Illinois Bankers Association

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Commercial Lending Update

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Table of Contents

Page

Bank Liability

- Bank Wins Malicious Prosecution Case....................................1
- Bank Not Liable Under Statute of Frauds...............................3
- Bank Liability Under the Fiduciary Obligations Act..................5
- Bank and Borrow Did Not Collude to Injure Another Lender......8
- Bank and Borrower Did Collude to Injure Another Lender.........9
- Bank Liability Due to Ambiguity in Deposit Agreement...........13
- Bank Not Liable for Honoring Fraudulently Endorsed Checks...14

Uniform Commercial Code

- Bank Wins Contest With Grain Co-op....................................16
- The UCC Meets SRECs..18
- Lien Lost by Surrender of Possession.................................. 20
- Security Interests Lost Due to Inadequate Description.............. 22
- UCC Misuse Results in Criminal Conviction...........................24
- Validity of UCC Filing Tested by Standard Search Logic............26
- Bank's Election of UCC Foreclosure Bars Other Remedies......... 28
- Bank's UCC Liens Trump Wage Claims in Federal Receivership...30

Other Cases

- Can a Wire Transfer Be Recalled After Acceptance?..................32
- Bank Loses Claim to Collateral 36
- Election of Wrong Remedy Blocks Creditor's Claim.................38
- Signatories to Note Liable Even if Not Named in Note.............40

Bank Wins Malicious Prosecution Case

The United States Court of Appeals for the Seventh Circuit ruled on March 2, 2022, in *Birch|Rea Partners, Inc. v. Regent Bank,* 27 F.4th 1245 (7th Cir. 2022), that the bank was not liable for malicious prosecution based on a lawsuit it earlier had filed against an appraisal firm and then withdrawn.

On May 16, 2007, SunTrust Bank hired Birch|Rea Partners, Inc., to appraise certain Indiana real estate it was thinking of purchasing. Birch|Rea's appraisal report valued the property at $3.23 million. SunTrust accepted the appraisal report, as did PNC Bank, the source of mortgage financing.

On October 19, 2007, the property owner sold the real estate to a subsidiary of SunTrust Bank subject to a $2.3 million mortgage loan from PNC Bank. A few years later, PNC Bank assigned the loan to American Capital Group, LLC. Even later, the loan was sold to Regent Bank. (A footnote by the court indicates that Regent at some point stepped out of the picture: "Stonegate Bank and Home BancShares, Inc. are successors in interest of Regent. 'Regent Bank' refers to all three defendants in this case." 27 F.4th at 1248 n.1. Thus, although it is not the real party in interest in the case, the opinion continues to refer to Regent Bank.)

In February 2016, Regent began to question the real value of the property. It retained a new firm of independent appraisers that determined the value to be only $200,000. Not content, Regent hired a law firm to investigate further. Regent and the law firm hired another certified appraiser named Potter to review the Birch|Rea appraisal. Potter spotted nine shortcomings in the Birch|Rea appraisal. His report indicated Birch|Rea had not complied with the Uniform Standards of Professional Appraisal Practice and that Birch|Rea had not used proper methods in appraising the real estate.

Based on Potter's report, Regent sued Birch|Rea for professional negligence, negligent misrepresentation, constructive fraud, and breach of contract. For some reason not explained in the opinion, Regent later voluntarily dismissed its lawsuit against Birch|Rea.

That was followed by Birch|Rea's lawsuit against Regent for malicious prosecution. Regent replied with a denial and a request for attorneys' fees under the Indiana frivolous litigation statute, Ind. Code §34-52-1-1. When Regent moved to dismiss the malicious prosecution case and, simultaneously, sought leave to proceed with an award of attorneys' fees, the trial court ruled in favor of Regent on Birch|Rea's malicious prosecution claim but denied Regent the right to pursue its frivolous litigation claim against Birch|Rea. An appeal followed.

The Seventh Circuit stated that four elements constituted a cause of action for malicious prosecution: (1) the defendant brought an action against the plaintiff; (2) the defendant acted with malice; (3) the defendant lacked probable cause to file the action; and (4) the action was terminated in the plaintiff's favor. Regent argued it had probable cause to sue Birch|Rea and did not act with malice. The Seventh Circuit agreed.

Regent had probable cause, said the court, because it consulted with independent appraisers who disagreed with the original valuation, it retained a law firm and, with the law firm, hired a certified appraiser who prepared a report pointing out what Birch|Rea had done incorrectly, and it relied on the report in suing Birch|Rea. The court also held Regent did not act with malice even though it withdrew the original action before an adjudication on the merits. The court also said even if Regent had been negligent in filing the original action, that was insufficient as it takes more to establish malice than mere negligence. So much for the malicious prosecution case against Regent.

As to Regent's claim that Birch|Rea's lawsuit was frivolous and, therefore, warranted the award of attorneys' fees, the court denied Regent's request. The Indiana frivolous litigation statute penalizes those who, in a civil action, pursue a claim that is frivolous, unreasonable, or groundless. The Seventh Circuit ruled that "Birch|Rea did not file a frivolous, unreasonable, or groundless lawsuit against Regent Bank. There is no evidence that the malicious-prosecution claim was brought to injure Regent Bank." 27 F.4th at 1252. And, further, "[t]he fact that Regent Bank quickly dropped its underlying claim suggests that it may have lacked merit." *Id.* This left Regent without the right to pursue its claim for attorneys' fees against Birch|Rea under the Indiana statute.

What's the point? This case illustrates that before a bank initiates litigation, it must marshal all the evidence necessary to support the allegations it proposes to make. Although it may file its lawsuit in good faith, the bank must be able to sustain its position even if it later decides that pursuing the action is not warranted because of the economic position of the defendant or for any other valid reason.

Bank Not Liable Under Statute of Frauds

In *Modern Industries, Inc. v. Oxford Bank Corp.*, No. 356456, 2022 WL 268535 (Mich.App. Jan. 27, 2022), the claimants sued the bank for alleged negligence in unilaterally changing the terms of certain loans in violation of the parties' agreement, breach of fiduciary duty by failing to properly distribute loans, and engaging in constructive fraud and misrepresentation by waiting to disclose unilateral changes to the final loan documents until the claimants were left with no choice except to close the loans. The court ruled in favor of the bank on all of the claims.

Prior to December 2017, Ronald Lammy was the sole owner of Modern Industries, Inc., and the coowner, with Michael T. Horan, of Livingston County Concrete, Inc. In 2017, Horan agreed to sell his interest in Livingston to Lammy for $2.25 million provided the closing took place before December 31, 2017. Lammy applied to the bank for a loan to fund the buyout as well for a separate loan to refinance the debt of Modern.

The Livingston buyout was documented by two notes. One for $1,492,500 with a five-year amortization schedule and the other for $1,012,000 with a three-year amortization schedule. Each note required monthly payments of principal and interest. The Livingston loan documents included a release provision stating, "Borrower waives, releases and affirmatively agrees not to allege any and all . . . claims . . . it may have, or claim to have[,] . . . against Bank . . . from the date of the Borrower's first contact with Bank up to the date of this Agreement." 2022 WL 258535 at *1. Closing of the Livingston loan took place during December 2017.

Another loan for $1,794,000, guaranteed by the Small Business Administration, to refinance Modern's debts closed in January 2019. It was due in a single payment of interest only one month after closing and, thereafter, in monthly payments of principal and interest. There was no release provision in those loan documents.

After closing the Livingston loan in December 2017, Lammy raised objections to changes in the principal amount of the notes. He claimed that his agreement with the bank was for a five-year note in the principal amount of $2,013,930 and a three-year note in the principal amount of $786,000.

When the Modern loan closed, Lammy claimed the 2017 proposal he approved called for a note in the principal amount of $1,995,780, interest only payable for 12 months followed by 108 monthly payments of principal and interest. He also contested the distribution of the loan proceeds. In dispute was whether the bank had promised Lammy it would modify the notes to conform to a 2017 proposal if he proceeded to close the Modern loan.

No resolution of the dispute was reached, so Lammy refinanced the loans with another lender and paid the Livingston and Modern loans in full. He then sought redress from Oxford with a lawsuit.

The court first ruled that Lammy had not properly established a claim for fraud because any such claim was barred by Michigan's statute of frauds. Lammy had asserted that Oxford had verbally assured him that, after closing the two loans, the errors in the loan documents would be corrected. Oxford answered there was no such agreement. The court said whether there was such a verbal agreement was irrelevant. The Michigan statute of frauds plainly stated, "A person shall not bring an action against a financial institution to enforce any of the following promises or commitments of the financial institution unless the promise or commitment is in writing and signed with an authorized signature by the financial institution: (a) A promise or commitment to lend money, grant or extend credit, or make any other financial accommodation." 2022 WL 258535 at *4.

Because Lammy had no written proof of his allegations, based on the statute, the court dismissed his fraud claim.

Next, the court dealt with Lammy's contention that the bank's last-minute change in the terms of payment of the Modern loan was fraudulent. The repayment terms had indeed been changed. The 2017 proposal provided for one year of interest-only payments, whereas the Modern loan documents provided for only one month of interest-only payments. Although admitting there was a change, the court said, "we are hard-pressed to conclude this change was anything more than a change to the terms of the loan during the negotiation process." 2022 WL 258535 at *5. And, said the court, "[t]he record also indicates [the bank] sent an e-mail with the draft documents to Lammy and his attorney . . . before each closing for [the borrower's] review and [the borrower] signed the loan documents." *Id.* Under Michigan law, "one who signs a written agreement knows the nature of the instrument so executed and understands its content," concluded the court. *Id.*

A claim by Lammy that the bank's withholding $85,000 of the Modern loan proceeds, and using $75,000 of the withheld funds to pay down the Modern loan, was an act of self-dealing and violated the terms of the Modern loan was also rejected. A review of the record showed that the application of funds was made when the double-counting of an item of collateral was discovered.

Finally, dismissing Lammy's claim against the bank for its alleged negligence, the court said the bank owed no duty to Lammy separate and apart from its contractual obligations, and thus all its obligations had been fulfilled.

What's the point? To avoid issues with prospective borrowers, term sheets used in negotiations should be carefully marked to indicate that they are for discussion only and create no binding obligations for either party. If a rejected borrower seeks redress against the bank by judicial means, a ready and reliable defense can be found in the statute of frauds or one of its offshoots found in many states.

Bank Liability Under the Fiduciary Obligations Act

The Illinois Fiduciary Obligations Act (FOA), 760 ILCS 65/0.01, *et seq.*, was the foundation for United States District Judge Sara L. Ellis's decision in *PLB Investments LLC v. Heartland Bank & Trust Co.*, No. 20 C 1023, 2021 WL 492901 (N.D.Ill. Feb. 9, 2021).

The class action case arose on a motion to dismiss filed by the defendants, Heartland and PNC Bank N.A. A motion to dismiss tests whether the plaintiffs (the complaining parties) have alleged enough in their complaint to allow the case to go forward. The court ruled that they had, vis-à-vis Heartland, but only as to events that occurred after a certain point in time. Because this was simply a motion to dismiss, the case is not necessarily over. There was a subsequent decision by Judge Ellis (*PLB Investments LLC v. Heartland Bank & Trust Co.*, No. 20 C 1023, 2021 WL 5937152 (N.D.Ill. Dec. 15, 2021)) that sustained the earlier decision.

As is so often the case, the factual basis for the case stems from a Ponzi scheme, in this case called Today's Growth Consultant, Inc. (TGC). Its operator was Kenneth D. Courtright III, who owned it with his wife. It did business under the name "The Income Store."

Courtright was the chief executive officer and president from March 2009 through August 2019, when his wife took over. TGC advertised investment opportunities on websites and radio, soliciting investors to enter into consulting performance agreements (CPAs). From 2013 onward, TGC sold more than 700 CPAs to more than 500 investors. TGC promised the investors a minimum rate of return in perpetuity on revenues TGC would develop from websites it would create.

TGC was successful in generating investments raising $75 million between January 2017 and October 2019. But it was equally unsuccessful in its efforts to create and develop websites. To cover the shortfall in returns he promised to investors, Courtright adopted a Ponzi scheme paying earlier investors with funds provided by later investors. Between January 2017 and October 2019, TGC paid investors $30 million, even though its revenues were only $9 million. 2021 WL 492901 at *2. The shortfall was funded by money from new investors. TGC also borrowed $12 million from distressed lending companies.

As is typical in Ponzi-style cases, Courtright appropriated $1.5 million from TGC between January 2017 and October 2019 to pay personal expenses including $36,851 for credit card charges and over $36,000 in private secondary school tuition. *Id.*

On December 13, 2019, TGC announced a temporary cessation of payments to investors. Two weeks later, the Securities and Exchange Commission (SEC) sued Courtright and TGC to terminate the Ponzi scheme and freeze the assets of TGC. In February 2020, the federal government filed a criminal complaint against Courtright charging wire fraud. A receiver appointed at the request of the SEC sued Heartland and PNC for violation of the FOA, breach of fiduciary duty, aiding and abetting Courtright's breach of fiduciary duty, negligence, and unjust enrichment.

The court's opinion was primarily directed toward Heartland. PNC was dismissed from the case.

The court noted that TGC had a business bank account at Heartland with Courtright as an authorized signatory. Courtright also had a personal banking relationship with Heartland because it held a mortgage on his two residences. Courtright made 1,400 funds transfers aggregating $5 million out of TGC's Heartland business account for fast food, mortgage payments to Heartland, insurance, and automotive expenses. *Id.*

Heartland's loan officer on the loans to TGC and Courtright reviewed all of TGC's loan applications and prepared commercial loan credit memos that Heartland used to approve or deny TGC's loan requests. Beginning in 2015, TGC made a series of requests for loans to cover shortfalls. In response to an August 2017 request by TGC for the renewal of a $200,000 line of credit, Heartland required current financial statements from Courtright. 2021 WL 492901 at *3.

It was not until August 2018 that Heartland obtained the current financial statements. The 2017 statements showed an operating loss of $2 million, and the midyear 2018 financial statements also showed a loss. After Heartland's officers reviewed the financial statements, they spoke with TGC's controller, who admitted that money coming in from new investors was being used to fund payouts to existing investors. That was confirmed in a September 2018 meeting with Courtright. On September 18, 2018, Heartland advised Courtright it was terminating its relationship with TGC, and on October 23, 2018, Heartland closed TGC's checking account. *Id.* Heartland did not advise the TGC investors of the Ponzi scheme.

The court began its opinion by noting that the FOA generally protects a bank from liability for the misappropriation of investor funds by a fiduciary unless the bank has actual knowledge of the misappropriation or knowledge of sufficient facts that its actions amount to bad faith. Therefore, the opinion focused on three issues: (1) Did Heartland have actual knowledge of TGC's and Courtright's misappropriation of investor funds? (2) Did Heartland have knowledge of sufficient facts with respect to TGC's and Courtright's misdeeds such that its actions amounted to bad faith? (3) Did Courtright violate his fiduciary duty to investors by making payments to Heartland on his personal debt? The court answered each of these questions in the affirmative.

First, the court said "actual knowledge" means what it says. 2021 WL 492901 at *5. It does not mean what Heartland should have known. It means facts that give rise to the

inference that Heartland actually knew of TGC's and Courtright's misconduct. So the fact that Heartland knew that investors wired money into TGC's account does not provide a basis for inferring that the bank actually knew of the misconduct that followed. In addition, the fact that Courtright made many money transfers from the TGC accounts to his personal account did not, in the view of the court, give rise to an inference that the bank had actual knowledge of wrongdoing because there are many legitimate reasons why a fiduciary would move large sums of money on behalf of those persons he or she represents.

The court concluded Heartland did not have actual knowledge of the Ponzi scheme until the September 10, 2018, meeting when TGC's controller admitted that new investor money was being used to make payments to established investors. That meant the claimants could pursue claims against Heartland only on the "actual knowledge" allegations that arose from misconduct occurring after September 10, 2018. But that was not the end of the story. There was still the issue of Heartland's potential liability for bad faith.

Here, the court pointed out that "bad faith" includes situations in which a bank suspects the fiduciary is acting improperly and deliberately refrains from investigating in order to avoid having knowledge that the fiduciary indeed is acting improperly. Negligence alone is not adequate to satisfy the bad-faith standard.

The court went on to say that the allegations made by the claimants against Heartland "suggest that Heartland only took cursory steps to investigate while at the same time ignoring signs of wrongdoing." 2021 WL 492901 at *8. It concluded that "[t]aken together, Plaintiffs' allegations against Heartland give rise to an inference of bad faith, allowing them to more generally pursue their claims against Heartland under the FOA." *Id.*

On the claimants' assertions they also had causes of action on a common-law aiding and abetting theory, the court said that those claims could also be advanced but only as to misconduct occurring after September 10, 2018.

As to other allegations of common-law liability that hinge on the existence of a fiduciary duty owed to the claimants, the court made the familiar observation that banks do not owe a duty of care to noncustomers, and even if they did, there was no allegation in the complaint that the claimants had reposed their trust and confidence in Heartland.

What's the point? Generally speaking, a bank has no liability under FOA for engaging in ordinary day-to-day banking activity. Liability under FOA arises when circumstances surrounding the relationship become suspect and the bank makes little or no effort to investigate.

Bank and Borrower Did Not Collude To Injure Another Lender

Under §9-332 of the Uniform Commercial Code, a party is liable for colluding with another when there is evidence that the two parties acted pursuant to an agreement or otherwise in concert with each other and the purpose of the concerted action was illegal, fraudulent, or otherwise wrongful toward the injured third party. In *NextGear Capital, Inc. v. Bank of Springfield,* Case No. 4:18-CV-01086-NCC, 2019 WL 2525753 (Bankr. E.D.Mo. June 19, 2019), the question was whether Bank of Springfield had colluded with its borrower, Gateway Buick GMC, Inc., to injure Gateway's floor-plan lender, NextGear Capital, Inc.

Gateway operated an automotive dealership in Hazelwood, Missouri, selling new Buick and GMC vehicles. Between August 11, 2015, and January 12, 2016, it executed a series of promissory notes totaling $13,625,000 with Bank of Springfield. The notes were secured by a blanket lien on all of Gateway's real property.

NextGear provided Gateway with floor-plan financing pursuant to a demand note and a loan and security agreement dated October 27, 2014. Gateway granted NextGear a blanket lien on its personal property, thereby giving NextGear a senior lien position in Gateway's accounts receivable and any funds Gateway would receive from General Motors. Gateway received two types of payments from General Motors: vehicle rebates and holdbacks that were proceeds from vehicles floor-planned by NextGear; and dealer incentive payments.

With Gateway experiencing financial difficulties, the three parties executed a series of forbearance agreements. On October 1, 2015, NextGear agreed to subordinate its claim to payments Gateway had coming from General Motors, except for the sales proceeds arising from the vehicles NextGear had floor-planned and for which it had not been paid. The parties executed an amended forbearance agreement on May 27, 2016, and another amended forbearance agreement on July 10, 2017. In the last of these agreements, there was a provision prohibiting Gateway from any further borrowing from the bank.

Because NextGear found, as early as May 2016, that Gateway was selling vehicles out of trust and not remitting the sales proceeds, it stationed risk managers at Gateway's premises to ensure that the sales proceeds were delivered to NextGear. The bank was aware of this as well as Gateway's financial difficulties.

Gateway had bank accounts with several different banking institutions, including Regions Bank. The NextGear loan documents obligated Gateway to deposit vehicle rebates and holdbacks from the sale of vehicles floor-planned by NextGear into the

Regions account. NextGear was party to a tripartite control agreement giving it control over the Regions bank account.

Gateway directed General Motors to deposit rebate, holdback, and incentive payments into Gateway's account at Bank of Springfield. Bank of Springfield knew the source of the deposits was General Motors. These deposits were a direct violation of the forbearance agreements, the floor-plan financing agreements, and the subordination agreements.

NextGear accused Bank of Springfield of acting purposefully to induce Gateway to deposit monies Gateway received from General Motors into Bank of Springfield for the purpose of making payments due the Bank on its Gateway notes. These moneys were supposed to be placed on deposit at Regions Bank. Despite demands from NextGear, Bank of Springfield refused to turn over the disputed funds. Litigation between NextGear and Bank of Springfield followed.

The decision arose from a motion to dismiss the case filed by Bank of Springfield. The Bank claimed its conduct fell within the protection of §9-332 of the Uniform Commercial Code. The court agreed.

Section 9-332 of the UCC states, "a transferee of funds from a deposit account takes the funds free of a security interest in the deposit account unless the transferee acts in collusion with the debtor in violating the rights of the secured party." 2019 WL 2525753 at *3. In the view of the court, the decision hinged on whether the bank was acting in collusion with Gateway when it obtained the General Motors payments.

The court said there was an insufficient allegation of collusion and ruled as follows:

> **[A] junior secured creditor is under no obligation to identify and segregate cash proceeds for the benefit of the senior secured creditor. . . . This is the case even if the junior secured creditor knew of the senior secured party's interest. . . . The collusion standard in Article 9 does not impose a duty on a transferee of funds to identify and segregate the funds absent a contractual obligation to do so. . . . As long as** [Bank of Springfield] **acts rightfully, it cannot be responsible for Gateway's potentially wrongful actions.** [Citations omitted.] 2019 WL 2525753 at *4.

What's the point? Courts do not penalize alleged collusion between a bank and its customer absent definitive proof of concerted conduct with a malicious purpose.

Bank and Borrower Did Collude To Injure Another Creditor

Keeping in mind *NextGearCapital,* in which a Missouri bankruptcy court rejected an assertion that a bank had colluded with a borrower to injure another creditor, we will revisit the issue of collusion in a Montana federal district court decision that came to

quite a different conclusion. *Banner Bank v. First Community Bank,* 854 F.Supp.2d 846 (D.Mont. 2012).

Banner Bank arose on Banner's motion for summary judgment. It raised a number of legal issues and ultimately resulted in a judgment in favor of Banner.

Banner was the successor to F&M Bank. F&M loaned $5 million to Superior Propane, LLC, in 2006. Two of the three principals of Superior, Gary Hebener and Dean South (H&S), guaranteed repayment of the loan. F&M was granted a security interest in all of Superior's assets that it perfected by the filing of a UCC1 Financing Statement with the Montana Secretary of State.

In April 2009, H&S obtained a $400,000 loan from First Community Bank. They granted FCB a security interest in five propane tanks. Superior guaranteed repayment of the loan. FCB filed a UCC1 Financing Statement with the Montana Secretary of State's office on April 23, 2009, listing four 30,000-gallon tanks and one 60,000-gallon propane tank as collateral. 854 F.Supp.2d at 849 n.2. South and Hebener were listed as debtors. The loan collateral was actually part of Superior's inventory and had not been purchased by H&S. The $400,000 loan had a term of six months and was supposed to provide funding to assist Superior in making its loan payments to Banner.

The loan proceeds from the $400,000 loan initially were deposited in H&S's checking account at FCB on April 21, 2009. The following day, South wrote a $200,000 check on that account payable to Superior, and Superior signed the check over to Banner as a partial payment on its debt to Banner. A week later, on April 29, 2009, South wrote another check, this time for $172,000, payable to Superior. Once again, Superior signed the check over to Banner as a partial loan repayment.

On October 8, 2009, South wrote a check for $78,000 on the account of Harold's Meter Service (an adopted d/b/a of Superior) at Mountain West Bank payable to the H&S account at FCB. Two months later, on December 4, 2009, there was a payment of $80,000 on the H&S personal loan account at FCB from the H&S checking account. The regular monthly payment on the H&S loan was $78,000 and the source of the funds, presumably, was the sale of the propane tanks. (That was confirmed by trial testimony by South that two of the 30,000-gallon tanks had been sold to a party in Wyoming for $80,000.)

Banner was not informed of the sale of the tanks. Before FCB made the personal loan to H&S, H&S told FCB they would get a release from Banner of its security interest in the tanks. But that never happened.

Banner did not learn of the sale until a year had passed. When it did, it demanded the $78,000 from FCB based on its perfected security interest in the tanks. FCB refused, and litigation followed.

FCB's first defense was that Banner would be unjustly enriched if it were awarded the proceeds of the sale of the tanks because Banner had been compensated by the almost $300,000 payments it received in 2009. The historical background was that when South and Hebener procured their $400,000 loan from FCB, they paid $300,000 to Superior and Superior, in turn, paid those funds to Banner. The remaining $100,000 was paid to Superior to try to keep it going. FCB's position was that when H&S paid the $300,000 to Banner, they were "paying" for the two propane tanks. The court summarily rejected that contention because when the $300,000 was paid to Banner, South and Hebener "did not tell Banner Bank that the payment was for the two propane tanks." 854 F.Supp.2d at 852. And in answer to the assertion that the $100,000 payment to Superior was for the tanks, the court said, "South testified that he and Hebener gave $100,000 to Superior for operating expenses, not as payment for the tanks. . . . Banner Bank believed that it was being paid what it was owed on the $5 million note. Banner Bank never granted a release of its security interest; nor did it know that a release was being sought." *Id.*

FCB next argued that it had perfected a purchase-money security interest in the tanks. It lost that argument too. The court's conclusion was that "FCB's argument that it has a purchase-money security interest is without merit, first because the propane tanks are inventory and second because there is no record of any purchase of the tanks from Superior by South and/or Hebener." 854 F.Supp.2d at 854. In the view of the court, FCB did not have a valid perfected security interest in the propane tanks because South and Hebener did not have rights in that collateral. It said that "FCB never demanded documentation of ownership in the collateral from [H&S] or any other proof that they had the power to transfer rights in the collateral." *Id.*

Advancing to the issue of collusion, the court detailed why a finding of collusion between FCB and South and Hebener was warranted. It said:

> **The court does not find that FCB intended at the outset of its loan transaction to collude with Superior Propane to the detriment of Banner Bank, but little by little FCB's conduct during the South/Hebener loan transaction edged toward and eventually transformed into a *de facto* collusion with Superior against Banner. FCB's complete failure to ascertain the ownership or power to transfer rights in the collateral as pledged by South and Hebener certainly permitted Superior Propane to defraud its primary secured creditor. Essentially FCB's inattention to the most important details of the loan transaction allowed South and Hebener to pledge assets they did not own for their $400,000 personal loan. Further, FCB's failure to require South and Hebener to provide documentation of Banner Bank's waiver of its security interest effectively kept Banner Bank completely in the dark about a potential bank conflict over Superior's assets or about a possibility that Superior might want to sell these encumbered assets.** 854 F.Supp.2d at 856.

The court's final comments are worth noting: "FCB either was aware of the wrongfulness of this transaction or chose to remain willfully ignorant." Such willful ignorance is ample evidence of collusion, said the court. *Id.*

What's the point? The Montana court essentially ruled that a bank, acting in concert with one of its borrowers, can be held to have colluded with its borrower if the bank remains passive in the face of mounting evidence that the borrower's intention is to harm another creditor. That test holds a bank to a far stricter code of conduct than that articulated in the collusion case previously reviewed here.

Bank Liability Due to Ambiguity in Deposit Agreement

Columbian Spot, LLC v. Dollar Bank, 2022 U.S. Dist. LEXIS 179888, 2022 WL 4610644 (W.D. Pa September 30, 2022, arose as a putative class action that sought to impose liability on the bank for charging its customers fees that were in violation of federal law and contrary to the deposit account agreement they signed .

These were some examples of the improper fees: (1) two or more fees for overdraft and non-sufficient funds on a single ACH transaction debit or check, (2) using a lesser balance than the money in the customer's account to determine when to assess an overdraft fee. It was also alleged that the Bank had not complied with Regulation E before being allowed to charge overdraft fees on certain transactions.

The complaint contended such practices constituted a breach of contract including a breach of the implied covenant of good faith and fair dealing. The bank argued that the fees it charged were in accordance with the unambiguous terms of the account agreements its customers had signed. The court said if the terms of the account agreements were unambiguous the Bank's motion would be granted. But not if there were any ambiguities.

The court stated it had reviewed the account agreements and, without disclosing what they were, said, "...the account Documents at issue contain sufficient ambiguities to render dismissal of the breach of contract claim inappropriate." The court also said because the breach of contract claim was not to dismissed, the claim of a violation of the covenant of good faith and fair dealing would not be dismissed.

What's the point? Ambiguities in written documents are construed most stringently against whomever has drafted them. This case is a good example of that rule applied to bank documents.

Bank Not Liable for Honoring Fraudulently Endorsed Checks

Navigators Specialty Insurance Co. v. California Bank & Trust, Case No. 8:17-cv-0991-JLS-KES, 2021 WL 4929554 (C.D.Cal. Sept. 27, 2021), arose on a bank's effort to avoid being held liable for checks it honored that bore fraudulent endorsements. It was successful, with the court basing its decision on California law.

A general contractor entered into a subcontract with a subcontractor under which the general paid the subcontractor's suppliers and sub-subcontractors via a joint check procedure. The procedure called for the subcontractor to obtain a lien waiver from its supplier and deliver it to the general. Then, the general would issue a check drawn on the general's account at its depository bank that named both the subcontractor and its supplier as payees. The subcontractor was to endorse the check and hand it to its supplier.

In January 2016, the subcontractor began forging the lien waivers and submitting them to the general. Unsuspecting, the general continued to issue checks on its depository bank. When the checks reached the subcontractor, the subcontractor endorsed them, forged the supplier's endorsement, and deposited the checks in the subcontractor's own account.

Months later, the general discovered the fraud, made a claim with its insurer under its crime and fraud policy, and was paid. The insurer then sued the bank that honored the fraudulent endorsed checks.

The case was in its second go-around, having been considered earlier by the Ninth Circuit Court of Appeals and remanded to the district court because the bank had not been given an opportunity to present an important defense the first time around.

That defense was §3405 of the California Uniform Commercial Code §1101, *et seq.,* the California version of UCC §3-405. But first, what lead to that defense: To begin, the court cited Cal.Com. Code §4401, which plainly states that a bank may charge against its customer's account only "an item that is properly payable from that account." But the court also noted an exception in circumstances in which a bank, "in good faith, pays an instrument" when "an employer entrusted an employee with responsibility with respect to the instrument and the employee or a person acting in concert with the employee makes a fraudulent indorsement of the instrument." 2021 WL 4929554 at *3, quoting Cal.Com. Code §3405(b).

The bank contended that the exception meant the fraudulent endorsements on the checks were effective and that the bank was not liable. Not so fast, said the court. There were a couple of hoops the bank still had to jump through.

First, there was the question of whether the subcontractor was the general's "employee." For that, the court turned to the California Labor Code. The Code defined the term "employee" to include an independent contractor. The court found the subcontractor to be an independent contractor because the general retained control over the performance of the job the sub was hired to do but not the means by which the subcontractor might accomplish the result. So, because the subcontractor was an independent contractor, it was an employee under California law.

Next, the question was whether the subcontractor was a " 'responsible' employee." California decisions, said the court, hold that a separate entity, or the employee of a separate entity, may serve as an employee or agent for purposes of Cal.Com. Code §3405.

Continuing, the court said even though the subcontractor did not operate within the framework of the general — as a traditional employee might — the general nonetheless had solely authorized the subcontractor to supply the information used to prepare the checks.

Thus, the subcontractor fell under the classification of an employee, even though it was an independent contractor, and was a responsible employee because of its role in the preparation and distribution of the checks bearing the fraudulent endorsements.

The public policy reason for UCC §3-405 was explained as follows: "Section 3-405 is based on the belief that the employer is in a far better position to avoid the loss by care in choosing employees, in supervising them, and in adopting other measures to prevent forged indorsements." 2021 WL 4929554 at *5, quoting UCC §3-045, cmt. 1.

The conclusion: UCC §3-405 made the forged endorsements of the checks legally effective, and the general and its insurers must bear the loss. The bank is not liable under UCC §4-401. NOTE: The result would be the same in Illinois under 810 ILCS 5/3-405(a)(3).

Bank Wins Contest with Grain Co-op

In *MidWestOne Bank v. Heartland Co-op,* 941 N.W.2d 876 (Iowa 2020), a farmer's secured lender prevailed over a grain co-op in a battle over whether the grain co-op could deduct drying and storage charges from sales proceeds due the farmer.

The farmer in question regularly delivered his crops to the co-op, a licensed grain dealer with a grain warehouse and handling facility. He had a contract with the co-op for the storage, drying, and sale of the grain. The farmer was also a customer of the local bank, borrowing money from 2013 through 2016, to fund operating expenses, and granting the bank a security interest in the grain and the proceeds of sale. The bank filed a UCC-1 financing statement with the Iowa Secretary of State's office on February 29, 2012, and renewed it on November 15, 2016.

The farmer signed an agricultural security agreement with the bank under which he was to keep the bank fully informed about the location of the grain, to permit no other liens to be asserted against the grain, and to make certain the grain was properly maintained. The farmer was to do any and all things necessary to cultivate, harvest, and protect the crops and was to provide the bank with a list of potential buyers of the crops. Once the crops were sold, payment was to be in the form of a check payable jointly to the farmer and the bank. The bank notified the co-op on three occasions between 2014 and 2016 of its security interest.

he co-op made six grain sales on behalf of the farmer between January 7, 2014, and February 24, 2017. In each case, the co-op deducted its cost of drying and storing the grain from the amount of the joint check it sent to the farmer and the bank. On March 16, 2018, the bank sued the co-op to recover the withheld funds. The co-op defended on the grounds that it was entitled to retain the funds based on the value of the services it had provided to protect the grain. It invoked the concept of equitable estoppel. After considering the effect of the applicable Iowa statute of limitations, the court ruled in favor of the bank. It said:

> **We have never held that a grain elevator, as an unsecured creditor, can recover under a common law or equitable unjust enrichment theory against a bank with a valid perfected security interest in the grain and proceeds. To the contrary, we have held the bank is entitled to summary judgment enforcing its security interest in the grain proceeds.** 941 N.W.2d at 886, citing *First State Bank v. Clark,* 635 N.W.2d 29, 34 (Iowa 2001).

In a footnote, the court observed that legislation had been introduced in the 2019 legislative session to give grain elevators a new priority over secured lenders, but it was never enacted. To that, the court said: "We defer to the legislature whether to give grain

elevators lien rights for storage and drying costs superior to a lender's prior perfected security interest in crops and their proceeds." 941 N.W.2d at 887 n.5.

Finally, in response to the co-op's argument that the bank waived its lien rights by cashing the joint order checks without objection, the court said there was no evidence that the bank discovered the deductions until 2017 so that, "while the actions of [the bank] may not have been a model of diligence, and even rather gullible, there is no triable issue on the question of an intentional and knowing waiver of [the bank's] interest in the proceeds through clear, unequivocal, and decisive conduct." 941 N.W.2d at 888, quoting *Peoples Trust & Savings Bank v. Security Savings Bank,* 815 N.W.2d 744, 764 (Iowa 2012).

What's the point? It takes a great deal of compelling evidence to induce a court to countenance an equitable carveout from the UCC's hierarchy of priorities.

Ode to the UCC

How Wondrus Art Thou, Oh my UCC,

Verily I Do Adore Thee,

Thou Has Given Me Tools,

To Outwit an Army of Fools,

Thou Hast Saved Me on Many a Day,

Against Those Who Wouldst Engage in Foul Play,

Three Steps I Coordinate,

So There Will Be Collateral to Liquidate,

First, Searching Takes Me Hither and Yon,

To Names and Places I Must Ponder,

And Finding No Other Filer Means I Need Not Go Yonder,

Second, Having Filed a Financing Statement There Will Be No Surprise,

That I Have Topped Everyone In Getting to the Prize,

And Last, Confirming That I Have Attained Priority,

Creates a Poorly Disguised Feeling of Superiority.

So Whence Cometh Judgement Day,

I Will Be Proud to Say, “I Did It the UCC Way”.

C@ 2023 Michael L. Weissman

The UCC Meets SRECs

Skyview Finance Co. v. Kearsage Trading, LLC, Civil Action No. 20-11666-PBS, 2023 WL 179837 (D.Mass. Jan. 13, 2023), tests whether a new species of collateral will be introduced to the Uniform Commercial Code. For that reason alone, it is noteworthy.

The case arose out of a pitched battle over whether certain contracts for the purchase of the alleged new collateral had been breached.

But first, to set the stage as had the district judge. An SREC is a tradeable environmental commodity that represents one megawatt hour of electricity generated by solar energy.

In certain states, including Massachusetts, there are regulations known as Renewable Portfolio Standards (RPS) requiring electricity suppliers to generate a portion of their electric power from a renewable energy source. If they do not produce enough on their own, electricity providers can purchase SRECs to ensure their compliance with RPS.

The year that an SREC is generated is known as a vintage year. Once produced, SRECs are " 'minted,' *i.e.,* certified, by a regulatory agency on a quarterly basis." 2023 WL 179837 at *1. A party can enter into a forward contract for SRECs that have not yet been generated or minted, meaning it can contract to purchase SRECs identified by a future vintage year at a set price. SRECs are generally delivered to a buyer as they are minted.

Any SRECs that are produced but not sold may be entered into a clearinghouse auction. There is no assurance that all the SRECs will be sold.

Now, to the case at hand. It was a contract dispute between a consolidator and trader of SRECs that acquired SRECs and resold them to utilities. The other contracting party was an independent producer of renewable energy that generated SRECs. They had entered into a series of contracts, some of which had been fully performed and others that were in dispute. Litigation arose over the disputed contracts.

As the court's opinion put it, "[o]n the eve of t 'al, [one party] submitted the novel argument that Article 2 of the [UCC] should apply to this case." 2023 WL 179837 at *6.

The court proceeded to consider that argument but found it wanting. It began by noting that UCC §2-105 applied to "goods" and that goods are "all things (including specially manufactured goods) which are movable at the time of identification to the contract for sale." *Id.,* quoting Mass.Gen. Laws ch. 106, §2-105. So, said the court, the question is

whether SRECs are goods. And that was a question on which "there is no case law on point." 2023 WL 179837 at *6.

Nonetheless, the court noted that a 2010 Massachusetts bankruptcy court had ruled that electricity was a "good" as defined by the UCC. In reply, the defendant argued that the SRECs were not goods because "they are not 'moveable' or 'tangible.' " *Id.* At best, said the defendant, the SRECs could be considered general intangibles, and even if so considered, they were still not subject to Article 2.

The court agreed with the defendant. It said the bankruptcy court case was based on the fact that "electricity is tangible and does possess physical properties." *Id.* But SRECs, said the court, are different. They are instrumentalities resulting from Massachusetts state regulations. Furthermore, in Massachusetts, SRECs are divorced from the underlying energy, and therefore they do not possess any of the physical properties of a tangible good. So far, so good.

But then the court made a comment that flies in the face of judicial economy. The court remarked, "Whether or not SRECs are intangibles for purposes of the UCC need not be decided now." *Id.* Despite the fact that the proponent of Article 2 coverage had focused on the "goods" argument, the case was an opportunity for a court to provide clarity on an issue that was bound to require judicial consideration in the future.

What's the point? As far as it goes, the decision is helpful since the future is likely to present other instrumentalities of a similar character.

Lien Lost by Surrender of Possession

In re Leaver, 627 B.R. 517 (Bankr. W.D.Wis. 2021), is a reminder that a lien initially perfected by possession can be lost by surrender of possession even if the debtor stipulates the lien continues.

Mr. Leaver was a dairy farmer who had business loans with Wisconsin Bank & Trust and the Farm Service Agency. In 2017, he entrusted dairy cows and youngstock he could not care for to Hillside Dairy. Hillside housed, cared for, milked, and managed Leaver's cows and youngstock until May 20, 2020.

Under Wisconsin law, Wis.Stat. §779.43(3), Hillside had a statutory lien on the livestock for its efforts. But the statutory lien would be lost if the lienholder surrendered possession.

Leaver filed his Chapter 12 petition for relief on April 21, 2020. Sixty days later, Hillside filed a proof of claim for $106,448.84. It was based on the statutory lien it had for boarding the livestock. Leaver filed a plan on July 20, 2020. Then, Leaver and Hillside executed an agreement that provided for the release of the livestock to Leaver and that Hillside would retain its lien rights. The agreement was approved by the court on July 31, 2020.

Leaver, with the obvious background support of the bank and the Agency, objected to the amount claimed by Hillside, but the objection did not raise the question of whether Hillside's secured status was still in place.

Since Hillside had voluntarily surrendered possession of the livestock, the court said, "Hillside gave up the priority its lien might have against [the Bank]." 627 B.R. at 523. But that was not the end of the story. The remaining question was wh ther Hillside still retained its secured status vis-à-vis Leaver. Did the agreement for Hillside to retain its lien, the one the court had approved, save the day for Hillside? No such luck.

The court said that once Hillside's statutory lien was terminated by its surrender of possession, "Article Nine applies to the transaction described in the Stipulation." *Id.* ad

The court then observed that Hillside's underlying transaction with Leaver met all the re uirements for the attachment of an Article 9 security interest.

However, the court ruled that Hillside had not perfected its ecurity interest. Hillside h not filed a UCC1 Financing Statement, nor had it remained in possession of the livestock.

Addressing the stipulation that the parties had executed and that the court had approved, the bankruptcy judge noted, "Neither the Stipulation nor any motion . . . included provision for post-petition perfection of the lien that was being granted." 627 B.R. at 527. Continuing, the court said, "The parties did not ask the Court to treat the Stipulation as a motion to approve credit that would be secured by a lien either junior, equal, or senior to the lien of [the Bank]." *Id.* And finally: "The failure to obtain a Court order deeming perfection or authorizing the credit given by Hillside leads to only one result. Hillside's claim in this case is not secured by a perfected security interest." 627 B.R. at 528.

What's the point? When perfection of a security interest depends wholly on possession of the collateral, surrender of the collateral terminates perfection and permits junior lienholders to advance their priority status.

Security Interests Lost Due to Inadequate Description of Collateral

Two recent cases emphasize the need for an adequate description of collateral when attaching and perfecting a security interest in commercial tort claims.

In *Polk 33 Lending, LLC v. Schwartz,* 555 F.Supp.3d 38 (D.Del. 2021), a lender sought to enforce a security interest against a debtor's directors and officers (D&O) liability claims. The alleged D&O claims arose in connection with the sale of the assets of a Chapter 11 debtor corporation. Polk, the lender, had provided debtor-in-possession (DIP) secured financing to the debtor under a DIP credit agreement.

The debtor corporation denied there were any D&O claims. The bankruptcy judge found that the assets were sold in an orderly fashion pursuant to an arm's-length asset purchase agreement in a competitive bidding environment. Ergo, no D&O claims.

On appeal in the district court, Polk contended there were D&O claims and that it was entitled to assert those claims because it had a perfected security interest in them. Turning attention to the DIP credit agreement, the court noted that it provided only that the collateral subject to Polk's security included "all commercial tort claims (including D&O Claims)." 555 F.Supp.3d at 43.

The court said, "The question is whether the DIP Credit Agreement identified the claims with the requisite specificity to convey a security interest in those claims to Polk." *Id.*

It did not, said the court, concluding: "This is the overgeneralized 'type of collateral' identification that is insufficient according to DCC Section 9-108(e)(1) and did not convey to Polk a security interest in the D&O claims." *Id.*

In *In re Main Street Business Funding, LLC,* 642 B.R. 141 (Bankr. D.Del. 2022), Lane, a creditor, was seeking an order directing the trustee of a bankruptcy estate to turn over the proceeds received from a court-approved settlement of a lawsuit.

Prior to the debtor's bankruptcy filing, Lane had loaned a debtor corporation $852,000. The debtor concurrently executed a security agreement ith a collateral description beginning "[a]ll tangible and intangible personal property of Debtor" and proceeding to list the usual UCC collateral categories. 642 B.R. at 146. Lane also perfected his security interest.

After the bankruptcy case had begun, the trustee settled litigation that the debtor had commenced prior to the bankruptcy filing. Lane's efforts to reach the settlement proceeds raised two questions: (1) did the settlement involve commercial tort claims?

(2) was the collateral description in the security agreement sufficiently detailed to cover those claims?

The claims sounded in fraudulent misrepresentation, conversion, civil conspiracy, breach of fiduciary duty, and aiding and abetting a breach of fiduciary duty. The court ruled they were clearly commercial tort claims.

Turning to the collateral description in the security agreement, the court held it was inadequate. It said, "a security interest in commercial tort claims cannot be obtained simply by generically describing collateral as 'all property' or even as commercial torts. . . . Instead, security interest in commercial tort claims must be specifically identified or described in the security agreement." [Footnote omitted.] 642 B.R. at 153.

What's the point? If a lender wants to have a security interest in a matter in litigation, the description in the security agreement must read as follows: "All funds and any other proceeds arising in any manner or form from that certain matter captioned ABC Industries, Inc. v. XYZ Corporation, No.__ in the XXXXXX Court for the XXXXXX District of XXXXXX State of XXXXXX."

UCC Misuse Results in Criminal Conviction

In *State of Tennessee v. Lyons,* No. M2019-01946-SC-R11-CD, 2023 WL 3446554 (Tenn. May 15, 2023), the Tennessee Supreme Court dealt with an instance in which Uniform Commercial Code (UCC) filings were the tools for criminal conduct. It sustained a judgment of the Tennessee Court of Criminal Appeals that misuse of the UCC filing system could support a conviction of criminal conduct for forgery and other crimes.

The four defendants had filed 102 different UCC1 financing statements with the Secretary of State of Tennessee. One of them was listed as the secured party in each instance. The collateral was shown as a "claim of lien" based on a contract or lien for an amount between $4 million and $12 million. The address shown for the secured party was the address at which the filer (secured party) lived.

Certain victims testified to the impact the false UCC filings had on them. A home seller almost lost the sale; another was denied a request for a personal loan; another had it show up on his credit report as a lien on his property.

The jury convicted each of the four defendants. Each was given a significant prison sentence. The Tennessee Supreme Court allowed them to appeal "solely on the issue of whether the evidence was sufficient to support the convictions for forgery." 2023 WL 3446554 at *4.

The court began by commenting on the UCC filing system, saying, "Unfortunately, the ease of the system, meant to facilitate painless secured transactions, left it vulnerable to persons with ill motives." *Id.* Because many of these fraudulent filings have been against prosecutors, judges, and other public officials, remedies have been added to the UCC to afford them relief. See, *e.g.,* Tenn. Code Ann. §47-9-513(e).

For a conviction of forgery to occur in Tennessee, there has to have been the making "of false entries in books or records." 2023 WL 3446554 at *6. The defendants contended that what they had done — filing the UCC1 financing statements — did not involve "false entries." They said that what the Tennessee statute addresses is "false making," creating a document that is something other than what it seems to be. But, said the defendants, the law does not cover a genuine document (such as a bona fide UCC1) containing false information. Finding another part of the Tennessee statute covered "false making," the court rejected the defendants' argument.

The next argument advanced by one defendant was that the UCC1s had not been entered in "books or records" as the forgery statute required. In essence, it was an appeal for the court to limit "books or records" to private records of a business and/or financial nature. There was no basis for that limitation in the statute, said the court.

Next, the court considered the requirement for conviction that the fraudulent conduct had been undertaken "with intent to defraud or harm another." 2023 WL 3446554 at *8. It said intent rarely can be proven by direct evidence, so "[i]t can be inferred from . . . all the circumstances of the case in evidence." The court noted the UCC1s were filed without any legal basis, the victims had no business dealings with the defendants, and the victims owed no money to the defendants. Thus, it concluded, "The evidence was clearly sufficient for a rational juror to find intent to defraud or harm." 2023 WL 3446554 at *9.

What's the point? The court's decision is consistent with discouraging blatant misuse of the UCC filing system. Even though the offenders did not gain any monetary advantage, their widespread harassment of innocent victims warranted a significant penalty.

Validity of UCC Filing Must Be Tested by Standard Search Logic

In *In re NRP Lease Holdings, LLC,* 50 F.4th 979 (11th Cir. 2022), the decision was supposed to be based on answers to three questions the Eleventh Circuit had certified to the Florida Supreme Court. But the Florida court found that the case turned on an issue the Eleventh Circuit did not address.

Beach Boulevard and its affiliated businesses filed petitions for Chapter 11 relief. The debtors were jointly and severally liable to the lender on two Small Business Administration-guaranteed loans. The loans were supposed to be secured by a security interest on all the debtor's assets. The lender filed two UCC1 Financing Statements identifying the debtor as "1944 Beach Blvd., LLC" rather than its actual legal name "1944 Beach Boulevard, LLC" as shown on the articles of organization filed with the Florida Secretary of State. 50 F.4th at 982.

Beach Boulevard contended that because of the lender's mistake, the lender's financing statements were seriously misleading and did not perfect its security interest. Beach Boulevard prevailed.

The controlling statutory provision was Fla.Stat. §679.5061 (Uniform Commercial Code §9-506), which deals with errors or omissions in financing statements. The statutory section begins with a validation of a UCC filing in case of "minor errors or omissions" unless those minor errors or omissions make the filed UCC1 Financing Statement "seriously misleading." Fla.Stat. §679.5061(1); UCC §9-506(a). It goes on to state that a financing statement that fails to sufficiently provide the name of the debtor is seriously misleading unless "a search of the records of the filing office under the debtor's correct name, using the filing office's standard search logic" would disclose the otherwise insufficient filing. Fla.Stat. §679.5061(3); UCC §9-506(c).

Disregarding the three questions certified to it by the Eleventh Circuit, the Florida court said the dispositive question was, "Is the filing office's use of a 'standard search logic' necessary to trigger the safe harbor protection of Section 9-506(3)?" The Florida Supreme Court said that it was. 50 F.4th at 984.

The Florida court noted that the Florida UCC does not explain what "standard search logic" means. The court said that it means a procedure that identifies the set of financing statements on file that constitute hits for the search or, stated differently, that produces an unambiguous identification of hits. It continued that the Florida registry provides for a search but does not have an option that is standard search logic.

Because Florida's UCC registry lacks a standard search logic, the safe-harbor test of §9-506(c) cannot be performed and the zero-tolerance rule of §9-506(b) controls. The

court's ruling was, "Because [the lender's] financing statements are seriously misleading under Florida law, they were not effective to perfect its security interest in all of Beach Boulevard's assets." 50 F.4th at 985.

Bank's Election of UCC Foreclosure Bars Other Remedies

In *Bank of America, N.A. v. City View Blinds of N.Y., Inc.*, CIVIL ACTION NO. 2● Civ. 9911 (SLC), 2022 WL 580764 (S.D.N.Y. Feb. 25, 2022), Bank of America sued City View Blinds of N.Y., Inc., and others for breach of a loan and a security agreement. Bank of America asserted claims for breach of contract, replevin, conversion, unjust enrichment, and account stated.

On April 8, 2019, Bank of America had entered into a loan agreement with City View, under which City View was granted a revolving line of credit of up to $4.8 million. 2022 WL 580764 at *1. The agreement was to be governed by New York law. That same day, City View executed a security agreement granting Bank of America a security interest in certain collateral. *Id.*

The honeymoon was short-lived. On October 21, 2019, Bank of America sent City View a notice of default. Apparently, the honeymoon was revived with a waiver of the default. But not for very long. *Id.*

On February 20, 2020, Bank of America delivered a notice of nonrenewal stating that on the expiration date of the note, all principal, interest, and other charges and fees would then be due and payable. 2022 WL 580764 at *2. The next day, Bank of America sent notice that it had elected to accelerate the maturity of the loan, making it immediately due and payable.

Thereafter, the parties negotiated a restructuring of the loan. On October 1, 2020, Amendment No. 1 was executed resulting in a new maturity date of April 30, 2021. Certain guarantors also stepped forward, securing their guaranties with collateral. But the required payment due under the restructure was not made.

On October 30, 2020, Bank of America demanded payment. But none was made. Two weeks later, the bank sent another notice of acceleration and demand for turnover of collateral demanding payment within seven days. The demand was unanswered.

On November 24, 2020, Bank of America filed suit and moved for summary judgment. The motion was unopposed.

With respect to Bank of America's claim for breach of contract, Bank of America prevailed. It also prevailed on its request to foreclose its security interests. But that was as far as the court was prepared to go.

Under New York law, in order to succeed in replevin (seizure of the collateral upon an event of default), Bank of America had to prove that its right to the collateral was

superior to the right of City View. 2022 WL 580764 at *6. Having a security interest in the collateral was not sufficient because that simply imposed a lien on the collateral. Ownership remained with City View. Further, the claim for replevin was duplicative of the foreclosure claim because both would end up with the same result.

And the same reasoning applied to Bank of America's claim for conversion (unauthorized dominion over personal property resulting in interference with a party's superior right of possession). The conversion claim was duplicative of the foreclosure claim.

Bank of America was granted the relief it requested but on only one of the claims it advanced.

What's the point? To borrow a phrase from the vernacular, when pursuing a borrower in default, a bank is entitled to just "one bite of the apple." That is, if the bank has chosen a remedy that is dispositive of all of its claims against the borrower's collateral, it will not be permitted to concurrently pursue other remedies that will produce the same ultimate result.

Bank's UCC Liens Trump Wage Claims in Federal Receivership

In a federal court receivership in the United States District Court for the District of Kansas, reported in *Bank Midwest v. R.F. Fisher Electric Co.*, 514 F.Supp.3d 1310 (D.Kan. 2021), the contestants were a bank with unpaid loans due from R.F. Fisher Holdings and G & G Leasing, LLC, and the International Brotherhood of Electrical Workers (IBEW) Local 124 representing employees with wage claims that were not paid when the borrowers ceased operations.

The case was a battle between the bank and the IBEW over the relative priority of their claims. The bank was due $11,416,051.84, *i.e.*, the unpaid balances of five promissory notes plus an overdraft. A series of security agreements were executed by the borrowers concurrently with the notes, and the bank had duly perfected its security interest by filing UCC1 Financing Statements with the Secretary of State of Kansas. The wage claims asserted by the IBEW totaled $137,955.11 and were for wages and benefits due IBEW members for their last week of work, which ended September 16, 2019.

In response to the IBEW's assertion that the order appointing the receiver gave it priority over the bank, the court turned attention to the section that granted a third priority to the costs of operating, maintaining, and repairing the collateral and a fourth priority to payment of the expenses of the collateral. Indebtedness due the bank was afforded only a sixth priority. But the court ruled against the IBEW. It noted that the term "Collateral" was defined in the order and included "all assets of debtor." The court then stated that "[e]mployee wages cannot be considered a cost of operating the collateral," that "the Union's argument conflates the operational costs of running Defendants' business with the costs of operating the Collateral," and that "employee wages are not 'payment of expenses of the Collateral.' " 514 F.Supp.3d at 1314. And, further, that there was no clear language in the order granting priority to wage and benefit claims over secured bank debt.

Having no luck with its contentions with respect to the order appointing the receiver, the IBEW then argued for various Kansas statutes that it said supported its claim of priority.

The first of these was Kan.Stat.Ann. §44-312. It stated that when a receiver was appointed for a corporation, copartnership, or individual under Kansas law, the wages due employees for the six-month period preceding the appointment "shall be preferred to every other debt" and shall be paid from the moneys "which shall first come into the hands of such receiver." 514 F.Supp.3d at 1316. In response, the bank argued the statute did not apply because the receiver had been appointed under federal, not state, law. The court said it did not matter which law applied because the statute "does not provide the [IBEW] with the relief it seeks in this case." *Id.* The court said the plain

language of §44-312 "does not give employee wages a lien or priority over secured liens. Instead, it simply indicates a preference for wages over other general debts." 514 F.Supp.3d at 1317.

Not yet finished, the IBEW then invoked Kan.Stat.Ann. §17-6910. It stipulated that when a corporation becomes insolvent, the employees shall have a lien on its assets for an amount not exceeding two months' wages, which shall be paid prior to any debts of the corporation. The court said the statute posed the question of "whether the [borrower's] assets [we]re subject to existing liens or whether such existing liens are included in the debts of the corporation." *Id.* The bank's position, of course, was that the employees' lien for wages was on the corporate assets, and those assets were subject to the preexisting liens of the bank. Addressing the language of the statute, the court said, "[a]lthough the plain language of §17-6910 grants employees a lien on the corporation's assets for wages due to them, it does not provide that this lien takes priority over existing and prior liens on those assets," "[n]or does it provide that the lien will take priority over secured interests." 514 F.Supp.3d at 1319. The result: judgment for the bank.

What's the point? Even though courts are generally sympathetic to wage claims of employees of insolvent borrowers, they will not use state statutory law to subordinate earlier perfected security interests in the borrower's assets to those wage claims unless the state law clearly grants the wage claims a lien priority position.

Can a Wire Transfer Be Recalled After It Is Accepted?

In *Blue Flame Medical LLC v. Chain Bridge Bank, N.A.*, 563 F.Supp.3d 491 (E.D.Va. 2021), a case involving Article 4A of the Uniform Commercial Code (UCC), the district court was called to decide when an accepted payment order may be cancelled. The factual background was a bit complex, so it is set forth in chronological order as follows.

1. March 20, 2020: John Thomas and Michael Gula contacted the California Department of General Services (DGS) about supplying N95 masks even though they had no previous experience with medical supplies.

2. March 23, 2020: Thomas and Gula formed a limited liability company called Blue Flame Medical LLC in the State of Delaware. They also opened an account for Blue Flame at Chain Bridge Bank, N.A., where they advised the officers that the account would receive domestic and foreign wire transfers totaling $100 million per month and would be directed to wire out an average of $25 million per month. They were provided with wire transfer instructions for the account.

3. March 25, 2020: DGS issued a purchase order to Blue Flame for a total of 100 million N95 masks for a total purchase price of $609,161,000, 75 percent being prepaid. The purchase order included a provision that DGS could "terminate performance of work under this Contract for its convenience . . . if [DGS] determines that a termination is in the State's interest." 563 F.Supp.3d at 496. The California purchase order included a delivery date of April 3, 2020.

4. March 25, 2020: Thomas sent a message to DGS at 11:46 p.m. that included a list of delivery dates for the 100 million masks indicating that the first million would be delivered on April 2, 2020, and that the entire shipment would be in California no later than April 24, 2020. At that point, DGS officials did not know that Blue Flame had been organized only two days earlier, was not qualified to transact business in California, had never delivered any masks to customers, and had opened its bank account only one day earlier.

5. March 25, 2020, 3:30 p.m.: Gula told Chain Bridge Bank that California is sending a wire transfer to Blue Flame account for $450 million. At 6:15 p.m., a Chain Bridge Bank officer asked Gula what the purpose of the incoming wire transfer was. Gula replied that it was the purchase of 100 million masks. In response to a question, Gula stated he did not know how long the incoming wired funds would remain in the account. The Chain Bridge Bank officer advised senior bank management, who said so large a wire transfer could not be held entirely at Chain Bridge Bank but would have to be spread over various accounts. Senior management stated it was "unbelievable" a two-day-old business could receive a $450 million contract from the State of California.

6. March 25, 2020: Chain Bridge Bank's senior management advised Gula by telephone that a $450 million deposit would not be covered by FDIC insurance and that it would have to be placed in "sweep" accounts at several institutions.

7. March 25, 2020, 6:17 p.m.: The senior management of Chain Bridge Bank asked Gula to identify the recipient of funds to be wired out of the account. They are told Wingar Industrial, Inc.

8. When searched for on the Internet, Wingar Industrial turned out to a cutlery company. Chain Bridge Bank's senior management became more suspicious.

9. March 26, 2020, 11:21 a.m.: The California State Treasurer's Office originated a wire transfer for $456,888,600 for the benefit of Blue Flame through the state's bank, JPMorgan. The transaction triggered a warning to JPMorgan's Fraud Payments Control Team that looks out for suspicious transactions. The team asked DGS to confirm the transaction, and it did so. Receipt of the wire transfer occurred at 11:55 a.m. at Chain Bridge Bank, and at 11:57 a.m., Chain Bridge Bank's personnel advised Gula that $456,888,600 had been received for the benefit of Blue Flame.

10. March 26, 2020, 12:07 p.m.: Concerned about the transaction, Chain Bridge Bank management placed a hold on the funds. JPMorgan's team asked Chain Bridge Bank if it knew the beneficiary of the funds and what their ultimate disposition would be, saying JPMorgan had concerns about whether the transaction was bona fide. Chain Bridge Bank management said it had its own concerns and put a hold the funds.

11. March 26, 2020, 12:44 p.m.: JPMorgan's Team questions Chain Bridge Bank's management, asking if Blue Flame is a new account or a well-established business.

12. March 26, 2020, 12:51 p.m.: An employee of DGS called Chain Bridge Bank in response to a message left on DGS's voicemail, confirming that the wire transfer was legitimate.

13. March 26, 2020, 12:55 p.m.: Chain Bridge Bank managers asked JPMorgan for documentation to support that the funds were transferred properly. DGS replied in the affirmative and referred the managers to an official in the California State Treasurer's Office.

14. March 26, 2020, 1:19 p.m.: Officials from the California State Treasurer's Office called Chain Bridge Bank and were told that Blue Flame's account had just been opened the previous day and that the funds had not been credited to the bank account of Blue Flame at that time.

15. March 26, 2020, 1:34 p.m.: Managers of Chain Bridge Bank asked JPMorgan's team whether a recall could be issued for the wired funds Chain Bridge Bank held. The

answer was that JPMorgan felt comfortable because Chain Bridge Bank was holding the funds.

16. March 26, 2020, approximately 1:39 p.m.: JPMorgan advised Chain Bridge Bank that JPMorgan was recalling the funds. Chain Bridge Bank asked for an official communication from JPMorgan requesting a recall of the funds.

17. March 26, 2020, 1:55 p.m.: Chain Bridge Bank advised Gula that it had received an official notice from JPMorgan to return the wired funds and that he should resolve the matter with the State of California.

18. March 26, 2020, 2:05 p.m.: JPMorgan sent a message to Chain Bridge Bank officially asking for a return of the funds. The recall corresponded to a 2:00 p.m. request from the California State Treasurer's Office that JPMorgan recalled the funds because the Treasurer was not satisfied with DGS's due diligence.

19. March 26, 2020, 2:30 p.m.: Gula visited with Chain Bridge Bank's senior managers, apologized for the transaction, and stated that he did not object to the return of the funds.

20. March 26, 2020, 3:21 p.m.: Chain Bridge Bank returned the funds to JPMorgan. The funds are credited to the account of the State of California at 4:02 p.m. The litigation followed.

On June 12, 2020, Blue Flame sued Chain Bridge Bank, claiming violations of §§4A-404(a) and 4A-204(a) of the UCC. On October 13, 2020, Chain Bridge Bank sued JPMorgan for indemnification of its litigation expenses. Each party filed a motion for summary judgment. The result was a ruling against Blue Flame on its claim against Chain Bridge Bank and in favor of Chain Bridge Bank on its claim against JPMorgan.

Blue Flame's claims against Chain Bridge Bank were based on an alleged violation of §4A-404(a) that occurred when Chain Bridge Bank returned the wired funds to JPMorgan. Section 4A-404(a) states that "if a beneficiary's bank accepts a payment order, the bank is obliged to pay the amount of the order to the beneficiary of the order." The court said there was no question whether the funds in question had been accepted because they had been credited to the account of Blue Flame. Despite that, Chain Bridge Bank argued that although the payment was accepted, it was not liable to Blue Flame for having returned the funds because JPMorgan had cancelled the payment. In making that contention, Chain Bridge Bank relied on §4A-211(e), which states: "A canceled payment order cannot be accepted." Section 4A-211(c)(2) provides that a cancellation order can trump an acceptance only if the cancellation is "effective." 563 F.Supp.3d at 503.

Section 4A-211(e) stated that a cancellation of a payment order is effective only if the order was issued to implement an unauthorized payment or, because of a mistake by the sender, the payment order (1) is a duplicate of a prior order, (2) directs payment to a

beneficiary not entitled to payment, or (3) directs payment of too great an amount. Finding none of the foregoing was present, the court said Chain Bridge Bank could not nullify its obligation to Blue Flame because JPMorgan's effort at cancellation was not effective.

Alternatively, Chain Bridge Bank argued the entire wire transfer was clearly in error because "California originated the funds transfer only as a result of having been misled about Blue Flame's bona fides as a PPE supplier." *Id.* The court made short work of that argument saying, "Chain Bridge cannot rely on problems with the underlying transaction to escape its obligation to its customer under the banking regulations." 563 F.Supp.3d at 504. But then the court said that despite Chain Bridge Bank's violation of the banking regulations, judgment would be in favor of Chain Bridge Bank because "[Blue Flame] cannot establish that it sustained any damages from that return. . . . The UCC does not provide for, and Blue Flame has not claimed, statutory damages for a violation of §4A-404(a)." *Id.* Moreover, said the court, even if the funds had been released to Blue Flame, there was ample evidence in the record that Blue Flame could not have fulfilled its contract with the State of California.

The remaining issue was whether JPMorgan had to indemnify Chain Bridge Bank for fees and expenses it had incurred in the litigation. Applying §4A-211(f), the court ruled that it did because that provision applies when "a sender has no right to cancel a payment order after it is accepted by the receiving bank." 563 F.Supp.3d at 510. Finding no evidence of an agreement between the two banks overriding that rule, the court entered judgment in favor of Chain Bridge Bank on its indemnification claim against JPMorgan.

What's the point? The rules of §4A of the UCC operate independently of the contractual arrangements that give rise to the origination, implementation, and possible cancellation of a payment order. Section 4A emphasizes finality so that financial transactions can be executed with the expectation that the sender and recipient of a wire transfer will abide by their respective obligations.

Bank Loses Claim to Collateral

In *Rome Granite, Inc. v. Pinnacle Bank,* A22A0447, 2022 WL 1492854 (Ga.A p. May 5, 2022), the bank lost its claim to certain collateral because it was unable to provide sufficient evidence that both it and the borrower intended to include the collateral but failed to do so as a result of a mutual mistake.

The borrower's relationship with the bank began before 2004 with a commercial loan secured by real estate. After 2004, the borrower acquired two additional tracts, named "Tracts 6 and 7," but they were not added to the collateral description in the bank's security documents. In 2012, the bank and the borrower consolidated separate loans into one secured by real estate, but the collateral description was not modified. Subsequently, the borrower built a loading dock on its property that extended over Tracts 6 and 7. In 2015 and 2016, the bank's security documents were modified again, but again no changes were made to the original collateral description.

The borrower later defaulted, and in 2019, the bank conducted a nonjudicial foreclosure under a power of sale. The bank was the purchaser at the sale. Thereafter, for a year following the sale, the parties acted as though the bank had foreclosed on all of the property owned by the borro er, including Tracts 6 and 7. But in 2020, the borrower learned that it still owned Tracts 6 and 7 and quitclaimed them to a limited liability company organized by the owner of the borrower.

Once it became aware of the fact that it did not own Tracts 6 and 7, the bank sued to reform the loan documents to include Tracts 6 and 7 as collateral because they had been excluded as a result of a mutual mistake of the parties. The trial court denied the bank's request for reformation of the loan documents, and the appeals court confirmed the decision.

The appeals court said that the burden on the party attempting to prove mutual mistake is a heavy one and that a court will relieve mistakes only if the evidence to support it is "clear, unequivocal, and decisive as to the mistake." Ga. Code Ann. §§23-2-21(a), 23-2-21(c).

Reviewing the evidence, the court found it conflicting. There was testimony by bank officers that they believed all of the borrower's real estate was covered by the security documents. There was evidence that Tracts 6 and 7 were located at the same treet address mentioned in the security documents as well as testimony from the borrower's owner that he did not realize that Tracts 6 and 7 were not covered by the security documents.

Conversely, the court found no evidence of specific discussions concerning the collateral to secure the borrower's indebtedness in the 2012 documentation. The bank officers did not inform the borrower that it intended Tracts 6 and 7 to be covered by its security interest. The borrower's owner testified that he signed the 2012 loan documents without giving any thought as to whether Tracts 6 and 7 were included. The court also noted that the 2012 transaction did not involve any additional financing, that the real estate appraisal for the 2012 transaction did not reference Tracts 6 and 7, and that the title insurance policy issued in 2012 did not cover Tracts 6 and 7.

Based on the foregoing, the court said the bank had not established clearly, unequivocally, and decisively that Tracts 6 and 7 were excluded from the 2012 loan documentation due to a mutual mistake.

What's the point? Although after-acquired personal property collateral can be included in a bank's collateral by using an after-acquired clause in the collateral description, that is not true of real estate. If it is intended that after-acquired real estate is to be part of the collateral securing the borrower's indebtedness, appropriate modifications must be made to the loan documentation.

Election of Wrong Remedy Blocks Creditor's Claim

In *Durham Commercial Capital Corp. v. Ocwen Loan Servicing, LLC,* 777 Fed.Appx. 952 (11th Cir. 2019), a pleading error prevented a secured creditor from enforcing its rights against its collateral. The result is informative for secured lenders and their counsel.

The facts were rather simple. A law firm was retained by a mortgage loan servicer to initiate foreclosure proceedings and to remit the amounts collected to it. Concurrently, the law firm entered into a factoring agreement with plaintiff Durham Commercial Capital Corporation, under which Durham purchased some of the law firm's accounts receivable and was granted a security interest in all of the law firm's accounts receivable. Durham sent notice to the mortgage servicer that Durham was owed what the mortgage servicer paid the law firm for its legal services.

Durham also sent notice to the mortgage servicer to pay Durham directly, but the mortgage servicer ignored the notice and paid the law firm $1,340,865.21 after receiving the notice. The law firm paid $202,238.47 to Durham, but Durham asserted it was entitled to $1,138,626.74 more. 777 Fed.Appx. at 953. The law firm sought bankruptcy relief, and Durham sued the mortgage servicer for $1,138,626. A jury trial ultimately ensued with an award to Durham. An appeal followed with a reversal in which the mortgage servicer prevailed based on New York law.

Counsel for Durham had founded Durham's entire case on §9-406(a) of New York's Uniform Commercial Code. That section provides that a debtor may satisfy its obligation by paying its creditor until a third party notifies the debtor that the right to collect the debt has been assigned to the third party. After that, the debtor cannot extinguish the debt except by paying the third party. Of course, the third party must have the right to enforce collection of the debt and that depends on showing that it has the status of an assignee.

The mortgage servicer argued on appeal that Durham failed to establish in the trial court that Durham had the status of an assignee of the law firm's accounts. Durham's reply in its brief was that the argument was immaterial because §9-406(a) provided a right to collect to both explicit assignees as well as secured parties. But later in the appeal, Durham's counsel admitted there was nothing in the record to suggest that the law firm had secured its account with the mortgage servicer to Durham. Thus, Durham was left with the argument that §9-406(a) afforded it a private right of action to collect. But that was too big a fish for the Eleventh Circuit to swallow.

The Eleventh Circuit reviewed §9-406(a) and found nothing to indicate that it creates a private right of action in favor of a secured party against an account debtor. Therefore, it

said, if there is any such right of action, "such a right must be implied." 777 Fed.Appx. at 955.

The court concluded there was no implied right of action for a secured party against an account debtor. The principal test was whether recognizing an implied right of action would be inconsistent with the New York legislative scheme. The court said §9-607(a)(3) already grants a secured party the right, after default, to enforce the obligations of an account debtor; thus, to grant an implied right of action under §9-406(a) "would be inconsistent with the overall legislative scheme." 777 Fed.Appx. at 956. Furthermore, in *IIG Capital LLC v Archipelago, L.L.C.,* 36 A.D.3d 401, 829 N.Y.S.2d 10 (2007), a New York state court had ruled that there is no authority to treat a factor's security interest as an assignment for collection. 777 Fed.Appx. at 957.

What's the point? This decision provoked the Permanent Editorial Board of the Uniform Commercial Code to publish PEB Commentary No. 21, which states that "an 'assignment' [is understood to be] an outright transfer of ownership of a specified payment right or a [security interest to secure an obligation] in a specified payment right." Under that approach, Durham won.

Signatories to Note Liable to Payee Even if Not Named in Note

In *Solidarity Ltd. v. JeffEx, LLC,* No. 20 CV 1456, 2023 WL 2683215 (N.D.Ill. Mar. 29, 2023), the principal issue as whether three individuals who had signed a promissory note were liable to repay it even though they weren't named in the body of the note. The court held they were.

Jeffrey Cioni, James Cioni, and David Brittsan were partners in a company called Rescue Tire Recycling (RTR). In 2015, they sought capital to fund RTR's operations. They retained a venture capital firm, Venture DNA, to assist in raising $20 million.

When that failed, they sought a bridge loan from Solidarity Ltd. to fund their operations pending receipt of funds from a bond issue. In September or December of 2015, Brittsan met with TJ Weber, an agent of Solidarity, to discuss a $175,000 bridge loan to JeffEx, an excavating contracting business owned by Jeffrey Cioni. In exchange for the loan, JeffEx would pledge certain items of equipment as collateral. Once the bond issue had been resolved, RTR would purchase the equipment from JeffEx, and JeffEx would use the funds it received from RTR to repay Solidarity.

On December 28, 2015, the Cionis and Brittsan signed a $175,000 commercial note. The note began with the usual language: "The Undersigned (whose principal place of business is listed below), jointly and severally, if more than one, for value received, promise to pay to the order of Solidarity Limited . . . the principal sum of $175,000 . . . [o]n or before 90 days from receiving the Principal Sum ('Maturity Date') [and i]n addition . . . $50,000 in interest." 2023 WL 2683215 at *2.

The "Defaults and Remedies" section of the commercial note stated that the "[f]ailure of the Undersigned to pay any amount due hereunder for a period in excess of ten days after it becomes due . . . shall constitute an event of default (Default) hereunder." *Id.* It also empowered Solidarity to declare the commercial note immediately due and payable without notice at any time during a default.

The commercial note reiterated, "The Undersigned, if more than one, agree that they are jointly, severally, and primarily liable for repayment of this Note." *Id.*

The signature page of the commercial note showed four signatures: Jeffrey Cioni signing on behalf of JeffEx, and separate individual signatures by Jeffrey Cioni, James Cioni, and David Brittsan, followed by their respective addresses. Nowhere in the text of the commercial note were the Cionis or Brittsan referenced. A security agreement was also executed by JeffEx in favor of Solidarity covering certain equipment.

In December 2015 and January 2016, Solidarity distributed a total of $175,000 to JeffEx. The commercial note matured on April 6, 2016, and was not repaid. A loan modification agreement was executed in April extending the maturity date to May 15, 2016, but, once again, the commercial note was not repaid. The modification agreement was signed by JeffEx and each of the three individuals.

In February 2020, Solidarity sued JeffEx and the three individuals. Although they admitted the commercial note had not been paid, the individuals denied they had personal liability.

The court denied the individual defendants' contention that the terms of the note were ambiguous. It said: "The Note unambiguously provides that any person who signed the Note would be jointly and severally liable for the debt to Solidarity. Because the Cionis and Brittsan signed the Note, they are jointly and severally liable to Solidarity." 2023 WL 2683215 at *4. Also, the court held that the contractual term "the Undersigned" unambiguously refers to those whose names were signed at the end of the note, including the Cionis and Brittsan.

What's the Point? The defendants attempted to manufacture an ambiguity where none existed. The fact that a contractual term is not defined in a loan document does not make it ambiguous. An undefined term will be given its plain and ordinary meaning as found in a standard ordinary definition.