

Cross Collateralization Generally Not Created By Note Alone

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From time to time, we review loan files for clients to confirm they have the collateral they think they do. Assume a lender has a properly perfected \$1,000,000 mortgage loan and a \$500,000 line of credit secured by all of the borrower's personal property. The borrower then asks for a new \$300,000 loan to purchase a piece of equipment. The lender prepares a promissory note and includes a reference that the existing mortgage and security agreement will collateralize the new loan. Any problems?

The answer is that it depends. If the mortgage and security agreement both contain future advance clauses and there are no, or sufficiently large, caps on the maximum amount of debt they collateralize, this method may work. If however, the existing collateral documents are limited to specific loans or cap the maximum amount of debt they collateralize, the lender may not have what it hoped to obtain. Furthermore, title and UCC searches should be completed to determine if any intervening liens exist.

Generally, liens are not created in a promissory note. While it is common to refer in the note to the collateral for a loan, the granting of lien rights must be explicit and is generally done in a mortgage for real estate and a security agreement for personal property.

So make sure you have the collateral you think you do. Check your existing loan documents if you want to rely on them to collateralize new debt, or take a new mortgage and/or security agreement to cover all indebtedness to make sure you are protected.

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