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Due Diligence in the Purchase of Secured Loans

Stephen L. Sepinuck

The facts of a recent case, *WM Capital Management, Inc. v. Stejksal*,¹ provide a wonderful cautionary tale for the buyers of secured loans and the lawyers that counsel them. A quick reading of the decision suggests that the losing party erred in conducting due diligence. In reality, however, the court's analysis is flawed and its conclusion erroneous. A proper analysis shows that both the losing party and the victorious party erred before entering into the transaction.

Facts

The facts can be simplified and summarized as follows:

(1) In 2010, Bank made a loan to Debtor, secured by substantially all of Debtor's assets. Bank perfected the security interest by filing a financing statement. The security agreement contained a future advances clause.

(2) In 2011, Bank made a second loan to Debtor. Although there was no need to do so due to the future advances clause in the initial security agreement,² Bank had Debtor authenticate a second security agreement covering the same collateral. Although the court did not mention it, counsel who participated in the case has indicated privately that Bank filed a second financing statement. This too was unnecessary.³

(3) Bank then sold the 2010 loan to Buyer 1 and the 2011 loan to Buyer 2.

(4) Debtor defaulted. Buyer 1 and Buyer 2 disputed the relative priority of their security interests.

The Court's Analysis

The court ruled that Buyer 1 has priority. It concluded that Buyer 2 could claim no benefit from the future advances clause in the initial security agreement because it was not an assignee or third party beneficiary of that security agreement.⁴ The court then ruled that Buyer 1's security interest has priority. The court did not indicate what the basis for this conclusion was; perhaps it was because Buyer 1's interest was first in time. That is, Buyer's 1 security interest was both created and perfected before Buyer 2's security interest was created or perfected.

If the court's conclusion were correct, it would suggest that buyers of secured loans should either search for earlier financing statements filed by the loan seller against the debtor or get some warranty about priority from the loan seller. Obtaining such a warranty is likely to be difficult because it is reportedly not standard practice in the secondary market for secured loans. Accordingly, conducting a search for filed financing statements is advisable. Doing so would also help the buyer discover if there is a secured party – other than the originator or its assignee – with priority in the collateral.⁵ But let's take a step back and analyze the priority more slowly and more correctly.

The Correct Analysis

Before the Sales – One lien or Two? When Bank made the 2011 loan, it is not clear whether Bank held one security interest in Debtor's collateral or two. If Debtor had not authenticated a second security agreement, the future advances clause in the original security agreement would have been sufficient to make the collateral secure the 2011 loan. Thus, there would have been one security interest securing two obligations. The fact that a second security agreement was created might not change things. After all, the collateral is the same and the parties are the same. In other contexts, such as when the collateral is real property, the doctrine of merger would apply and the lienholder would be deemed to have a single lien. Certainly, there are occasions when it is appropriate to treat a single lender as having two different liens on the same collateral, such as when they have different priorities because the intervening interest of someone else is subordinate to one of those liens and superior to the other. But this brings us to the more critical point.

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Regardless of whether Bank had one security interest or two, there was but a single priority date. Priority of competing security interests is generally based on the first-to-file-or-perfect rule of § 9-322(a)(1). Thus, even if Bank's 2011 loan was secured by a separate security interest, the priority of that interest dated from when the initial financing statement was filed, not when the second security agreement was authenticated or when the second financing statement was filed. Thus, even if Bank had two security interests, they were of equal priority.

Priorities After the Sales. Bank's sale of the loans did not alter the priorities. There are three different ways to analyze the issue, but they each lead to the same result.

First, if, Bank initially had only one security interest despite the existence of two security agreements and two financing statements, and if selling the loans did not affect that but was instead akin to creating a participation interest, then the two buyers undoubtedly continued to share priority. After all, there would still be only one lien.

Second, if, Bank initially had only one security interest but the act of selling one of the secured obligations⁶ caused the security interests to bifurcate or sever, each security interest would remain perfected.⁷ Moreover, the priority of each would date back to Bank's first financing statement because there was never a period thereafter – for either security interest – when there was neither filing nor perfection.⁸

Third, if Bank initially had two security interests in the same collateral, each security interest remained perfected after the sale,⁹ with the result that again their priorities date back to when the first financing statement was filed. Moreover, it would not matter whether Bank assigned the financing statements, provided a timely continuation statement was filed before the statements lapsed.¹⁰

Lessons

Now consider this situation from the perspective of anyone buying a secured loan from the originator. Presumably, as part of its due diligence prior to the purchase, the buyer makes some assessment of the creditworthiness of the borrower and the value of the collateral. Presumably it also either gets the originator to represent and warrant that the security interest is perfected or it independently so concludes after conducting a search for filed financing statements.¹¹

What the buyer also needs to do, however, is inquire whether the originator has made any other loans to the borrower. If the originator has made another loan, and if

that loan is secured by the same collateral – which it might be pursuant to either a separate security agreement or the terms of the security agreement associated with the loan to be sold – the buyer would be getting a security interest of equal priority with the security interest securing the other loan.

If the buyer learns that the originator made a subsequent loan to the same borrower secured by the same collateral,¹² the buyer might need some additional protection. Specifically, it should get each of the following:

1. An assignment of the filed financing statement, so that the buyer is made the secured party of record. This would prevent the originator from terminating the financing statement if the borrower repays the other loan.¹³
2. A subordination agreement by which the originator agrees that its retained security interest in the collateral is subordinate to the security interest the buyer is acquiring (or, if the originator has already sold the subsequent loan, a subordination agreement with the buyer of that loan).
3. Because a subordination agreement executed by the originator *might* not be binding on a later buyer of the other secured loan who is unaware of the subordination agreement,¹⁴ covenants by the originator to: (i) inform any buyer of the other loan of the subordination agreement; and (ii) obtain from such a buyer an agreement to be, or acknowledgment that it is, bound by the subordination agreement.

Conclusion

It does not appear that Buyer 1 performed this due diligence. Had it done so, it might have avoided this whole dispute. Although Buyer 1 did win in its dispute with Buyer 2, that was a result of the court's erroneous application of the law. Future loan buyers might similarly get lucky, but reliance on felicity is not a path to financial success.

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Notes:

1. [2016 WL 6037851](#) (N.D. Ill. 2016).
2. See U.C.C. § 9-204(c) (making the future advances clause effective).

3. Even if the new security agreement created a new security interest, the original filed financing statement would have been effective to perfect that security interest. *See* U.C.C. § 9-502(d) (a financing statement may be filed before the security agreement is authenticated or the security interest attaches). Moreover, a financing statement is effective to perfect with respect to future advances regardless of whether it mentions future advances and even if the parties had not contemplated future advances at the time the financing statement was filed. *Id.* at cmt. 2.

4. [2016 WL 6037851](#) at *2.

5. The loan buyer should also strongly consider assessing the value of the collateral and the creditworthiness of the borrower.

6. It would not matter which loan was sold first.

7. *See* U.C.C. § 9-310(c).

8. *See* U.C.C. § 9-322(a)(1).

9. *See* U.C.C. § 9-310(c).

10. The court did not discuss whether either financing statement was continued. It is unclear what would happen if, after the sales, a continuation statement was filed with respect to one of the financing statements but the other financing statement lapsed. Resolution of that issue is beyond the scope of this article.

11. Depending on the nature of the collateral, it might alternatively or additionally be necessary to ascertain who has possession of the collateral, *see* U.C.C. § 9-313, check for notations on certificates of title to the collateral, *see id.* § 9-311(a)(2), (d), check to see if anyone has control over the collateral, *see id.* § 9-314, or check to see if perfection has occurred under federal law, *see id.* § 9-311(a)(1).

Federal law preempts Article 9 by requiring filing in a federal office to perfect a security interest in the following property: (i) vessels, [46 U.S.C. §§ 31321–31330](#); (ii) rolling stock, [49 U.S.C. § 11301](#); (iii) civil aircraft, [49 U.S.C. §§ 44107, 44108](#); and (iv) a registered copyright, [17 U.S.C. § 205\(a\)](#); *In re World Auxiliary Power Co.*, [303 F.3d 1120](#) (9th Cir. 2002).

Federal law also provides that compliance with regulations to be issued by the Secretary of the Interior is the exclusive means to perfect a security interest in certain Alaskan fishing rights. *See* [16 U.S.C. § 1855\(h\)\(1\)–\(3\)](#). Such regulations will, apparently, provide for recordation of security interests with a central registry to be created by the National Marine Fisheries Service. However, no such registry currently exists and until the regulations are final, perfection is governed by other law. *See* Sustainable Fisheries Act, [Pub. L. No. 104-297, § 110\(e\)](#), 110 Stat. at 3592 (codified at 16 U.S.C. § 1855 note). *See also* *Gowen, Inc. v. F/V*

Quality One, [244 F.3d 64](#), 70 (1st Cir. 2001) (security interests effective and perfected by otherwise applicable law “remain so at least until the establishment of the registry”).

12. If the buyer learned that the originator made an *earlier* loan to the same borrower secured by the same collateral, the buyer might not want to raise the issue of priority at the time of the purchase, but instead let the issue remain dormant unless and until the borrower defaults and it becomes apparent that the collateral has insufficient value to satisfy both secured obligations. At that point, the buyer could assert that its security interest shares priority with the security interest securing the earlier loan.

13. Note, a buyer of a secured loan should insist on this even if the originator has not made another loan to the same borrower secured by the same collateral.

14. In other words, it is unclear whether a lien subordination agreement somehow changes the nature of the subordinating creditor’s property rights in the collateral – in which case it would seem to be binding on an assignee – or is merely a promise not to assert priority – which might not affect an assignee. *See In re Kors, Inc.*, [819 F.2d 19](#) (2d Cir. 1987) (a bankruptcy trustee who avoided and preserved an unperfected lien that was contractually entitled to priority was not entitled to the benefit of the subordination agreement); U.C.C. § 9-339 cmt. 2 (“[o]nly a person entitled to priority may make [a subordination] agreement: a person’s rights cannot be adversely affected by an agreement to which the person is not a party”). *See also* JOHN F. HILSON & KATHERINE E. BELL, *ASSET-BASED LENDING: A PRACTICAL GUIDE TO SECURED FINANCING* § 9:2.6 (8th ed. 2015); John F. Hilson, *The Perils of Participations (Redux)*, [4 THE TRANSACTIONAL LAWYER 1](#) (Apr. 2014); John F. Hilson & Stephen L. Sepinuck, *The Perils of Participation (and Secrets to Successful Subordinations)*, [2 THE TRANSACTIONAL LAWYER 1](#) (Dec. 2012); *Southern Fidelity Managing Agency, LLC v. Citizens Bank & Trust Co.*, [82 U.C.C. Rep. Serv. 2d 412](#) (D. Kan. 2014) (loan originator’s subordination agreement was not binding on entities that had previously acquired a participation interest in the loan because the participation agreement required the participants’ consent to any subordination agreement), *rev’d on other grounds*, *In re Brooke Cap. Corp.*, [588 F. App’x 834](#) (10th Cir. 2014).

The few cases treating an assignee of a contractually subordinated debt as bound by the subordination simply assume that conclusion without analyzing the issue. *See, e.g., Mitec Partners, LLC v. U.S. Bank*, [605 F.3d 617](#) (8th Cir. 2010).



Recent Cases

SECURED TRANSACTIONS

Scope Issues

In re Clean Burn Fuels, LLC,
[2016 WL 5717232](#) (M.D.N.C. 2016)

A seller of corn to the debtor had only a security interest, not ownership, of corn in a storage bin on the debtor's property and leased to the seller by the debtor because even though the agreement expressly provided that title remained with the seller until "the [corn] leaves the storage bin and moves across the weighbelt into the plant at [the debtor's] Ethanol Facility," the agreement also provided that delivery is complete when the corn is received at the debtor's facility, and thus delivery occurred when the corn arrived at the storage bin. Retention of title by a seller of goods after delivery is limited in effect to reservation of a security interest.

Priority Issues

WM Capital Management, Inc. v. Stejskal,
[2016 WL 6037851](#) (N.D. Ill. 2016)

A creditor that received an assignment from the original secured party of a 2011 note secured by all of the debtor's assets could not assert priority over a bank that received an assignment from the original secured party of a 2010 note secured by the same assets, even though the 2010 note had a cross-collateralization clause, because the creditor did not receive an assignment of the 2010 security agreement. The notes and security agreements were separately assigned to different entities and now exist as separate and distinct loan packages.

Enforcement Issues

Northwest Bus. Fin. LLC v. Able Contractors, Inc.,
[2016 WL 6459837](#) (Wash. Ct. App. 2016)

Summary judgment was properly denied on a factor's claim against an account debtor for paying the debtor directly. Although the factor's financing statement covered all accounts, and a notification attached to most of the debtor's invoices to the account debtor instructed the account debtor to remit all payments to the factor, the invoices on which the account debtor made direct payment to the debtor lacked that notification. Moreover, an instruction to pay must identify the accounts it covers and a statement that "all" accounts have been assigned does not reasonably identify the covered accounts. Finally, it was not clear that the factor had in fact purchased the accounts at issue.

Fagen, Inc. v. Exergy Dev. Group of Idaho, LLC,
[2016 WL 5660418](#) (D. Minn. 2016)

A secured party and debtor that, after default, entered into an agreement by which the secured party purchased 99 of the debtor's 100 membership units in a subsidiary and retained a security interest in the remaining membership, and which further provided that if the debtor failed to obtain sufficient financing to repay all loans by a specified date, the remaining membership unit automatically transferred to the financier, was a secured transaction with respect to the one remaining membership unit. Accordingly, the financier violated Article 9's rules on enforcement by relying on the automatic transfer provision instead of using the Article 9 rules regarding a disposition or acceptance of collateral. By agreeing to the transaction, the debtor did not agree to an acceptance of the remaining membership unit after default because the driving force behind that agreement was the need for further financing, not to effectuate a strict foreclosure.

Bank of America v. Florida Glass of Tampa Bay, Inc.,
[2016 WL 6778877](#) (M.D. Fla. 2016)

Although the security agreements and mortgages in connection with six loans to related corporate entities each provided for the appointment of a receiver in the event of default, no receiver would be appointed because the secured party did not demonstrate: (i) fraudulent conduct on the part of the borrowers or guarantors; (ii) imminent danger that the collateral will be lost or squandered; (iii) that its legal remedies are inadequate; (iv) or there is a probability that the harm to the secured party from denying its motion would be greater than the injury to the borrowers.

BANKRUPTCY

In re New Investments, Inc.,
[2016 WL 6543520](#) (9th Cir. 2016)

Although a Chapter 11 plan may cure a default on a secured obligation, and thereby de-accelerate the debt, because § 1123(d) provides that the amount necessary to cure must be determined according to the agreement and applicable nonbankruptcy law, the debtor remains obligated to pay interest at the default rate. The court did not specify whether the default rate applies for the remainder of the loan or only until cure is achieved.

LENDING & CONTRACTING

In re Energy Future Holdings Corp.,
[2016 WL 6803710](#) (3d Cir. 2016)

First-lien and second-lien noteholders, who pursuant to their indentures were due a premium if the debtor voluntarily redeemed the notes, were entitled to the

premium even though the debtor's obligation on notes was automatically accelerated by the bankruptcy filing and the bankruptcy court declined to lift the stay to permit the noteholders to de-accelerate the debt. The debtor's payment of the notes in bankruptcy was optional because the debtor could have reinstated the accelerated notes' original maturity date under § 1124(2). Indeed, the debtor's whole purpose in filing for bankruptcy was to pay the notes while avoiding the \$431 million premium. Moreover, there was no conflict between the term of the indenture providing for the premium and the term providing for payment after acceleration. Although a premium contingent on "prepayment" cannot apply after the debt's maturity, a premium tied to "redemption" can.

Lesa, LLC v. Family Trust of Kimberley and Alfred Mandel,

[2016 WL 6599912](#) (N.D. Cal. 2016)

Contractually subordinated creditors' cross-complaint to rescind their loan transaction did not violate the terms of their intercreditor agreement with the senior lender, which prohibited them from commencing or prosecuting and "legal or equitable action against Borrower" before the senior creditor was paid in full. That language had to be read in context as prohibiting only actions to collect the subordinated debt. A claim for rescission is not an act to collect the debt; rescission restores the parties to their position before contracting whereas collecting a contractual debt involves enforcing expectation interests.

Power UP Lending Group, Ltd v. Murphy,

[2016 WL 6088332](#) (E.D.N.Y. 2016)

Both the chief executive officer and the general counsel of a corporate borrower were bound by the forum selection clause in the loan agreements in connection with the lender's claims against them for fraudulent inducement and intentional interference with contract. The forum selection clause was clearly communicated to each of the individual defendants, is mandatory, and broadly covers "[a]ny suit, action or proceeding arising [under the loan agreements]," and the defendants are principals of, and therefore "closely related" to the signatory corporation, so that it was or should have been reasonably foreseeable to them that the forum selection clause might be enforced against them in the event of a breach.

Gault v. Sass Electric, Inc.,

[2016 WL 5539872](#) (Cal. Ct. App. 2016)

A term in a settlement agreement and promissory note providing that the creditor "shall waive the remaining amount owed" if the obligor paid \$386,000 within three years was not contingent on the absence of default. Accordingly, even though the debtor defaulted and the creditor obtained a stipulated judgment for the unpaid portion of the entire \$692,000 debt, the debtor's obligation was fulfilled when the debtor brought the total amount paid to \$386,000 within three years.

In re First Farmers Financial Litigation,

[2016 WL 6647923](#) (N.D. Ill. 2016)

Although the guaranty and security agreements relating to a \$2 million loan each contained a clause selecting Florida law, the court would apply Illinois law to the promissory note, which lacked such a clause, in part because the note would be usurious – and unenforceable – under Florida law and parties presumably intended to be bound by a valid contract.

Torin Associates, Inc. v. Perez,

[2016 WL 6662271](#) (S.D.N.Y. 2016)

A lender was entitled to summary judgment on its claim against two guarantors even though the borrower failed to execute the promissory note because the guaranty agreements expressly provided the guarantors would be liable regardless of whether the "indebtedness or liability may otherwise be or become unenforceable" and the guarantors did not dispute either that the loan was made or the terms of the loan.



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