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A Dragnet Clause and a Future Advances Clause Can Reach the Collateral of a Loan that Has Already Been Repaid

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Introduction

This memorandum will explore the secured transactions issues that arose in *In re Omni Enterprises.* In that case, the Bankruptcy Court in Alaska held that a bank may enforce the security interest of a prior loan that has already been repaid to cure a new loan that was in default.[1] The prior loan was secured by the debtor's deposit accounts, and contained a cross-collateralization clause and future advances clause; however, the new loan did not mention the deposit accounts at all.[2] When the debtor defaulted on the new loan, the bank argued, among other things, that it continued to have a security interest in the deposit accounts because of the cross-collateralization clause and the future advances clause in the prior loan.[3] The trustee for the debtor argued that holding for the bank's interpretation would result in a "never ending future

[1] In re Omni Enters., Inc. v. First Nat'l Bank Alaska, No. A15-00076-HAR, 2016 WL 3213562, at *1 (Bankr. D. Alaska May 31, 2016), *rev'd sub nom*. Jipping v. First Nat'l Bank Alaska, No. 3:16-CV-00125 -SLG, 2017 WL 927987 (D. Alaska Mar. 8, 2017).
[2] *See id.* at *2–3.
[3] *See id.* at *9.

advances obligation."[4] Ultimately, the bankruptcy court held that despite the first loan having been paid off, the collateral on the first loan could be used to satisfy the debt on the second loan.[5]

This decision was recently reversed in the District Court of Alaska.[6] On March 8, 2017, almost one year after the initial decision, the District Court reversed the bankruptcy court's decision, and held that the bank did not have a valid security interest in the deposit accounts.[7] The District Court interpreted the two loan documents differently than the Bankruptcy Court, and stated that the prior loan was not within the realm of related documents with regards to the new loan.[8] The District Court sought to interpret the loan documents in a way that gave "ordinary words their ordinary meaning" and that used an "objective standard."[9]

This memorandum seeks to explore two issues: (1) whether a dragnet clause (or cross-collateralization clause) can reach the collateral of a loan that has already been repaid; and (2) whether a future advances clause can halt the termination of a loan that has already been repaid. The District Court's reversal of the Bankruptcy Court's decision does not affect these issues because the District Court "assume[d], without deciding, that the 2009 Security Agreement remained in effect after Omni paid off the 2009 Loan . . . ."[10] This memorandum will address the issues that were set to the side in the District Court's decision.

This memorandum will take a twofold approach for each of the dragnet clause issue and the future advances clause issue. First, it will discuss the law as it stands for dragnet clauses, and then it will discuss how different courts have ruled with regards to cases that involve dragnet

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[4] *See id.* at *11.
[5] *See id.* at *1.
[6] *See* Jipping v. First Nat'l Bank Alaska, No. 3:16-CV-00125 -SLG, 2017 WL 927987, at *1 (D. Alaska Mar. 8, 2017).
[7] *See id*.
[8] *See id.* at *4.
[9] *See id.* at *5.
[10] *See Jipping*, 2017 WL 927987, at *3 (D. Alaska Mar. 8, 2017).

clauses and loans that have already been repaid. Then, it will do the same for future advances clauses. Finally, it will explore different ways a drafter can avoid the results of *In re Omni Enterprises*, and instead, create an agreement that accurately memorializes the result that each party desires.

I. Dragnet Clauses

A. The Law as it Stands

A dragnet clause is a clause that seeks to "extend the secured obligation to all debts whenever and however arising owing by the debtor to the secured party."[11] Although a dragnet clause is commonly used to secure future advances, as discussed *infra*, it can also be used to secure a wide variety of different assets, including the creditor's expenditures,[12] obligations owed to affiliates of the secured debtor,[13] and more.

In the past, courts have been skeptical of dragnet clauses because of their susceptibility to overreaching by creditors.[14] However in 2004, the First Circuit, in *Pride Hyundai, Inc. v. Chrysler Fin. Co.,* held that the only restriction on dragnet clauses under the U.C.C. is that the secured party must act in good faith in enforcing the clause.[15] The court held, "The risk that creditors may abuse broad dragnet clauses is offset by the expansion of the duty of good faith to include a standard of commercial reasonableness."[16] Under U.C.C. § 9-102(a)(43), good faith means the secured party must be "honest in fact" and must "observe reasonable commercial standards of fair dealing." Thus, dragnet clauses can have a far reach as long as the secured party acts in good faith.

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[11] Secured Transactions Under UCC (MB) § 2D.04 (2017).
[12] *See, e.g.,* First Nat'l Bank & Tr. Co. v. Sec. Nat'l Bank & Tr. Co., 676 P.2d 837 (Okla. 1984).
[13] *See, e.g., In re* E. A. Fretz Co., 565 F.2d 366 (5th Cir. 1978).
[14] Secured Transactions Under UCC (MB) § 2D.04.
[15] 369 F.3d 603, 613–615 (1st Cir. 2004).
[16] *Id.* at 615.

With regard to loans that have already been repaid, the critical question is when does a security agreement terminate? A repayment of a loan only works to terminate the outstanding security interest – it does not terminate the security agreement itself.[17] Further, while U.C.C § 9 discusses secured transactions generally, it does not discuss at what point a security agreement terminates.[18] Thus, if a security agreement has not yet been terminated, a dragnet clause may work to revive the security interest of a prior loan for the purposes of satisfying a future loan even if the prior loan has been paid off.[19] When a loan has been paid off, but a later loan causes the previously extinguished security interest to arise anew, this is known as a revival of the security interest.[20]

B. How Different Courts Have Ruled With Respect to Loans that Have Already Been Repaid

Cases involving dragnet clauses and their various secured interests are very fact specific. This is because these cases are largely about contract interpretation, and how a court reads the various documents that are at issue. As can be seen *supra*, the result can differ depending on whether the documents had general boilerplate language or whether the documents had some other language that would change the meaning of the terms.[21] Furthermore, the result can also not only affect whether certain collateral acts as a security interest, but also whether a party has priority over another.[22]

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[17] Secured Transactions Under UCC (MB) § 2D.04.
[18] *See id.*
[19] *See id.*
[20] *See id.*
[21] *See, e.g.*, *In re* Massey, No. 09-81220-TRC, 2010 Bankr. LEXIS 65, at *10 (Bankr. E.D. Okla. Jan. 6, 2010); Tennant v. Fifth Third Bank, No. 11-07599-JKC-11, 2012 Bankr. LEXIS 4026, at *15 (Bankr. S.D. Ind. Aug. 30, 2012).
[22] *See, e.g.*, Lowell Dev. & Fin. Corp. v. Winter Hill Bank (*In re* Natale), 508 B.R. 790, 795 (Bankr. D. Mass. 2014).

In re Massey is a case that illustrates a situation in which boilerplate dragnet language was enforced as between a consumer and a lender, resulting in a judgment in favor of the creditor. In *In re Massey*, the court held that a debtor's vehicle served as collateral for the debtor's various credit card loans and other loans despite the vehicle loan having already been repaid.[23] In this case, the debtor entered into a vehicle loan to purchase a 2005 Chevy Trailblazer, paid off the loan, and then entered into subsequent loans that each contained a cross-collateralization clause, pulling the Trailblazer into each loan.[24] The debtor testified that she would not have entered into the subsequent loans if she had known that the Trailblazer served as collateral for each of the loans.[25] Nevertheless, the creditor never released the lien on the Trailblazer, and the court held that the various cross-collateralization clauses were valid.[26]

A similar result occurred in *In re Natale*, which involves the effect of a dragnet clause on the order of priority as between two commercial lenders.[27] In this case, there were multiple mortgages on a group of properties, and the second mortgagee was seeking a declaratory judgment that it had priority over the deficiency claim of the first mortgagee.[28] The first mortgagee's security agreement, however, contained a dragnet clause.[29] If this clause were to be given effect, then the first mortgagee's claim would take priority.[30] The court ruled that the dragnet clause should be enforced because there was no evidence of unfairness or oppressiveness in the agreement between the debtor and the first mortgagee.[31]

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[23] *See In re Massey*, 2010 Bankr. LEXIS 65, at *10.
[24] *See id.* at *2–7.
[25] *See id.* at *7–8.
[26] *See id.* at *8.
[27] *See In re Natale*, 508 B.R. at 795.
[28] *See id.* at 791.
[29] *See id*.
[30] *See id.* at 795.
[31] *See id.* at 804.

A different result occurred in *Tennant v. Fifth Third Bank.* In this case, the court refused to enforce the dragnet clause in a mortgage agreement because there was specific language in the mortgage agreement stipulating that the security agreement ended when the mortgage was repaid.[32] In this case, a debtor entered into a home equity line of credit agreement and a mortgage agreement with a lender.[33] When the debtor paid off the loan, the lender did not release the mortgage, and later argued that the debtor did not request the mortgage to be released.[34] The court emphasized that the home equity line of credit agreement stated "[l]ender shall discharge" the mortgage upon full payment of the indebtedness due; thus, the debtor was under no obligation to request that the mortgage be released, and the mortgaged property did not serve as collateral to any other loans.[35]

II. Future Advances Clauses

A. The Law as it Stands

U.C.C. § 9-204(c) states, "A security agreement may provide that collateral secures, or that accounts, chattel paper, payment intangibles, or promissory notes are sold in connection with, future advances or other value, whether or not the advances or value are given pursuant to commitment." Comment 5 to that section explains "parties are free to agree that a security interest secures any obligation whatsoever" and "[d]determining the obligations secured by collateral is solely a matter of construing the parties' agreement under applicable law."[36] In other words, drafters may provide that collateral secures any future advances, even those not contemplated by the initial agreement.

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[32] *Tennant*, 2012 Bankr. LEXIS 4026, at *15.
[33] *See id.* at *2–4.
[34] *See id.* at *14.
[35] *See id.* at *15.
[36] U.C.C. § 9-204(c) cmt 5.

With regard to collateral securing a loan that has already been repaid, the U.C.C. does not discuss whether a future advances clause "revives" the collateral or creates a completely "new" security interest in the collateral.[37] However, whether a revived security interest or a completely new security interest, the repayment of a loan does not terminate the underlying security agreement.[38] As stated *infra*, the repayment of a loan only terminates the outstanding security interests.[39] Nevertheless, while the underlying security agreement may still stand, a debtor may attempt to effectuate its termination by procuring a termination statement from the creditor.[40]

B. How Different Courts Have Ruled With Respect to Loans that Have Already Been Repaid

Like cases involving dragnet clauses, cases involving future advances clauses are equally fact specific. Again, these cases involve a significant amount of contract interpretation; thus, issues such as the jurisdiction's articulation of the parol evidence rule will come into play.[41] However, with regard to actions outside of the contract, a creditor can, for example, file a U.C.C. financing statement in order to solidify its superior position.[42]

In re Conte is factually very similar to *In re Massey*, as discussed *supra*, but in this case, the court ruled in favor of the creditor for a different reason.[43] In *In re Conte*, a debtor entered into a loan agreement to purchase a car, pledging the car as collateral.[44] The loan agreement contained a future advances clause.[45] Later, the debtor entered into a subsequent credit card

[37] Secured Transactions Under UCC (MB) § 2D.04.
[38] *Id.*
[39] *Id*.
[40] U.C.C. § 9-513(c)(1).
[41] *See, e.g.*, Cmty. Credit Union v. Conte (*In re* Conte), 206 F.3d 536 (5th Cir. 2000).
[42] *See, e.g.*, *In re* Oak Rock Fin., LLC, 527 B.R. 105, 110 (Bankr. E.D.N.Y. 2015).
[43] *See generally In re Conte*, 206 F.3d 536; *In re Massey*, 2010 Bankr. LEXIS 65.
[44] 206 F.3d at 537.
[45] *See id.*

agreement with the creditor, and also paid off the initial loan for the car.[46] Despite the loan having been paid off, the creditor refused to turn over title to the car because the debtor still owed substantial credit card debt.[47] The court stated that under the parol evidence rule, a future advances clause must be within the contemplation of the parties at the time that the agreement was made.[48] The court ruled that the future advances clause was within the parties' contemplation and thus the car was made to serve as collateral for the subsequent credit card debt.[49]

In *In re Oak Rock Fin., LLC*, a court also ruled in favor of the creditor, but in this case because the creditor perfected his security interest by filing a U.C.C. financing statement.[50] In this case, a debtor entered into a security agreement with the creditor, and the creditor subsequently filed a financing statement with the Secretary of State, listing after-acquired assets as collateral.[51] Later, the debtor paid off the original loan with proceeds from subsequent loans.[52] The debtor argued that its loan was satisfied, and thus the financing statement was extinguished as a matter of law.[53] The court stated that a majority of jurisdictions hold that once a financing statement has been filed, a lender "may advance funds, pay off loans, and readvance funds, all of which will be perfected by the original financing statement without the need to file additional

[46] *See id.* at 538.
[47] *See id.*
[48] *See id*.
[49] *See id.* at 539.
[50] *See In re Oak Rock Fin., LLC*, 527 B.R. at 110.
[51] *See id*.
[52] *See id*. at 119.
[53] *See id*. at 108.

financing statements."[54] Thus, the creditor in this case was a secured creditor, and the financing statement remained unaffected despite the original loan having been paid off.[55]

III. Implications

A. How the Debtor in *In Re Omni Enterprises* Ended Up Where He Ended Up

The debtor in *In Re Omni Enterprises* ultimately received a judgment in its favor following the District Court's reversal of the Bankruptcy Court's decision.[56] Nevertheless, the debtor in *In re Omni Enterprises* had to deal with the aftermath of the original 2009 loan for a long eight years after the loan was made – until the Bankruptcy Court's decision was made this year in 2017.[57] Drafters should allow *In re Omni Enterprises* to serve as an example that the lack of careful drafting can lead to serious consequences. Furthermore, the fact that there is a reversal shows that contract interpretation can very much be in the eye of the beholder. In its decision, District Court noted that the Bankruptcy Court's interpretation of the two loan documents "constitutes a 'somewhat circular' construction of the relevant terms so as to result in an 'exceedingly obscure connection between the 2009 and 2013 Security Agreements."[58] Needless to say, security agreements can involve many clauses that affect the agreement in different, sometimes conflicting ways, and drafters should do their best to resolve the conflicts before a court is called in to do so.

B. How Other Debtors and Creditors Can Better Draft Their Agreements

There are various ways future debtors and creditors can better protect their interests in security agreements. For example, instead of relying on a dragnet clause to capture assets into its

[54] *Id.* at 119.
[55] *See id.* at 120.
[56] *See Jipping*, 2017 WL 927987, at *1.
[57] *See id.*
[58] *See id*. at *4.

net, a lender could itemize each asset that it would like to serve as collateral.[59] Part of the issue in *In re Omni Enterprises* was the fact that the second loan agreement did not explicitly state that the deposit accounts acted as collateral for the second loan; thus, if the lender had itemized the deposit accounts, then the assets at stake would be clear for both parties, even if the loan had been paid off at the time.[60] Another related method is to include any referenced documents as an exhibit. For example, an agreement that contains a cross-collateralization clause can include as an exhibit to the agreement the other document that references the asset that is being cross-collateralized upon. Furthermore, if possible, the debtor can draft a defeasance clause into the agreement itself.[61] The defeasance clause will act to terminate the agreement once the debt is repaid.[62]

Another more concrete way for debtors and creditors to better protect their interests is for each party to file or request subsequent documentation. The creditor can file a financing statement and the debtor can request a termination statement.[63] After a loan is made, a creditor can file a financing statement, as the creditor did in *In re Oak Rock Fin., LLC*.[64] The financing statement will put other creditors on notice of the true financial status of the debtor.[65] The debtor

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[59] *Even Though Original Loan Had Been Paid Off, Lender's Former Security Interest in Deposit Accounts is Impliedly Incorporated by Reference Into Second Set of Loan Documents*, 2016-27 COM. FIN. NEWSL. 54, July 4, 2016.
[60] *In re Omni Enters.*, 2016 WL 3213562, at *3.
[61] *See In re* Ladner, 50 B.R. 85 (Bankr. S.D. Miss. 1985).
[62] *See id.* at 91.
[63] *In re Oak Rock Fin., LLC*, 527 B.R. at 117; *Even Though Original Loan Had Been Paid Off, Lender's Former Security Interest in Deposit Accounts is Impliedly Incorporated by Reference Into Second Set of Loan Documents*, 2016-27 COM. FIN. NEWSL. 54, July 4, 2016.
[64] *See In re Oak Rock Fin., LLC*, 527 B.R. at 117.
[65] *See id*.

on the other hand can request a termination statement from the creditor once a debt is paid off.[66] The debtor should not only request a termination statement stating that the loan is repaid, but also that the underlying security agreement terminates because of the repayment.[67]

Conclusion

As the law stands, creditors have much power in drafting dragnet clauses that encompass a wide variety of interests. The courts will enforce the dragnet clause as long as the clause is in line with good faith and fair dealing. However, as different courts can see "good faith" differently, creditors are advised to not seem too greedy.[68] On the flip side, debtors are advised to be as precise as possible when drafting security agreements. Because collateral can potentially secure multiple loans even when the original loan has already been repaid, the debtor can potentially be on the hook until all debts owed to a creditor are repaid.[69] Ultimately, parties should remember to draft provisions for their specific transaction, as opposed to relying on boilerplate language that can potentially put both parties in precarious situations.

[66] *Even Though Original Loan Had Been Paid Off, Lender's Former Security Interest in Deposit Accounts is Impliedly Incorporated by Reference Into Second Set of Loan Documents*, 2016-27 COM. FIN. NEWSL. 54, July 4, 2016.
[67] Secured Transactions Under UCC (MB) § 2D.04.
[68] Secured Transactions Under UCC (MB) § 7C.02.
[69] Secured Transactions Under UCC (MB) § 2D.04.