

# The Transactional Lawyer

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## Managing the Risk of Legal Error in Arbitration

**Stephen L. Sepinuck**

### A CAUTIONARY TALE

Arbitrators sometimes make mistakes. Sometimes spectacular mistakes. Consider the case of Martin Evans. He and Craig Nielsen purchased several H&R Block franchises, with each franchise owned by a separate limited liability company. Nielsen provided financing for Evans, who signed a promissory note for the amount due. The note provided that, upon default, Nielsen was authorized “to charge or setoff all sums owing on the debt” against Evans’ interests in the LLCs. Evans did default and Nielsen proposed to keep the LLC interests in full satisfaction of the debt. Evans objected and brought an action seeking a declaration that Nielsen’s seizure of the LLC interests was ineffective and that Evans remained a member of the LLCs.

The matter was referred to arbitration pursuant to the parties’ agreement. The arbitrator ruled that Article 9 of the UCC did not apply because § 9-109(d)(10) generally excludes recoupment and setoff from the scope of the Article.<sup>1</sup> The arbitrator then added that, even if Article 9 did apply and even if Nielsen had failed to comply with § 9-620 by not obtaining Evans’ consent to Nielsen’s acceptance of the collateral in satisfaction of the debt, the acceptance was effective and Evans’ only right was to recover damages for the loss of a surplus.<sup>2</sup>

Both rulings are patently wrong. Setoff is a mechanism for netting mutual *debts*. A security interest, on the other hand, is an interest in personal *property* that secures a debt.<sup>3</sup> Evans’ interests in the LLCs were his personal property, not debts. Thus, the note provided for a security interest, not setoff. The fact that the note described Nielsen’s right as a “setoff” is immaterial: Article 9 applies to any transaction, “regardless of its form,” that creates a security interest.<sup>4</sup> The arbitrator’s ruling, if applied generally, would allow people to avoid application of Article 9 simply by labeling the creditor’s rights as a “setoff.” It is therefore bad policy in addition to being clearly erroneous.

Article 9 is equally clear that acceptance of collateral in satisfaction of the secured obligation is *ineffective*, not wrongful, unless the debtor consents after default.<sup>5</sup> Thus, if Evans timely objected to Nielsen’s proposal, as he apparently did, Evans remained the owner of his LLC interests.

Despite these errors, a Utah trial court confirmed the arbitration decision. In March, that ruling was affirmed on appeal.<sup>6</sup> The appellate court noted that the judiciary’s role is not to review an arbitrator’s award for legal error, but merely to determine whether the arbitrator exceeded his authority. The court then concluded that the decision was not so without foundation as to justify refusing to enforce it based on irrationality or manifest disregard for the law.<sup>7</sup>

For litigators and transactional attorneys alike, this case should be troubling. Arbitration is frequently touted not only as speedier, less expensive, and more confidential than litigation, but also as less prone to error because of the expertise and experience of the arbitrators. But if even flagrant errors of law cannot be corrected, two questions naturally follow: (i) how does the risk of legal error in arbitration differ from the risk in litigation; and (ii) how should transactional attorneys manage that risk to protect their client’s interests?

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### ASSESSING THE RISK OF ERROR

#### *Quantitative Risk of Error*

There are some reasons to believe that the risk of error is lower in arbitration than in litigation. First, arbitrators can be screened and chosen for their expertise

in the legal issues in dispute or for their familiarity with the parties' industry. Such was apparently not done in *Evans v. Nielsen*, however. The arbitrator in that case was a professor of clinical law experienced in dispute resolution, but with no apparent expertise in commercial law.

Second, arbitrators have a bit more freedom to confer and consult with third parties before rendering a decision. For example, under the rules of the American Arbitration Association, an arbitrator may obtain help from an associate, a research assistant or other person if the arbitrator informs the parties and the person providing help agrees to be bound by the confidentiality rule that binds the arbitrator.<sup>8</sup> In contrast, a judge may obtain written advice from a disinterested expert on the law only after giving advance notice to the parties and affording them the opportunity both to object and to respond to the advice received.<sup>9</sup> Despite this greater freedom afforded arbitrators, it is not clear that either arbitrators or judges avail themselves of this authority in anything other than an exceptional case.

On the other hand, there is one reason to think that the frequency of error in litigation might be less than in arbitration. Judicial decisions are a matter of public record. No judge likes to be wrong and most take the time to inform themselves about the law that applies to the dispute before them. Presumably, arbitrators too want to get the law correct – indeed their selection as arbitrator in future cases probably depends on their reputation – but the confidentiality of their decisions makes it difficult to assess their competence and correctness. Secrecy might beget sloth.

These countervailing considerations leave us with little guidance; each is merely an untested hypothesis about which process is more prone to an erroneous decision. Moreover, for several reasons, it is unlikely there will ever be a reliable, empirical study of the comparative frequency of error in arbitration and litigation. First, there is the normative or epistemological problem of determining which decisions are wrong. While the arbitrator's decision in *Evans v. Nielsen* was unquestionably wrong, such blatant errors are, one can hope, relatively rare. Instead, many errors will concern matters about which reasonable minds could disagree. It seems likely, therefore, that we could never have widespread consensus on which decisions were in fact erroneous. Second, not all errors are equivalent. Thus, even if we could quantify the rate of error, it is doubtful we could objectively determine the significance of those errors. Finally, too much of each data set is unavailable. Many judicial rulings at the trial court level never lead to a reported decision or even to an unreported decision

available on Lexis or Westlaw. Arbitrators are often not required to explain their reasons and the great bulk of arbitrations rulings are confidential. Moreover, there is no way to ensure that any sampling of either data set would be representative.

### *Qualitative Risk*

While the relative quantum of error might never be known, in at least one respect the risk of error in arbitration seems qualitatively different – and greater – than the risk of error in litigation. That is because an arbitrator's decision may be based on notions of justice and equity; it need not be consistent with the law.<sup>10</sup> Thus, for example, an action barred by the applicable statute of limitations might nevertheless lead to an arbitration award.<sup>11</sup>

Indeed, one distinguished commercial lawyer recently reported that he received arbitrator training several years ago from a national arbitration service. During that training, the group of prospective arbitrators was given a hypothetical involving an effort to collect a usurious loan and told that the penalty under applicable law for charging usurious interest was a forfeiture of the right to all interest. When asked how they would rule in the case, approximately one-third stated they would apply the law and prohibit the lender from recovering any interest. Approximately one-third said they would reduce the interest rate to the highest non-usurious amount. The remaining one-third stated that they would enforce the agreement as written despite the prohibition on usury. The trainers did not indicate that any of these ruling would be improper.

For these reasons, some arbitration decisions will be contrary to what the law requires. This is, of course, also true with respect to litigation,<sup>12</sup> but appellate review of judicial decisions provides an opportunity to correct legal errors by the trial judge. In contrast, judicial review of an arbitration decision – at least in federal court – is restricted to evidence that the award was procured by fraud or corruption, the arbitrator was patently partial to one side, the arbitrator's misconduct prejudiced one party's rights, or the arbitrator exceeded his or her authority.<sup>13</sup> Manifest disregard of the law *might* be an additional basis for a federal court to refuse to enforce an arbitration award, but that point remains in doubt.<sup>14</sup> What is clear is that parties cannot by agreement expand the bases for federal judicial review, such as by authorizing courts to review for any legal error.<sup>15</sup> The risk of legal error is, simply put, "the price of agreeing to arbitration."<sup>16</sup>

It is important to understand, however, that these rules apply only to review in federal court. A few states, such as New Hampshire, provide for a more expansive judicial review of arbitration decisions, including review for plain error.<sup>17</sup> In addition, at least one state – California – authorizes parties to provide in their arbitration agreement for judicial review of arbitration decisions based on legal error.<sup>18</sup> Nevertheless, most states, particularly those that have enacted the Revised Uniform Arbitration Act,<sup>19</sup> do not permit judicial review for legal error, even if the parties provide for it.<sup>20</sup>

### Strategies for Minimizing Risk of Error

If we accept the proposition that the risk of legal error in arbitration is greater than the risk of legal error in litigation – or if we simply want to reduce or manage that risk for whatever reason – there are four different strategies the transactional lawyer could employ.

*Require the Arbitrator to Follow the Substantive Law.* Contracting parties that expect their counterparts to strictly comply with their contractual and legal duties might choose to circumscribe an arbitrator's otherwise wide discretion to render a decision based on notions of justice and equity. They can do this by including in the agreement a requirement that the arbitrator's decision be based upon and consistent with the parties' legal rights. This should prevent an arbitrator from willfully disregarding the law in favor of some sense of justice or equity. However, it is doubtful that this approach would have any effect on unintentional error, such as apparently occurred in *Evans v. Nielsen*.

*Provide for Appeal to a Panel of Arbitrators.* The parties can provide for *non-judicial* review of an arbitration decision. For example, they can permit an appeal of the arbitrator's findings of fact and conclusions of law to an appellate arbitrator or to a panel of appellate arbitrators. Indeed, the rules of some arbitration organizations expressly envision an appeals process while those of others, such as the AAA, implicitly permit it.<sup>21</sup> If such review is desired, the arbitration clause in the parties' agreement should: (i) require the initial arbitrator to apply the law; (ii) require the initial arbitrator to state in writing the basis for the arbitrator's decision;<sup>22</sup> and (iii) specify the grounds for reversal on appeal, the standard of review, and the procedures to be followed.

*Provide for Judicial Review.* If applicable state law provides for judicial review based on legal error, the parties could require the arbitrator to follow the law and choose the state courts in that state as the exclusive forum for enforcing or challenging an arbitration award.

Alternatively, if applicable state law permits parties to expand the scope of judicial review to include legal error, the parties could require the arbitrator to follow the law, provide for judicial review based on legal error, and choose the state courts in that state as the exclusive forum for enforcing or challenging an arbitration award.

Unfortunately, providing for appeal to either a panel of arbitrators or a court undermines two of the principal benefits that arbitration purports to have: speed and lower cost. The process might still be a bit faster and less expensive than litigation due to less discovery and motion practice, but the parties have to pay the arbitrator whereas they do not pay a judge. Moreover, if the parties arrange for judicial review for legal error, a third principal benefit of arbitration – confidentiality – is also compromised. For these reasons, parties concerned about error might wish to rethink the decision to arbitrate at all.

*Reconsider Whether and What to Arbitrate.* There are some types of contracts and disputes for which arbitration might be particularly desirable. For example, a business that provides goods or services to consumers might want to require arbitration to avoid class proceedings or juries. Arbitration might also be appropriate with respect to a transaction involving trade secrets or confidential information which, if disclosed or made available publicly, might prompt or affect other litigation.

Finally, some businesses might want to arbitrate to help insulate themselves from – that is, to evade – the law. For example, a client who tends to charge usurious interest in a state with a significant penalty for doing so might wish to provide for mandatory arbitration in the hope that the arbitrator will not be inclined to enforce those penalties. Similarly, a buyer of structured settlement payments might attempt to use arbitration to bypass the statutory procedures designed to protect individuals from this somewhat predatory practice – although one somewhat notorious lender found that this did not work.<sup>23</sup> Of course, evading the law might not be the most legitimate reason to provide for arbitration and an attorney drafting an agreement that skirts the law should carefully consider whether doing so violates applicable ethical rules.<sup>24</sup>

On the other hand, there are several other situations for which parties might wish to avoid arbitration. One pair of arbitration advocates identified three:

- (1) high stakes (“bet-the-company”) disputes, in which the parties may fear an aberrational arbitration award subject only to limited judicial review

(2) disputes in which the parties anticipate needing emergency relief, which arbitration is ill-suited to provide; and

(3) disputes in areas with clear and well developed law and contract terms, because the industry expertise of arbitrators is of less value and the limited judicial review in arbitration more problematic.<sup>25</sup>

Transactional lawyers should carefully consider this list. The first item in particular seems predicated on the risk of legal error in arbitration. More generally though, transactional lawyers should consider that parties enter into written agreements in large measure to detail their legal rights. An agreement to arbitrate is, to some degree, an agreement to surrender those rights and allow an arbitrator to render a decision contrary to the law. Query if that is what the client really wants.

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#### Notes

1. Interim Award at 4 (Oct. 31, 2011).

2. *Id.*

3. See § 1-201(b)(35).

4. § 9-109(a)(1).

5. See § 9-602(a)(1), (b)(2), (c).

6. Evans v. Nielsen, [2015 WL 1325540](#) (Utah Ct. App. 2015).

7. *Id.* at \*3-6.

8. AAA [Code of Ethics for Arbitrators in Commercial Disputes](#), Canon VI(b) (2004).

9. [Code of Judicial Conduct for United States Judges, Canon 3\(A\)\(4\)\(c\)](#); ABA [Model Code of Judicial Conduct, Rule 2.9\(a\)\(2\)](#).

10. See AAA, [Commercial Arbitration Rules and Mediation Procedures](#), Rule 47(a) (2013) (“The arbitrator may grant any remedy or relief that the arbitrator deems just and equitable and within the scope of the agreement of the parties”).

11. Broom v. Morgan Stanley DW Inc., [236 P.3d 182](#) (Wash. 2010).

12. See Bayer Cropscience LP v. Texana Rice Mill Ltd, [2015 WL 1474393](#) (E.D. Mo. 2015) (citing to UCC § 9-322(a)(1) as the applicable priority rule but improperly describing it as a first-to-perfect rule, rather than a first-to-file-or-perfect rule, and reaching the wrong result).

13. See [9 U.S.C. § 10\(a\)](#) (applicable only to federal courts). See also [Cal. Civ. Pro. § 1286.2](#) (specifying the exclusive bases for a California court to vacate an arbitration award); General Mills, Inc. v. BCTGM Local 316G, [2014 WL 5100650](#) (N.D. Ill. 2014) (arbitrator exceeded her authority in case concerning employer’s discharge of an employee by awarding damages to the union).

14. Compare *Stolt-Nielsen S.A. v. AnimalFeeds Int’l Corp.*, [559 U.S. 662](#), 672 n.3 (2010) (suggesting that an arbitration decision may be reversed for a manifest disregard of the law, which “requir[es] a showing that the arbitrators knew of the relevant [legal] principle, appreciated that this principle controlled the outcome of the disputed issue, and nonetheless willfully flouted the governing law by refusing to apply it”); *LaTour v. Citigroup Global Markets, Inc.*, [544 F. App’x 748](#) (9th Cir. 2013) (upholding an arbitration award after reviewing it for manifest disregard of the law); *Wachovia Sec. LLC v. Brand*, [671 F.3d 472](#), 480-83 (4th Cir. 2012) (concluding after *Stolt-Nielsen* that manifest disregard of the law remains a basis for vacating an arbitration award); *Schwartz v. Merrill Lynch & Co., Inc.*, [665 F.3d 444](#), 451-52 (2d Cir. 2011) (same); *Broom v. Morgan Stanley DW Inc.*, [236 P.3d 182](#) (Wash. 2010) (a facial legal error is a basis for vacating an arbitral award because it indicates that the arbitrators exceeded their powers), with *Med. Shoppe Int’l, Inc. v. Turner Invs., Inc.*, [614 F.3d 485](#), 489 (8th Cir. 2010) (manifest disregard of the law is no longer a basis for vacating a arbitration award); *Frazier v. CitiFinancial Corp.*, [604 F.3d 1313](#), 1324 (11th Cir. 2010) (same); *Citigroup Global Mkts., Inc. v. Bacon*, [562 F.3d 349](#), 355 (5th Cir. 2009) (same). See also Michael H. LeRoy, *Are Arbitrators Above the Law? The “Manifest Disregard of the Law” Standard*, [52 B.C. LAW REV. 137](#), 180-81 (2011).

15. See *Hall Street Assocs. v. Mattel, Inc.*, [552 U.S. 576](#) (2008).

16. *Oxford Health Plans LLC v. Sutter*, [133 S. Ct. 2064](#), 2070-71 (2013).

17. See, e.g., [N.H. Rev. Stat. § 542:8](#) (permitting courts to correct or modify an award for “plain mistake”). See also Stephen K. Huber, *State Regulation of Arbitration Proceedings: Judicial Review of Arbitration Awards by State Courts*, [10 CARDOZO J. CONFLICT RESOL. 509](#)

(2009); Hall Street Assocs. LLC v. Mattel, Inc., [552 U.S. 576](#), 590 (2008) (suggesting that the scope of judicial review might be different under state law); Schmidt v. UBS Fin. Servs., Inc., [10 N.E.3d 1145](#) (Mass. Ct. App. 2014) (§ 10 of the FAA does not apply in state court).

18. See Cable Connection, Inc. v. DIRECTV, Inc., [190 P.3d 586](#) (Cal. 2008).

19. Eighteen U.S. jurisdictions have adopted the Revised Uniform Arbitration Act of 2000 (Alaska, Arizona, Arkansas, Colorado, D.C., Florida, Hawaii, Michigan, Minnesota, Nevada, New Jersey, New Mexico, North Carolina, North Dakota, Oklahoma, Oregon, Utah, and Washington). Other states have a different statutory scheme, some modeled after the previous Uniform Arbitration Act. E.g., [Del. Code tit. 10, ch. 57](#).

20. See, e.g., HL 1, LLC v. Riverwalk, LLC, [15 A.3d 725](#), 735 n.11 (Me. 2011).

21. See AAA, [Optional Appellate Arbitration Rules, Rule A-1](#) (2013); Paul B. Marrow, *A Practical Approach to Affording Review of Commercial Arbitration Awards: Using an Appellate Arbitrator*, [60 DISP. RES. J. 10](#) (2005) (referring to rules of the International Institute for Conflict Prevention and Resolution, the Judicial Arbitration and Mediation Services, and the National Arbitration Forum).

22. Cf. AAA, [Commercial Arbitration Rules and Mediation Procedures](#), Rule 46(b) (requiring a reasoned award if both parties request one).

23. See Symetra Nat'l Life Ins. Co. v. Rapid Settlements, Ltd., [2009 WL 1057339](#) (Tex. Ct. App. 2009) (assignee of payments from structured settlement violated public policy by using arbitration scheme to bypass state statutory requirement of judicial approval for the assignment); Symetra Nat'l Life Ins. Co. v. Rapid Settlements, Ltd., [657 F. Supp. 2d 795](#) (S.D. Tex. 2009) (factor was permanently enjoined from effectuating a transfer of rights to payment under structured settlements through the use of arbitration rather than by complying with state statutes on transfer); Symetra Life Ins. Co. v. Rapid Settlements, Ltd., [2011 WL 4807901](#) (S.D. Tex. 2011) (obligor on structured settlements had claim for tortious interference with contractual relations against assignee of structured settlement payments that attempted to use arbitration to avoid state statutes requiring court approval of the transfers because the assignee had no colorable argument that arbitration could be used in such a manner). See also Symetra Life Ins. Co. v. Rapid Settlements, Ltd., [599 F. Supp. 2d 809](#) (S.D. Tex. 2008); Symetra Life Ins. Co. v. Rapid Settlements, Ltd., [2007 WL 114497](#) (S.D. Tex. 2007); Fidelity and Guaranty Life

Ins. Co. v. Harrod, [2007 WL 2847966](#) (Md. 2007); R & Q Reinsurance Co. v. Rapid Settlements, Ltd., [2007 WL 2330899](#) (S.D. Fla. 2007); Symetra Life Ins. Co. v. Rapid Settlements, Ltd., [2007 WL 1643211](#) (S.D. Tex. 2007); Allstate Settlement Corp. v. Rapid Settlements, Ltd., [2007 WL 1377667](#) (E.D. Pa. 2007); In re Rapid Settlements, Ltd., [2007 WL 925698](#) (Tex. Ct. App. 2007) (refusing to order arbitration against issuer of annuity for structured settlement).

24. See [N.Y. Ethics Op. 584](#) (1987); [Alaska Ethics Op. 84-4](#) (both distinguishing between an illegal clause or contract and an unenforceable clause or contract). See also Greg M. Duhl, *The Ethics of Contract Drafting*, [14 LEWIS & CLARK L. REV. 989](#), 1012-17 (2010).

25. Christopher R. Drahozal and Stephen J. Ware, *Why Do Businesses Use (or Not Use) Arbitration Clauses?* [25 OHIO STATE J. ON DISP. RESOL. 433](#), 437(2010).



## Recent Cases

### SECURED TRANSACTIONS

#### Attachment Issues

*Hepp v. Ultra Green Energy Services, LLC*, [2015 WL 1952685](#) (N.D. Ill. 2015)

The managing member of a LLC did not have actual authority to bind the LLC to a note and security agreement and might not have had apparent authority, which requires conduct by the principal that causes a third party to believe that the agent is authorized.

#### Perfection Issues

*In re The Adoni Group, Inc.*, [2015 WL 2080521](#) (Bankr. S.D.N.Y. 2015)

The financing statement that a secured party filed one day before the debtor authenticated the security agreement, and hence was not authorized when filed but became authorized the following day, was effective to perfect.

*In re Oak Rock Financial, LLC,*

[2015 WL 1303137](#) (Bankr. E.D.N.Y. 2015)

The security interest of a bank, as the administrative agent to a group of lenders, was perfected by the financing statement the bank filed in its individual capacity in 2001 and later assigned to itself as administrative agent. The fact that the loan to the bank in its individual capacity was or might have been paid off is immaterial because the financing statement never lapsed and therefore is effective to perfect the later security interest, even if the subsequent security interest was not contemplated when the financing statement was filed. The fact that the bank and the debtor expected the security interest to the bank as administrative agent be perfected by a financing statement filed in 2006 but which later lapsed is also immaterial because perfection is based on the public record, not the subjective intent of the parties. The assignment did not make the 2001 financing statement seriously misleading because a search conducted under the debtor's name would have disclosed the financing statement. Finally, no new filing was needed in Utah, the location of a creditor that purchased a loan participation from the debtor, because that creditor was not the debtor.

### **Priority Issues**

*HSBC Bank USA v. Perez,*

[2015 WL 2078683](#) (Fla. Ct. App. 2015)

The relative priority of two banks that each acquired an original promissory note for the same mortgage loan was based not on the order in which they filed an assignment of the mortgage but pursuant to the first-to-file-or-perfect rule of Article 9. Accordingly, the bank that took possession of its note first had priority with respect to the mortgage.

### **Liability Issues**

*Brooklands, Inc. v. Sweeney,*

[2015 WL 1930239](#) (S.D. Fla. 2015)

A prospective debtor that paid a \$10,000 breakup fee and signed a release of liability when it cut off negotiations with a prospective lender, but then sued when the prospective lender failed to terminate its financing statements, could bring no claim under RICO or for fraudulent inducement or unjust enrichment because such claims related to conduct that predated the release and were therefore covered by it. However, the prospective debtor could bring claims for tortious interference with an advantageous business relationship and for slander based on the failure to terminate the financing statement.

## **BANKRUPTCY**

*In re CTLI, LLC,*

[528 B.R. 359](#) (S.D. Tex. 2015)

The business social media account maintained for a limited liability company by its former majority owner was property of the LLC's bankruptcy estate. Requiring the former owner to transfer administrative privileges over the account to debtor would not violate the privacy rights of the former owner.

*In re Big Drive Cattle, LLC,*

[2015 WL 1509824](#) (Bankr. D. Neb. 2015)

Prepetition payments made by a feedlot to the owner of cattle following the feedlot's sale of the cattle were avoidable preferences. The payments were not made from funds held in constructive trust for the owner because the owner, as a member of the feedlot, knew of and consented to the feedlot's grant of a security interest in its deposit accounts and the subsequent deposit of the sale proceeds into those deposit accounts caused the funds to lose the protection they would otherwise have had as bailment proceeds.

*In re Bill,*

[2015 WL 1776277](#) (Bankr. D. Idaho 2015)

Because a secured party that, on the petition date, had a perfected security interest in a boat that the debtor co-owned with his mother: (i) released its security interest postpetition to permit the boat to be re-titled in the mother's name; and (ii) contemporaneously received a new security interest from the mother, and the transfer of the lien was not authorized by the court, the lien was avoidable. The transactions did not result in a mere continuation of the original security interest because the documents expressly referred to a release of the original interest and the grant of a new one.

*In re Britt Motorsports, LLC,*

[2015 WL 1880057](#) (Bankr. E.D.N.C. 2015)

The motorcycle manufacturer that, without court approval, provided motorcycles to the debtor postpetition engaged in unauthorized and avoidable secured financing. The transaction was not a consignment because even though the manufacturer had the right to take the motorcycles back at any time, the documents obligated the debtor to pay for the goods, the debtor was billed upon shipment of the goods rather than upon sale, the debtor was authorized to set the retail price, the debtor received the profit from re-sales rather than a commission; and the debtor did not need the manufacturer's authorization prior to selling a unit.

*In re Callas,*

[2015 WL 1850260](#) (Bankr. N.D. Ill 2015)

While a mortgagee's perfected but unenforced assignment of rents constitutes a sufficient security interest in rents to make post-petition rents cash collateral, the rents that the debtor received prepetition were not cash collateral because, under Illinois law, an assignment of rents does not grant the mortgagee a lien on rents until the mortgagee takes steps after default to obtain possession of the property and start collecting the rents.

## GUARANTIES & RELATED MATTERS

*136 Field Point Holding Co. v. Invar Int'l Holding, Inc.,*  
[2015 WL 1254846](#) (S.D.N.Y. 2015)

Corporation that guaranteed the obligation of its individual owners to pay \$1 million if they failed to vacate a luxury apartment after their lease term expired was enforceable even if the obligation of the individuals was an unenforceable penalty because the guaranty agreement expressly provided that it was "absolute under any and all circumstances, without regard to the validity, regularity or enforceability of the Transaction Documents."

*In re Estate of Nardoni,*

[2015 WL 1514908](#) (Ill. Ct. App. 2015)

Bank that made a new loan to pay off two previous loans thereby extinguished the original loans. As a result, the estate of an individual who had signed a continuing guaranty of the original loans was discharged.

## LENDING & CONTRACTING

*Fifth Third Bank v. Rogers,*

[2015 WL 2269042](#) (Ky. Ct. App. 2015)

A decedent's estate that entered into a stock purchase agreement with the decedent's four brothers was entitled to an equitable lien against the assets of the corporations. The lien was entitled to priority over the mortgages and security interests of a bank because: (i) the bank failed to follow its own due diligence policy before making the loan by not checking for pending litigation; (ii) the loan officer knew the stock purchase agreement had been executed and that one of the brothers was deceased, but did not ask whether the decedent or his estate had any current interest in the corporations; and (iii) the bank had in its possession corporate bylaws requiring five directors to take action, but acted on corporate resolutions bearing only four signatures without inquiring about the missing fifth signature. Thus the bank was on inquiry notice of the equitable lien.

*XL Specialty Insurance Co. v. Truland,*

[2015 WL 2195181](#) (E.D. Va. 2015)

The language in an indemnification agreement which provided that the indemnitor's obligations "shall not extend and be enforceable against her sole and separate estate" was ambiguous: it could mean property titled only in the indemnitor's name or property that she acquired using funds constituting her separate property under the relevant domestic relations law. Reading the words in context suggests that the phrase was intended to refer to assets based on title, not by source of funds.

*In re Residential Capital, LLC,*

[2015 WL 2226232](#) (Bankr. S.D.N.Y. 2015)

A bank could unilaterally amend the deposit agreement with its customer to make the customer liable as a guarantor for any debts its affiliates owed to the bank. The amendment was effective even though the depositor tried but was unable to close all of the deposit accounts during the notice period because of the number of checks outstanding. The amendment was not unconscionable and did not violate the statute of frauds requirement that guarantees be in writing because the deposit agreement – with its provision regarding unilateral amendment – was in a writing signed by the depositor. As a result, the bank was entitled to debit the deposit accounts to satisfy obligations incurred by the depositor and its affiliates before and during their bankruptcy case, primarily for the bank's attorney's fees incurred in monitoring the case.

*In re Mac-Go Corporation,*

[2015 WL 1372717](#) (Bankr. N.D. Cal. 2015)

Because a lender's note, loan agreement, and security agreement provided that the debtor was to pay the costs and expenses of enforcement, including the lender's attorney's fees, the lender was entitled to recover the attorney's fees the lender incurred in successfully defending against the trustee's claims for avoidance of preferential, fraudulent, and unauthorized postpetition transfers. The attorney's fee clauses were not limited to actions brought by the lender and thus apply to proceedings in which the lender successfully defended an action by raising the enforceable terms of the contracts.

*PNC Bank v. Presbyterian Retirement Corp.,*

[2015 WL 1931395](#) (S.D. Ala. 2015)

Whether a party has, by its conduct, waived arbitration is normally a matter for the court decide and that presumption was not overcome by language in the arbitration clause providing that "[a]ny disagreement as to whether a particular dispute or claim is subject to arbitration . . . shall be decided by arbitration" because that language did not reference waiver issues, let alone conduct-based waiver issues.

*Police and Fire Retirement System of City of Detroit v. Midwest Business Credit, LLC,*

[2015 WL 1880788](#) (Ky. Ct. App. 2015)

The subordination clause in a recorded mortgage did not subordinate the mortgage to another creditor's mortgage created and recorded a year later because a subordination clause must describe the mortgage gaining priority with "reasonable specificity." If the mortgage gaining priority does not exist when the subordination clause is drafted, the clause must specify the maximum amount, interest rate, and term of the debt secured by the mortgage gaining priority.

*Conway v. Done Rite Recovery Services, Inc.,*

[2015 WL 1989665](#) (N.D. Ill. 2015)

A debt collector that allegedly violated the Fair Debt Collection Practices Act and several state statutes could invoke the arbitration clause in agreement between the borrower and the lender because the clause covered "any third party providing any good or services in connection with the origination, servicing and collection of amount due under the Contract."



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## Notices

### ACCESSING THE UCC ONLINE

The [Cornell Legal Information Institute](#) is one of the few places to access the official text of the Uniform Commercial Code on line for free. Unfortunately, the site does not include the official comments. More important, the site is not maintained and is not up to date. For example, the site does not incorporate the 1999 conforming amendments to Articles 2 and 2A that were made in connection with the revision to Article 9. Thus, those articles are more than 15 years out of date! This problem was reported more than a year ago but the problem has not been corrected.

The version of the Uniform Commercial Code on [Lexis \(UCC\)](#) is similarly out of date. Many of the 1999 amendments to Article 2 are not incorporated. What is more, the conforming amendments to Articles 2, 2A 4, 5, 8, and 9 – made in connection with 2003 revision to Article 7 – are not incorporated into those Articles (even though the 2010 amendments to Article 9 are properly reflected).

The version on [WestLaw \(UCC\)](#), does include the 1999 amendments to Article 2 but, like the Lexis version, fails to incorporate the 2003 amendments to Articles 2, 2A 4, 5, 8, and 9.

It is unknown how correct and how current the other articles are on these sites. Until a complete inventory is taken and all errors are corrected, readers are well advised to avoid these electronic sources and use either a printed version or an electronic version of a particular state's commercial code. The state commercial codes are available in one central place on [Westlaw \(State Codes\)](#).

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