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Future-Advance Clauses

Saving Lien Priority and Perfection in Subsequent Loans

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Future-advance (or "dragnet") clauses can be found in most loan documents today, but have you ever considered whether you can enforce them? One could easily argue that loaned money is collectable, either under the promissory note or not, but what happens when the debt is secured and the future advance is a wholly different loan? This article explores the state of the law on security for future advances and practical considerations.

What Are Future Advances?

Unless a statute dictates otherwise, a future-advance clause permits a lender to extend its security interest in original collateral to all future loans made to the same borrower. The initial security agreement remains intact and secures the future loans without the need to execute another security agreement. Such an arrangement is beneficial for lenders and borrowers because it allows for the extension of future credit without incurring additional transaction costs for each new security agreement.

A future-advance clause is but one type of "dragnet" clause that not only relates to securing future loans, but also aims to cross-collateralize all future *and past* obligations. Dragnet clauses cast a wide net to secure all of a borrower's obligations, ensuring repayment to the lender. These clauses are enforceable under appropriate circumstances, but courts narrowly construe them because they can be used oppressively.[1]

Future-advance clauses exist most frequently in loans where a lender does not fund the entire amount of the loan at closing, such as home-equity loans, construction loans and business operating lines of credit. To be sure, many other loans include future-advance clauses in order to ensure the repayment of present and future debts, even if such debts are not anticipated at the time.

Intent

The intention of the parties is a key factor in determining whether future advances are secured by existing collateral. Intent is not settled simply because a mortgage or security agreement recites that future advances are also secured (although failure to include a future-advance clause is fatal and cannot be overcome by simply referring to the security agreement in a different instrument).[2] Intent is often construed as "coming within the contemplation of the parties."[3]

The "reasonable contemplation" requirement is met when the security agreement between the parties clearly contains a future-advance clause, is not ambiguous and is not as a result of mutual mistake.[4] As one can imagine, intent is difficult to determine from the face of a contract, so courts have historically looked to other types of evidence in order to determine whether the parties intended that a future loan would be secured by a prior mortgage.

The Nature of the Debt

The similarity of past and future debts incurred by a borrower is one way courts have gleaned intent to be bound by a future advance clause. In such cases, the subsequent debt must have been of the same general class of debt as the original and be within the contemplation of the parties when the security agreement was made, unless it was the intention of the parties to cover advances of a different class.[5]

This "relatedness" test asks whether (1) the advance is of the same class as the primary obligation; (2) the advance is so related to the primary obligation that the consent of the debtor might be inferred; (3) the other indebtedness was intended to be separately secured; and (4) the secured party relied on the clause in making the future advance.[6] For example, in *Gardner v. Guldi*,[7] the court held that a bank's second loan did not constitute a future advance under the prior mortgage that secured the first loan because the second note stated that the collateral was various autos and equipment, whereas the first note was secured by real property.

Revised UCC Article 9

In recent years, Revised Article 9 of the Uniform Commercial Code (UCC) has called into question whether the intent of the parties can be determined from a particular test — whether it be

1 *See In re Natale*, 508 B.R. 790, 801-02 (Bankr. D. Mass. 2014).

2 *See In re Duckworth*, 2012 WL 986766, at *6 (Bankr. C.D. Ill. March 22, 2012).

3 *See Kimbell Foods Inc. v. Republic Nat'l Bank of Dallas*, 557 F.2d 491, 495 (5th Cir. 1977); *aff'd, sub nom., United States v. Kimbell Foods Inc.*, 440 U.S. 715, 99 S. Ct. 1448, 59 L. Ed. 2d 711 (1979).

4 *In re Trinity Meadows Raceway*, 252 B.R. 660, 666 (Bankr. N.D. Tex. 2000).

5 *See* § 9-204:99; "What Is Not a Covered Future Advance: Unrelated Debt," 8A Part II, Anderson U.C.C. § 9-204:99 (3d. ed.) (citing *Heath Tecna Corp. v. Zions First Nat'l Bank*, 609 P.2d 1334, 1337 (Utah 1980)).

6 *See In re Fassinger*, 246 B.R. 513 (Bankr. W.D. Pa. 2000) (applying Pennsylvania law).

7 724 So. 2d 186 (Fla. Dist. Ct. App. 1999).

the relatedness test, the same parties test or otherwise — and instead requires the intent of the parties to be determined from the document, if at all possible. The official commentary to amended UCC § 9-204 explicitly disavowed prior case law interpreting dragnet clauses using special interpretive tests, providing:

> Determining the obligations secured by collateral is solely a matter of construing the parties' agreement under applicable law. This Article rejects the holdings of cases decided under former Article 9 that applied other tests, such as whether a future advance or other subsequently incurred obligation was of the same or a similar type or class as earlier advances and obligations secured by the collateral.[8]

Recent case law has followed the edict of the UCC comments where the language of the contract was clear. In *In re Windham*,[9] the court enforced a future-advance clause's application to subsequently incurred obligations of a different nature than the note listed in the original security agreement, even though one of the two borrowers had no knowledge of the subsequent advances; in *In re Sierra*,[10] a dragnet clause in mortgage securing debt of "for unlimited funds" was held valid, and in *In re Miller*,[11] a dragnet clause was upheld because it was unambiguous and executed by sophisticated parties.

Nevertheless, and notwithstanding the revised UCC, some courts have continued to rely on state law factors to determine parties' intent.[12] For examples of ambiguous clauses to avoid, review *Merchants National Bank v. Stewart*,[13] *Wallace v. United Mississippi Bank*,[14] *In re Chiodetti*[15] and *In re Ballarino*.[16]

Future-Advance Clauses in Bankruptcy

The scattered case law regarding future advances across the nation leaves room for debtors, junior creditors, unsecured creditors and trustees to challenge a lender's security interest in future advances in bankruptcy, where a priority of liens drives distributions. The issue of future advances comes up in a variety of circumstances, including motions for stay relief;[17] claim objection and stay relief;[18] a motion to determine secured status;[19] a motion to reopen to obtain a discharge;[20] and plan confirmation.[21]

The U.S. Bankruptcy Court for the Western District of Texas recently took up an interesting future-advance issue in *In re Guiles*.[22] The debtor obtained a loan from Randolph Brooks Federal Credit Union (RBFCU) in the amount of $19,024.57 in order to purchase a 2007 Chevrolet Silverado. RBFCU noted its security interest on the certificate of title. Four years later, the debtor obtained a second loan from RBFCU, secured by the same vehicle, for $14,525, and a portion of the new money was used to pay off the remaining balance of the first loan. The chapter 13 trustee argued that the second loan created a new debt and that RBFCU failed to perfect its new security interest because it did not note the new debt on the vehicle's certificate of title.

The court looked to the motor vehicle laws in Texas and determined that, as in most states, a creditor may perfect a lien on a motor vehicle "only by recording the security interest on the title as provided by this chapter."[23] The title included the name and address of the lienholder, RFBCU and the date of each lien on the vehicle,[24] but the issue was whether the introduction of the second note, issued by the same creditor to the same debtor and secured by the same collateral, destroyed RBFCU's perfected security interest by essentially resetting the process and requiring the notation of a new lien. Hon. **Craig A. Gargotta** found that the notation of a new lien was not required. The court looked to the old "reasonable contemplation" requirement and determined that the parties intended the future-advance clause to secure the second note because the security agreement was clear and not ambiguous.

The *Guiles* court found support for its decision in *In re Conte*,[25] a similar case in which a debtor took out a loan secured by his vehicle. The security agreement also contained a future-advance clause that indicated that the collateral secured "any other loans [that] you have with the credit union now or in the future and any other amounts you owe the credit union for any reason now or in the future."[26] The debtor later responded to a credit card advertisement from the creditor and obtained a MasterCard credit card.[27]

When the debtor paid off the balance of his car loan, he requested that the creditor return the title, but the creditor refused, arguing that the debtor owed money on his MasterCard.[28] The debtor claimed that his loan was satisfied and that the future-advance clause should not extend to his credit card agreement, but the Fifth Circuit disagreed, finding the dragnet clause to be unambiguous.[29]

Satisfaction of Initial Loan

In *Guiles*, the trustee also argued that the second loan could not be a future advance because RBFCU "advanced new monies *after* satisfaction of the [first] Note."[30] In other words, the trustee argued that the second loan was not a future advance because the original loan was paid off with the second loan's funds. The court also rejected this argument, noting that "at no point was the Debtor relieved of her obligation to RBFCU" because the second loan was used to pay off the remainder of the first loan.[31]

8 U.C.C. § 9-204 Official Comments; *see also Pride Hyundai Inc. v. Chrysler Fin. Co.*, 369 F.3d 603, 613 (1st Cir. 2004) (referencing official comments of U.C.C. § 9-204).
9 568 B.R. 263 (Bankr. N.D. Miss. 2017).
10 2006 WL 3354011 (Bankr. D. Mass. Nov. 17, 2006).
11 2015 WL 2208369 (Bankr. E.D. Tenn. May 1, 2015).
12 *See, e.g., In re Hildyard*, 2014 WL 222113 (Bankr. D. Kan. Jan. 17, 2014) (relying on Kansas law to find that borrower's subsequent debts were secured under dragnet clause because later notes referenced mortgage, and subsequent debts were of same kind or character as original transaction).
13 608 So.2d 1120 (Miss. 1992).
14 726 So.2d 578, 586 (Miss. 1998).
15 163 B.R. 6 (D. Mass. 1994).
16 180 B.R. 347 (D. Mass. 1995).
17 *Windham*, 568 B.R. at 263.
18 *Hildyard*, 2014 WL 222113.
19 *Natale*, 508 B.R. at 790.
20 *In re Sierra*, 2006 WL 3354011.
21 *Miller*, 2015 WL 2208369.
22 2017 WL 4838751, at *1-7 (Bankr. W.D. Tex. Oct. 24, 2017).
23 Tex. Transp. Code Ann. § 501.111(a).
24 Tex. Transp. Code Ann. § 501.021(a).
25 206 F.3d 536 (5th Cir. 2000).
26 *Id.* at 537.
27 *Id.*
28 *Id.* at 538.
29 *Id.* at 539.
30 *Guiles*, 2017 WL 4838751, at *5 (emphasis added).
31 *Id.*

continued on page 96

from page 43

The few other courts to consider similar facts under similar laws reached the same conclusion.[32] Florida's statute, and likely others, also notes that a future-advance clause is valid "although there may be no advance made at the time of the execution of such mortgage or other instrument and *although there may be no indebtedness outstanding at the time any advance is made*."[33]

Intervening Liens

Different considerations come into play when new, intervening lenders enter the picture. Lenders who intend to retain priority under dragnet clauses for future advances must not only have clear language that evidences their intent to secure future liens, but they also must not extend credit when they have actual knowledge of intervening liens. To do so means risking losing priority,[34] but, where a lender with a duly recorded mortgage extends future advances without actual knowledge of an intervening purchaser (constructive notice is not enough), it might rely on its valid future-advance clause to protect its security.[35]

An original lender's priority *vis-à-vis* an intervening creditor also hinges on whether the original lender is obligated to advance additional amounts (as opposed to extending optional credit). Under this "obligatory-optional advance rule," a mortgage that is given to secure obligatory future advances takes priority over intervening liens that attach after the mortgage is given but before the optional advances are made.[36] The lender must receive actual notice of the intervening lien to lose priority.

For example, in *In re Qualstan Corp.*,[37] the court held that an advance made by a lender holding an open-ended mortgage has priority over other liens, unless, at the time of the advance, the lender (1) had notice of other liens and (2) was not obligated to make an advance.[38] However, a mechanics' lien might take precedence over a secured loan made after the start of construction because the lender would be put on notice of the potential for a mechanic's lien by simple virtue of the construction.[39]

For obvious reasons, a lender that is contractually required to fund additional amounts up to a stated maximum should be protected in doing so. Under Florida law, a future-advance clause is valid "*whether such advances are obligatory or to be made at the option of the lender*."[40] The nature of the lender's obligation (mandatory or optional) is apparently irrelevant to the lender's security interest in Florida. Armed with the knowledge of an intervening lien, a senior secured lender seeking to extend additional credit should nevertheless seek a subordination agreement with the intervening lienor in order to ensure continued priority.

The Issue of Financing Statements

Somewhat surprisingly, a lender is not required to note its future-advance clause in its financing statement if the security agreement includes proper future-advance language. Official Comment 7 to § 9-204 states that "[t]here is no need to refer to ... future advances or other obligations secured in a financing statement." Similarly, Official Comment 2 to § 9-502 indicates that "a financing statement is effective ... to perfect with respect to future advances under security agreements, regardless of whether ... future advances are mentioned in the financing statement and even if not in the contemplation of the parties at the time the financing statement was authorized to be filed." A future-advance clause in a duly recorded mortgage is itself sufficient to put creditors on notice of additional loans between a bank and borrower.

Best Practices

The trend in recent case law and the revised UCC is to uphold an arm's-length contract with an unambiguous future advance clause. Only where a court finds that a future-advance clause is ambiguous should it delve into the hazy world of determining the parties' intent by looking at whether (1) the advances were of the same class and character, (2) the parties were the same or (3) the extension of credit was obligatory. Lenders and their counsel should familiarize themselves with their state's statutes and case law.

Aim to upgrade the language of your future-advance clause from a boilerplate clause to something more specific to demonstrate that the parties clearly intend for the security agreement to cover all future advances of every kind. In making the subsequent advances, always reference the initial security agreement and future-advance clause, and require the borrower to initial that language in the subsequent loan documents. Take all necessary measures to document the requisite intent that the security extends to all future advances, just in case the language of the clause is found to be ambiguous. abi

32 *Id.* (citing *In re Dickey*, 214 B.R. 145, 147 (Bankr. W.D. Pa. 1997) (finding that when lien is initially noted on title, payment of one loan through later-issued funds from lienholder does not extinguish secured claim or require re-notation of lienholder's interest on title); *In re Spaziano*, 16 B.R. 799, 800 (Bankr. D.R.I. 1982) (finding that when security interest is properly perfected through notation of lien on title, second loan between same parties secured by identical collateral does not require re-notation of lien)).

33 Fla. Stat. 679.04(1)(a) (emphasis added).

34 *See NAB Asset Venture III LP*, 815 N.E. 2d 606 (Mass. App. Ct. 2004) (noting general rule that intervening lien takes priority over future advances where there is no evidence to indicate contrary intent); *Rosenthal & Rosenthal Inc. v. Benun*, 140 A.3d 547 (N.J. 2016) (holding optional future advances made pursuant to future advance mortgage with actual knowledge of intervening lien are subordinated to intervening lien) (referencing N.J.S.A. § 46:9-8.2).

35 *Cook v. Springfield State Bank*, 2005 WL 1186532 (Ky. App. 2005).

36 *Shaw Acquisition Co. v. Bank of Elk River*, 639 N.W.2d 873 (Minn. 2002).

37 310 B.R. 833 (Bankr. S.D. Ohio 2004).

38 *Id.* (referencing Ohio R.C. § 5301.232). *See also Hampton v. Gulf Fed. Sav. & Loan Ass'n*, 287 Ala. 172, 249 So. 2d 829 (1971) (holding after notice of attaching of junior lien, senior mortgagee will not be protected in making optional future advances under his mortgage given to secure such advances).

39 *Glenstone Block Co. v. Pebworth*, 264 S.W.3d 703 (Mo. Ct. App. S.D. 2008).

40 Fla. Stat. § 679.04.

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