

Commercial Law Newsletter

Joint Newsletter of the Commercial Finance and Uniform Commercial Code Committees



November 9, 2010

Fall 2010

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FEATURED ARTICLES

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FEATURED REPORT

In addition to the featured articles, members of the ComFin and UCC Committees have recently put together the featured report available at the following link:

- **Second Report of the ABA Advisor NCCUSL Drafting Committee for a Certificate of Title Act for Vessels, October 13, 2010**

UCC SPOTLIGHT

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COMMERCIAL FINANCE COMMITTEE CHAIR REPORT

Introduction:

As the new Chair of the Commercial Finance Committee, let me first say that it is an honor and a privilege to lead this Committee along with our Vice Chair, Neal Kling, and to continue and expand the work of our outstanding past Chairs and Vice Chairs. We are one of the largest and strongest Committees within the Business Law Section and we will continue to provide an ever-expanding array of high-quality, up-to-the minute content to our members through a variety of media, including this Newsletter.

Let me also take this opportunity to thank and congratulate my predecessor, Lynn Soukup, for her outstanding service as Chair during the past three years, which increased both the output and the reputation of the Committee in significant ways.

We have a terrific group of active Subcommittees and Task Forces -- please go to the Commercial Finance Committee's [website](#) for reports on their meetings and upcoming activities. We have started two new Task Forces jointly with the UCC Committee. One is the Joint Task Force for the Legislative Enactment of Amendments to Revised Article 9, for which volunteers from all 50 states are sought (an excellent article by Ed Smith summarizing the amendments is contained in this Newsletter). The other is a Joint Task Force on Survey of the Law of Guarantees, which will provide a state-by-state summary of the law of guarantees similar to the Commercial Lending Law state-by-state summary published to great acclaim by our Committee in 2009.

The lifeblood of a Committee is its members generally, and specifically those members who become active. We are seeking persons who would like to give speeches, participate in CLE and non-CLE panels, and generally become active in the work of the Committee. If you are interested, we will find a role for you. You will meet some fun and interesting people, gain exposure for yourself and your practice, and establish a network of contacts throughout the USA and Canada (and it looks good on your firm bio as well!). If you are interested in being active, please contact me at jschulwolf@goodwin.com.

Recent and Upcoming Meetings:

Our recent Fall Meeting in Chicago, held jointly with the UCC Committee, was a great success. It featured four outstanding programs:

- Workouts and Forbearance Agreements, presented by Kyle Mathews of Sheppard Mullin and Christine Gould Hamm of Husch Blackwell
- Primer on Financing Goods, presented by Marshall Grodner of McGlinchey Stafford and Elizabeth Davidson of Jenner & Block
- Mezzanine Loans -- the Vagaries of Membership Interest Collateral, presented by Teresa Harmon and Mohammed Shaheen of Sidley Austin, Norm Powell and Andy Kostoulas of Young Conaway, and Jim Prendergast of First American Title

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- Beyond *TOUSA*, presented by Jonathan Cooper and Dimitri Karczas of Goldberg Kohn

MARK YOUR CALENDARS

November 9-10, 2010 - Forum:

Cape Town Convention and Aircraft Protocol, Assessing and Advancing Ratification - Rome, Italy. More information is available in the UNIDROIT [press release](#), or go directly to the forum's [website](#).

November 19-20, 2010 - ABA Business Law Section's Fall Meeting - Washington, D.C.

Additional information about the ABA Business Law Section's Fall Meeting is available [here](#).

January 12, 2011 - Financial Contracts in Bankruptcy (Swaps and Derivatives) - New York, NY.

This discussion will be moderated by Paul Ricotta. More information is available on the Association of Commercial Finance Attorney's [website](#).

January 25-26, 2011 - CFA Asset-Based Capital Conference - Las Vegas, NV.

See the Commercial Finance Association's (CFA) [website](#) for further details.

April 14-16, 2011 - ABA Spring Meeting - Boston, MA.

Registration details are coming soon! All programs and meetings will be held at the Boston Marriott Copley Place (800-228-9290) and the Westin Copley Place (800-WESTINS or 800-937-8467).

June 5-9, 2011 - International Association of Commercial Administrators (IACA) 34th Annual Conference - Winnipeg, Manitoba.

The 34th IACA Annual Conference will be at the Delta Winnipeg in Winnipeg, Manitoba, Canada. More information is available at IACA's [website](#).

August 5-8, 2011 - ABA Annual Meeting - Toronto, Ontario.

More details will be coming soon to the ABA's website!

Program materials are available on the Commercial Finance Committee [website](#). Kudos to Tony Callobre of Bingham McCutchen and Marshall Grodner of McGlinchey Stafford for their excellent work in organizing these programs on behalf of the Committee.

We will next meet at the Business Law Section Spring Meeting in Boston from April 14 - 16, 2011. Boston is a great city, and it should be an excellent meeting. One travel note – book early, since it is Patriots' Day weekend (the weekend of the Boston Marathon, which is run on the Monday following the weekend). We will be presenting three excellent CLE programs:

- Commercial Law Developments, our annual and always-popular survey presented by Steve Weise of Proskauer Rose and Teresa Harmon of Sidley Austin
- State of the Syndicated Loan Markets, chaired by Bridget Marsh of LSTA
- A Midnight Ride -- A Call to Arms on the Basics of Swaps and the Challenges of Documenting the Rights of Swap Providers in Collateral Shared with other Lenders, chaired by Perry Hicks of Cadwalader

A preliminary schedule and information on our annual joint dinner with the UCC Committee will soon be posted on the Commercial Finance Committee [website](#).

[Jeremy Friedberg](#) of Leitess Leitess Friedberg and [Christine Gould Hamm](#) of Husch Blackwell are coordinating our programs and subcommittee meetings, so if you have an idea for a panel or presentation or would like to participate in one, please contact Jeremy, Christine, or me at jschulwolf@goodwin.com.

Best wishes for the fall and holiday seasons, and I look forward to seeing you in Boston in April.

Jim Schulwolf

Commercial Finance Committee Chair

UNIFORM COMMERCIAL CODE COMMITTEE CHAIR REPORT

Fall Meeting in Chicago:

The UCC and Commercial Finance Committees had a terrific turnout at their joint Fall Meeting which was held on October 20, 2010 in Chicago. The excellent program materials on workout and forbearance issues, LLC membership interest collateral, the basics of financing goods and clawback risk post-*TOUSA* can be found on the UCC Committee's [website](#).

Subcommittees and Task Forces:

Please visit the UCC Committee's [website](#) to read reports from our various subcommittees and taskforces on their projects and meetings.

I am pleased to report that we have two new task forces:

The Joint Task Force (with the Commercial Finance Committee) for the Legislative Enactment of Revised Article 9 for which [Thomas Buiteweg](#) and [John McGarvey](#) are co-chairs and which will seek to assist the National Conference of Commissioners on Uniform State Laws and other bodies with the enactment in the U.S. of the recent updates to UCC Article 9.

VIEW CURRENT REPORTS AND DEVELOPMENTS OF THE ...

COMFIN SUBCOMMITTEES AND TASK FORCES

- [Subcommittee on Agricultural and Agri-Business Financing](#)
- [Subcommittee on Aircraft Financing](#)
- [Subcommittee on Creditors' Rights](#)
- [Subcommittee on Cross-Border and Trade Financing](#)
- [Subcommittee on Intellectual Property Financing](#)
- [Subcommittee on Lender Liability](#)
- [Subcommittee on Loan Documentation](#)
- [Subcommittee on Loan Workouts](#)
- [Subcommittee on Maritime Financing](#)
- [Subcommittee on Real Estate Financing](#)
- [Subcommittee on Secured Lending](#)
- [Subcommittee on Syndications and Lender Relations](#)
- [ADR Task Force](#)
- [Model Intercreditor Agreement Task Force](#)
- [Surveys of State Commercial Laws](#)

UCC SUBCOMMITTEES

- [Subcommittee on Annual Survey](#)
- [Subcommittee on Article 7](#)
- [Subcommittee on General Provisions and Relations to Other Law](#)
- [Subcommittee on International Commercial Law](#)
- [Subcommittee on Investment Securities](#)
- [Subcommittee on Leasing](#)
- [Subcommittee on Letters of Credit](#)
- [Subcommittee on Membership](#)
- [Subcommittee on Payments](#)
- [Subcommittee on Sale of Goods](#)
- [Subcommittee on Secured Transactions](#)

UCC AND COMFIN JOINT TASK FORCES

- [Commercial Finance Terms Joint Task Force](#)
- [Deposit Account Control Agreements Joint Task Force](#)
- [Filing Office Operations and Search Logic Joint Task Force](#)
- [Legislative Enactment of Article 9](#)
- [Model IP Security Agreement Joint Task Force](#)
- [Survey of State Guaranty Laws](#)

A Joint Task Force on Survey of State Guaranty Laws to be co-chaired by [Jeremy Friedberg](#), [Brian Hulse](#) and [James Prior](#) to survey the law of guarantees across the U.S. The survey will have a practical bent and will focus on what practitioners reviewing guarantees would want to know about applicable state law.

Please contact the chairs of these task forces at the email addresses linked to their names above or me at pchristophorou@cgsh.com if you are interested in joining or if you have topics or projects that you think are worth pursuing.

Please also join one or more of our other subcommittees or task forces. Even if you cannot attend ABA meetings, our subcommittees and task forces are always working on various long-term projects and welcome contributors. For instance, the International Commercial Law Subcommittee is currently studying and crafting a publication on the substantive and choice of law rules applicable to securities, securities accounts and deposit accounts in various key non-U.S. jurisdictions. The Joint Task Force on Commercial Law Terms is currently working on a wiki of important commercial law terms.

Spring Meeting in Boston:

The UCC Committee will be meeting next on April 14 through 16, 2011 at the Business Law Section Spring Meeting at Copley Place in Boston. A preliminary schedule and registration materials will soon be available on the main page of our website. Our program offerings for the Spring Meeting are varied:

- Difficult Debtors: People and Nations and Trusts, Oh My!
- What Every Deal Lawyer Should Know about Consumer Regulation
- Lehman - Over Two Years Later: Lessons for Secured Parties, Derivative Counterparties and Owners of Custodied Financial Assets

Stay tuned for information on the joint committee dinner at the Spring Meeting with the Commercial Finance Committee. Please join us in Boston!

Best wishes for the fall season,

Penny Christophorou
UCC Committee Chair

Featured Notes

Please take the Model Intellectual Property Security Agreement (MIPSA) Task Force Survey. The MIPSA Task Force has created a survey using SurveyMonkey on specific drafting issues relevant to the granting clause of an IP security agreement and is asking everyone to participate. Please take a moment to fill out the [survey](#). For more information, please see the Intellectual Property Finance Subcommittee's [webpage](#) or the PowerPoint presentation from the MIPSA Task Force's joint meeting with the Intellectual Property Finance Subcommittee in San Francisco which has been posted to [YouTube](#).

Public Service Project

The following worthwhile public service project has been undertaken by the Business and Corporate Litigation Committee's Pro Bono and Public Service Subcommittee.

The Business Law Section is partnering with the Mississippi Center for Justice ("MCJ") to raise funds to support residents of coastal communities impacted by the Gulf oil spill.

COMMITTEE LEADERSHIP ROSTERS

- [Commercial Finance Committee](#)
 - [Uniform Commercial Code Committee](#)
-

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DO YOU WANT TO...

- **WRITE FOR AN OFFICIAL ABA PUBLICATION?**
- **GET PUBLISHED, WITHOUT TOO MUCH OF A TIME COMMITMENT?**
- **CONNECT WITH OTHER MEMBERS OF THE COMFIN AND UCC COMMITTEES?**

If so, submit an article for possible publication in a future issue of the Commercial Law Newsletter. Publishing an article with the Commercial Law Newsletter is a great way to get involved with the ComFin Committee and the UCC Committee. Articles can survey the law nationally or locally, discuss particular commercial finance or UCC issues, or examine a specific case or statute. If you are interested in submitting an article, please contact one of the following Commercial Law Newsletter Editors – [Christina B. Rissler](#), [Carol Nulty Doody](#) or [Kelly L. Kopyt](#).

MCJ is one of the few organizations standing between low-wealth communities and economic disaster by working with advocacy organizations in Mississippi, Alabama, Louisiana and Florida to identify and address the legal needs of individuals, small businesses and communities bearing the weight of the disaster.

Contributions made by members of the Business Law Section will be used to address the legal needs of the poor arising as a direct result of the oil disaster. MCJ has created a dedicated [contribution page](#) for the Section's use.

Feel free to contact [Mac McCoy](#) with any questions you may have regarding this public service project, which is coordinated by the Business and Corporate Litigation Committee's Pro Bono and Public Service Subcommittee, with co-sponsorship by the Young Lawyer Committee and the Section's Committee on Pro Bono.

Equity Interests as Collateral in Commercial Lending: Enforcing Security Interests in Stocks, Partnerships and LLCs Upon Borrower Default. This 90-minute CLE [webinar/teleconference](#) will be presented by Lynn Soukup and Steve Weise with an interactive Q&A and will be held **Thursday, November 11, 2010, at 1:00-2:30 pm EST.**

This CLE webinar will provide strategies for counsel advising lenders holding equity interests as collateral in commercial loans on how to properly perfect their security interests and to evaluate and pursue enforcement remedies in the event a borrower defaults.

Commercial Loan Workouts: Forbearance Options and Waivers After Default, This 90-minute CLE [webinar/teleconference](#) will be presented by Matthew T. Gensburg with an interactive Q&A and will be held **Wednesday, December 8, 2010, at 1:00-2:30 pm EST.**

This CLE webinar will provide guidance to lenders' counsel for crafting and negotiating a commercial loan workout to strengthen the lender's claims and minimize risk and liabilities due to a borrower's bankruptcy or foreclosure.

Featured Articles

A SUMMARY OF THE 2010 AMENDMENTS TO THE OFFICIAL TEXT OF ARTICLE 9 OF THE UNIFORM COMMERCIAL CODE

By [Edwin E. Smith](#), Bingham McCutchen LLP¹

The 2010 amendments to the Official Text of Article 9 of the Uniform Commercial Code were approved in 2010 by the Uniform Commercial Code's sponsoring organizations, the American Law Institute and the Uniform Law Commission. These 2010 amendments (the "Amendments") are expected to be considered by state legislatures as early as 2011 with a view to all states enacting the Amendments by their July 1, 2013, uniform effective date. This article provides a summary of the statutory amendments.

A Joint Task Force for the Legislative Enactment of Revised Article 9 has been created by the Business Law Section's Commercial Finance and UCC Committees to assist in the enactment of the 2010 amendments to Article 9. This task force is seeking members from all states and from the District of Columbia. If you are interested in serving on the task force, please contact [Thomas Buiteweg](#) or [John McGarvey](#), the Joint Task Force for the Legislative Enactment of Revised Article 9 co-chairs.

I. CHANGES RELATING TO THE FILING RULES

The Amendments contain a number of changes related to the rules for filing financing statements in Part 5 of Article 9.

A. Name to be Provided on a Financing Statement When the Debtor is an Individual

Some courts have struggled with the question of what name a financing statement must provide for an individual debtor in order for the debtor's name on the financing statement to be sufficient. The problem arises because individuals do not typically have a single name. An individual's name on his or her birth certificate, driver's license, passport, tax return or bankruptcy petition may all be different. Moreover, the debtor may be known in his or her community by a name that is not reflected on any official document. It would appear that most cases decided under the 1998 revisions to Article 9 finding the individual debtor's name provided on the financing statement to be insufficient have involved the secured party making a filing error rather than being uncertain as to the debtor's actual name. Nevertheless, the cases have created a level of uncertainty that has led secured parties to search and file financing statements under multiple names.

To provide greater guidance, the Amendments offer to each state one of two alternatives for the name of an individual debtor provided on a financing statement to be sufficient. If Alternative A is in effect in the state in which the financing statement is filed, and if the debtor holds a driver's license that has not expired and has been issued by the state, then the name of the debtor that must be provided on the financing statement is the name of the debtor as it appears on the driver's license. This is the so-called "only if" rule, i.e., the debtor's name on the financing statement will be sufficient "only if" the name provided is the name on the driver's license.

Of course, the name on the driver's license cannot be entered onto the financing statement without consideration. The financing statement's written form or electronic template will require that the financing statement set forth the surname and first personal name of the debtor. The secured party will need to determine which name on the driver's license is the debtor's surname and which is the debtor's first personal name. This would normally be an easy task. For example, if the name on the driver's license is *Lester Henry Smith*, it would appear obvious that the debtor's surname is *Smith* and that the debtor's first personal name is *Lester Henry* would then be inserted in the financing statement block for "additional names." In other cases, determining from the driver's license which name is the debtor's surname and which name is the debtor's first personal name may not be as easy and may require the secured party to perform additional investigation.

Under Alternative A, if the debtor does not hold a driver's license issued by the state in which the financing statement is filed, then either of the following names for the debtor would be sufficient as the debtor's name on the financing statement: (1) the individual name of the debtor, as under current Article 9, or (2) the debtor's surname and first personal name.

Under Alternative B, any of the following names for the debtor would be sufficient as the debtor's name on the financing statement: (1) the debtor's name as shown on the debtor's driver's license if the debtor holds an unexpired driver's license issued by the state, (2) the individual name of the debtor, as under current Article 9, or (3) the debtor's surname and first personal name. Alternative B has been called the "safe harbor" approach, in contrast to the "only if" approach reflected in Alternative A.

Under either Alternative A or Alternative B, if the debtor holds two driver's licenses issued by the state, the most recently issued driver's license is the one to which reference should be made to determine the debtor's name to be provided on the financing statement.

In some states, the same office of the state that issues a driver's license also issues an identification card for an individual who does not hold a driver's license, and the state or office does not permit an individual to hold both a driver's license and a non-driver's license identification card at the same time. A Legislative Note to amended section 9-503 suggests that, regardless of which alternative is adopted, these states should refer to the non-driver's license identification card as an alternative of equal dignity with the driver's license.

The rationale for choosing the driver's license name as the name of the debtor to be provided in order for the debtor's name on the financing statement to be sufficient is that in most cases an individual debtor holds a driver's license that is offered as a form of identification when the debtor seeks to obtain secured financing. For lenders that extend credit on a volume basis, procedures can easily be established for the lender to search the records of the filing office under the driver's license name and to file in the filing office a financing statement providing that name as the name of the debtor.

To be sure, a rule that contemplates use of the debtor's driver's license name is not without risk. The driver's license may expire, or the debtor may exchange the current driver's license for a new driver's license. Either event could constitute a change in the name that Article 9 requires to be provided for the debtor. This may be the case if the debtor's name on an expired driver's license is different from a name that would be sufficient for the name of the debtor to be provided on a financing statement in the absence of a driver's license name or if the name of the debtor on the new driver's license is different from the name of the debtor as it appeared on the old driver's license.

If a search under the new name required to be provided for the debtor, following the filing office's standard search logic, does not disclose the financing statement filed under the expired or original driver's license name, the financing statement would become seriously misleading. In that case, the normal rules for a name change under section 9-507(c) would apply. The financing statement would remain effective for collateral in existence on the date of the name change and for collateral acquired by the debtor during the four-month period after the date of the name change. For the financing statement to be effective for collateral acquired by the debtor after the end of the four-month period, the secured party would need to amend the financing statement within the four-month period to provide the debtor's new name.

The observers from the lending community reasoned that, under either the "only if" rule of Alternative A or the "safe harbor" rule of Alternative B, the risk that debtor name changes may be more likely to occur than under current law was more than offset by the greater certainty of being able to look to the debtor's driver's license name.

It is important to emphasize that the driver's license name is relevant for a particular state only if Article 9's choice of law rules in the forum state point to the law of that particular state to determine perfection and the effect of perfection and non-perfection of a security interest that must or may be perfected by filing. For example, if an individual debtor's principal residence is in Illinois, the debtor will be considered to be located in Illinois under section 9-307. A financing statement must be filed in Illinois to perfect by filing a security interest in collateral in which a security interest is perfected by filing in the state of the debtor's location. If the debtor holds an Ohio driver's license rather than an Illinois driver's license, the Ohio driver's license will be irrelevant for purposes of perfecting a security interest that must be perfected by a filing in Illinois.

Based on the views expressed by observers from the American Bankers Association working group it is expected that a number of states will be encouraged by them to adopt Alternative A. But a Legislative Note suggests that a state considering adopting Alternative A should verify that its Uniform Commercial Code database is compatible with the state's driver's license database as to characters, field length and the like. Alternative A would not be workable in a state if a significant number of names reflected on driver's licenses issued by the state could not be entered in the Uniform Commercial Code database of the state, resulting in secured parties not being able to comply with the "only if" rule. If there is lack of compatibility, the lack of compatibility could still be rectified by a change in computer systems that established compatibility or a filing office regulation that explains how a driver's license name should be modified to be entered into the Uniform Commercial Code databases of the filing office.

B. Definition of "Registered Organization"

The Amendments modify the definition of "registered organization" to reflect that an organization is a registered organization if it is formed or organized solely under the law of a single state by the filing of a public record with the state rather than, as under current Article 9, by the state merely being required to maintain a public record showing that the organization has been organized. This change will more accurately reflect that a registered organization includes an organization whose "birth certificate" emanates from the act of making a public filing. The change also confirms that, like the typical corporation, limited partnership or limited liability company, a statutory trust formed under the laws of a state by a filing in the secretary of state's office of that state is a registered organization.

Furthermore, the Amendments expand the definition of "registered organization" to include a common law trust that is formed for a business or commercial purpose and is required by a state's business trust statute to file with the state an organic record, such as the trust agreement for a common law trust. This change will mean that a Massachusetts business trust, for example, will be considered to be a registered organization rather than, as would appear to be the case under current Article 9, an organization that is not a registered organization. This type of common law business trust, i.e., a common law business trust that, because of a public filing requirement, will be considered a registered organization under the Amendments, is referred to in this article as a "Massachusetts type business trust."

The change will not affect a common law trust formed for a purpose that is not a business or commercial purpose or a common law trust formed for a business or commercial purpose that is not required to file a public record with the state. As under current Article 9, neither of these types of common law trust would be a registered organization. Only a common law trust that is a Massachusetts type business trust will be considered a registered organization under the Amendments.

C. Name of Registered Organization

Some concern in practice has been expressed that, in determining the name of a debtor that is a registered organization for the purpose of providing the debtor's name on a financing statement, there may be more than one name of a registered organization reflected on a state's public record. This circumstance could arise when the state maintains a searchable database of the names of registered organizations but where the database uses abbreviations or has limited field codes. In that case, for example, the name of a corporation reflected in its charter document in a public file with the state and the name reflected on the state's publicly available database may differ. If the secured party is to file a financing statement providing the corporation's name as debtor or to search for the debtor's name in the state's filing office records, the secured party may be uncertain as to whether the name should be the name on the corporation's charter

document or the name in the searchable database.

The Amendments clarify that, for a financing statement to be sufficient, the name of the registered organization debtor to be provided on the financing statement is the name reflected on the “public organic record” of the registered organization. In most cases, a registered organization’s “public organic record” is the publicly available record filed with the state to form or organize the registered organization. If the registered organization is formed by legislation, the legislation is the public organic record in which the registered organization’s name is found. If the registered organization is a Massachusetts type business trust, the registered organization’s name is that reflected on the required publicly available filing, usually the trust agreement.

Accordingly, in the example above of the corporation with a name on its publicly available charter document that is different from the name on the state’s publicly searchable database, the debtor’s name to be provided on the financing statement should be the debtor’s name as reflected on the charter document.

If the name of the debtor on a public organic record is amended, the name of the debtor to be provided on a financing statement is the name as so amended. If otherwise there is more than one public organic record stating the debtor’s name, the debtor’s name is that provided on the most recently filed public organic record as the debtor’s name.

D. Name of Debtor When Collateral is Held in Trust

The Amendments distinguish a trust that is a registered organization, i.e., a statutory trust or a Massachusetts type business trust, from a common law trust that is not a registered organization. To be sufficient under the Amendments, when the collateral is held in a trust that is a registered organization, a financing statement must provide, as the name of the debtor, the name reflected as the trust’s name on the public organic record of the trust.

If collateral is held in a trust that is not a registered organization, the name to be provided on the financing statement, as under current Article 9, must be the name of the trust itself or, if the trust has no name, the name of the settlor. This rule applies even if, as typically is the case with a common law trust, the trustee and not the trust meets the Article 9 definition of “debtor.” In the case of collateral held in a testamentary trust without a name, the name of the testator should be provided. The reference to the name of a testator is a change from current Article 9; the corresponding provision in current Article 9 does not refer to a testator, only a settlor.

The amendments also require that, when the collateral is held in a trust that is not a registered organization, the filer must provide in a separate part of the financing statement a statement that the collateral is held in trust. The reference to “collateral held in trust” replaces the reference under current Article 9 to the debtor being the trust or the trustee. The reference to the debtor being a trust or trustee was thought to be confusing in practice especially because typically under a common law trust in most states the debtor would be the trustee.

If the name of the settlor or testator is provided as the debtor’s name, the filer must provide in a separate part of the financing statement sufficient information to distinguish the trust from other trusts of the same settlor or testator. That distinguishing information often could be, for example, merely the date of the trust agreement.

The requirement that this information be inserted in a separate part of the financing statement was intended to reduce the risk that a secured party would provide the information in the debtor’s name block of the financing statement. Under the search logic of the filing office in some states, additional information provided in the debtor’s name block may cause the financing statement to be ineffective if a search of the debtor’s name without the additional information would fail to disclose the financing statement.

E. Name of Debtor When Collateral is Administered by a Personal Representative

Current Article 9 refers to the possibility that the debtor may be an estate. The amendments more accurately refer to collateral that is being administered by a personal representative of a deceased debtor. In such a case the name of the deceased debtor on the financing statement will be sufficient as a “safe harbor” if the name provided is the name of the debtor on the court order appointing the personal representative. If the appointment order contains more than one name for the debtor, the first name of the debtor on the appointment order is sufficient.

F. Debtor’s Change of Location

Under current Article 9, if a debtor changes its location to a new jurisdiction, a secured party whose security interest was perfected by filing in the original jurisdiction has a period of up to four months to continue the perfection of its security interest by filing a financing statement in, or otherwise perfecting the security interest under the law of, the new jurisdiction. The four-month grace period applies, however, only to collateral in which the secured party’s security interest was perfected at time of the change of location. Of course, a security interest in property acquired by the debtor after the time of the change of location will not be perfected at the time of the change because the security interest in the after-acquired property will not attach until the property is acquired by the debtor and the debtor then

has rights in the collateral. There is no grace period under current Article 9 for perfection of any security interest that may attach to post-change of location after-acquired property of the debtor.

The amendments add a grace period for the after-acquired property. They do so by providing that the financing statement filed in the original jurisdiction is effective with respect to collateral acquired within four months after the debtor's location changes. The secured party can continue perfection beyond the four-month period by filing a financing statement or otherwise perfecting under the law of the new jurisdiction.

The amendments will provide greater protection for a secured party with a security interest in after-acquired property of its debtor if the debtor changes its location. However, a post-relocation secured party considering extending credit to the debtor on the basis of a first priority security interest in the after-acquired property, and a buyer or a lessee of the after-acquired property who is not a buyer in ordinary course or a lessee in ordinary course, will need to do sufficient diligence to know to search for financing statements in the debtor's original jurisdiction during the four month period following the debtor's change of location to the new jurisdiction and, if the search discloses a conflicting financing statement, to obtain an appropriate release.

G. New Debtor

The Amendments provide similar protection for a security interest in after-acquired property if a new debtor becomes bound by the original debtor's security agreement and the new debtor is located in a different jurisdiction from the jurisdiction in which the original debtor was located. For example, if Old Debtor located in State A merges into New Debtor located in State B, under current Article 9 there is a grace period of up to one year for the secured party of Old Debtor to file a financing statement against New Debtor in State B to continue the effectiveness of the financing statement that the secured party filed in State A against Old Debtor. But the grace period applies only to a security interest that was perfected by filing in State A at the time of the merger. There is no grace period for perfection of any security interest that may attach to post-merger after-acquired property. Using an approach similar to that taken with respect to property acquired by a debtor after it relocates, the Amendments provide for a grace period of up to four months in the case of such an interstate merger.

As under current Article 9, a security interest in post-merger after-acquired property that is perfected solely by the financing statement filed by the secured party against Old Debtor in State A will be subordinate to a security interest of a competing secured party perfected by the filing of a financing statement against New Debtor in State B. This result for an interstate merger is consistent with the treatment of after-acquired property of a new debtor in the case of an intrastate merger.

H. Other Filing Related Changes

The Amendments provide for other changes to the filing rules in Part 5 of Article 9:

- Only an initial financing statement may indicate that the debtor is a transmitting utility, in which case the financing statement does not lapse. Current Article 9 suggests that an initial financing statement may be amended to indicate that the debtor is a transmitting utility. The statutory change will make the transmitting utility filing provision consistent with the public-finance and manufactured-home transactions filing provision and will respond to the International Association of Commercial Administrators' concerns about the operational difficulty for filing offices to capture such amendments and prevent the amended financing statements from being treated as having lapsed.
- A filing office will no longer be permitted to reject a financing statement that fails to provide the type of organization of the debtor, the jurisdiction of organization of the debtor, or the organizational identification number of the debtor or a statement that the debtor has none. This information was not considered to be sufficiently useful in practice and often added cost and delay to the filing process.
- The term "correction statement" as used in current Article 9 has been changed to the more accurate "information statement." Under the amendments, an information statement may, but need not, be filed by a secured party of record who believes that an amendment or other record relating to the financing statement of the secured party of record was filed by a person not entitled to do so. Under current Article 9 a correction statement may be filed only by the debtor.
- The uniform forms of initial financing statement and amendment have been updated to reflect the Amendments.

II. CHANGES UNRELATED TO FILING

The Amendments contain some changes that are less connected to the filing rules in Part 5 of Article 9:

- Current section 9-406 renders unenforceable an anti-assignment term of a payment intangible or promissory note that secures an obligation. By way of contrast, current section 9-408 permits a sale of a payment intangible or promissory note notwithstanding an anti-assignment term but does not require the account debtor or maker to attorn to or otherwise recognize the buyer. The amendments clarify that effectiveness of an anti-assignment term of a payment intangible or promissory note in the case of a sale or other disposition of collateral under section 9-610 or an acceptance of collateral under section 9-620 is governed by section 9-406 and not by section 9-408.

- The Amendments modify the definition of the term “authenticate” to conform to the definitions of “sign” in Article 1 and Article 7.
- The Amendments modify the definition of “certificate of title” to take into account state certificate of title systems that permit or require electronic records as an alternative to the issuance of certificates of title.
- The Amendments modify the requirements for control of electronic chattel paper to conform them with those in Article 7 for electronic documents of title and in the Uniform Electronic Transactions Act for transferable records. The result is that the new requirements set forth the current requirements as a “safe harbor” but permit other control systems as well.
- The Amendments clarify that a registered organization organized under federal law, such as a national bank, that, by authorization under federal law, designates its main or home office as its location is located in the state of that office for purposes of Article 9. The provision is a confirmation of a clarification currently stated in the Official Comments.
- The Amendments expand the list of collateral for which a licensee or buyer takes free of a security interest if the licensee or buyer gives value without knowledge of the security interests and before it is perfected.
- The Amendments confirm that a secured party’s authorization to record an assignment of a mortgage securing a promissory note assigned to the secured party in order for the secured party to conduct a non-judicial foreclosure sale of the mortgaged real property applies when there is a default by the mortgagor. The language in current Article 9 could arguably have been read to refer to a default by the assignor of the promissory note rather than by the mortgagor.

III. TRANSITION RULES

The Amendments contain their own set of transition rules in Part 8 of Article 9. The transition rules for the Amendments are modeled upon the transition rules used in connection with the 1998 revisions to Article 9 set forth in Part 7 of Article 9.

However, the transition rules for the Amendments are somewhat shortened from those in Part 7 of Article 9 since the Amendments, unlike the 1998 revisions, do not contemplate an expansion of the scope of Article 9 or a change in collateral category definitions. Moreover, although the transition rules for the Amendments do contemplate the possibility that the law governing perfection may change under the Amendments because the location of a debtor may change under the Amendments, the category of cases in which the law governing perfection will change is much narrower than under the 1998 revisions and will likely be applicable only to a Massachusetts type business trust.

FORBEARANCE AGREEMENTS AND WORKOUTS: CASE UPDATE

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Two years after the financial crisis, the economy is still in “recovery” and many lenders and borrowers are still dealing with its aftereffects. When the recession began, most of the case law that lenders and borrowers relied on in conducting their workout negotiations came out of prior recessions. Now, however, recent cases² have been reported in some important areas of law such as: lender liability, commercial reasonableness and guaranty enforcement. Below are summaries of some recent cases in these important areas of law.

LENDER LIABILITY

A few years ago, as we were just accepting the facts of the financial crisis, several practitioners and other market participants predicted a massive increase in the number of lender liability claims asserted against banks and suggested that the Courts may be less accommodating to the financial institutions (compared to the lender liability case law of the late 1990s and early 2000s). Certainly, the number of lender liability cases in 2009 and so far in 2010 appear to exceed the number of lender liability cases working their way through the Courts in 2007 and before. However, it is difficult to identify lender liability cases, because lender liability can be based on so many theories of law. Perhaps, we have seen more workouts, and fewer foreclosures, than expected - foreclosures tend to fuel lender liability claims.

In any event, lender liability principles are important considerations for lenders and borrowers during the forbearance negotiation process. “Lender liability” generally refers to the liability of the lender to a borrower or another third party arising out of or related to the lending transaction. Such liability could be based on (a) contract claims, such as breach of contract or breach of an implied covenant of good faith and fair dealing, (b) tort claims, such as negligence, tortious interference with contract, tortious interference with business relationship, or breach of fiduciary duty, or (c) even statutory claims, such as violation of unfair business practices statutes, RICO, environmental statutes, and lien foreclosure statutes. In addition, many cases assert multiple theories of liability with respect to the same actions of the lender.

The three cases discussed below highlight common lender liability claims addressed in the recent cases.

***Interpharm, Inc. v. Wells Fargo Bank, N.A.*, 2010 WL 1257300 (S.D.N.Y. Mar. 31, 2010)**

Interpharm, Inc. manufactured and sold generic pharmaceutical drugs. Hoping to expand its business, Interpharm obtained a secured credit facility from Wells Fargo Bank, including a revolving line of credit. The credit agreement provided Wells Fargo with substantial discretion to adjust advance rates and determine eligibility of accounts and inventory. A year and a half into the term of the credit facility, as a result of low revenue, high costs, and increased competition, Interpharm breached the financial covenants.

A. The Forbearance and Workout Process

Wells Fargo and Interpharm subsequently negotiated five forbearance agreements over the course of the next nine months, each of which included a release and waiver of any claims Interpharm had against Wells Fargo arising on or before the date of the applicable forbearance agreement. During the negotiation of the first forbearance agreement, Wells Fargo excluded certain receivables from the borrowing base, which reduced availability and, in Interpharm's view, pressured Interpharm to sign the forbearance agreement. The first forbearance agreement (a) added an additional amount (nearly ten percent) to the revolving line of credit, (b) included a forbearance for a period of about two months, (c) required Interpharm to obtain subordinated debt financing within less than thirty days, (d) added financial covenants, and (e) increased interest and fee rates.

Interpharm asserted that Wells Fargo knew the added financial covenants were "unattainable" and "unreasonable" at the time of the first forbearance agreement. Less than three months later, Interpharm breached the financial covenants and Wells Fargo increased rates and fees to the applicable default rates. Later that month, Wells Fargo excluded certain accounts from eligible accounts, based on the account debtors' rights to charge back. Interpharm was unable to pay suppliers and, eventually, concerned that it could not make payroll, which prompted Interpharm to enter into a second forbearance agreement with Wells Fargo.

The second forbearance agreement was a short-term "interim" forbearance agreement to address Interpharm's immediate issues. It included (a) additional security interests in favor of Wells Fargo, (b) Interpharm's agreement to hire a chief restructuring officer acceptable to Wells Fargo who would prepare a budget, request advances from Wells Fargo, make payments to Interpharm's creditors and administer the budget, (c) amended the definition of eligible accounts to exclude all wholesalers, and (d) an agreement to forbear for a period of three days.

The third forbearance agreement, which was entered into four days after the second, included (a) an agreement to forbear for a period of four months, (b) required Interpharm to reduce payroll expenses by twenty percent, and (c) required Interpharm to take action to sell its real estate. About thirty days later, Wells Fargo reduced the advance rate on inventory by about ten percent, based on a third-party liquidation value analysis of inventory, which reduced availability and prompted the fourth forbearance agreement.

The fourth forbearance agreement (a) changed the inventory advance rate to forty-nine percent or a lesser rate determined by Wells Fargo in its sole discretion, and (b) added the account of one of the wholesalers back in as an eligible account. Interpharm then executed two agreements to sell Interpharm's assets. To obtain funding through the closings of the asset sales, Interpharm entered into a fifth forbearance agreement, which provided for forbearance through closing and a forbearance fee due at closing of the asset sales.

Thereafter, Wells Fargo demanded a release and waiver of claims from Interpharm as a condition to releasing Wells Fargo's liens on the property to be sold. Interpharm refused and then asserted that Wells Fargo's refusal to release liens caused Interpharm to structure the sales in a way that resulted in significant tax liabilities to Interpharm. Wells Fargo also deducted attorneys' fees from an amount it returned to Interpharm without explaining the reason for the attorneys' fees.

B. Borrower's Claims Against Lender

Interpharm then repudiated the forbearance agreements and sued Wells Fargo, asserting claims for (1) breach of contract with respect to the credit agreement and the forbearance agreements, (2) breach of the duty of good faith and fair dealing, (3) tortious interference with business expectations, (4) unjust enrichment, and (5) breach of fiduciary duty. Wells Fargo filed a motion to dismiss based on the broad release and waiver contained in the forbearance agreements. The Court dismissed all but two claims against Wells Fargo.

C. Enforceability of the Release and Waiver of Claims

The Court referred to the "well settled" rule under New York law that a clear and unambiguous release that is knowingly and voluntarily entered into is enforceable, unless there is a legal defense such as fraud, duress, or undue influence. Although the Court found that the release and waiver in the fifth forbearance agreement was unambiguous and clear, Interpharm asserted that the release and waiver should be voided because Interpharm was under economic duress at the time.

Noting that a release between two sophisticated parties is "voided for economic duress only in 'extreme and extraordinary cases'", the Court stated the elements necessary for economic duress: the plaintiff must be compelled to agree by means of a wrongful (unlawful) threat and precluded from exercising free will (no other alternative). Here, the Court found that Wells Fargo's actions did not constitute

wrongful threats and that Interpharm was not compelled to agree to the release. Wells Fargo's actions were not "wrongful threats," because Wells Fargo had the legal right to accelerate the debt and foreclose its security interest and, therefore, had the right to threaten remedies it believed it was legally entitled to exercise.

According to the Court, Interpharm's "assertions provide largely that the Bank drove a hard bargain, not that it did anything unlawful." When analyzing whether Interpharm was compelled to agree to the release and the forbearance agreements, the Court identified at least three alternatives for Interpharm: (1) file for bankruptcy, (2) find a new lender, or (3) sue Wells Fargo to enforce the Credit Agreement. Because Wells Fargo did not make wrongful threats and other alternatives existed, the Court found that Interpharm did not agree to the release under economic duress.

After finding that the release was not voidable for economic duress, the Court determined that the release was effective to release claims arising at or before the fifth forbearance agreement, but not to release any claims relating to Wells Fargo's actions after the fifth forbearance agreement. Therefore, the Court dismissed Interpharm's claims other than breach of contract and breach of duty of faith and fair dealing arising out of (1) Wells Fargo's alleged refusal to release liens without an additional waiver and release and (2) Wells Fargo's alleged wrongful withholding of unspecified attorneys' fees.

***Dollar Tree Stores Inc. v. Toyama Partners, LLC*, 2010 WL 1688583 (N.D. Cal. Apr. 26, 2010)**

Dollar Tree Stores Inc. operated a retail store in a shopping center that was in need of renovation. Comerica Bank financed the renovation project with a construction loan to the landlord. Dollar Tree asserted that the renovation interfered with its business and negotiated a settlement with the landlord. Under the terms of the settlement, Dollar Tree agreed, among other things, to vacate the premises for a period of time and then to accept replacement premises in the newly renovated shopping center, which would include Dollar Tree and another retail business as anchor tenants. The settlement also included a \$500,000 closing fee to Dollar Tree, financed through the Comerica loan, rent abatement and other monetary compensation.

Before the renovation project was completed, the other anchor tenant terminated its lease, which resulted in a default under the Comerica construction loan. In response to the default, Comerica ceased further funding of the renovation project, which remains incomplete. The landlord failed to provide replacement premises in the newly renovated shopping center to Dollar Tree, which violated the terms of the amended and restated lease agreement.

Dollar Tree sued the landlord and Comerica. Its claims against Comerica included tortious interference with contract, tortious interference with prospective economic advantage, breach of a subordination, non-disturbance and attornment agreement, breach of the implied covenant of good faith and fair dealing, lender liability (based on negligence) and unfair competition. Comerica filed a motion to dismiss, which the Court granted.

In granting the motion to dismiss, the Court applied the facts to the elements of each claim:

• **Tortious Interference with Contract:**

The elements for tortious interference with contract are:

- "(1) a valid contract between plaintiff and a third party;
- (2) defendant's knowledge of this contract;
- (3) defendant's intentional acts designed to induce a breach or disruption of the contractual relationship;
- (4) actual breach or disruption of the contractual relationship; and
- (5) resulting damage."

Dollar Tree asserted that Comerica's agreement to finance the renovation project was a conspiracy between Comerica and the landlord intended to cause a breach of the original lease and that Comerica's decision to cease funding caused a foreseeable breach of the amended and restated lease entered into in connection with the settlement. Here, the Court focused on element (3) and held that the facts did not support a "plausible theory" that Comerica intended to induce a breach of either lease. The Court also noted that Comerica's decision to cease funding, which was consistent with its rights under the construction loan agreement, was for "a legitimate business purpose and was justified...."

• **Tortious Interference with Prospective Economic Advantage**

The elements for tortious interference with prospective economic advantage are:

- "(1) an economic relationship between the plaintiff and some third party, with the probability of future economic benefit to the plaintiff;
- (2) the defendant's knowledge of the relationship;
- (3) intentional acts on the part of the defendant designed to disrupt the relationship;
- (4) actual disruption of the relationship; and
- (5) economic harm to the plaintiff proximately caused by the acts of the defendant."

This tort also requires the assertion of an “independent wrongful act” – acts designed to interfere with a contract are not enough. Here, the Court could find no independent wrongful act by Comerica, relying heavily on its analysis of the tortious interference with contract claim.

- **Breach of a Subordination, Non-Disturbance and Attornment Agreement**

The subordination, non-disturbance and attornment agreement provided that Comerica would not disturb, diminish or interfere with Dollar Tree’s possession of the leased premises (absent Dollar Tree’s default of the lease). Dollar Tree asserted that Comerica knew the construction loan agreement would interfere with the lease and, therefore, breached the subordination, non-disturbance and attornment agreement. Here, the Court summarily held that it could not “infer that the act of lending money alone would result in a breach of this agreement.”

- **Breach of Implied Covenant of Good Faith and Fair Dealing**

Dollar Tree asserted that Comerica breached the covenant of good faith and fair dealing implied in the subordination, non-disturbance and attornment agreement by financing a renovation project, which required Dollar Tree to vacate the premises, and by refusing to continue funding after the event of default. The Court dismissed these claims as well, after discussing the scope of the implied covenant of good faith and fair dealing. In the Court’s view, Dollar Tree was attempting to use the implied covenant to impose additional substantive duties on Comerica – specifically, a duty to continue financing even during a default or a duty not to finance a project that may affect Dollar Tree’s operation of the premises.

- **Lender Liability (based on negligence)**

Dollar Tree asserted that Comerica was liable for negligent lending. According to the Court, the general rule is that Comerica had no duty of care to the landlord/borrower unless Comerica’s role exceeded that of a mere lender of money. The Court noted that no facts were asserted to indicate that Comerica had a more expansive role in the transaction. In this case, the Court declined to impose a greater duty on Comerica with respect to a third-party not in privity (i.e., Dollar Tree) than Comerica had with respect to the borrower.

- **Unfair Competition**

Dollar Tree alleged that Comerica’s agreement to make the construction loan and subsequent decision to cease funding were unlawful, unfair and fraudulent business acts and practices under California’s Unfair Competition Law. The “unlawful” acts and practices referred to in the statute are those acts and practices that violate other laws. Given the Court’s dismissal of all other claims, there were no “unlawful” acts and practices of Comerica to support a claim under the Unfair Competition Law.

***FAMM Steel Inc. v. Sovereign Bank*, 571 F.3d 93 (1st Cir. 2009)**

FAMM Steel, a family owned steel fabricator, began expanding its business operations in the late nineties with financing from Sovereign Bank. When FAMM began experiencing financial difficulty, went into covenant default and its comptroller left the business, Sovereign required FAMM to hire a particular outside consultant to oversee FAMM’s accounting while a replacement comptroller was found. FAMM objected to Sovereign’s requirement, but Sovereign stated that it was its “prerogative” to require FAMM to hire the consultant. FAMM acquiesced. FAMM eventually hired a permanent comptroller, selected by the consultant. Sovereign also required that the consultant remain an employee of FAMM to train the new comptroller and to continue to oversee FAMM’s accounting.

The new comptroller and the consultant allegedly engaged in mismanagement, including failing to reconcile bank statements, failing to pay monthly taxes and presenting inaccurate financial data that showed a profit when in fact FAMM was operating at a loss. When FAMM’s other officers discovered the mismanagement and reported it to Sovereign, Sovereign required FAMM to hire a particular turnaround officer.

FAMM’s business operations continued to deteriorate, and although Sovereign allegedly indicated a forbearance agreement would be entered into, Sovereign eventually sold the loan at a significant loss. The buyer liquidated FAMM’s assets to repay the loans.

A. FAMM’s Claims Against Sovereign

After the closure of FAMM’s business, FAMM sued Sovereign and claimed, among other things, that (a) Sovereign breached the implied covenant of good faith and fair dealing, (b) Sovereign created, and then breached, its fiduciary duties to FAMM, and (c) Sovereign created a situation in which FAMM became Sovereign’s instrumentality.

B. The Implied Covenant of Good Faith and Fair Dealing

The Court concluded that Sovereign did not breach the implied covenant of good faith and fair dealing despite allegations that Sovereign (a) refused to answer inquiries from FAMM’s subcontractors and suppliers when FAMM’s operations were deteriorating, (b) failed to respond to restructuring proposals or offers to purchase, (c) failed to waive covenant defaults, (d) failed to issue a forbearance agreement despite promises to do so, and (e) failed to extend the line even though it promised it would do so if FAMM made principal reductions.

The Court noted that, when all these events took place, FAMM was in default under the loan documents: “when the borrower is in default, that necessarily alters the contours of the covenant of good faith and fair dealing.” The Court then found that the majority of the allegations were based on failure to take actions that Sovereign was not required to take under the loan documents and dismissed them. The Court further held that FAMM had not produced sufficient evidence to support the claims that Sovereign promised to issue a forbearance agreement and extend the line, primarily because no specific discussion of the terms of the forbearance occurred, and there was conflicting testimony (from the turnaround officer) that Sovereign had ever promised to extend the line.

FAMM argued for the first time on appeal that Sovereign had also breached the implied covenant because it forced FAMM to hire the consultant that ultimately hired the new comptroller. Even though the argument was waived (because it was raised for the first time on appeal), the Court noted that the argument would have failed anyway because there was no evidence that Sovereign acted dishonestly or that it was purposefully trying to injure FAMM by insisting that the consultant be hired, nor was there any evidence that Sovereign knew the consultant would not perform his job adequately.

C. Breach of Fiduciary Duty

FAMM argued that Sovereign exerted such a level of control that Sovereign had acquired control over FAMM’s day-to-day operations and therefore owed, and breached, a fiduciary duty to FAMM. The Court disagreed and held that Sovereign did not have sufficient control to create a fiduciary duty. The Court found that even though Sovereign had required FAMM to hire the consultant and the turnaround officer, there was no evidence that either individual was acting under Sovereign’s direction, nor was there any evidence that the comptroller hired by the consultant was acting under Sovereign’s direction. The Court noted that although Sovereign had insisted on the hiring of certain officers, FAMM’s other officers, with final say over the company’s decisions, remained in place.

D. Instrumentality

The “instrumentality” theory is a claim that a lender has taken such control of its borrower that the borrower has ceased to exist except in shell form and is therefore merely a conduit of the lender. The theory requires a *strong* showing that the lender has taken total control of the borrower and that the borrower had no separate, independent existence of its own. The Court held that FAMM made an insufficient showing. The Court acknowledged that Sovereign and the consultant and turnaround officer interacted, but there was no evidence that Sovereign was directing their actions or that Sovereign had assumed the requisite control. The Court noted that FAMM’s other officers still had final say over the company’s decisions, and that “an inference [of total control] seems implausible in light of the losses the bank suffered as a result of [the consultant]’s actions.”

COMMERCIAL REASONABLENESS

Throughout the workout process, state law remedies enforcement, including Article 9 public and private sales, is typically the backdrop that shapes negotiations. In connection with such public and private sales, the question of paramount importance is whether the sale is “commercially reasonable.” The three cases below illustrate the difficulties creditors have had in conducting a commercially reasonable sale and some of the arguments borrowers have raised in attempting to establish that a sale was commercially unreasonable.

***Bremer Bank, N.A. v. John Hancock Life Ins. Co.*, 2009 WL 702009 (D. Minn. Mar. 13, 2009)**

The following is a simplified description of the facts of the case. The creditor made a loan to the borrower to acquire an aircraft, and in return, the creditor took a security interest in the aircraft. When the borrower defaulted, the creditor foreclosed on its security interest and sold the aircraft to the winning bidder. The borrower then sued the creditor, alleging, among other things, that the creditor failed to conduct a commercially reasonable sale of the aircraft.

A. Allegations of Commercial Unreasonableness

The borrower claimed that the foreclosure sale was commercially unreasonable under applicable New York law because (a) the price paid by the ultimate buyer was too low, and (b) the means the creditor used to conduct the sale were inadequate. The borrower’s first argument for commercial unreasonableness is referred to as the “proceeds” test and essentially inquires into whether the sale price was optimal. The second argument is referred to as the “procedures” test and inquires into whether the procedures used to sell the collateral conform to commercially accepted standards.

B. Proceeds Test

The borrower valued the aircraft at \$20 million. The ultimate buyer purchased it for just under \$13 million. The Court began its analysis by noting that, even if a better price could have been obtained at a sale conducted under different circumstances, that fact, without more, cannot establish that a sale was commercially unreasonable. The Court also noted that a low sale price, without more, would not render a sale commercially unreasonable unless “the price is so low as to shock the conscience of the Court.”

The Court found that the creditor had marketed the sale adequately (discussed in more detail below) and that \$13 million was the best price offered under the circumstances. Moreover, the Court noted that, if the borrower truly believed that the aircraft was worth \$20 million, it could and should have bid at the foreclosure sale to protect its equity interest therein.

C. Procedures Test

The borrower alleged that the procedures the creditor used were commercially unreasonable because, among other things, the sale took place only a month after the notice of the sale was delivered, the aircraft was not made available for inspection by potential buyers, and the creditor described the aircraft in a way that was “seriously misleading” and “designed to discourage bidding” because the creditor’s description of the aircraft revealed all of its faults and described a long time frame for refurbishing it.

Despite the fact that the creditor sold the aircraft a month after it noticed the sale, the Court found that its marketing procedures were sufficient given that the creditor published an advertisement for the sale in four different trade publications for a month, the creditor advertised the sale on a trade website that received 15,000 hits per day, the creditor directly contacted 448 entities and individuals that it thought might be interested, and the creditor engaged in follow-up negotiations with 31 such parties. Further, the Court found that failure to make the aircraft available for inspection did not render the sale commercially unreasonable. As an initial matter, there was no evidence that any potential buyer had requested access, and further, the creditor released detailed descriptions and technical specifications of the aircraft to interested parties. With respect to the creditor’s disclosure of the aircraft’s faults and timeframe it would take to repair them, the Court found that the comments were accurate, and as such, were not false, misleading or disparaging, which, had they been, may have rendered the sale commercially unreasonable.

***Hicklin v. Onyx Acceptance Corp.*, 970 A.2d 244 (Del. Super. Ct. 2009)**

Onyx Acceptance Corp. financed a car Hicklin bought and took a security interest in it. When Hicklin stopped making payments, Onyx repossessed the car and sold it at a private auction. The car was worth \$4,000, needed about \$1,300 in repairs and Onyx sold it for \$1,500. Onyx then sued Hicklin for a deficiency, and Hicklin defended on the grounds that the sale was commercially unreasonable.

The trial Court held that the sale was commercially reasonable under Delaware law because the sale price, \$1,500, was greater than 50% of the car’s value less the repair costs. The appellate Court upheld the ruling. The Delaware Supreme Court, however, reversed.

A. Commercial Reasonableness of Every Aspect of Sale or Safe Harbor

The Court held that Onyx could prove the commercial reasonableness of the sale in one of two ways: (a) demonstrate that every aspect of the sale was commercially reasonable, or (b) demonstrate that it sold the car in accordance with the accepted practices of reputable dealers in that type of property. Onyx presented no evidence throughout the trial and its appeals that the car was sold in accordance with accepted practices of reputable dealers. It therefore had to establish that every aspect of its sale was commercially reasonable.

B. A Fair Price, Without More, Is Insufficient

The Court held that although obtaining a satisfactory price is the purpose of requiring a secured party to resell collateral in a commercially reasonable way, it is only one aspect of commercial reasonableness. Moreover, it is improper to reason backwards from price alone to determine commercial reasonableness of the overall sale process. In particular, the Court found that Onyx’s evidence was insufficient to establish that *every aspect* of the sale was commercially reasonable.

Onyx presented the testimony of one employee of ten years who stated that private auctions generally resulted in higher sale prices than public ones. The Delaware Supreme Court did not find this sufficient. It reasoned that establishing that private auctions *generally* result in higher sales prices is insufficient to establish that the *specific* auction procedures used in this case were commercially reasonable. Without proof of the specific auction procedures, Onyx had failed to carry its burden of establishing commercial reasonableness.

***Textron Financial Corp. v. Lentine Marine Inc.*, 630 F. Supp. 2d 1352 (S.D. Fla. 2009)**

Textron Financial Corp. financed Lentine Marine, Inc.’s boat selling operation and took a security interest in Lentine’s inventory. When Lentine defaulted, Textron obtained a Court order entitling it to repossess the boats. Textron then sold some of the boats back to their manufacturers and had some of the others sold through competitors of Lentine. Textron then sued for a deficiency. Lentine defended on the grounds that the sales were commercially unreasonable.

A. Applicable Florida Law

The Court held that, under Florida law, Textron could obtain a deficiency by showing that the disposition was commercially reasonable or that the fair market value of the collateral was less than the debt the collateral secures. Textron failed in both attempts in its motion for summary judgment, because the evidence it put forth was not sufficiently specific.

B. Broad Allegations of Commercial Reasonableness Are Insufficient

With respect to the boats Textron sold back to the manufacturers, Textron submitted an affidavit of an officer that attached the sales agreements and asserted that the prices were higher than that currently available on the retail market. The Court did not regard these as sufficient for summary judgment purposes, because Textron failed to put forth any evidence other than a bald assertion that the prices were higher than the retail market or that the contracts were in conformity with reasonable commercial practices among dealers in the

industry. Textron did not submit samples of other similar contracts or explain how the prices in the contracts entered into were set.

With respect to the boats Textron sold through competitors of Lentine, Textron submitted affidavits from officers of the companies that Textron hired to resell the boats. Those affidavits described the officers' experience in the industry and asserted that the boats were sold for fair market value. For purposes of summary judgment, the Court held that the affidavits were insufficient, because they failed to include specific factual information about the sales or about the current retail market. Without that information, the Court could not determine whether the sales were made in conformity with reasonable commercial practices among marine dealers, that every aspect of the sale was commercially reasonable or that the resale prices represented fair market value.

GUARANTY ENFORCEMENT

Guarantors typically sign guaranties in good times because they don't believe that the borrower will default on its loan obligations. When the borrower defaults and the lender seeks to enforce the guarantor's payment obligations, litigation often results. Below are summaries of three recent cases highlighting some common themes in guaranty enforcement.

***TW General Contracting Services, Inc. v. First Farmers Bank & Trust*, 904 N.E.2d 1285 (Ind. Ct. App. 2009)**

First Farmers Bank & Trust made two loans to TW General Contracting Services, Inc., and principals of TW executed guaranties of the loans at the time the loans were made. The loans were evidenced by two separate notes. The notes were subsequently amended and restated several times, and additional loans, evidenced by other promissory notes, were made. Apparently, the guarantors never signed any acknowledgement of, or consent to, the amendment and restatement or the additional loans. As principals of TW, however, they did sign the new notes on TW's behalf. TW defaulted on the notes, and Farmers sued TW and the guarantors.

A. Guarantor Intentions

The guarantors argued that they were not liable on the renewed notes because, as set forth in an affidavit, they did not intend to guarantee the new loans, and they had not consented to the renewed notes.

B. Enforceability of the Plain Language of the Guarantees, Without Regard to Intent

The Court reviewed the guaranties, determined that the language was unambiguous and enforced them in accordance with their terms. It put no weight on the affidavit regarding the intent of the guarantors. The Court held that the guaranties clearly included any and all debt, whenever arising and howsoever evidenced, owing to Farmers by TW. Further, the guaranties contained language authorizing Farmers to renew, extend and modify existing indebtedness without affecting the guarantors' liability. The Court held that it was not material that the promissory notes failed to refer to the existing guaranties.

***Moore v. Wells Fargo Construction*, 907 N.E.2d 1038 (Ind. Ct. App. 2009)**

Wells Fargo financed a construction company's purchase of drilling equipment and took a security interest in the equipment. Moore, one of the principals of the construction company, guaranteed the debt. The construction company defaulted and then went into bankruptcy. Wells Fargo (apparently with an order of the bankruptcy Court) repossessed the equipment, sold it and then sought a deficiency judgment against Moore.

A. Defense of Failure to Conduct Commercially Reasonable Sale

Moore argued that Wells Fargo could not collect a deficiency from him because Wells Fargo failed to conduct a commercially reasonable sale of the repossessed equipment. Wells Fargo countered with an argument that Moore's guaranty released Wells Fargo from its obligation to conduct a commercially reasonable sale.

B. Guaranty Cannot Release the Statutory Obligation to Conduct a Commercially Reasonable Sale

The Indiana Court of Appeals initially sided with Wells Fargo and held that the release was unambiguous and would be enforced in accordance with its terms. *Moore v. Wells Fargo Construction*, 903 N.E.2d 525 (Ind. Ct. App. 2009). However, upon re-hearing, the Court held that the obligation of a creditor to conduct a commercially reasonable sale could not be released under the UCC. As such, the Court went on to evaluate whether Wells Fargo in fact conducted a commercially reasonable sale of the equipment.

***SNTL Corp. v. Centre Ins. Co. (In re SNTL Corp.)*, 571 F.3d 826 (9th Cir. 2009)**

SNTL Corporation guaranteed hundred of millions of dollars in reinsurance obligations of certain of its affiliates to Centre Insurance. When SNTL and its affiliates began experiencing financial difficulty, SNTL and Centre entered into an agreement pursuant to which SNTL paid Centre approximately \$160 million in exchange for which Centre released SNTL from liability under its guaranty. The agreement contained a revival clause, which provided that, if a Court of competent jurisdiction "enters a final order, judgment or other finding that ... a payment under the [agreement] ... constitutes a voidable or preferential transfer ... or is otherwise ... subject to a claim of preference," Centre was entitled to declare the agreement null and void or exercise "any other remedy provided by law, equity, statute

or contract.”

SNTL and its affiliates filed for bankruptcy, and while the proceeding was pending, the California Insurance Commissioner commenced a suit in state Court against Centre seeking to recover the \$160 million payment as a preference. Centre ultimately settled the suit with the Commissioner, returning \$110 million of the \$160 million. The state Court approved the settlement. Centre then filed a proof of claim against SNTL, under the theory that the settlement had triggered the revival clause of the agreement between the parties.

SNTL sought to disallow the claim arguing that (a) the settlement did not constitute a “final order, judgment or other finding” that triggered the revival clause, and (b) SNTL’s guaranty was released as of the date of the bankruptcy filing and its obligations could not be revived thereafter.

A. Order Approving Settlement Triggered the Revival Clause

Centre argued, and the Court agreed, that when the state Court entered its order approving the settlement between Centre and the Commissioner, the revival clause was triggered. The approval order specifically stated that the payment Centre made was in settlement of preference claims. The Court held that this triggered the revival clause under the express terms of the clause.

The Court then held that, once the revival clause was triggered, under its express terms, Centre could either terminate the agreement between the parties or pursue all available rights and remedies under applicable law. The Court held that the general principle that a guarantor’s obligations revived was applicable law, and Centre could thus elect to revive SNTL’s obligations. SNTL argued that the general principle was only applicable if the creditor involuntarily returned a payment, and Centre returned it voluntarily pursuant to a settlement with the Commissioner. The Court dismissed this argument, stating that it “misconstrues the nature of voluntariness” and that “a payment made in settlement of contested litigation is not truly voluntary”.

B. Contingent Claim for Revived Obligations

SNTL argued that its guaranty was released as of the date it filed for bankruptcy, and as of that date, it had no obligation to Centre. SNTL argued that Centre’s settlement with the Commissioner, entered into after the bankruptcy filing, could not alter the amount of Centre’s claim that existed on the bankruptcy filing date. The Court disagreed, holding that on the date SNTL filed for bankruptcy, Centre had a contingent claim, and the fact that the contingency came to pass after that date was immaterial.

THE LOAN SYNDICATIONS AND TRADING ASSOCIATION: THE 2010 LOAN MARKET UPDATE

By **Bridget Marsh and Ted Basta**³

Introduction

At different times since the credit crisis began in 2008, it seemed that the loan market might be consumed by the financial crisis – either swept aside as an unintended consequence of the regulatory reform laws or irrevocably altered by one of the more recent bankruptcy court decisions. Within the market, its participants continue to grapple with an infrastructure strained by high levels of distressed trading and settlement delays that exceed target. Notwithstanding these challenges, the market continues to function. Indeed, it seems poised to improve – pricing has recovered from the 2009 lows; trading volumes remain impressive; and the looming “re-financing cliff” now appears less dramatic.

In our update published in this newsletter early last year, we noted that the loan market had entered an era of unprecedented volatility (with loan prices more closely correlated to, and no longer shielded from, the daily price fluctuations of other asset classes). We highlighted the steep pattern of price declines, record trading volumes, and rising default rates. More than eighteen months later, volatility has diminished, prices have advanced, and defaults have lessened significantly. The news is not uniformly good, however. The market’s investor base has contracted, and both par and distressed trading volumes have fallen, indicating a shrinking market. In this update, we will provide an overview of the leveraged loan market in 2009 and the first half of 2010, focusing on the improvements seen in this market in the six months prior to August 2010. Against this backdrop, we then explore how the LSTA has responded to the recent market challenges and how we view the future.

2009-2010: A Market Recap

Although 2008 will be remembered for the leveraged loan market’s first annual negative return, with the S&P/LSTA Leveraged Loan Index (LLI or Index) recording a 29% loss, 2009 notably saw a record gain of 51.6% under the same LLI index. 2010 seems to have witnessed a “leveling-out” compared with those two tumultuous years. As we entered mid-August 2010, the Index had returned 5.15% on the year and default rates were at an 18-month low of about 4%.

Entering 2009, loans were trading in the high-60 to low-70 price range. Losses had been amplified by excessive leverage, forcing some investments to be sold into a secondary loan market at a difficult time (secondary bids having hit a low during 4Q08). The loan market’s

default rate then spiked to an unprecedented rate of above 10% during 1Q09, reflecting poor economic fundamentals. But these factors were offset by a series of technical factors that drove the market forward. These included increasing demand as well as shrinking supply – due, in part, to bond-for-loan take outs. In this climate, cross-over lenders stepped in to capture the still-attractive senior secured yields available in the secondary market and, as a result, drove an increase in trading volumes by 23%. During 2Q09, trading volumes reached a total of \$133 billion – the first time quarterly volumes were reported north of \$108 billion in more than a year. In turn, the LLI registered a 19.2% return during 2Q09 as prices improved by approximately 20% (Figure 1), making 2Q09 the strongest quarter on record.

Prices continued to rise in the second half of 2009, surging back up to the mid-80s as bid-ask spreads fell below 150 basis points for the first time since Lehman's collapse. Because bids were well into the 80s and repayments (from bond-for-loan take out deals) were beginning to accumulate, CLOs (which benefit from purchasing loans priced above 80) were finally able to put substantial capital to work. Technical market factors continued to drive loan prices higher, with net new loan supply remaining virtually static. As borrowers continued to make loan repayments, most of 2009's primary issuance was dedicated to refinancings, including amend-to-extend deals that pushed out maturity dates and further reduced the amount of outstanding loans. Of the \$56.3B of institutional issuance, only 43% or \$24.3 was "net new money" while \$74B of bond deals served to replace existing loans (Figure 2). These technical conditions were the primary driver of price recovery for much of the year.

After four quarters of "repayment surplus", the dollar value of the outstanding LLI shrunk by 12% to less than \$530 billion. Trade prices rallied by a record 21 points, or 31% across all of 2009, while the 2009 LLI returned 51.6%, which more than compensated for the sharp 29% dip in 2008.

Over the same 12 months, the secondary market finally normalized, returning to its pre-Lehman state. Indeed, it underwent the greatest rally in its history. During 2009, the distribution of loans traded at both ends of the price spectrum changed course dramatically. The percentage of loans traded at or above 90 rose to 55% from 7%, while loans traded below 80 fell to 23% from 64% at the beginning of the year (Figure 3).

Although returns exceeded expectations in 2009, there were still a number of pending issues facing the leveraged loan market as it entered 2010. First, the default rate remained high. Second, annual trade volumes (as a measure of liquidity) had fallen for the second consecutive year to \$474B, from \$510B in 2008 and \$520B in 2007. Third, distressed trade volume (those loans trading on LSTA distressed trading documentation) averaged \$35B per quarter in 2009 versus the previous high of \$14B (Figure 4). As a consequence of this large distressed trade volume, settlement times were further delayed, increasing by 20 business days and settling on average 68 business days after the trade date (T+68). And, besides the threat of future regulatory changes, a sizable volume of loans were approaching maturity within the next few years and soon would need to be refinanced. This looming threat (dubbed the "refi cliff") raised concerns about who would provide the necessary liquidity to refinance and was exacerbated by a lack of new CLO issuance in 2009 (in the past, 60% of new loans had been acquired by CLOs, thus providing a critical source of liquidity for the primary market).

2010

1Q10 witnessed some improving economic fundamentals. Credit strengthened, and earnings improved. The loan default rate plunged to 5.8%, from 10% at year-end (Figure 5). These favorable developments were briefly offset in February 2010, as sovereign debt concerns (largely driven by Portugal, Ireland, Greece and Spain) increased. On the technical side, despite a stronger primary market, net new loans made (\$12.2B) were once again outpaced by loan repayments (\$26.5B). However, existing demand, as a result of repayments, was buoyed by \$3.6B of 1Q10 inflows into loan funds – compared to the \$4.9B reported across all of 2009. During this quarter, the LLI returned an impressive 4.64% on a combination of strong technical factors and improving fundamentals. But, for the third consecutive quarter, trade volume fell again, this time by 7% to \$110B. Prices in the secondary market, meanwhile, improved by 4%, with the average trade price rising above 90 for the first time in 2 years.

The market continued to perform well in April 2010, but, after 16 consecutive months in which the index yielded a positive return, the LLI turned negative in May, posting a negative 2.23% return. May 2010's loan market correction was attributable to two broad causes – the European contagion and a shift in technical market factors. Europe's sovereign default and related woes weighed heavily not only on loans but across the entire capital structure, as lenders shed risk and sought safe harbors. Within the primary market, as loan fund inflows slowed, supply increased as new demand decreased. While at the same time, high yield bond issuance, a source of cash inflow, was curtailed. Thus, the cash, which lenders had been receiving from bond-for-loan take outs which had driven demand for excess loans, disappeared (Figure 6).

In June 2010, notwithstanding the uncertainty surrounding Europe, U.S. economic fundamentals and loan technical market factors remained solid. For the first time in two and a half years, not a single loan defaulted in the LLI, and, as a result, the default rate fell to an 18-month low of 4.02%. U.S. GDP growth had now been solid for three consecutive quarters, and LLI issuers reported nine straight months of year-over-year EBITDA growth. On the technical side, institutional loan issuance slowed for the third consecutive month as did bond take-outs, resulting in a reduction of LLI outstandings of approximately \$10B for the quarter (Figure 7). At the same time, inflows into bank loan funds were at a four week moving average of \$72.6 million. Against this backdrop, although one might reason that loan prices "should" have increased in June, they did not in fact do so and have, unfortunately, followed the volatile direction of the

equity markets. Overall, the market performed poorly, however, with the LLI returning only 0.44%. June's results led to a negative 1.24% for 2Q10 and further reduced this year's 1st half return to 3.34% (Figure 8). Even though the secondary prices retreated from their highs during the very light trading sessions of May and June, prices in the secondary still rose 2.9% in 2Q10 to an average of 92.38 – a level not seen since 4Q07.

To summarize, the “good news” in the first half of 2010 was that the default rate fell to an 18-month low of 4.02%, four new CLOs were placed successfully, and, through a series of amend-to-extend deals, the refi-cliff looked much more manageable than it once did – an estimated \$40B and \$60B of loan maturities, which were due in 2011 and 2012, had been materially extended.

Offsetting this “good news” were some discouraging developments: following 1Q10's 6% decline, secondary loan trading volumes fell by 9% (\$10B) in 2Q10 to below \$100B. In this respect, 2Q10 represented the 4th consecutive quarter of decline and the first time volumes were reported at or near \$100B since the ill-fated fourth quarter of 2008. This decrease in trading, however, was itself a byproduct of improving economic fundamentals: it was driven, in part, by lower distressed volumes, which themselves are a sign of improving credit quality and stronger corporate earnings. Between the end of March 2010 and the middle of August 2010, distressed trading volume plunged by 38% to \$21.8B – the lowest level reported in 1½ years (between 1Q08 and 1Q10 distressed trading averaged \$35B per quarter).

Despite reduced trading activity, settlement times worsened for the 4th consecutive quarter. The average settlement time of distressed trades during 2Q10 widened even further to T+72, but the median tightened to T+55 (from T+58) signifying that 50% of trades settled within T+55. The lower median was driven by a higher percentage of trades settling within the LSTA guideline of T+20, which increased to 17% – the highest percentage of trades since 2Q09. Moving forward, distressed settlement times appeared to be poised to improve. First, the number of deals trading on distressed documentation fell below 200 for the first time in 18 months and, second, open 2Q10 distressed trade volume was recorded at only \$10.6B as compared to the quarterly average of \$23.5B that was reported during each of the previous four quarters.

The LSTA's Response

Given the market challenges outlined above, the LSTA has been active in the courts, in the market, and in Washington, D.C. We have expressed our views in critical loan market cases as “amicus curiae”; we have revised our trading documents, intervened to resolve market disruptions, and tackled settlement issues; and we have actively engaged in discussions with politicians, legislators, and regulators, often bringing to their attention potential unintended consequences of legislative drafting.

Amicus Briefs

With the sharp spike in defaults in 2008, there was a commensurate rise in litigation in the loan market. In some instances, the cases resulted in decisions that threatened to erode creditors' rights. The LSTA, therefore, did not hesitate to file amicus briefs in cases that might negatively impact the loan market. Fortunately, our efforts contributed towards several significant victories.

In 2009, we filed an amicus brief in *Trust for the Certificate Holders of the Merrill Lynch Mortgage Investors, Inc. v. Love Funding Corp.*, an important appellate decision involving the law of champerty under New York's Judiciary law. Earlier, a New York federal district court had held that an assignment of litigation rights violated the New York champerty statute. On appeal, the United States Court of Appeals certified a series of questions to the New York Court of Appeals concerning the proper construction of the New York champerty statute. In our brief filed with the New York Court of Appeals, we argued that New York's champerty statute, which prohibits companies from buying or taking assignments “with the intent and for the purpose of bringing an action or proceeding thereon,” should be construed narrowly and that assignments of loans with litigation rights are not champertous transfers because the litigation rights are only one means of realizing the value of the underlying asset. Both the New York Court of Appeals and the United States Court of Appeals opinions are broadly in line with the approach we urged, and the federal district court's ruling has thus been reversed. This important decision eliminates any lingering concerns about the application of champerty in the distressed debt trading market.

In another important victory for the syndicated loan market this year, the New York Court of Appeals unanimously found in *DDJ Capital Management v. Rhone Group* that it is not unreasonable for lenders to rely on a borrower's representations in a credit agreement about the accuracy of unaudited financial statements without conducting their own investigation of those statements. In the LSTA's amicus brief filed in support of the lenders, we argued that because most companies release audited financial statements once per year, lenders lend not only on the basis of the latest audited statements but also on the basis of recent unaudited financial statements. We explained that lenders typically require borrowers to represent that those unaudited statements are accurate, rather than engage in their own financial due diligence, and that to require more of the lenders would cause material disruption in the commercial lending market. In accepting these arguments, the Court of Appeals held that a trier of fact could find that the lenders “were justified in relying on the representations” for which they had negotiated. In a possible sign of the impact of our amicus brief, the Court of Appeals justices repeatedly referred to the LSTA's amicus brief during oral argument, questioning the parties' counsel about the impact their decision could have on the corporate loan market.

Although we have been successful in key cases, there have been losses as well. The arguments set forth in our amicus brief filed in *In re*

Philadelphia Newspapers unfortunately did not sway the court. In that case, the United States Court of Appeals for the Third Circuit found that secured creditors could be blocked from “credit bidding” in an auction of the assets of the debtor in a “cram-down” plan of reorganization. We were disappointed with this decision and remain convinced that it threatens one of the fundamental expectations of secured lenders in the loan market – that they can protect their interests by credit bidding for their collateral when a borrower files for bankruptcy. We will continue to monitor developments in this area.

Most recently, the LSTA has filed an amicus brief in support of the lenders in *Citicorp North America v. Official Committee of Unsecured Creditors of TOUSA*. There the bankruptcy court held that loans to the TOUSA parent company secured by guarantees from its subsidiaries, the proceeds of which were used to fund a settlement with a joint venture, constituted a fraudulent conveyance. Refusing to look at the company on a consolidated basis, the bankruptcy court concluded that the subsidiaries that pledged their collateral to secure the loan received no value in return and were insolvent when the loan was made, and, consequently, voided those liens. In its brief, the LSTA argues that, amongst other things, in concluding that the loan was a fraudulent transfer, the court improperly ignored the consolidated business organization of the borrower and adopted an unduly narrow (and commercially unworkable) definition of “value.” Oral arguments were set for October 29th, and the LSTA will continue to follow the case closely.

In another important area for the distressed debt market, the LSTA expressed views on the application of Federal Rule of Bankruptcy Procedure 2019, which requires certain participants in the bankruptcy process to report information about creditors and their claims against the debtor. The latest changes proposed by the Committee on Rules of Practice and Procedure in August 2009 would have required every member of any entity or group representing more than one creditor to disclose the nature and amount of each claim or economic interest the creditor holds in the case, including the price paid and the date the claims or interests were acquired. The LSTA submitted a letter to the Rules Committee opposing the required disclosure of proprietary price and date information. In June 2010, we learned that the Rules Committee had significantly revised the previous version of the proposed rule and the recommendations made by the LSTA were largely adopted.

Primary Market Initiatives

Anticipating the eventual revival of the primary market, the LSTA has launched a project to refresh the LSTA’s Model Credit Agreement Provisions which originally had been published in 2005 and to expand them to include language addressing defaulting lenders and the requirements imposed by the Foreign Account Tax Compliance Act (“FATCA”) which became law in March as part of the HIRE Act.

Following the collapse of Lehman, parties no longer simply focus on the borrower’s creditworthiness, assuming that the other lenders would satisfy their payment obligations. Although the Loan Market Association in the UK published standard defaulting lender language in 2009, we chose to wait until debate in the U.S. market subsided and the language became more settled. After reviewing member comments, we plan to finalize standard language by year’s end. The overriding concern with such provisions is whether certain terms will be enforceable upon a defaulting lender’s filing for bankruptcy; ultimately, the LSTA’s form of defaulting lender language will seek to balance that concern with the market’s need for clarity and certainty.

The Model Credit Agreement Provisions will also be expanded to include language addressing FATCA (FATCA will apply generally to loans made after March 18, 2012). FATCA imposes a 30% withholding tax on any “withholdable payments” made to foreign financial institutions (FFI) unless the FFI agrees with Treasury to report information about certain accounts to the IRS. Pursuant to our draft language, if a payment made to a lender would be subject to withholding tax imposed by FATCA if such lender fails to comply with the FATCA reporting requirements, then such lender must deliver to the borrower and agent documentation sufficient for them to comply with their obligations under FATCA. The LSTA also has submitted a comment letter to the IRS/Treasury on FATCA, arguing that the implementation of FATCA could have a significant negative impact on the U.S. corporate loan market. The LSTA suggested that offshore loan securitization vehicles (including CLOs) should be exempted from the FATCA reporting and withholding requirements because their governing documents typically precluded them from obtaining the necessary reporting information. Instead, the LSTA suggested that the regulations adopt a certification mechanism, whereby each payor could rely on a FATCA compliance certification from its payee.

Secondary Market Initiatives

As noted above, although overall secondary trading volume in 2009 had fallen to \$474B from a peak of \$520B in 2007, distressed trading continued to set record numbers and averaged \$35B per quarter in 2009 ([Figure 4](#)). With such increase in distressed trading volume, the LSTA continued its efforts to improve its distressed trading documents, seeking to eliminate more of the obstacles impeding the market’s attainment of faster settlement times. We introduced a data-driven shift date process for selecting the date on which the market convention for transferring debt shifted from par documents to distressed documents⁴ and are finalizing a new distressed trade termination mechanism (both of which are discussed below).

The implementation of the LSTA’s new Shift Date Rules in January marks another significant step towards streamlining the drafting of distressed documentation. Under the former shift date polling process, the LSTA polled dealers, seeking their opinion on when the market shifted from trading a particular credit on par documents to distressed documents and then posted the results on its website.

Parties to a distressed trade, for which a shift date was required, could then choose to use that information and negotiate a shift date – a process that sometimes contributed to settlement delays. Under the new Shift Date Rules, instead of merely acting as a conduit for information, the LSTA reviews dealer-supplied trade data to determine the shift date for particular debt. The date selected by the LSTA is binding on all loan market participants. By publishing one shift date for the market, thereby eliminating the need for parties individually to negotiate and agree a date, the LSTA has removed one of the obstacles to faster settlement times.

Because the market seemed to have quietly adjusted to the termination mechanism (the “Buy-in/Sell-out Mechanism” or “BISO”) introduced in par trading in 2009, with participants judiciously invoking the provision, the timeline for the par BISO was tightened in January 2010 with the hope that this stricter timeline would result in more par trades settling in a timely manner. In addition, the LSTA Board approved the inclusion of a BISO mechanism in the LSTA Distressed Trade Confirmation. Once finalized, the BISO mechanism for distressed trades will largely adopt the BISO mechanism in the Par Confirm but with certain important modifications to reflect the complexities of distressed trading. One of the most notable differences between the two regimes will be the extended timeline for effecting a cover transaction, a necessary modification which accommodates the idiosyncrasies of bankruptcy proceedings, parties’ need to negotiate additional trade terms, and the buyers’ performance of due diligence. Although we published in early August a revised version of our trading documentation (the turn eliminated some of the optionality of the distressed settlement documents), we expect to publish yet another new version by year’s end. At that time, we plan to introduce the new distressed BISO mechanism.

Regulatory Reform Initiatives

The LSTA has been actively responding to the government’s regulatory reform initiatives and, during the past year, has tried to ensure that the loan market is not unintentionally caught by some of the proposed changes in the Dodd-Frank Act, including the risk retention rules and the Volcker Rules. Although the LSTA’s primary focus has been on the risk retention rules, we believe that the legislation presents possible threats to Loan-only CDS or CDX and total return swaps on loans. During the next six months, the regulators will be drafting the rules required by the new 2,300-page Act. As that process unfolds, the LSTA plans to be completely engaged in the discussions, preparing comment letters and submitting white papers as appropriate.

* * *

Today’s market is beginning to resemble more closely the loan market pre-financial crisis. In this environment, the LSTA remains committed to promoting a fair, efficient, and liquid market for loans and maintaining its position as the market’s principal advocate. In fact, the LSTA Board has revised our mission statement to provide that we are also committed to growing the corporate loan market.

We know that we will be called upon to address issues raised by our membership as a result of regulatory changes and court decisions and to help effectively and promptly resolve those issues to ensure the market continues to operate smoothly and efficiently. In addition, we will continue to work with market participants to eliminate market inefficiencies. As we commented in our conclusion last year, in all our efforts to resolve those issues, the LSTA will continue to strive to resolve market challenges ever mindful of both its buy-side and sell-side constituents. Although sometimes regarded as having divergent views, we believe that the market’s challenges of 2010 and beyond will raise more issues of shared concern to buy- and sell-side alike. We remain confident that these challenges can be faced and surmounted.

THE NEW FATCA TAX WITHHOLDING RULES — PRACTICAL CONSIDERATIONS FOR DRAFTING CREDIT AGREEMENTS

By Carol P. Tello, Sutherland Asbill & Brennan LLP

On March 18, 2010, the Foreign Account Tax Compliance Act (“FATCA”) was enacted into law. FATCA is designed to require foreign entities to identify and report to the IRS information about U.S. persons that hold accounts with foreign banks, other financial institutions, and investment funds or who have an ownership interest in a foreign entity. Although the FATCA requirements will not become effective until January 1, 2013, some parties are already modifying the provisions of their lending agreements to address this change in law. This article will provide an overview of FATCA, will consider the question of whether FATCA needs to be addressed currently in lending agreements, and how existing provisions of lending agreements may be amended to account for the new FATCA requirements.

In addition to the new FATCA provisions, another important consideration is the fact that the Internal Revenue Service (“IRS”) has identified the existing withholding and reporting requirements as a “Tier 1” issue, meaning that the issue is of high strategic importance to the IRS. The consequence is that IRS examiners are, and will be, reviewing taxpayers’ compliance with documentation, withholding, and reporting requirements. Because the IRS is under a Congressional mandate to ensure that U.S. persons may not hide behind foreign accounts and entities to avoid their U.S. tax responsibilities, ensuring FATCA compliance will be an important aspect of IRS audits in the future. Lenders, administrative agents, and borrowers need to ensure that their agreements properly take into account this very important tax issue.

Overview of FATCA⁵

The FATCA tax regime is designed to ensure that offshore income of U.S. persons is reported. To achieve that goal, all foreign entities are subject to U.S. reporting or certification procedures. The FATCA provisions are triggered by the payment of a “withholdable payment,” as discussed below, to a foreign entity. If the applicable requirements of FATCA are not satisfied, the U.S. payor must withhold U.S. tax equal to 30 percent of the payment made to the noncompliant foreign entity.

Under the FATCA rules, which are contained in sections 1471-1474 of the Internal Revenue Code, foreign entities are divided into two classes: foreign financial institutions (“FFI”) and non-financial foreign entities (“NFFE”). FFIs include depository and investment banks, mutual funds, and likely certain insurance companies. FFIs must enter into an agreement with the IRS in which they are obligated to determine which of their account holders are U.S. persons and provide to the IRS identifying information about the U.S. account holder and about the account. Although an NFFE has similar due diligence requirements, an NFFE is not required to enter into an agreement with the IRS, but, instead, may provide the U.S. payor with a certificate that either the NFFE has no U.S. account holders or identifies its U.S. account holders.

Withholdable Payment

A withholdable payment means (i) U.S. source fixed determinable annual periodic income, commonly referred to as “FDAP,” which is currently subject to U.S. withholding tax when paid to a foreign person, and (ii) the gross proceeds from the sale of property that produces FDAP income. The latter category generally is capital gain income that is not subject to U.S. tax when paid to a foreign person.

Not only would FATCA potentially impose withholding tax on such capital gain income, it would impose withholding tax on the gross proceeds with no basis offset, thereby potentially subjecting return of capital to withholding tax. For FFIs that receive such income for their own account which are located in a country with which the United States does not have in effect an income tax treaty, no refunds are permitted. Consequently, in that case, the withholding tax is a final tax.

Recent IRS Guidance – Notice 2010-60

The statutory provisions leave much guidance to regulations. The IRS recently issued its first FATCA guidance, Notice 2010-60, on August 27, 2010, in which it provided rules for identifying which existing accounts are held by U.S. persons, as well as guidance on other priority matters. The guidance is termed as “preliminary” by the IRS and certainly raises as many questions as it answers. Notice 2010-60 requested comments from stakeholders by November 1, 2010 on numerous issues. To provide final detailed guidance in time for FFIs as well as NFEEs to establish their own compliance procedures is a very difficult task, which is why the comment period was short. However, Treasury officials have indicated informally that they will accept comments submitted after November 1, 2010.

Notice 2010-60 provides procedures that U.S. financial institutions (“USFI”) must apply to determine the status of a foreign entity to which the USFI makes a payment. Different procedures are provided for pre-existing and new individual accounts and pre-existing and new entity accounts. Nonetheless, the procedures are similar in their application.

The following description is limited to a high level summary of the procedures. Generally, the first step is to review existing searchable electronic databases and identify persons already identified as U.S. persons for existing withholding rules. Following that step, a search of records is made for “indicia” of U.S. status such as a U.S. address. Documentation must be obtained from those account holders to determine whether the account holder is a U.S. or non-U.S. person. For new accounts, documentation must be obtained when the account is opened; otherwise with some exceptions, the account holder is treated as a recalcitrant account holder subject to 30 percent withholding. One important distinction for entity account holders is that the foreign financial institution may rely on third party data to treat the entity as engaged in an active trade or business. In that case, the FATCA provisions do not apply.

Grandfathered Obligations – Exempt From Withholding

Significantly, for commercial finance lawyers who draft credit agreements and similar documents, Notice 2010-60 addresses the statutory grandfather rule for obligations outstanding on March 18, 2012. Under that rule, an obligation in existence on March 18, 2012, will not be subject to withholding under FATCA unless there is a material modification of the obligation under Treas. Reg. §1.1001-3, which is discussed below. Notice 2010-60 provides guidance on the scope of the term “obligation,” which will include any legal agreement that (i) produces or could produce certain types of U.S. source FDAP income (such as interest) and (ii) has a definitive expiration or term. An obligation that undergoes a “material modification” will be treated as newly issued as of the date of the modification.

What this means is that obligations that are executed or materially modified on or before March 18, 2012 will not be subject to any requirement to withhold 30 percent U.S. tax. As a practical matter, this is very helpful because the regulatory guidance has not been completed so while agreements currently being negotiated may take account of the FATCA requirements, when final guidance is provided, agreements that are modified now may need to be amended to conform to that final guidance. In the meantime, grandfathered obligations will not be subject to the FATCA withholding requirement.

It should be noted that the language of Notice 2010-60 does not extend an exception from reporting to the IRS for grandfathered obligations, which is consistent with the statute. Therefore, a borrower will need to be able to identify the U.S. or non-U.S. status of the

lender. Further guidance will presumably provide more information about the reporting obligations of a borrower that pays interest under a grandfathered obligation.

One interesting aspect of the interplay of the grandfather date and the FATCA effective date is that payments under obligations that are executed or materially modified after March 18, 2012 will not become subject to withholding under FATCA until the effective date of January 1, 2013. However, for obligations executed in that time period, FATCA provisions should definitely be included in the tax provisions.

“Material Modification”

For obligations that are treated as debt obligations under U.S. tax law, as noted above, the tax regulations apply to determine whether a material modification has occurred. Although the underlying legislative history anticipates that regulatory guidance will be provided as to the application of those tax rules, government officials in public remarks have recently said that they do not intend to change the existing regulations.

Under the “material modification” regulations, certain modifications generally will constitute a material modification, which will cause grandfather status to be terminated as of the effective date of modification. Those modifications are: (i) changes in yield; (ii) changes in the timing of payments; (iii) changes in the obligor or debt collateral; (iv) changes from debt to equity and from recourse to nonrecourse classification; and (v) changes involving financial and accounting covenants.

Revolvers

Not explicitly addressed by the tax regulations is the treatment of revolvers. Logically, a drawdown on a revolver that does not exceed the agreed commitment amount should not be treated as a material modification and, thus, as not a newly issued obligation. Similarly, it would seem that a repayment of a revolver executed on or prior to March 18, 2012 should not be subject to FATCA. An *increase* in an amount of a term loan or revolver loan commitment, however, may constitute a material modification that would not enjoy grandfather status for purposes of chapter 4 if executed after March 18, 2012.

In recent public comments, a government official seemingly agreed with the foregoing analysis by stating that he did not believe that it would be appropriate to go back and taint a prior tranche that was issued prior to the grandfathering date. However, this statement raises the question of what is an “issuance” and an “issuance date.” The government official noted that these questions are currently being considered; concepts in the original issue discount regulations, which provide specific rules about what is considered an issuance, and how to deal with separate tranches, may provide some guidance. Without guidance, however, it is not clear how revolvers will be treated for purposes of “material modification.”

Should a drawdown or a repayment of a revolver constitute a “material modification,” it is not clear whether only the additional loan amount or the entire loan amount (including the pre-existing loan commitment) would become subject to FATCA. As the IRS intends to issue further guidance, this issue hopefully will be addressed in that future guidance.

The ABA Tax Section plans to submit comments concerning Notice 2010-60, which specifically addressed revolvers.

Coordination With Existing Withholding Regimes- Foreign Person and Back-Up Withholding

Currently, private lending arrangements generally will contain tax provisions that require the lender to provide the borrower either a Form W-9 or, in the case of a foreign lender, a Form W-8BEN or Form W-8ECI (withholding certificates) so that withholding will not be imposed or will be reduced in the case of certain payments to foreign lenders. In addition, the borrower must report on the interest payments made either on a Form 1099 for a U.S. lender or on a Form 1042/1042S for a foreign lender.

The FATCA statutory provisions mandate that duplicative withholding be eliminated to the extent possible. Consequently, only one tax will be collected under all of the various withholding regimes. Guidance to eliminate duplicative withholding and reporting has not been issued to date, but is anticipated.

Amendment of Existing Lending Agreement Tax Provisions To Comply With FATCA

Most credit agreements contain a gross up provision requiring the borrower to make additional payments to make the lender whole when certain taxes are imposed. Withholding taxes (either backup withholding or withholding imposed on a foreign person) commonly are excluded from the scope of the gross up provision on the basis that compliance with those provisions are within the control of the lender and the borrower should not be required to compensate the lender when the lender has the ability to prevent the withholding event. Similarly, a foreign lender generally will have within its control the ability to comply with the FATCA provisions.

However, there may be instances when an FFI cannot obtain the information necessary to identify its account holders, either because the account holder does not provide the necessary information or the account holder does not waive its local law privacy rights so that the FFI is unable to report the necessary information to the IRS. Although the FATCA provisions allow for an election for withholding to be imposed only on that portion of the payment that is attributable to the “recalcitrant” account holder, the IRS is considering remedies

when an FFI has too many recalcitrant account holders. Such a remedy may be outside the scope of the lender-borrower relationship, but it could result in the IRS revoking the foreign lender's agreement with the IRS, in which case, withholding would be required. Consequently, despite the efforts of the foreign lender-FFI to comply, it may not be able to do so.

In such a case, which party should bear the cost? The borrower would argue that it has no ability to require the lender's account holders to waive their privacy rights. The lender would have the ability to request a waiver from its account holders, but likely under local law would not be able to require a waiver. This would be a particularly difficult case because in a private lending deal the lender's account holders would have no ownership interest in the interest payments, but yet potentially could prevent the lender from meeting its FATCA obligations.

Liability of U.S. Administrative Agents

Under current U.S. cross-border withholding rules, each party that has control, custody, or receipt of U.S. source FDAP income is a "withholding agent," meaning that each such party has liability for the U.S. tax that should have been withheld and any accrued interest on that tax. As a result, a U.S. administrative agent is a withholding agent under the current withholding provisions. While the foreign payee has liability as well, generally, the IRS will assert a deficiency against the last U.S. withholding agent in the chain that pays the U.S. FDAP income to a foreign recipient.

The same liability rule applies to "withholdable payments" subject to the FATCA provisions. Assuming that a U.S. administrative agent is a USFI, it will also have the responsibility to determine the status of the foreign lenders for purposes of the FATCA provisions.

SUMMARY

Although not currently in effect, FATCA will impact cross-border lending agreements at least prospectively. Borrowers' and U.S. administrative agents' counsel may wish to ensure that FATCA provisions are included in current agreements so that, should a material modification occur to the agreement after March 18, 2012, the borrower and U.S. administrative agent are protected from having to gross-up for FATCA withholding. U.S. administrative agents and borrowers, as withholding agents, may wish to ensure that they have the right to request the proper certifications from non-U.S. lenders. Until more complete guidance is provided, very general broad provisions will need to be drafted to account for a potentially changing compliance environment and requirements.

UCC Spotlight

By [Stephen L. Sepinuck](#), Professor, Gonzaga University School of Law, former Chair of the UCC Committee, and [Kristen Adams](#), Professor, Stetson University College of Law, Vice Chair of the UCC Committee.



The purpose of this column is to identify some of the most disconcerting judicial decisions interpreting the Uniform Commercial Code or related commercial laws. The purpose of the column is not to be mean. It is not to get judges recalled, law clerks fired, or litigators disciplined for incompetence. Instead, it is to shine a spotlight on analytical errors, and thereby provide practitioners and judges with reason to disregard the opinion.

***Merrill Lynch Business Financial Services, Inc. v. Kupperman*, 2010 WL 2179181 (D.N.J. 2010)**

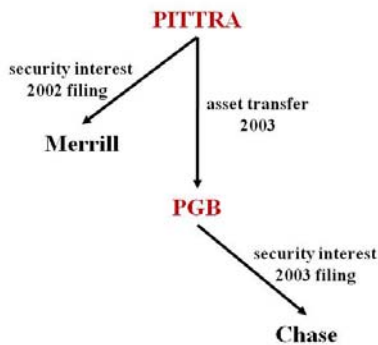
This case concerns the priority of two security interests, one granted by the debtor and one granted by the debtor's predecessor. The court got much of the analysis correct but fumbled badly near the end and reached a grievously wrong result.

The dispute has its origin in 2002, when Arthur Kupperman formed PITTRA G.B. International, Inc. ("PITTRA") to import and export industrial food ingredients. PITTRA obtained a \$2¼ million loan from Merrill Lynch Business Financial Services Inc. ("Merrill"). That loan was secured by all or most of PITTRA's assets and Merrill's security interest was perfected by a filed financing statement. Over several years, the loan balance was increased to \$4¼ million, primarily as a result of Kupperman's fraud.

Meanwhile, in 2003, PITTRA had in fact sold many of its assets to PGB International, LLC ("PGB") another entity formed and owned by Kupperman to import and export industrial food ingredients. The following year, PGB obtained a secured loan from JP Morgan Chase Bank ("Chase"). Chase's security interest was perfected by a filing against PGB. By 2006, the loan balance was about \$3 million.

Eventually, the two borrowers defaulted and Kupperman's fraud was discovered. Merrill and Chase then each claimed priority in the assets of PGB. The following diagram illustrates the relationship of the parties.

Chase claimed that Merrill could not identify the assets transferred years before from PITTRA to PGB, or their proceeds, and therefore Merrill was not entitled to priority. The court disagreed. The court first noted that Merrill's security interest extended to both existing and after-acquired collateral of PITTRA and its successors. It then concluded that PGB was a successor to PITTRA. In reaching this conclusion, the court observed that: (i) the two entities operated out of the same location, (ii) PITTRA transferred its office furniture, equipment, customer lists, supplier lists, telephone numbers, and general goodwill to PGB; and (iii) the entities had the same owners. In addition, it is worth noting that PITTRA apparently stopped conducting business on its own after the asset sale.



So far, so good. Although the court did not cite Article 9's rules on "new debtors," *see* § 9-203(d), (e), those rules contemplate that an entity can become bound by operation of law to a security agreement created by its predecessor.

The court then moved to perfection. It cited to and quoted § 9-507(a), which provides that a filed financing statement remains effective with respect to transferred collateral, and concluded therefrom that Merrill remained perfected in the assets of PGB. What the court did not seem to appreciate is that § 9-507(a) applies only to transferred collateral. That rule has no application to collateral acquired by an entity after it becomes a "new debtor."

The court should have looked to § 9-508.⁶ That section makes the filing against a predecessor effective against a differently named successor, but only with respect to the collateral the successor owned at the time it became a new debtor and the collateral acquired within four months thereafter. *See* § 9-508(a), (b). In reality, Merrill's security interest was perfected only in the collateral transferred from PITTRA to PGB, property acquired by PGB within four months thereafter, and possibly the proceeds of all such collateral. If Merrill had been able to identify that property, it would have been entitled to priority under the first-to-file-or-perfect rule of § 9-322(a)(1). As to all the other collateral – everything acquired by PGB more than four months after it became a new debtor – Chase's security interest should have been entitled to priority under § 9-322(a)(2).

Not only did the court err in its analysis of perfection, but it also looked to the wrong priority rule. Instead of looking to § 9-322(a), the court instead relied upon § 9-325. That section deals with the so-called "double-debtor" problem: two security interests in the same collateral granted at different times by different debtors. However, that section gives priority to the first security interest only if:

- (i) the second debtor "acquired the collateral subject to a security interest created by another person";
- (ii) that security interest was and remains perfected; and
- (iii) priority would be different under § 9-322 or § 9-324.

With respect to the transferred collateral, the first two of these requirements were met but not the last because Merrill had filed before Chase. With respect to assets acquired by PGB after it became a new debtor, the first requirement was not met. Those assets were not already subject to Merrill's security interest when PGB acquired them; instead Merrill's security interest could have attached only at the time PGB acquired them. In other words, the security interests of Merrill and Chase attached simultaneously, and that is not a situation to which § 9-325 applies.

The sense one gets from reading the opinion is that the court committed an all too common yet fundamental error. It treated the collateral as a single mass rather than analyzing it item by item. Under Article 9, the analysis of such matters as perfection and priority often varies depending on the type of collateral at issue or the time of attachment. Because this can be different for different items of collateral, the analysis must proceed separately for each.

Roswell Capital Partners LLC v. Alternative Construction Technologies,
2010 WL 3452378 (S.D.N.Y. 2010)

This case concerns what happens to a security interest when the secured obligation is extinguished. The court was on sound footing in the principal part of its analysis, but it strayed far afield in its alternative holding about the efficacy of an unauthorized termination statement.

The case had its beginnings in 2005, when JMB Associates loaned \$630,000 to Alternative Construction Technology, Inc. ("ACT"), secured by certain personal property. JMB perfected its security interest by filing a financing statement. The secured obligation was represented by two promissory notes, each of which provided that it could be "converted into equity of [ACT] at the option of the Payee." The notes also provided that if JMB did convert the notes to equity, JMB could "unwind the transaction" and convert the equity back into debt if the price of ACT's stock ever fell below \$2.00 per share.

In 2006, in connection with a public offering, JMB elected to convert the notes to equity interests in ACT. Subsequently, Roswell Capital Partners, LLC, as collateral agent for a group of lenders, acquired a perfected security interest in virtually all of ACT's assets. In

connection with those transactions, ACT – the debtor – filed a termination statement for JMB’s financing statement.

In 2008, JMB tendered its stock to ACT in an effort to unwind the prior conversion and re-convert the equity to debt. Eventually, litigation ensued as to whether JMB’s claimed security interest in ACT’s assets had priority over Roswell’s. The parties agreed that Roswell’s security interest was perfected but Roswell challenged both the attachment and perfection of JMB’s security interest.

Attachment

The court began its analysis by noting that the UCC defines a “security interest” as “an interest in personal property or fixtures which secures payment or performance of *an obligation*.” § 1-201(b)(35) (emphasis added by the court). The court then concluded that JMB’s security interest was extinguished when the underlying obligation was converted into ACT common stock. It further concluded that JMB’s security interest did not re-attach when JMB rescinded the conversion, apparently based in part on the fact that the note did not state that JMB’s security interest in ACT’s assets would survive conversion of its debt into equity.

The second of the court’s conclusions has some appeal. If JMB’s security interest was indeed extinguished in 2006, when JMB converted the notes to stock, it is unlikely that the security interest would re-attach absent some clear language to that effect in the security agreement. After all, security agreements are typically interpreted against the drafter, and that is usually the secured party. In other words, the parties certainly could have provided for re-attachment, but there was no evidence that they had.

The court’s first conclusion – that the security interest was extinguished in 2006 – is a bit more questionable. While the court was correct in observing that a security interest must secure “an obligation,” that obligation need not be a debt. Indeed, the definition expressly refers to “payment *or performance* of an obligation,” and one does not normally perform a debt. Accordingly, a security interest can secure contractual duties other than payment of a debt. This point is further supported by the fact that § 9-203(b)(1) requires for attachment that value be given and § 1-204 defines “value” to include “any consideration sufficient to support a simple contract.”

Given that JMB’s security agreement apparently secured ACT’s obligations under the promissory notes, and the notes gave JMB the right to unwind its election to convert the notes to stock, the security interest should have continued to secure this right/obligation after the conversion to stock in 2006. Thus, it is not at all clear that JMB’s security interest was indeed extinguished in 2006.

Perfection

The far more troubling aspect of the court’s opinion was its analysis of perfection. The court began by noting that, except as provided in § 9-510, upon filing a termination statement, the financing statement to which the termination statement relates ceases to be effective. § 9-513(d). Section 9-510(a) provides that a filed record is effective only to the extent it was filed by someone authorized to do so under § 9-509. Section 9-509 in turn requires the secured party’s authorization to file a termination statement, except in certain circumstances not applicable to this case. These are fair propositions and the court was right to begin with them.

Then, quoting *In re S.J. Cox Enterprises, Inc.*, 2009 WL 939573 (Bankr. E.D. Ky. 2009), the court stated that “termination of a financing statement, *even if mistaken*, releases the secured creditor’s lien against the debtor’s property” (emphasis added by the court). This statement is partially correct. Filing a termination statement does not release the lien. It merely renders the financing statement ineffective to perfect. It may well be that the security interest was extinguished prior to the filing of the termination statement; as such would indeed be the normal state of affairs. Moreover, if the lien still existed, the filing of a termination statement would not necessarily negate perfection if the security interest were perfected in a manner other than by filing. Putting this small slip aside, the court was correct that a *mistakenly filed* termination statement is effective. That is, a mistakenly filed termination statement does make the financing statement to which it relates ineffective. While the Code does provide that the common law of mistake does survive and supplements the Code’s rules, *see* § 1-103(b), it is unlikely that a mistakenly filed termination statement would be deemed ineffective against innocent third parties.

Unfortunately, the court’s next few sentences went well beyond this. The court stated: “This clear rule accords with the policy of the UCC. Potential creditors must be able to rely on termination statements filed in the public record, even if they were filed in error *or without authorization*” (emphasis added). Absolutely not! A mistakenly filed *but authorized* termination statement is effective. An *unauthorized* termination statement is not effective. Indeed, that is what the Code clearly states in the sections quoted by the court at the beginning of its discussion of this issue.

The court offered no explanation of how its statement can be squared with the language of the Code. Nor is the court correct about policy. The filing system provides searchers merely with inquiry notice. A financing statement does not tell searchers that named secured party *has* a security interest, merely that it *may have* one. The searcher must complete its due diligence to ascertain what rights the putative secured party actually has. Indeed, a financing statement could be filed – mistakenly or maliciously – by someone with no claim to any rights in the listed collateral. Similarly, a termination statement might be filed by someone without authorization to do so, and therefore be ineffective to undermine the secured party’s perfection. The searcher must complete its due diligence. If the court were correct, then debtors and interlopers could unilaterally un-perfect a creditor’s security interest. They cannot. A new comment to § 9-518, still in draft form, will be making this point more clear:

Sometimes a person files a termination statement or other record relating to a filed financing statement without being entitled to do so. . . . If the person that filed the record was not entitled to do so, the filed record is ineffective. . . . Just as searchers bear the burden of determining whether the filing of initial financing statement was authorized, searchers bear the burden of determining whether the filing of every subsequent record was authorized.

Rothrock v. Turner,
2010 WL 2267226 (D. Me. 2010), recons. denied,
2010 WL 3199481 (D. Me. 2010)

This case involves perfection of a security interest in a certificated security and the proceeds thereof. The court overlooked the key provisions of Article 9 bearing on the issue, and as such reached the wrong result on some important aspects of the case.

The facts of the case can be simplified without affecting the analysis. In 2004, Parco Merged Media Corp. became indebted to Bruce Rothrock on a \$600,000 loan. The loan was secured by a pledge of the debtor's 175,000 shares of stock in MultiSpectral Solution, Inc. To perfect his security interest, Rothrock took possession of the stock certificate.

In March 2008, Scott Cohen, the debtor's treasurer, contacted Rothrock and offered to submit the stock certificate to J.P. Morgan in return for a cash payout as part of a merger and stock redemption taking place at the time. Rothrock, who was chairman of the debtor's board of directors, understood that Cohen would be acting as his agent, rather than as debtor's agent, with respect to this transaction. Rothrock agreed and delivered the stock certificate to Cohen.

On May 12, 2008, Cohen tendered the stock certificate to J.P. Morgan, signing the transmittal form as treasurer of the debtor and directing that the funds be remitted to a deposit account in the name of the debtor but over which Rothrock had sole signatory power. The letter included no indication either of Rothrock's interest in the stock or that Cohen was acting as an agent for Rothrock.

One week later, a petition for involuntary bankruptcy was filed against the debtor. A few days after that, the first installment of stock redemption proceeds was deposited into the debtor's deposit account. Rothrock promptly transferred the proceeds to one of his personal deposit accounts. In August, the second installment of stock redemption proceeds was deposited into the debtor's deposit account and Rothrock promptly wired those funds to a personal account. The bankruptcy trustee then sued to recover the funds under a variety of theories, including that the transfer was an unauthorized post-petition transfer of estate assets. The bankruptcy court entered summary judgment for the trustee and Rothrock appealed.

Putting aside issues of breach of fiduciary duty and fraud, much of the case centered on whether Rothrock's security interest in the stock remained perfected after he released possession of the stock certificate to Cohen. Acknowledging that a secured party can perfect through delivery, *see* §§ 9-313(a), (c), 8-301, and that delivery can be to the secured party's agent, the court correctly noted that the debtor cannot for this purpose serve as the secured party's agent. *See* § 9-313 cmt. 3. Thus, according to the court, the issue came down to whether Cohen was acting as the secured party's agent or the debtor's agent.

The court assumed that Cohen acted as each party's agent, but at different times. Specifically, Cohen acted as Rothrock's agent in accepting the stock certificate in March but became the debtor's agent, at the latest, in May when he endorsed the stock certificate as treasurer of the debtor and submitted it to JP Morgan with instruction to remit the proceeds to the debtor's deposit account. This is an intriguing assumption, one to which we will return below. Unfortunately, even accepting this assumption the court's reasoning from this point was flawed.

Citing to § 9-313(e), the court concluded that Rothrock lost perfection on May 12, when Cohen became the debtor's agent. However, § 9-313(e) merely says that perfection "by delivery" expires when the debtor obtains possession. It does not foreclose the possibility that the secured party may remain perfected by some other method. For example, the secured party could have perfected through a filed financing statement. More relevant to this case, the secured party could be perfected automatically for a temporary period. Specifically, § 9-312(g) provides that a secured party who relinquishes possession of a certificate security to the debtor for the purpose of sale, exchange, presentation, collection, enforcement, renewal, or registration of transfer, remains automatically perfected for 20 days. Presentation of the stock certificate to the transfer agent in connection with a merger redemption undoubtedly falls within this rule. Thus, the court should have concluded that Rothrock could remain perfected in the stock as late as 20 days after May 12.

Because identifiable cash proceeds of the stock were received within that 20-day period, Rothrock's security interest in those proceeds was also perfected and it remained perfected as long as the proceeds were identifiable. *See* § 9-315(c), (d)(2).

On a motion for rehearing, Rothrock argued for precisely the analysis presented here. The court refused to consider the argument, particularly the impact of § 9-312(g), because Rothrock had not argued it before the bankruptcy court or initially on appeal. The court then returned to the assumption that Cohen had shifted allegiances, having first served as agent for Rothrock and then for the debtor.

The court stated that while it was willing to entertain this assumption for the purposes of summary judgment, it was not willing to “accept that this artificial transfer triggers the exception under [§ 9-312(g)].” The court expressed concern that this would “enable parties to obfuscate the time of transfer,” and thereby potentially convert a rule providing a short period of temporary perfection into a longer one.

That concern may be legitimate, but it does seem that, having been shown the errors in its initial analysis, the court was looking for a way to save face. Moreover, it failed to look at this from the perspective of the creditor. Rothrock’s security interest was initially and indisputably perfected by delivery and possession of the stock certificate. Rothrock then delivered the certificate to Cohen, a person Rothrock took to be his own agent, to facilitate redemption. It was Cohen’s later actions that made him seem to be the debtor’s agent. If the court had concluded that Cohen, as an officer of the debtor, had never truly been Rothrock’s agent, then its ultimate conclusion would have been correct. Perfection would have lapsed 20 days after Cohen received the certificate, a time before Cohen submitted the certificate for redemption, and Rothrock’s security interest in the redemption proceeds would never have been perfected. More important, secured parties could deal with such a rule. If an officer of the debtor can never serve as the secured party’s agent, secured parties can simply avoid delivering possession to such a person.

But that does not appear to be what the court held. Instead, the court seems to have ruled that because Cohen submitted the stock certificate to J.P. Morgan as the debtor’s agent, Cohen had always been the debtor’s agent. That is a rule to which secured parties cannot adjust. Secured parties cannot be expected to control all the actions of their representatives. If a representative’s action – after agreeing to serve as the secured party’s agent – may cause the representative to retroactively be deemed never to have been the secured party’s agent, secured parties will be vulnerable to a retroactive loss of perfection and will have no way to protect their interests.

Despite the court’s errors, it is not clear that the court reached the wrong result. Recall that the bankruptcy court ruled that Rothrock’s transfer of the redemption proceeds to his personal account was an unauthorized post-petition transfer, and thus avoidable by the trustee. That should be true even though Rothrock did have a perfected security interest in the proceeds. So, the court was correct in requiring Rothrock to return the funds. However, Rothrock should still be entitled to a perfected security interest in the funds he returns.

Southwest Bank of St. Louis v. Pouloukefalos,
2010 WL 2266072 (Ill. App. Ct. 2010)

This case involves a dispute over fixtures between the landlord and a secured creditor of the tenant. The relevant facts begin in 2003, when Converters Extruded Films, Inc. (“Original Tenant”) leased building space from two individuals and then installed in the building equipment to be used in the commercial production of plastics. The equipment was brought in piece by piece, reassembled, welded, and then bolted to the floor, ceiling rafters, and joists. The assembly process required removal and replacement of some of the rafters in the ceiling.

Two years later, Original Tenant sold its business and assigned the lease to the debtor. On the same day, Southwest Bank of St. Louis loaned the debtor \$1 million, secured by all of the debtor’s equipment, including fixtures. The bank filed a financing statement in Missouri, where pursuant to § 9-307 the debtor was located, but did not record its interest in Cook County, Illinois, where the building was located. Thus, the bank did not file a fixture filing under § 9-502(b).

In 2008, after defaulting on its obligations to both the bank and the landlords, the debtor abandoned the leasehold, including the fixtures. The landlords filed a complaint to distrain the fixtures for past-due rent and property taxes. The following day, the bank filed a replevin action seeking attachment of the fixtures. The cases were then consolidated.

The landlords claimed both a landlord’s lien for the unpaid rent and ownership of the fixtures. The latter claim was based on a clause of the lease agreement providing that “all . . . fixtures . . . which are permanently affixed to the Premises . . . shall thereupon become the property of Landlord without any payment to tenant.” The trial court ruled for the landlords, concluding that although the bank’s security interest was perfected, the landlord’s lien had priority. The bank appealed.

The appellate court affirmed. In doing so, the court erred both with respect to the facts and the law. Although it noted at the beginning of its opinion that the trial court had ruled that the bank’s security interest was perfected, when the appellate court moved to the analysis, it inexplicably characterized the bank’s interest as unperfected. There was no explanation for this discrepancy. The court then compounded this error on the facts by expressly ruling that the bank’s lack of a fixture filing was fatal to perfection. This is simply not true. A fixture filing is not necessary to perfect, *see* § 9-502 cmt. 4, merely to enhance priority, *see* § 9-334.

Fortunately, the court’s errors do not appear to have led to a wrong result. The default priority rule for fixtures is that a security interest, even if perfected, is subordinate to a conflicting interest of an encumbrancer or owner of the real estate. *See* § 9-334(c) & cmt. 5. The secured party can obtain priority if its security interest is perfected by a fixture filing before the interest of the owner or encumbrancer is of record, *see* § 9-334(e)(1), but here the bank never filed a fixture filing and, even if it had, the filing would have been long after the

landlords' interest in the property was recorded (and the goods had become fixtures). Moreover, the landlords had an alternative argument: pursuant to the lease, they had become the owners of the fixtures two years before the bank's security interest purported to attach. So the court reached the correct result, albeit for the wrong reason.

Useful Links and Websites

Compiled by Commercial Law Newsletter Co-Editors Kelly Kopyt, Carol Nulty Doody, and Christina Rissler

Please find below a list of electronic links that our members may find useful:

1. www.lexology.com— In cooperation with the Association of Corporate Counsel Lexology provides articles and practical tips relating to the practice of law.
2. The UCCLAW-L listserv, is sponsored by West Group, publisher of the "UCC Reporting Service." The listserv is an e-mail discussion group focusing on the Uniform Commercial Code. To subscribe to the UCCLAW-L listserv, go to <http://lists.washlaw.edu/mailman/listinfo/ucclaw-l>
3. The American Law Institute http://www.ali.org/index.cfm?fuseaction=projects.proj_ip&projectid=21
4. U. Penn's archive of NCCUSL final acts and drafts can be accessed at <http://www.law.upenn.edu/bll/archives/ulc/ulc.htm>
5. Pace University's database of the United Nations Convention on Contracts for the Initiation Sale of Goods and International Commercial Law Database can be accessed at <http://cisgw3.law.pace.edu>
6. Gonzaga University's new Commercial Law Center has a variety of links to useful sites and can be accessed at http://www.law.gonzaga.edu/Centers-Programs/commercial_law_center/default.asp
7. The International Association of Commercial Administrators (IACA) maintains links to state model administrative rules (MARS) and contact information for state level UCC administrators. That information can be accessed at <http://www.iaca.org>
8. The Uniform Law Commissioners maintains information regarding legislative reports and information regarding upcoming meetings, including Joint Review Committee for Uniform Commercial Code Article 9. You can access this information at <http://www.nccusl.org/Update/>
9. Information on the work of The United Nations Commission on International Trade Law ("UNCITRAL") (including the work of its working groups on Procurement, International Arbitration and Conciliation, Transport Law, Electronic Commerce and Insolvency Law) available at <http://www.uncitral.org/uncitral/en/index.html>
10. The American College of Commercial Finance Lawyers – <http://www.accfl.com>
11. The Secretariat of Legal Affairs (SLA) develops, promotes, and implements the Inter-American Program for the Development of International Law. For more information go to <http://www.oas.org/DIL/>
12. The National Law Center for Inter-American Free Trade (NLCIFT) is dedicated to developing the legal infrastructure to build trade capacity and promote economic development in the Americas. For more information go to <http://www.natlaw.com>.
13. Information on the Hague Conference on Private International Law and its current status available at http://www.hcch.net/index_en
14. Information on the (International Institute for the Unification of Private Law "UNIDROIT") project to enhance the internal adequacy and cross-border compatibility of existing national laws, including the Draft Convention on Substantive Rules Regarding Intermediated Securities, available at <http://www.unidroit.org/english/workprogramme/study078/item1/main.htm>
15. In addition, the Commercial Finance Committee's Task Force on Surveys of State Commercial Laws [website](#) links to surveys of the law of all 50 states (except Connecticut, DC and Puerto Rico).

With your help, our list of electronic resources will continue to grow. Please feel free to forward other electronic resources you would like to see included in future editions of the Commercial Law Newsletter, by sending them to [Christina B. Rissler](#), the Commercial Finance Committee Editor, or [Carol Nulty Doody](#) or [Kelly L. Kopyt](#), the Uniform Commercial Code Committee Editors.

Figures

Figure 1

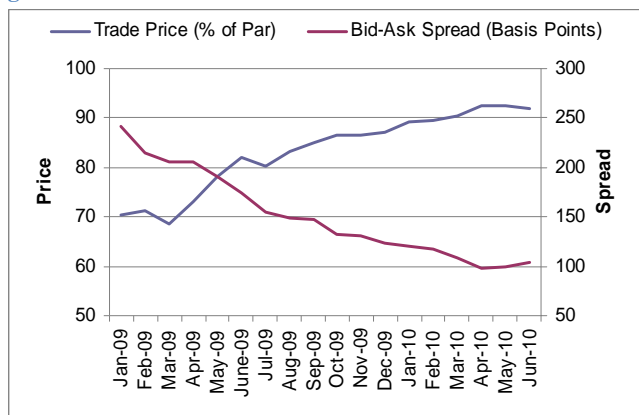


Figure 2

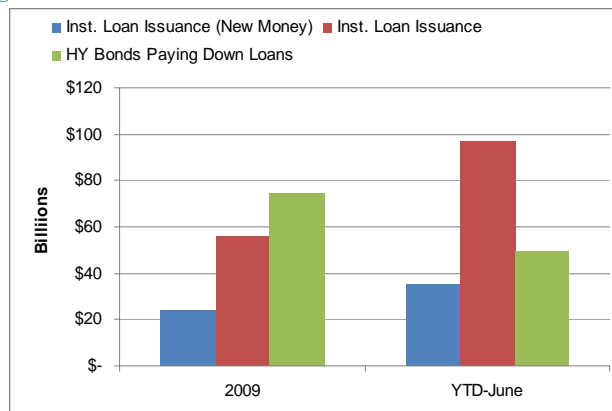


Figure 3

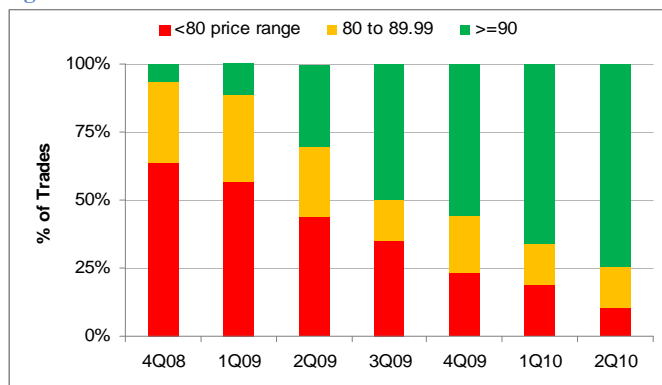


Figure 4

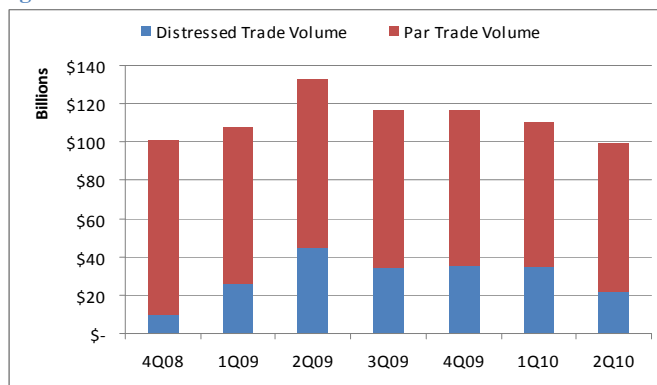


Figure 5

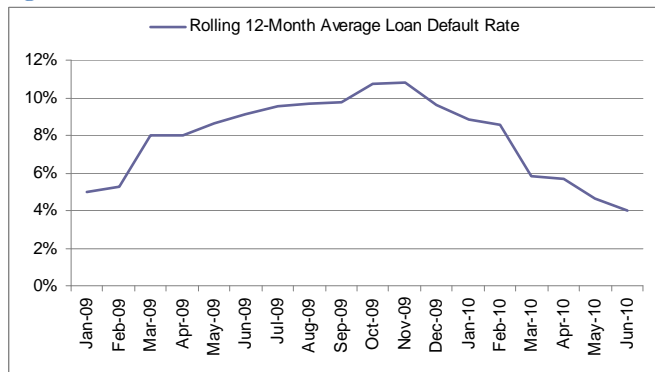


Figure 6

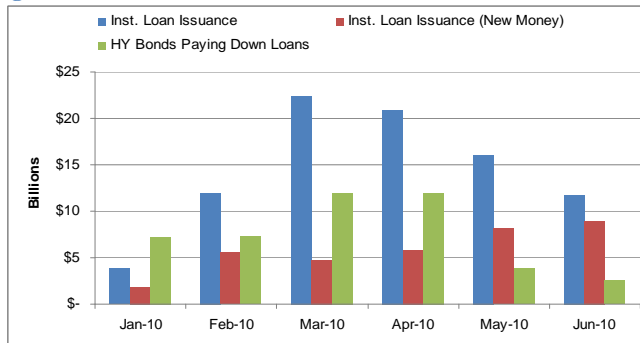


Figure 7

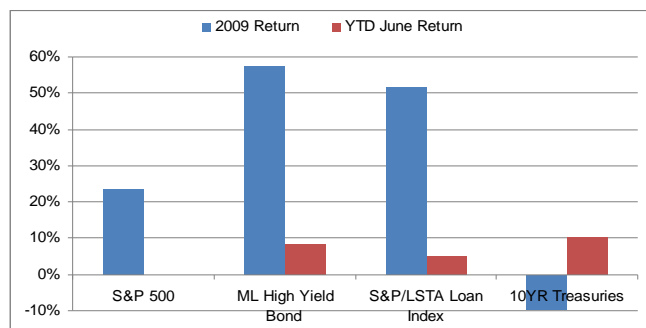
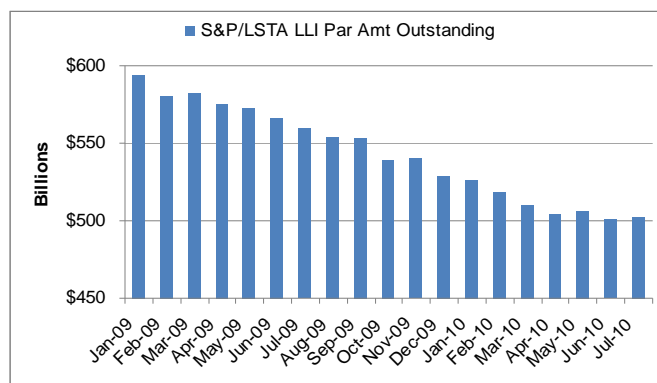


Figure 8



¹ For a more detailed version of this article, including a discussion of the 2010 changes to the Official Comments, see Edwin E. Smith, *A Summary of the 2010 Amendments to Article 9 of the Uniform Commercial Code*, 42 UCC L.J. 4 (2010).

² Note that many of the cases described in this article, Forbearance Agreements and Workouts: Case Updates, address the lender's motion to dismiss and, therefore, generally state the alleged facts in a manner that is most favorable to the claimant and least favorable to the lender.

³ The authors of the Loan Syndications and Trading Association: the 2010 Loan Market Update are employees of the Loan Syndications and Trading Association, a not-for-profit organization. Bridget Marsh is Senior Vice President and Assistant General Counsel, and Ted Basta is Senior Vice President, Market Data & Analysis. For further information, please visit the LSTA's [website](#).

⁴ Parties entering into a par trade execute an LSTA Par/Near Par Trade Confirm and settle on an assignment agreement. Parties entering into a distressed trade execute an LSTA Distressed Trade Confirmation and settle on an assignment agreement and the LSTA's form of Purchase and Sale Agreement for Distressed Trades.

⁵ For a more detailed discussion of FATCA, see Carol P. Tello, *Reporting, Withholding, and More Reporting: HIRE Act Reporting and Withholding Provisions*, 39 TAX MGMT INT'L J. 243 (2010).

⁶ This assumes that PITTRA and PGB were located in the same state. The court noted that PGB was incorporated in New Jersey but did not mention where PITTRA was formed. If the two entities were not located in the same state, then Merrill would not have been perfected in any property acquired by PGB after it became a new debtor and would have been perfected in the assets transferred by PITTRA to PGB only for one year. See § 9-316(a)(3).