contained a merger clause stating that the subsequent agreement, “together with Related Documents, constitutes the entire understanding and agreement” of the parties, the bank’s later loan was not secured by deposit accounts. The original security agreement was not a Related Document because it was not executed in connection with the subsequent loan.

In re Flechas & Associates, P.A.,
2018 WL 4162195 (Bankr. S.D. Miss. 2018)
The individuals that purported to purchase a fraction of an individual lawyer’s right to a contingency fee did not have a lien or other interest in the right to the fee because the lawyer’s law firm, not the lawyer himself, was the entity that contracted with the clients and had the right to the fees.

Mac Naughten v. Harmelech,
A lawyer who acquired no security interest in his clients’ assets because the security agreement described the collateral as “all real or personal property wherever located,” which was not a reasonable description, could not unilaterally amend the security agreement and sign the clients’ names even though the original agreement contained language granting the lawyer permission “to sign [the clients’ names] to any UCC-1 or other documents reasonably necessary to perfect the security interest in the Property.” That language deals with perfecting the security interest, but there was no security interest to perfect.

In re WB Services, LLC,
An unpaid seller of heaters did not have a security interest in the heaters pursuant to § 2-401 even though the sales agreement provided that the seller retained title until the buyer made payment because the seller still had possession of the heaters. Thus, the seller was not entitled to summary judgment on the preference claim brought by the buyer’s bankruptcy trustee to recover prepetition payments on the basis that § 547(b)(5) was not satisfied.
Perfection Issues


Filed financing statements that described the collateral as “[t]he pledged property described in the Security Agreement attached as Exhibit A hereto,” and which attached the security agreement, were nevertheless ineffective to perfect because the attached security agreement did not define the pledged property and instead referenced a bond resolution that defined the term but which was not attached. It did not matter that the bond resolution was a publicly available document because it was not filed with the UCC records. Amendments to the financing statements that did describe the collateral were also ineffective because, by the time they were filed, the debtor’s name had changed so as to make the name listed for the debtor in the originally filed financing statements seriously misleading, and the amendment did not correct the debtor’s name.

In re 180 Equipment, LLC, 2018 WL 4006294 (Bankr. C.D. Ill. 2018)

A filed financing statement that described the collateral solely as “[a]ll Collateral described in First Amended and Restated Security Agreement dated March 9, 2015 between Debtor and Secured Party,” but which did not attach the referenced security agreement, was ineffective to perfect. While § 9-108(b)(6) provides that any method of identifying the collateral is sufficient “if the identity of the collateral is objectively determinable,” the collateral description in the financing statement was effectively blank, and that is not objectively determinable even though it might have put searchers on notice that the secured party claimed a security interest in some assets of the debtor.

Priority Issues

In re Energy Future Holdings Corp., 2018 WL 3752231 (3d Cir. 2018)

The first-lien lenders who funded the debtor’s Deposit L/C Loan Collateral Account did not have priority over the other first-lien lenders in the remaining balance of that account when the credit facility ended because the intercreditor agreement gives all the first-lien lenders pari passu priority in all the collateral. While the credit agreement gives priority in the Deposit L/C Loan Collateral Account to pay “Deposit L/C Obligations,” the first-lien lenders who funded that account are not owed such obligations.


A bank with a perfected security interest in the debtor’s assets was entitled to the insurance proceeds for a destroyed item of equipment because the trust that initially perfected a security interest in equipment had allowed its financing statement to lapse, and thus its security interest had become unperfected. Although the trust claimed that, when its security interest was perfected, it repossessed the collateral and then leased it back to the debtor, nothing in the record supported that allegation. Although the trust’s contract with the debtor provided for title to revert back to the trust upon default, that language did nothing more than create a security interest. Although the trust was a loss payee on the insurance policy, that did not give the trust any greater rights to the proceeds.

Enforcement Issues


The holder of a promissory note that called for payment of $35,200 per month until the entire $2.5 million was paid had no claim to have the payment obligation accelerated despite the maker’s default because the note provided that late payments give rise to a default when they are outstanding as of the “Maturity Date,” which is defined as the seven-year anniversary of the note. For the same reason, the holder could not enforce the terms of the note providing for a security interest in specified collateral.


A motorcycle dealer that had no arbitration clause in its sales agreement with a customer could not, in connection with the customer’s class action against the dealer for negligence, false advertising, unfair competition, and violations of the Consumers Legal Remedies Act, invoke the arbitration clause in the customer’s agreement with the lender that financed the purchase. The arbitration clause did not mention the dealer and while the clause did mention the lender’s agents, the dealer was not the lender’s agent and, even if it were, the customer’s claims were made against the dealer in its own capacity, not in its supposed capacity as the lender’s agent.
Liability Issues


A client of a futures commission merchant had no claim against the merchant for ordering the client to liquidate the client’s account when the client failed to meet a margin call, even though that allegedly resulted in losses of $266 million, which was $115 million more than the client would have suffered if the client’s trading procedures were followed. There was no breach of contract because the agreement expressly authorized the merchant’s actions. It also gave the merchant a security interest in the assets credited to the account and gave the merchant broad rights to protect and preserve its security interest, including the right to instruct the client to conduct an immediate bulk sale. Given the extreme volatility at the time, the court would not second guess the reasonableness of the merchant’s instructions.


A factor that purchased a contractor’s accounts was not liable to an unpaid subcontractor under the Texas Construction Trust Fund Act for misappropriation of trust funds because the factor was not a “trustee” within the meaning of the Act.


A car dealership that sold a retail installment contract to a lender, and which pursuant to the sales agreement was obligated to “file and/or record all documents necessary to reflect a valid and enforceable first priority security interest” in the vehicle sold, breached that obligation by failing to perfect the security interest even though there was no other lien on the vehicle. Pursuant to the sales agreement, the dealership was therefore obligated to repurchase the installment contract. Damages would not be reduced by the amount that might be recovered by foreclosing on the vehicle, although the lender would be required to assign the contract back to the dealership upon payment.


Although a secured party was entitled to a default judgment against the debtor for the amount of the debt and, pursuant to the security agreement, for the attorney’s fees incurred in enforcement, the secured party could not recover the attorney’s fees of its national counsel that drafted the complaint but failed to be admitted pro hac vice or to appear and participate in the local action. The court relied on cases dealing with an award of attorney’s fees authorized by state statute, not by contract.


An entity formed by a secured party to receive and operate the assets of the debtor after the secured party acquired the assets by credit bid at a foreclosure sale had successor liability for the obligations of the debtor. The entity operated the same business by producing the same product, albeit in a different manner, in the same facilities, with the same employees, and selling them to the same customers. There was commonality of leadership and ownership because two voting members of the debtor’s board of directors became directors of the new entity and the secured party, which owned 21% of the debtor, owned 94% of the new entity. The new entity held itself out as a continuation of the debtor by using the same brand name and trademark, the same telephone and fax numbers, and the same website. And, the new entity paid over $1 million of the debtor’s obligations to critical vendors to maintain the business.

Bankruptcy

Claims & Expenses


Because the purchase agreement, pursuant to which a university acquired real property subject to a use restriction, was non-assignable, the university’s claim for breach for failing to get the restriction removed was not assignable. Thus, the claim filed by the entity that subsequently purchased the real property from the university and purported to receive an assignment of the breach of contract claim was disallowed.

Automatic Stay & Injunctions

*In re Peake*, **2018 WL 3946169** (Bankr. N.D. Ill. 2018)

A city that prepetition had impounded a vehicle for unpaid tickets and postpetition refused to release the vehicle to the Chapter 13 debtor until confirmation of a plan treating the city as a fully secured claimant violated the automatic stay. Although the city did have an interest in the vehicle and that interest would become unperfected if the city relinquished possession, the city’s conduct was not excepted from the stay by § 362(b)(3). Retention of the vehicle is not an act to continue or maintain the perfection of its interest in the vehicle because section 362(b)(3) contemplates a definite, positive act to continue or maintain perfection, such as filing a continuation statement under the Uniform Commercial Code.
Avoidance Powers

In re Dependable Auto Shippers, Inc.,
An accounts financier that, one day before the debtor filed for bankruptcy, was paid off with funds loaned to the debtor by another lender two days earlier did not receive an avoidable preference because the funds were earmarked for payment to the accounts financier, and thus were not property of the debtor. Although the loan documents lacked a provision expressly stating that the loaned funds were to be used to pay the accounts financier, contained a merger clause, and declared that there were no third-party beneficiaries, extrinsic evidence – including the need for the accounts financier to be paid off so that it would release its existing security interest, thereby allowing the new lender to have a first-priority security interest – demonstrated that the debtor was obligated to use the loaned funds to pay the accounts financier.

In re Evergreen International Aviation, Inc.,
Although a corporate parent might not, if its subsidiaries are all insolvent, indirectly benefit from credit extended to its subsidiaries, and thus not receive reasonably equivalent value in exchange for its downstream guaranty of the subsidiaries’s obligations, the trustee submitted evidence that only some of the subsidiaries were insolvent. Consequently, the trustee was not entitled to summary judgment.

Lending & Contracting

In re Rychman Creek Resources, LLC,
The owner of 80% of the equity in a reorganized LLC, which sent notification that it was exercising its call option with respect to the remaining 20%, could not withdraw that “offer” merely because it mistakenly thought the purchase price was $1.5 million rather than $11 million. The option itself was an offer and the owner’s notification was an acceptance.

Unison Co. v. Jul Energy Development, Inc.,
2018 WL 4426204 (D. Minn. 2018)
An arbitration panel that ordered rescission of the parties’ contract and restitution in excess of $400,000 did not exceed its authority. Even though the parties’ contract provided that “in no event shall [the aggrieved party] . . . be liable . . . for damages . . . in excess of ten percent (10%) of the Contract Price, regardless of whether such liability arises out of breach of contract, guarantee or warranty, tort, product liability, indemnity, contribution, strict liability, or any other legal theory,” because rescission is the complete undoing of the contract, the Panel’s determination on how to restore the parties to their pre-contractual positions was not constrained by any contractual provision.

Fuller Landau Advisory Servs. Inc. v. Gerber Fin. Inc.,
2018 WL 3768035 (S.D.N.Y. 2018)
An investment banking advisory service that found a buyer for a client and was therefore entitled to a success fee based on the purchase price and the amount of any debt “assumed” by the buyer, was not entitled to have the amount of debt that the buyer guaranteed included in the calculation. To “assume” a debt is to take on primary liability for it, not to guarantee it.

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Announcing the Second Edition of
Transactional Skills: How to Structure and Document a Deal
with Two Dozen New Exercises – Available October 22, 2018

This book is designed to help train law students in the skills needed for successful transactional lawyering. Through carefully designed text and exercises, the first part of the book helps students understand and strategically use the different types of contract terms, translate deal terms to precise contract language, use forms appropriately, and spot and resolve ambiguity. Students also practice deal design, due diligence, and negotiating contract language.

The second part of the book consists of four simulated commercial transactions through which students further develop their transactional lawyering skills by structuring, negotiating, and documenting a deal on behalf of a one of the parties to the transaction.

Most of the exercises are based on recent cases or the documents used in real transactions, and thus are both realistic and timely. The exercises are also scaffolded – that is, for each skill, they are presented in order of increasing length and complexity – to facilitate student learning. Throughout, the authors emphasize the importance of knowing the law applicable to the transaction and to each particular term, and how that knowledge should affect how a clause is drafted or a transaction is structured.

The book is accompanied by an extensive teacher’s manual that includes a detailed response to each problem and is supported by a companion web site on which are posted PowerPoint slides for teachers and electronic versions of documents that students are tasked with revising.