

Commercial Law Newsletter

Joint Newsletter of the Commercial Finance and Uniform Commercial Code Committees



July 30, 2012

Summer 2012

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Joint Report from the Chairs

Dear Members:

We hope that everyone is enjoying this hot summer. We had a great Spring Meeting in Las Vegas, with strong attendance and outstanding programs, CLE sessions, and subcommittee meetings. We thank everyone who participated in, and also attended, those programs, sessions, and meetings.

For those of you who have not already registered, the Annual Meeting is coming right up and will take place from August 3-5 in Chicago. Our headquarters will be the Chicago Downtown Marriott. Both the UCC and Commercial Finance Committees have an outstanding series of programs and subcommittee meetings for your education and enjoyment. Our collective CLE programs are as follows:

1. Commercial Law Forms: One Size Does Not Fit All: Tips on How to use Forms Wisely (Friday, August 3, 2012 -- 8:00 a.m. to 10:00 a.m., Chicago Ballroom A/B 5th Floor)

2. Review of the Loan Syndications and Trading Association's Model Credit Agreement: (Friday, August 3, 2012 -- 2:30 p.m. to 4:30 p.m., Armitage and Belmont Rooms, 4th Floor);

3. Only the Shadow Knows: What is the Shadow Banking System and How Can It Be Regulated: (Saturday, August 4, 2012 -- 8:00 a.m. to 10:00 a.m., Chicago Ballrooms G&H, 5th Floor)

4. Lending to LLC's: Dealing with Key Collateral, Workout and Bankruptcy Issues: (Saturday, August 4, 2012 -- 10:30 a.m. to 12:30 p.m., Addison Room, 4th Floor)

5. Financing Mortgage Loans and RMBS/CMBS Litigation: Are We Having Fun Yet? Do We Really Need to Read the TIA? (Saturday, August 4, 2012 -- 10:30 a.m. to 12:30 p.m., Indiana and Iowa Rooms, 6th Floor)

6. Princes into Toads: How Recharacterization and Other Readjustments to Your Transactions Could Wreak Havoc on Your Rights: (Sunday, August 5, 2012 -- 8:00 a.m. to 10:00 a.m., Chicago Ballroom G&H, 5th Floor)

7. Federal Receiverships: The Solution to the Current Patchwork of State Receivership Laws: (Sunday, August 5, 2012 -- 8:00 a.m. to 10:00 a.m., Chicago Ballroom A/B 5th Floor)

8. Two's Company, Three's a Crowd: Triangular Arrangements in Commercial Law: (Sunday, August 5, 2012 -- 10:30 a.m. to 12:30 p.m., Chicago Ballroom G&H, 5th Floor)

9. Thunderclouds on Your Horizon? What Happens If Your Cloud Provider Becomes Insolvent? (Sunday, August 5, 2012 -- 10:30 a.m. to 12:30 p.m., Chicago

Article 9 Webinar hosted by
Strafford Publications [click here to
register](#)

August 2-7, 2012 – ABA Annual
Meeting – Chicago Marriott
Downtown in Chicago, Illinois.
[click here to register](#)

November 14, 2012 – Commercial
Finance Committee and Uniform
Commercial Code Committee Joint
Meeting – JW Marriott Desert Ridge
in Phoenix, Arizona. Save the date!

Ballroom A/B, 5th Floor)

These will be outstanding programs and we encourage all to attend. We thank the
Program Chairs and panelists for their hard work in putting these programs together.

Our UCC/ComFin Joint Dinner will be held on Friday, August 3 at 7:00 p.m. at
Fogo de Chao. Tickets are available on either the UCC or ComFin website, or the ABA
Business Law Section website. Our UCC/ComFin joint meeting will be held on Friday,
August 3rd, 2012 -- 10:30 a.m. to 12:30 p.m., in Salons I and II, 7th Floor.

Our Subcommittees and Task Forces continue to remain active and are always
looking for new and interested volunteers. We continue to be interested in volunteers for
our Revised Article 9 Enactment Task Force, which is working to ensure the enactment of
the recently proposed amendments to Article 9 in the fifty states, our Task Force on Survey
of the Law of Guarantees, which will produce a fifty-state summary of the law of
guarantees, our Model Intellectual Property Security Agreement Task Force, which will
produce a “standard form” intellectual property security agreement, our commercial law
terms “wiki” Task Force, and our new Task Force on Security Interests in Limited Liability
Company Membership Interests. Please go to the ComFin or UCC website for more
information on these Task Forces.

We continue to seek new members, and in particular new members who would
like to become active in the work of a committee. If you would like to give a speech,
participate in panels, or become active in the work of a subcommittee or task force, please
contact either Norm Powell (npowell@ycst.com) or Jim Schulwolf
(jschulwolf@goodwin.com). There is plenty of work to be done and there are plenty of
great people to meet and work with.

Upcoming Meetings. Our joint ComFin/UCC Fall Meeting will take place on
Wednesday, November 14 at the J.W. Marriott Desert Ridge in Scottsdale, Arizona, from
11:00 a.m. to 4:00 p.m. Our 2013 Spring Meeting will take place from April 4-6, 2013, at
the Washington Hilton in Washington, D.C. Details will be available on the ABA Business
Law Section website, and, as always, the meetings will be full of informative educational
panels.

We look forward to seeing you in Chicago.

Penny Christophorou
UCC Committee Chair
pchristophorou@cgsh.com

Jim Schulwolf
Commercial Finance Committee Chair
JSchulwolf@goodwin.com

P.S. Following the Annual Meeting, Penny Christophorou will step down as UCC Chair
and will be succeeded by Norm Powell. Penny has done a truly outstanding job in her
three years as Chair, bringing her trademark enthusiasm and creativity to UCC and
combined UCC/ComFin activities and helping to maintain and grow the outstanding level
of cooperation among our Committees. We will miss Penny and wish her well in her new
role as a member of the Business Law Section Council, and we welcome Norm Powell as
UCC Chair.

Jim Schulwolf

VIEW CURRENT REPORTS AND DEVELOPMENTS OF THE FOLLOWING COMMITTEES AND TASK FORCES:

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 Commercial Law
Newsletter](#)
- [Subcommittee on General Provisions
and Relations to Other Law](#)
- [Subcommittee on International
Commercial Law](#)

Featured Notes

Also, for those of you looking for good pro bono/volunteer opportunities, the ABA
Business Law Section and Junior Achievement are partnering to promote youth
financial literacy. Business lawyers often witness firsthand the high cost of ignorance
about personal finances. Volunteer yourself and your firm to provide personal finance

- [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](#)

COMFIN AND UCC 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](#)
- [Security Interests in LLC and other Unincorporated Entity Interests Joint Task Force](#)

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instruction to high school students within the Junior Achievement program. Check [here](#) for more information about the Section's efforts.

Featured Articles

LEGISLATIVE STATUS OF THE 2010 AMENDMENTS TO UCC ARTICLE 9

By Paul Hodnefield

As the uniform effective date of the 2010 Amendments to UCC Article 9 (the "2010 Amendments") rapidly approaches, many business lawyers are paying close attention to the progress of this legislation. This article summarizes the current legislative status of the 2010 Amendments and offers a glimpse of what to expect for the legislation over the next year.

As of June 22, 2012, twenty-seven states and Puerto Rico have enacted the 2010 Amendments. Nine of those states enacted the legislation during 2011. The rest did so this year. Two states, Illinois and North Carolina, have passed the legislation, but the bills still await action by their governors. The 2010 Amendments legislation is still pending in Massachusetts, Pennsylvania, and the District of Columbia. One or more of these states could still enact the 2010 Amendments before year-end.

Effective Date

With one exception, all of the 2010 Amendments bills, both enacted and still pending, adopt the uniform effective date of July 1, 2013. Only Puerto Rico may end up with a different effective date. Puerto Rico has a unique situation because it finally enacted Revised Article 9 as a package with the 2010 Amendments. The enacted bill provides that the law takes effect one year after approval, which would be on January 17, 2013. However, Puerto Rico introduced legislation in May 2012 to correct some translation errors and mistaken cross-references in the original bill. If passed, the new bill would result in a later effective date.

There is growing concern that some states will not enact the 2010 Amendments before the uniform effective date. The legislatures in three states, Alabama, New Mexico and Oklahoma, adjourned this year before the 2010 Amendments bills could make it out of committee. Another 16 states and the U.S. Virgin Islands have not yet introduced legislation to enact the 2010 Amendments.

At this point, it is not only possible but perhaps even likely, that some states will fail to enact the 2010 Amendments prior to the uniform effective date. While it would be ideal to have the changes take effect in all states at the same time, there is little cause for alarm if the law becomes effective in some states at a later date.

Unlike the situation when Revised Article 9 was enacted back in 2001, it will not be a major problem if a few states have not enacted the 2010 Amendments by July 1, 2013, as the proposed amendments mostly consist of clarifications to existing law. The effective date is irrelevant for those changes. Moreover, the situations where inconsistent effective dates could create risk are likely to be so rare that they may not occur at all.

Individual Debtor Name Sufficiency

Perhaps the most-watched issue concerning the 2010 Amendments is what legislative alternative each state selects for the sufficiency of individual debtor names under Section 9-503(a)(4). The Joint Review Committee for UCC Article 9 and stakeholders spent more time debating individual debtor name sufficiency options during the drafting process than any other single issue. The drafters and stakeholders were unable to agree on whether it was best to designate a single sufficient source for the individual debtor name or

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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 UCC Committee and the ComFin Committee. Articles can survey the law nationally or locally, discuss particular UCC or Commercial Finance 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 **Annette C. Moore, Glen Strong, Carol Nulty Doody, Celeste B. Pozo, Christina B. Rissler, or Rebecca Gelfand.**

Conclusion

Next year will be a busy one for the 2010 Amendments legislation. Nineteen states have yet to enact the 2010 Amendments, including California, New York, and Delaware. The legislatures meet year-round in some of the remaining states, so it is possible that bills could still be introduced and even passed during 2012.

[Click here](#) for a copy of the current 2010 Amendments legislative status chart.

Paul Hodnefield is Associate General Counsel at Corporation Service Company. He can be reached at (800) 927-9801, ext. 2375, or phodnefi@cscinfo.com for questions or more information.

to create a simple safe harbor. In the end, the Joint Review Committee chose to offer two legislative alternatives in the official text of Section 9-503(a)(4).

Section 9-503(a) Legislative Alternative A ("Alternative A") provides that a financing statement is sufficient only if it provides the name indicated on the debtor's driver's license. The driver's license must be unexpired and issued by the same state where the law governs perfection and priority. Section 9-503(a) Legislative Alternative B ("Alternative B") offers a safe harbor for the name on the debtor's driver's license, but other names could be sufficient as well.

So far, twenty-three states and Puerto Rico have enacted the 2010 Amendments with Alternative A. All of the currently pending bills also follow Alternative A. Only four states, Colorado, Connecticut, Oregon, and Washington, chose to enact the legislation with the Alternative B safe harbor. Debates over the merits of Alternative A versus Alternative B will likely continue as more states consider which is the best option to include in the legislation.

Section 9-521 Safe Harbor Forms

The greatest deviation from the official text of the 2010 Amendments is found in the safe harbor forms provisions of Section 9-521. The final versions of the financing statement, amendment and related addendum forms had not yet been approved when states began to introduce the 2010 Amendments legislation in early 2011. Consequently, the early bill introductions provided text representations of the form fields.

Even after the final form versions became available, the legislation drafting systems used by a few states lacked the ability to incorporate the images of the approved forms. These states either provided the form field text in Section 9-521 or incorporated by reference the form and format set forth in the official text of the 2010 Amendments.

Several states chose a non-uniform approach to Section 9-521. Fifteen states either omitted the amendments to Section 9-521 entirely from the 2010 Amendments legislation or retained existing non-uniform versions. Six states enacted the 2010 Amendments with form field text instead of the images in Section 9-521. Only four states have enacted the 2010 Amendments with the approved form images incorporated into Section 9-521.

It is not clear how many states will introduce the legislation next year with images, text, or non-uniform provisions. However, it is clear that Section 9-521 will vary from state-to-state. The good news is that no filing offices have indicated that they would refuse to accept the new forms.

WHAT'S MARKET: 2012 MID-YEAR TRENDS IN LARGE CAP AND MIDDLE MARKET LOAN TERMS

By Sarah Norris, Maria Barclay and Tim Fanning

Although loan market investors became more cautious during May, for much of the first half of 2012 increased investor demand and liquidity resulted in a more positive outlook for the US loan markets after the volatility and uncertainty seen in 2011.

One positive development is the increase in collateralized loan obligation (CLO) issuance this year. Market participants are closely watching CLO issuance levels to determine whether there will be a significant withdrawal of CLOs from the loan asset class as the reinvestment periods of older CLOs expire and they cease being active loan market investors.

Another favorable indicator for the loan markets is the level of M&A activity. While M&A deal volume has not yet recovered to pre-financial crisis levels, the deal pipeline in May 2012 suggested that there could be some improvement in loan volumes in the coming months. However, market watchers are concerned that political and economic headwinds could chill strategic and financial buyers' near-term interest in pursuing corporate acquisitions.

A notable trend in the early part of 2012, driven largely by increased demand for leveraged loans by investors searching for yield, is that increasingly borrower-friendly terms became available to some borrowers. This trend is seen in the significant number of refinancings, covenant-lite deals and dividend recaps so far this year.

However, a number of factors that upset the loan markets in the second half of 2011 are ongoing and, beginning in May 2012, market sentiment deteriorated, due primarily to the worsening financial crisis in the Eurozone. Other current causes for lender concern include political deadlock in the US, economic slowdown in important world economies and questions over US regulatory changes, including the new proposed leveraged lending guidelines from the FDIC, the OCC and the Federal Reserve Board.

By mid-June 2012 investors had begun demanding higher returns on leveraged loans, which some commentators predict could herald the return of more lender-favorable terms generally in loans later in 2012. This article will discuss loan term trends seen in the first half of 2012.

Uncapped Incremental Facilities

Both large corporate loans and larger middle market loans typically include incremental facilities. Incremental facilities are often capped, so that facilities can be increased or additional tranches of debt can be added to the loan up to the dollar amount of the cap. However, it is now becoming common, particularly in large corporate deals, for loan agreements to permit the borrower to incur an uncapped amount of additional debt if it meets a certain pro forma leverage ratio after incurring the incremental facility.

Most favored nations (MFN) provisions remain common in incremental facilities. Under an MFN provision, if the interest rate margin on an incremental loan is higher than for existing loans, the margin on the existing loans will increase (if necessary) to ensure that it is not more than a specified number of basis points (typically 50 basis points) less than the margin on the incremental loan. While some sponsors have successfully negotiated for the exclusion of the MFN provision entirely, or to make the MFN provision subject to a sunset provision so that it does not apply after a specified time period after closing (such as two years), this is not currently the norm.

Changes to Loan Buyback Provisions

Provisions permitting loan buybacks continue to be standard in many loan agreements, in many cases on borrower-favorable terms. Until recently, if loan buybacks were permitted, the borrower was required to conduct the purchase through a Dutch auction open to all lenders. Now, some loan agreements allow the borrower to conduct buybacks through open market purchases with specific lenders.

Sponsor buybacks are also frequently permitted, although less often in smaller middle market deals. Where sponsor buybacks are permitted, the sponsor's voting rights on the purchased loans are limited and the sponsor and certain affiliates are typically not

allowed to hold more than 20% to 30% of the loans. This limitation is an attempt to ensure that the sponsor does not gain too much voting power in the event of the borrower's bankruptcy. Sponsor buyback provisions frequently treat purchases by sponsor debt fund affiliates differently, often increasing applicable caps on purchases significantly (some close to 50%).

In earlier sponsor buyback provisions the sponsor was usually required to represent that it did not have material non-public information about the borrower that was not disclosed to the lenders. However, this representation was not always required in loans in the first half of 2012.

Frequent Inclusion of Equity Cures

Equity cure provisions have become standard for large corporate sponsored deals. They typically have a limit of two cures that can be exercised in any four-quarter period. Equity cure provisions also frequently include a cap on the total number of cures that can be exercised over the life of the loan. In some 2012 deals this limit is as high as six cures, compared to the more traditional limit of between three and five cures.

Equity cure provisions are also being included in larger sponsored middle market deals. An important issue in these deals is the extent to which the proceeds of an equity injection should be applied to repay the loan. In some cases, the equity cure proceeds must be used to pay down the loan to the extent necessary to cause the borrower to comply with the loan agreement's leverage ratio. In contrast, in large corporate deals borrowers are not typically required to pay down debt with equity cure proceeds.

Incorporation of Documentation Principles

In early 2011 deals, some top-tier sponsors successfully negotiated for their loan documents to be based entirely on sponsor precedent, as was common prior to the recent financial crisis. However, in the first half of 2012 it was more common for commitment letters to include specific documentation principles to govern the negotiation of the final loan documents.

Documentation principles are found in both large corporate and middle market deals and can vary. However, they generally require loan documents (or identified sponsor precedent) to be negotiated in good faith and subject to changes to reflect the operational and strategic requirements of the borrower and its subsidiaries in light of their size, industry, business practices, proposed business plan and, less frequently, current credit market conditions.

Use of Market Flex and Reverse Flex

Market flex provisions can be used by arrangers to make deals more attractive to potential lenders and to achieve a successful syndication of the loan. Specific market flex terms are often highly negotiated, but typical modifications made based on flex include, among others, pricing increases, tenor changes, the addition of caps to certain EBITDA add-back amounts and net cash amounts, structural flex, the incorporation of call premiums and limitations on equity cures.

Although pricing increases alone are often sufficient to attract lenders to under-sold deals in the large corporate market, increased pricing is less likely to be sufficient to attract additional lenders in a middle market deal, particularly a "credit with a story." Instead, the transaction may need to be wholly restructured or renegotiated in order to close.

Unlike market flex terms, reverse flex is not customarily documented in commitment papers (although a few deals have included specific reverse flex provisions). Reverse flex is not limited to pricing changes and can also permit the borrower to increase incremental facilities or cut or limit any related MFN provisions, eliminate call protection or add sponsor buyback rights.

Inclusion of Call Protection

A soft call (prepayment penalty or call premium payable when a loan is refinanced or repriced) of 1% in the first year remained common in large corporate deals in the first half of 2012. Traditionally, soft calls were not customary in middle market loans. However, since institutional investors from the large corporate market have entered the middle market, soft call prepayment penalties have sometimes been included in middle market deals.

If the term sheet for a middle market loan does not include call protection, it may be specifically contemplated in flex provisions with a 2% call premium in the first year after closing and a 1% call premium in the second year (or a 1% call premium only in the first year) being typical. Generally, large corporate loans do not include hard calls (payable with mandatory prepayments, such as from excess cash flows or asset sale proceeds). However, hard calls are sometimes included in flex provisions for middle market deals, particularly mezzanine loans.

A point of negotiation in recent deals with sponsored borrowers has been whether an exception should be included in the

loan agreement for prepayment penalties following a change of control of the borrower. This exception would allow a sponsor to sell the borrower and repay the loans without having to pay a prepayment penalty under the loan agreement.

Influx of European Borrowers

The US loan markets are currently experiencing an influx of European borrowers, prompted by a decrease in available credit from European banks. US loan transactions with European borrowers can raise a number of issues related to practice, deal structure, documentation and collateral because of differences between the US and European loan markets. For example:

- Lenders in the US often expect to be granted liens over all parent, subsidiary and borrower assets. This may be problematic for borrowers from some European jurisdictions, depending on local laws governing secured transactions.
- European deals apply the concept of “certain funds” in acquisition finance, which requires that diligence be completed and loan documentation be in place when the acquisition agreement is signed. In US deals, “SunGard” language is often included, which reduces the number and scope of conditions precedent to funding the initial loans, providing greater certainty for the seller that the buyer’s financing will close.
- Collateral packages for similar loans differ between US and European deals, which could present issues during intercreditor negotiations. For instance, mezzanine loans in Europe are often secured on a junior basis, while in the US they are generally unsecured.
- Legal issues that are common in US deals, such as margin regulations, anti-tying regulations, Del Monte concerns in stapled financings and Xerox provisions for acquisitions are unfamiliar to many European borrowers.
- Bankruptcy laws in Europe are focused more on consensual restructuring and intercreditor provisions than bankruptcy laws in the US.
- In Europe, there is an expectation that diligence reports will be shared and relied on by lenders. In the US, it is typical to require a non-reliance letter for shared diligence reports.
- Required lender percentages for lender voting provisions differ between US and European deals (66 2/3% is common in European deals while 50% is typical in US deals).
- Material adverse change (MAC) events of default are more common in European deals than in US deals.
- Market flex provisions are more limited in European deals than in US deals.

Continued Availability of Covenant-lite Loans

In the large corporate market, covenant-lite loans have continued to be available to strong borrowers in 2012 (though they are still rare in the middle market), with more than \$15 billion of covenant-lite loans coming to market in the first four months of the year, according to some estimates. These deals have generally not included naked revolvers (revolvers with no financial maintenance covenants). Instead, covenant-lite loans with revolving tranches typically include springing financial maintenance covenants, which generally become applicable when certain availability requirements are not met in asset-based lending (ABL) deals or when specified amounts are outstanding under a cash flow revolver.

In addition, in cash flow deals, there is sometimes negotiation over when the financial covenants will be tested, which may be either on a pro forma basis at each borrowing or only as of the end of a quarter. Some loan agreements permit the borrower to pay down the revolving loans after the end of a quarter so that the financial covenants do not apply.

Negotiation of Financial Performance Measurements

EBITDA Add-backs

EBITDA add-backs allow borrowers to increase EBITDA. Add-backs may include, among others, adding the earnings of a newly-acquired business, deducting losses generated by a business that is sold, or reflecting cost savings and expenses arising from a business restructuring or other internal efforts to improve efficiency.

Negotiated points include whether:

- Add-backs must be capped. While caps on non-cash items are more common in the middle market, it is typical for caps on cost savings and restructuring add-backs to be included in both middle market and large corporate deals.
- Costs savings must be actually realized or whether projected savings can be included.
- Add-backs must be certified by the borrower, verified by third parties or be acceptable to the administrative agent or required lenders. Large corporate deals tend to only require a certification from the borrower.

Net Leverage Ratio Calculations

A net leverage ratio calculation measures the borrower’s outstanding debt net of its unrestricted cash. Major points of

negotiation include whether the cash that can be deducted from the amount of outstanding debt should be capped and whether unrestricted cash must exceed a threshold amount before it is subtracted from debt in leverage ratio calculations.

Some recent large corporate deals have not capped the amount of cash that can be deducted. In many middle market deals, the cash must be held in accounts that are subject to control agreements in favor of the collateral agent in order to be deductible from debt in leverage ratio calculations. However, this is not typical in large corporate deals.

Other Financial Performance Measurement Negotiations

Other notable points of negotiation relating to financial performance measures are:

- Whether to include minimum EBITDA covenants in middle market deals. There has been resistance by middle market borrowers to include minimum EBITDA covenants, and some have successfully negotiated exclusion of these covenants from their deals.
- How broadly to define first lien debt in a first lien leverage ratio test, with some borrowers arguing for narrower definitions.

Addition of OFAC Representations and Covenants

The Office of Foreign Assets Control (OFAC) prohibits US companies and their foreign branches from engaging in transactions involving property belonging to individuals and entities appearing on OFAC's Specially Designated Nationals and Blocked Persons (SDN) list, absent an applicable exemption or authorization by OFAC. Because a primary focus of OFAC has been to deprive persons on the SDN list of access to US financial services and credit, US financial institutions have come under increased scrutiny to ensure their compliance with OFAC requirements. In recent years OFAC violations have resulted in larger and more frequent penalties.

This increased scrutiny and potential for large penalties has caused lenders to push for more fulsome representations and covenants related to OFAC. In turn, borrowers are negotiating for knowledge and materiality qualifiers, arguing that it is too difficult to comply with these representations and covenants without qualifiers. However, lenders tend to regard this matter as one of risk allocation and resist incorporation of qualifiers because exceptions are not included in the OFAC regulations themselves.

Limited Increase in PIK Toggles

In early 2012, PIK toggles began to reappear in some loans, having largely disappeared from loan transactions since the onset of the financial crisis. PIK toggles allow borrowers to pay interest either in cash or by payment-in-kind (PIK), meaning that the amount of the interest is added to the balance of the outstanding loans. During the term of the loan, the borrower can switch back and forth between payment in cash and PIK, allowing it to reduce outgoing cash payments when necessary.

Because PIK toggle loans present more risk to lenders as unpaid interest is capitalized, they typically receive an increased interest rate (generally an additional 25 to 75 basis points) on PIK interest. However, as the year progressed PIK toggles faded away again as lenders and loan investors became more cautious.

Inclusion of Collateral Release Mechanisms

Recently some loan agreements have included collateral release mechanisms. If a borrower obtains an investment grade rating and repays a term loan B tranche of its debt, its collateral is released and its remaining outstanding loans become unsecured. Provisions that allow collateral to be released in this way often also include a reinstatement mechanism under which the remaining loans again become secured if the borrower's credit rating deteriorates or its leverage ratio exceeds a specified level.

Changes to Securities Demand Provisions

Securities demand provisions are found in some bridge loan fee letters and require the borrower to issue permanent debt securities, the proceeds of which are used to repay the bridge loans upon arranger demand. Before the financial crisis, this provision had generally included a "holiday" period (usually up to 180 days) after closing of the bridge loan during which the arrangers could not make a securities demand. Currently, however, arrangers are generally not allowing holiday periods and are requiring that the securities be issued before or at closing.

A Look Ahead

At the beginning of 2012, the loan markets recovered from the second half of 2011 as confidence in the US economy slowly returned. However, starting in May, renewed concerns over the Eurozone crisis and the strength of the global economy again caused

lenders to proceed with caution. Although it remains unclear whether more positive sentiment will return to the loan markets during the remainder of 2012, market participants speculate that M&A deal volume may improve and that additional European borrowers will seek loans in the US, both leading to more opportunities for US lenders in the coming months.

Sarah Norris, Maria Barclay and Tim Fanning are PLC Finance attorney editors with the Practical Law Company. For a copy of this article published on the Practical Law Company website which includes links to recent examples of loan agreements, see *Practice Note, What's Market: 2012 Mid-year Trends in Large Cap and Middle Market Loan Terms, Practical Law Company*, (<http://us.practicallaw.com/5-520-1920>)

PURCHASE MONEY SECURITY INTERESTS FOR REPETITIVE SALES

By W. David Arnold and Dan R. Fotoples

Introduction

During lean and difficult economic times, suppliers of goods often see credit risks increase as buyers' sales take a hit and the bills become harder to pay. In turn, suppliers may be reasonably skeptical of their customers' abilities to adhere to payment schedules. However, if suppliers withhold goods from customers from fear of non-payment, it only exacerbates the economic woes because the supplier suffers a decrease in revenue and the buyer has less product to sell to its customers. To avoid such a situation and to give the supplier reasonable assurances of payment, the supplier should consider an option under Article 9 of the UCC called a purchase money security interest. Purchase money security interests ("PMSI") are a valuable tool to suppliers who have concerns about their buyers' abilities to pay for goods sold on credit. Our perception, however, is that this tool is often seen as useful for a one-time sale, but inefficient where the supplier and buyer engage in frequent transactions. On the contrary, PMSIs can be efficient, useful, and cost effective for suppliers and buyers transacting in repetitive sales environments.

As counsel to suppliers of automobile parts, we often see repetitive sales occurring within the supply chain including original equipment manufacturers ("OEMs") and Tier 1, 2, and 3 suppliers. This article uses these transactions as examples of how a PMSI can be used effectively for repetitive sales. We discuss how a supplier, making repetitive sales within the context of Tier 1-2 transactions, can use PMSIs as a tool to protect itself in this economic environment. The first part of the article discusses PMSIs generally, as well as the general set-up of Tier 1-2 transactions and how a PMSI fits into that structure. The second part of the article discusses how to efficiently design and structure a purchase money security agreement.

Purchase Money Security Interests

The Uniform Commercial Code governs PMSIs. A PMSI is an interest in goods securing an obligation for payment for the price of the goods. In the context of an advance, it secures the obligation to re-pay the advance. UCC § 9-103. PMSIs are available for inventory, software, livestock, or other goods. UCC § 9-324. This article addresses only PMSIs covering inventory purchases. For the purposes of the UCC, "inventory" is defined as goods for sale, lease, or work in progress. UCC § 9-102(48). Therefore, the sale of parts among automobile suppliers and buyers qualifies as inventory.

A perfected PMSI in inventory has priority over a conflicting, usually senior, security interest in the same inventory and entitles the buyer to specific kinds of proceeds. Sometimes, the priority given to purchase money security agreements is referred to as a "super priority." A PMSI is used when the supplier wishes to retain its interest in the value of the inventory but a primary lender, usually a bank, has a senior security interest. Typically, the primary lender's interest will be a blanket interest, including after-acquired inventory, equipment, accounts receivable, etc., thereby forcing the supplier into a junior creditor role with respect to the inventory items. A PMSI allows the supplier to trump the primary lender's blanket interest as to the specified goods sold. Therefore, a supplier will want to consider a PMSI when selling to a buyer on credit when the goods will be held by the buyer for a period of time and not immediately converted to finished goods and sold thereafter.

There are certain hoops to jump through to perfect the PMSI and leap over normally-superior creditors. *See* UCC § 9-324. First, the supplier and buyer must execute a security agreement, which can be part of the sales agreement. Note that the PMSI agreement must relate only to goods transferred after the security agreement. Courts reject security agreements covering prior debts as invalid PMSI agreements. Any inventory transferred to the buyer before the creation of the PMSI agreement will remain unprotected. However, the fact the debtor held one item of inventory before properly creating, filing and giving notice does not subordinate the purchase money creditor regarding inventory acquired in the future. The purchase money agreement will still cover inventory received after the creditor finishes the perfection process.

Second, the PMSI must be perfected. Perfecting the interest is similar to other security interests. The enterprise must file the

appropriate financing statements with the appropriate secretary of state or other filing agency, and a perfected interest results.

Third, as spelled out above, in order to receive priority over other lenders, the PMSI must already be perfected at the time the customer receives the goods that comprise the inventory. The supplier must file the financing statement before the goods are delivered.

Fourth, the PMSI creditor must give written notice to the holder of the conflicting security interest if the other creditor has filed a financing statement. The notice must indicate the PMSI creditor is acquiring or expects to acquire a PMSI on certain items in the buyer's inventory. Furthermore, the notice must describe the covered inventory by item or type. This notice also must be received by the other holder prior to the debtor's receipt of the goods. The notice is valid for five years.

After completing all of the steps to obtain a PMSI, the supplier will have additional remedies if necessary to collect monies owed or to re-possess the goods sold on credit. With respect to the inventory, the supplier will be first in line for repayment if bankruptcy should occur, and it will have rights to the inventory or some limited proceeds if the inventory has been sold by the buyer.

Automobile Parts Manufacturers and Suppliers

The automobile parts supply chain operates through a tiered system. At the top of the food chain is the marketplace – car dealerships and the like. Next, sits the original equipment manufacturers. These manufacturers assemble parts they manufacture or acquire from other suppliers to create a finished product.

Below the OEMs are Tier 1 suppliers. Tier 1 suppliers are direct suppliers to OEMs – supplying parts that are then assembled to create the finished product. Below Tier 1 suppliers are Tier 2 and 3 suppliers. Each lower tier supplies customers in the tier above it with materials to create its products, but does not supply OEMs. This type of supply chain is common among industries. Therefore, using it as an example of how to use PMSIs should be generally instructive.

Despite the commonalities between supply lines in automotive manufacturing and other industry supply lines, there are a few intricacies in the automotive context bearing on the efficacy of PMSIs that may not be present in other supply lines. Consider the relative economic power between supplier and buyer. Tier 1 suppliers do not possess the bargaining strength to impose a PMSI on an OEM. However, a Tier 2 supplier may be in a position to force the Tier 1 supplier to agree to a PMSI. If the Tier 2 supplier is a “sole source” supplier – that is, the Tier 1 enterprise can only get its goods through a certain Tier 2 supplier, the Tier 2 supplier may possess the leverage to obtain a PMSI. A “sole source” situation is fairly common in the automotive context because OEMs subject Tier 2 goods to testing for quality. Since all goods in the market must be approved, a given item's market may be relatively small, making it difficult for the Tier 1 company to find alternative means of supply. Therefore, a Tier 2 supplier will often be in a position of economic strength to force a Tier 1 buyer to accept the terms of a PMSI.

Setting aside OEMs, we will look at a hypothetical transaction between a Tier 1 supplier and a Tier 2 supplier. The Tier 1 supplier (Company A) assembles rear-view mirrors while the Tier 2 supplier (Company B) provides the reflective glass. Since the current economic climate has resulted in depressed car sales, Company B may be concerned the poor revenue flow will trickle up the supply chain. Company B may become suspicious and skeptical of Company A's ability to stay above water and pay their bills. Rather than refrain from selling to Company A its mirrors on credit, Company B should look into the possibility of obtaining a PMSI on the goods sold to Company A.

However, Company B and Company A transact business about once every two months, in varying amounts depending on the amount of rearview mirrors Company A sells to the OEMs. If the type of items do not vary extensively from order to order, a PMSI should cover all the glass sold to Company A by Company B and kept in Company A's inventory. Furthermore, one PMSI will apply to all like-inventory sold from Company B to Company A for five years. The language in the UCC provision governing PMSIs indicates the notice must be received within five years of the debtor receiving the goods. This means a notice is good for five years. *See* White & Summers, Uniform Commercial Code, Vol. 4, § 33-4 (2009). Therefore, the PMSI is not simply good for one sale, but can cover many transactions over a five year period between a supplier and purchaser.

Nevertheless, there are some limitations on using the same PMSI for more than one transaction. For example, if the supplier changes the type of item, say from reflective glass to a steering wheel, the security interest may not hold up – a new PMSI would be required. However, for many suppliers in the automotive context, consecutive orders are for parts that are similar enough to qualify under the same purchase money security agreement. The next section discusses the degree of similarity required between items from order to order.

Furthermore, obtaining a PMSI makes economic sense because, for relatively low cost, it protects monies or advances from disappearing in bankruptcy. The costs to obtain and to maintain a PMSI would be similar to those associated with obtaining any security interest. Moreover, compared with the money and assets that could be saved, it seems worth the trouble. Otherwise, if the

buyer goes into bankruptcy, the supplier may end up waiting in line behind dozens of other unsecured creditors. In the automotive context, orders for parts can be very large and very expensive, and suppliers should not take the risk of losing out on the value of those parts. If suppliers are dealing with the same customers, transacting sales for the same types of items, and the orders are sufficiently large, a PMSI is a protection worth a hard look. In many commercial situations, a PMSI is very efficient and makes good economic sense.

How to Properly Structure a Purchase Money Security Interest

The steps to obtain and to perfect a purchase money security agreement are outlined above. This section discusses how to structure a purchase money agreement in such a way as to ensure its validity and its ability to apply to as many items as possible. If the security interest is termed broadly enough to cover many different kinds of items, then fewer of these interests need be filed to protect a supplier's security interest, saving the supplier time and money.

The ability to utilize one PMSI for many transactions depends in large part on the description included in the notice to the existing creditor, as mandated in UCC § 9-324(b)(4). Using Ohio law as an example, the courts have imposed a relatively low bar regarding identification of goods. Ohio interprets the requirements of UCC § 9-324 as consistent with other security interest laws requiring descriptions of the collateral. The test of one of "reasonable identification," and a detailed itemization is not required. For example, a reference to "equipment" was enough for one Ohio court, given the circumstances of the case and the definition of "equipment" provided by the Ohio Revised Code. While equipment is dealt with separately from inventory in PMSI statutes, the two are treated similarly enough to compare interpretations of "reasonable description." Descriptions of items in inventory require only details such as specific listing, category, quantity, and the like. Another Ohio court accepted "new and used boats" as illustrative enough to fulfill the requirements of PMSIs. The court specifically rejected the idea that descriptions are insufficient unless they are exact and detailed, in regards to security interests. The purchase money creditor wrote a generic list of products on the PMSI agreement, some of which did not apply to any goods sold to the buyer, but the court found the description satisfactory.

As one can see, the bar is low and a broad description appears to be sufficient. A broad interpretation by courts increases the value and efficiency of a PMSI. Hypothetically, in the automobile context, a single PMSI could be utilized to protect shipments of engines, although there may be substantial differences amongst the engines. The security interest could protect many shipments of tires, although the difference between tires may be substantial. Since the interpretation of "describe" is so broad, fewer PMSIs are required to protect goods sold by a supplier to a buyer on credit.

However, other states may require more detailed description than the Ohio courts require. This article does not discuss other states' laws relating to PMSI descriptions or agreements. Before pursuing a PMSI, a company should examine how the courts in its jurisdiction interpret the provision requiring the creditor to "describe" the goods. A narrower interpretation of the word "describe" may require more PMSI filings, but obtaining the interest may nevertheless be worthwhile for the company, depending on the size of the shipment, the size of the company, and the viability of the buyer.

Despite the relative breadth of the word "describe," companies should consider being as specific as possible under the circumstances, especially in the automotive context. As mentioned above, parts sold from Tier 2 suppliers to Tier 1 suppliers must be approved. Therefore, it is unlikely parts sold from a Tier 2 to a Tier 1 will vary frequently. Practically speaking, usually the exact same item is sold each and every time. When each transaction is identical, there is no reason not to be specific. While courts *permit* vague or broad descriptors, being overly broad may still create problems in dealing with other creditors or the buyer. When the items are identical shipment to shipment, there is no reason to be inexact in the PMSI description.

Parties transacting business in Ohio should also conduct additional research into the matter before attempting to enter into a PMSI. Although this article briefly discusses Ohio law, the paragraphs above are not meant to be legal advice nor should any enterprise rely on this article when structuring a PMSI. Each interest is different and, if done correctly the first time, a PMSI can be procured at relatively little cost in future years, using the original agreement as a model.

Conclusion

Depending on one's business model, a PMSI could be a valuable protection against non-payment or bankruptcy in tough economic times. With proper perfection of a PMSI, sellers can leapfrog senior creditors regarding certain items of inventory. When payment is uncertain, suppliers should take steps to protect themselves. A PMSI provides that protection and allows the supplier to maintain its transactions with the purchaser.

LOAN PARTICIPATIONS – TIME FOR ANOTHER LOOK

Part I

By Andrew Connor

A loan participation is an arrangement between lenders in which one lender (“Lender A”, also known as the “lead”) makes a loan to a borrower and separately, then or later, sells an interest in the loan to another lender (“Lender B” or the “participant”). Sometimes, there are multiple sales to different participants. In most cases, Lender A retains an interest in the loan, but it is not unknown for the lead to sell participations totaling 100% of the loan. Lender A holds all the loan documentation in its own name, is the secured party with respect to any collateral, is the beneficiary of any guarantee(s), and services the loan, acting as the lender which deals with the borrower.

The use of participations has benefits to both originators of loans and to the purchasers of the participations. In many instances, Lender B buys the participation as a way to make a loan which it otherwise could not make. Lender A sells the participation because it wishes to lessen its exposure. And, because banks are subject to loan limits imposed by law (as well as internally imposed limits), if a borrower wants a larger loan than a bank is allowed or willing to make, the bank may need to sell a participation in order to make the loan.¹ At the same time, the participant gets to diversify its loan portfolio and to obtain business it would not otherwise get.

Participations are different from situations where A and B each make a loan to the borrower independently. They are also different from “club” loan facilities and syndicated facilities, where two or more lenders acting together agree to extend credit to a borrower and one of the lenders is named agent for all lenders, administering the loan and acting as secured party on behalf for all if there is collateral. In either of these instances, each lender has a direct contractual relationship with the borrower. With a participation the participant does not: the loan documentation is only between the lead and the borrower. Indeed, the borrower may not even know that there is a participant, which is sometimes how Lender A wants things in order to keep Lender B away from the borrower. Lender A controls the customer relationship, the terms of the loan, and the administration of the loan. As between the lead and the borrower, that is simpler and more convenient. Adding additional lenders to the relationship adds complexity – questions about administration and about what voting rights the lenders have among themselves with respect to approving amendments, modifications, and waivers. In a participation, whatever agreements may be made between Lender A and Lender B with respect to loan administration are usually not part of the borrower’s deal with Lender A.

The document setting forth the participation between Lender A and Lender B is typically called a participation agreement. It can be lengthy or short and as creative as the parties choose to make it to define the interest which A is selling and B is buying. Lender B’s participation interest may be based on a straight percentage of the loan or it may be more complicated, such as based on the concept of last-in, first-out for the participant. If the credit facility includes both a term loan and a revolving loan, Lender B may only participate in one loan, rather than both. It is also not unknown for the participant to receive interest at a different rate than is applicable to the underlying loan. The arrangement between Lender A and Lender B may allocate specific collateral or even subordinate one loan to the other. Thus, if there is a revolving credit facility based on accounts and inventory (although secured by additional collateral) and a term loan (secured by the same collateral), the participation agreement may provide that in a default scenario all proceeds of accounts and inventory are applied first to pay down the revolving line. The agreement may also include a right on the part of Lender A to repurchase the participation or give Lender B the right to purchase the entire loan from Lender A in certain circumstances.

Recently, we had occasion to review a participation agreement for an unhappy participant. The subject loan, a term loan, had originally been made by the lead and then our client bought a participation. A year or so later, the loan became due but was not paid and was in default. The lead had just notified our client that the lead was going to sell the loan to a third party at a discount. Our client had then reviewed the participation agreement (which was signed without our involvement), was perturbed by what it said, and asked for our advice.

The participation agreement itself was slightly over six pages in length. It described the participation as an undivided interest in the loan made by the lead to the borrower, and said that the sale of the participation constituted an assignment, without recourse to the lead, of an undivided interest in the lead’s right, title and interest in and to the loan, loan documents and any collateral security the same. It also did not prohibit the lead to sell all of its remaining interest (including assigning the collateral security rights) without bothering to require that the purchaser assume the participation agreement. Conceivably, if the lead sold the loan without having the buyer assume the participation agreement, our client would be left with a right to receive payments from the old lead, but not the new one.

Moreover, our client had spoken to the lead about the situation and learned that the lead had not told the prospective buyer

about the participation. Apparently, the lead thought that the buyer would not be willing to assume the participation agreement and such disclosure might kill the deal. Quite possibly the buyer was purchasing the note with the expectation that it would be entitled to keep 100% of any collections.

So the client wanted to know what were its rights. Could it prevent the sale or require the new lead to honor the participation? And, assuming that the new lead did assume the participation agreement, could our client force any action by the lead with respect to trying to collect the debt?

We thought of several theories that might apply. The participation agreement did *sell and assign* to our client an undivided interest in the loan, the loan documents and the collateral. It seemed possible that our client insist upon institution of foreclosure and collection proceedings. Didn't the lead have a responsibility to try to collect the loan? We set out to explore these possibilities. The participation agreement did contain some troubling provisions limiting or disclaiming duties on the part of the lead, but loan participations have been around for decades, so we expected to find that courts had established some basic principles applicable to loan participations which would afford protection to participants. By analogy, Article 2 of the Uniform Commercial Code permits a seller of goods to disclaim implied warranties, but if an express warranty fails of its essential purpose, then a disclaimer of the implied warranty of merchantability is not effective. We thought there might be cases establishing basic rights of loan participants – perhaps something akin to “good faith and fair dealing” being implied into every loan participation.

Alas, our research did not lead to such clarity. The courts have said various and inconsistent things about what duties a lead has to its participant, and have taken some unexpected (to us, anyway) positions about the nature of the participant's interest. Participants have been disappointed somewhat more frequently than we expected, often because of unanticipated circumstances and unclear drafting. This article reviews what we found and what that meant to our client. We end by making some suggestions for achieving greater clarity and certainty in such future transactions, for the benefit of all concerned, we hope.

Duties of the Lead

Given that a participant has no direct relationship with the borrower and therefore no direct means of insisting that the loan be performed in accordance with the loan documents, we thought that courts probably had implied a duty on the lead to protect the participant's interest. But how strict would that duty be?

We found that where the participation instrument is silent about loan administration, courts have held that the originating lender exercises sole control over the collection and enforcement of the loan, but the courts have recognized a duty of the lead to exercise reasonable care in these activities. For example, in *Carondelet S.&L. Ass'n v. Citizens S.&L.*², the court stated that the lead (Citizens) had a duty “to exercise the care and prudence which ordinary men would exercise under like circumstances in dealing with their own affairs.”

Carondelet involved a real estate loan by Citizens Savings & Loan Association to finance construction of a dormitory at Southern Illinois University. Carondelet Savings and Loan Association and another lender, Bohemian Savings & Loan Association, purchased participations in the loan from Citizens in 1965. The loan performed until late in 1969, when student housing demand dropped. Over the next three years, Citizens made several efforts to salvage the situation, with Bohemian's support but over objections by Carondelet. Citizen's efforts included modifying the payment schedule, reducing monthly payments for a time, and allowing the loan to go without payment for 8 months during 1972, before Citizens finally decided to foreclose. Carondelet sued, seeking money damages or rescission, alleging that Citizens' actions constituted breach of contract or breach of fiduciary duties. The trial court ruled that the participation agreement did not require immediate foreclosure upon default and gave Citizens “the exclusive right to decide how to service” the loan and was only obligated to foreclose after exercising reasonable efforts to collect the loan. So, there was no breach of contract. The court emphasized that the participation agreement granted a great deal of discretion to Citizens and that Citizens' forbearance and other efforts to salvage the loan were reasonable exercises of that discretion.

In *Carondelet*, the court said that Citizens was a fiduciary for its participants, but found no breach of duty. Accordingly, we thought that we might find that courts have implied fiduciary duties on the lead. But in the other cases that had considered the issue, courts had generally declined to find that a fiduciary relationship exists unless the terms of the participation agreement could be read to create it. For example, in *First Citizens Federal Savings & Loan Ass'n v. Worthen Bank & Trust Co.*,³ the Ninth Circuit Court of Appeals said that a fiduciary relationship “should not be inferred absent unequivocal contractual language.”

A case where such language was present is *Women's Federal Savings & Loan v. Nevada National Bank*⁴, and as a result the court found a fiduciary relationship and that the lead had failed to meet its duties. Here's the story: Women's Federal Savings & Loan (“WOFED”) was located in Ohio, but had a relationship of some sort (not explained) with John and Barbara Cavanaugh. The Cavaughns acquired a casino-motel in Reno, Nevada called the Gold Dust West (“GDW”). They contacted WOFED about financing some improvements to GDW, and WOFED was interested but insisted that a local Nevada bank participate as co-lender and agree to administer the loan. Mr. Cavanaugh contacted Nevada National Bank (“NNB”), and it agreed to fill that role.

WOFED and NNB entered into a participation agreement, and WOFED purchased a 90% interest in the loan of \$2.8 million which NNB made to the Cavanaughs in July 1977. The loan was secured by a first deed of trust in favor of NNB on the GDW real estate, which deed of trust contained a prohibition against creating any junior liens without the consent of the beneficiary. WOFED was not a beneficiary of the first deed of trust or a secured party in any other way vis-à-vis the borrower.

The terms of the participation agreement called for NNB to “act as a trustee with fiduciary duties” in administering and servicing the loan. In addition, the agreement specifically required NNB to monitor and to periodically investigate the financial condition of the Cavanaughs and GDW, and to inform WOFED promptly of any development that threatened the security of its investment, and required that NNB establish an impound account for real estate taxes and insurance premiums, and a custodial account for amounts due to WOFED.

Subsequently, GDW had financial trouble, and in January 1978, NNB loaned the Cavanaughs an additional \$1.5 million secured by a second deed of trust on the GDW property, without informing or obtaining consent from WOFED. In June 1980, NNB advanced a further \$750,000 under the second deed of trust, again without informing or obtaining consent from WOFED. The interest rates on these two loans were higher than the rate applicable to the loan in which WOFED was a participant, such that the Cavanaughs’ monthly payment to NNB eventually was almost three times the monthly payment amount to WOFED.

In September 1982, the Cavanaughs became three months delinquent on the WOFED-NNB loan, which was their first serious delinquency on that loan. WOFED contacted NNB concerning this delinquency and learned, for the first time, that the Cavanaughs and GDW had been having difficulties. WOFED also learned that NNB had extended additional loans to the Cavanaughs and taken the second deed of trust and that NNB had failed to establish the required segregated impound and custodial accounts. WOFED directed NNB to file a notice of default on the first deed of trust, but this became moot as the Cavanaughs were able to cure the default within the statutory period and subsequently stayed current on the loan.

Notwithstanding that WOFED had received all payments due to it, it filed suit against NNB claiming breach of contract and breach of fiduciary duties and seeking rescission of the participation and disgorgement of NNB’s profits from the second deed of trust loan. At trial, the district court found that NNB had breached its contractual and fiduciary duties to WOFED, but concluded that WOFED had failed to show that it had been damaged by those breaches. The court therefore refused to grant rescission or order any disgorgement.

On appeal, however, the Ninth Circuit Court of Appeals felt otherwise and held that rescission was appropriate, *even though WOFED had received all payments that were due on its loan*, saying that WOFED should not be compelled to stay in the relationship after its fiduciary had proven itself untrustworthy and holding that WOFED had bargained for, and was entitled to receive under its contract with NNB, something more than just sharing the risk of the loan to the Cavanaughs.

Guaranty Sav. & Loan v. Ultimate Sav. Bank is another case that found a fiduciary relationship between lead and participant, but solely based on wording in the participation agreement. Unfortunately, our client’s participation agreement contained no such language. Worse, it explicitly denied that the lead was a fiduciary.

In fact, we found few cases other than *Carondelet*, taking the view that the lead had any implied fiduciary duties. In one, *First Bank of WaKeeney v. Peoples State Bank*,⁵ a Kansas appeals court suggested that a fiduciary relationship “may be implied if a joint venture is found”. For this, however, the court said that the participation agreement had to contain some language giving the participant explicit control over the loan. How much control, the court did not say. But our client had very little control over the loan. The participation agreement gave the lead very broad powers to amend or to modify the loan documents, to waive their terms, to waive the lead’s other rights and powers, to refrain from exercising any or all of such powers, and to release collateral, all without our client’s consent. Only reductions in the principal or interest rate and extensions of the stated maturity of the loan were subject to our client’s approval. This was not a strong basis for claiming that there was a joint venture.

In *Royal Bank of Canada v. Interfirst Bank Fort Worth, N.A.*⁶ the court decided that the lead, Interfirst Bank Fort Worth, and the participant, Royal Bank of Canada, had a principal-agent relationship, but that was not enough to establish a fiduciary duty on the part of the lead.

There, Royal Bank tried to emphasize that the participation gave rise to fiduciary duties because it provided that Interfirst would exercise the same care in respect of the loan as it used in the making and the handling of its own loans – wording similar to the implied duty of the lead characterized as “fiduciary duty,” according to *Carondelet*. In support, Royal Bank pointed to the “blind” nature of the participation (under which Royal Bank was not to have any contact with the borrower), subjecting RBC to a greater level of dependency, as a basis for imposing a higher duty on Interfirst as the lead. But the court rejected that view and said that “ordinarily, banks involved in commercial arms-length transactions do not stand in a fiduciary relationship with each other,” and that “the normal degree of trust between a lead bank and a participatory bank is not enough alone to give rise to a fiduciary relationship.”

Women's Federal illustrates the perils that come with being a fiduciary and it is not surprising that lead lenders would seek to avoid such duties. But, even if the lead is not a fiduciary, as an agent it must have some duties and, as noted, some courts have said that the lead is obligated to exercise reasonable care in handling the loan.

But what is reasonable care, and when does it have to be exercised? Does the lead have this duty only with respect to its actions after the participation is actually sold? Or does it apply to the entire relationship, including the lead's actions before the participant invests? Is the participant entitled to a presumption that the lead exercised reasonable care in making the loan? Possibly, we thought, our lead might have failed to exercise appropriate care in making the loan. If so, there might be a basis to seek a remedy. So, we asked our client if it had queried the lead for the underwriting information, the basis for the loan, before deciding to purchase the participation.

"Yes," they said, they had. And did they rely on that, we asked? "Sure," the client answered. "The lead gave us lots of information and verbally assured us that they thought the risk was minimal and that we'd have no problems."

The participation agreement, however, included an express statement that our client had made its own credit analysis of the borrower and the loan. It also contained a disclaimer by the lead stating that it made no representations or warranties about the borrower, the accuracy of any information provided to our client, the legality or enforceability of the loan documents, the filing of financing statements, or the financial condition of the borrower (except that the outstanding loan principal balance was as stated and that the lead owned the loan and had the power and authority to sell the participation).

In such circumstances, at least one court has held that reliance by the participant was unjustified and not actionable. In *Bank of the West v. Valley National Bank of Arizona*⁷, the lead (Bank of the West) made loans to Technical Equities Corporation ("TEC"), but as the line of credit grew, Bank of the West decided that it needed a participant in order to avoid violating its lending limit. Valley National Bank became the participant, eventually committing to 50% of the loan and agreeing to bear 50% of any "Extraordinary Expenses". (Under the participation agreement, the lead was to bear the ordinary costs of managing the loans.)

TEC was primarily in the business of buying and selling residential property. In January 1985, Bank of the West discovered that TEC had in some cases bought a property and then re-sold it at a higher price with 100% financing, carrying the value on its books at the higher re-sale price. The case did not say whether Bank of the West's failure to learn this was due to sloppy underwriting, but whatever the reason, Bank of the West immediately notified Valley National Bank by telephone and the banks made no further loans to TEC after that. At this point, the total debt of TEC to the banks was about \$10.3 million, of which Valley National, as participant, had funded approximately \$4 million.⁸

During the next three months, Bank of the West did an investigation, eventually generating two reports – one short and one much longer -- both of which were critical of TEC. Bank of the West did not share these reports with Valley National. In fact, not until September 1985, did Bank of the West inform Valley National of the seriousness of the problems, which it did by sending TEC a letter freezing the line of credit⁹ and sending a copy to Valley National.

TEC filed for bankruptcy in February 1986, resulting in many disputes and much litigation. To quote the court:

"Its failure led to numerous lawsuits involving the banks. Hundreds of Technical Equities investors sued Bank of the West and others. Bank of the West sued Technical Equities accountants and underwriters. Bank of the West spent about \$5 million on settlements and almost \$6 million on attorneys' fees to defend against the investors' suits, and collected \$5 million in settlements from Technical Equities' accountants and others, leaving it with a net expense of about \$6 million."

Bank of the West then sued Valley National, seeking to recover one-half of the \$6 million as "Extraordinary Expenses". Valley National denied the claim and counterclaimed for fraud, based on Bank of the West's concealment of the two reports. At trial, Bank of the West won on the "Extraordinary Expenses" claim, but Valley National won a jury verdict on its fraud counterclaim. But the trial judge then set aside the jury verdict on the fraud claim because it found that (a) Valley National was contractually obligated to make the payment which brought its share up to 50%, so that payment was not based on fraudulent concealment of the reports (or their substance); (b) *Valley National was contractually obligated to make its own independent assessment of TEC's creditworthiness, so could not have justifiably relied on Bank of the West* [emphasis supplied], especially not after receiving a copy of the September letter to TEC; and (c) Valley National's loss was caused by TEC's collapse, not any concealment by Bank of the West.

Both banks appealed. The Ninth Circuit Court of Appeals addressed the fraud claim first and held that justifiable reliance was an element necessary to establish the claim and was entirely missing because of express wording in the participation agreement requiring Valley National to make its own assessment of TEC. Valley National claimed that regardless of the contract terms, it did in fact rely on Bank of the West for important information concerning TEC, and the Court of Appeals acknowledged that -- saying "so far as the record shows, Valley National participated in the loan without much independent evaluation, largely on the basis of Bank of the West's judgment." That was not sufficient, said the court:

“Valley National’s problem is that regardless of what they actually did, the banks expressly agreed to a relationship in which each would investigate independently and exercise independent judgment. . . . Valley National agreed that it ‘independently and without reliance upon any representations of Lender [Bank of the West] . . . made and relied upon [its] own credit analysis and judgment. . . . That necessarily implies that, *to the extent that it did rely on Bank of the West, Valley National’s reliance was not justifiable* [Emphasis added].”

So, even assuming a duty to exercise reasonable care in making the loan, that duty can be effectively undermined by the participation agreement. And, unfortunately, that is what our client had agreed to.

In our research, however, we ran across a case that offered another possibility. In *Banque Arabe et Internationale D’Investissement v. Maryland National Bank*,¹⁰, the court acknowledged that there could be a claim for breach of a duty to disclose, if the lead knew something not known to the participant.

Banque Arabe was successor by assignment to BAII Banking Corp. (“BAII”). BAII had purchased a \$10 million participation in \$35 million of loans by Maryland National Bank (“MNB”) to eight affiliated real estate partnerships. The loans defaulted and Banque Arabe eventually sued MNB and an affiliate alleging negligent misrepresentation and breach of a duty to disclose certain information.

The court held that under New York law negligent misrepresentation is not actionable unless there is a special relationship of some kind between the parties and that the participation did not rise to such a level, being an arm’s length commercial agreement between sophisticated financial institutions. Similarly, without wording in the participation agreement to create it, the court declined to find any fiduciary relationship between the parties.

But the court did say that there could be a claim for breach of a duty to disclose in three situations, one of which is “where one party possesses superior knowledge not readily available to the other, and knows that the other is acting on the basis of mistaken knowledge”.

Perhaps, we thought, our client might have such a claim. Did the lead know something important which it failed to disclose and which was not otherwise “readily available” to our client? We explored the issue with the client, but to no avail. So far as the client knew, there was no material information withheld by the lead. The basic story was that the economic downturn had adversely affected the borrower’s business, a risk that our client admitted to us it had considered and elected to ignore when it purchased the participation.

We were forced to conclude, and advise our client, that we could not make a credible argument that there was any breach of duty by the lead or that one would arise if the lead sold its interest in the loan and the collateral security.

We turned then to the question of whether the client might have some recourse against the borrower. Here, too, the caselaw was not very helpful, sometimes surprisingly so. In the second part of this article we’ll visit the cases, several of which involve the demise of Penn Square Bank and its repercussions. Following that discussion, we will present the reader with a list of issues to be considered when a participation is being documented.

ARTICLE 9 - FORECLOSURES SALES; A UNIQUE APPROACH/SAFE HARBOR?

(This article was first published in the June 2012 issue of *The Secured Lender*, a publication of the Commercial Finance Association, and is reprinted with permission.)

By Barry Freeman

Overview

This article suggests a different approach and possible "safe harbor" for a UCC Article 9 foreclosure sale. Article 9 prescribes a statutory framework governing the foreclosure process for personal property security interests, which are set forth in the default provisions of Chapter 6 of the Revised Uniform Commercial Code (the "Code") commencing at Section 9-601 through 9-629.¹¹ A basic concern a secured creditor faces in a foreclosure sale is the requirement to accomplish the disposition in a "commercially reasonable" manner, as required by the Code.¹² Failure to conduct a commercially reasonable sale exposes the secured party to post sale defenses and damages asserted by the debtor, guarantors, and possibly other third parties such as creditors or trustees in bankruptcy. Depending upon the gravity of the failure to comply with the Code, potential claims of subordination may also

be asserted in a bankruptcy case, especially when dealing with a private UCC sale to insiders or existing management who have recently formed new entity ("Newco") to acquire the assets (the "Friendly Foreclosure").

Two common issues frequently encountered need to be addressed by the foreclosing secured creditor: First, what is the best and safest course of action to take to sell the assets, i.e. public sale, private sale or acceptance of the collateral in partial or full satisfaction of the debt.¹³ If either of the first two options are chosen (public or private sale), the secured party needs to determine who should conduct the sale, how it should be advertised, does a landlord's waiver exist, etc. Rarely will the secured party conduct the sale on its own and if it did, would such a decision be commercially reasonable? The norm is to employ a professional such as an auctioneer.

Second, regardless of whether a public or private sale is pursued, the secured party must carefully proceed to avoid future challenges. In the case of a private sale to former insiders or management of the debtor, extra care is needed to avoid challenges and claims of bad faith, fraudulent conveyance, etc.

Thus, having a fiduciary, such as an assignee for the benefit of creditors ("ABC"), who concurrently conducts the ABC sale with the foreclosure sale as the agent of the secured party, may insulate the secured party and substantially reduce the exposure to a successful challenge to the disposition. The "agency" must be clearly defined and documented so that the fiduciary duty owed by the assignee to the debtor's creditors is not compromised. In addition, the credibility and reputation of the assignee may enhance the sale and perhaps generate a greater return. There are also advantageous statutory provisions supporting the joint sale approach, which are discussed below.

An ABC is similar to, but also unlike a bankruptcy under Chapter 7 or 11 of the Bankruptcy Code. Commencing an ABC does not create an automatic stay¹⁴, nor is there a plan process or a contract rejection procedure available. However, under California law¹⁵, there are statutory provisions that enhance the common law assignment procedure. For example, writs of attachments obtained within 90 days of making the assignment are voided,¹⁶ and Civil Code provisions restrict lessors from exercising remedies for a period of 90 days from the date of the ABC.¹⁷ Upon commencement of the assignment the debtor's property is beyond the reach of third party unsecured creditors. However, the assignee takes debtor's property subject to all existing liens and there is no stay or injunction preventing secured creditors from exercising rights. Thus, to some extent the success of the assignment proceeding is consensual. Also, filing an involuntary petition in bankruptcy is available to recalcitrant unsecured creditors which filing may terminate the ABC¹⁸.

The California assignee can also pursue preferences under Code of Civil Procedure 1800. However, 9th Circuit Federal courts do not accept this position, ruling that that state law preference recovery runs afoul of the supremacy clause.¹⁹ California intermediate Courts of Appeal have declined to follow the 9th Circuit holding that the 9th Circuit decision is not binding upon State courts.²⁰ It is beyond the scope of this article to address the supremacy clause issue or other generic comments comparing the cost and burdens of ABC's versus a bankruptcy case. The focus of this article is addressing the benefits to a secured creditor of utilizing the ABC as its agent to conduct the Article 9 Foreclosure.

Sales of Assets Jointly by Assignee and Secured Creditor

As noted above, Article 9 prescribes the procedures that must be followed in disposing of collateral²¹. These rules require the secured creditor to proceed in a "commercially reasonable manner" and prescribe the consequences of not complying with the Code²².

Section 9-617 specifies that a transferee acquires the following rights at a foreclosure sale which are:

1. All of the debtor's rights in the collateral;
2. A discharge of any junior security interest in the collateral (assuming appropriate notice has been given); and
3. A discharge of the lien of the secured party.

On the other hand, when the assignee for the benefit of the creditors ("Assignee") sells the assets/collateral, the sale also transfers to the purchaser all of the assignor's (debtor's) rights to the collateral, but this sale is subject to valid liens all of which survive the sale unless the secured party consents to releasing its lien on the asset sold and agrees to having its lien attach to the proceeds. Thus, by combining the Article 9 sale with the Assignee's sale (by having the Assignee act as the agent of the secured party and conducting a joint sale), the result is that the sale is no longer subject to the liens of the foreclosing creditor and all those liens junior to it, and the sale transfers to the purchaser whatever rights the debtor has in the collateral from both the Assignee and the foreclosing secured party. This device also limits the leverage that a junior lienor may have to obtain a "carve-out" or other consideration from the Assignee or the debtor in exchange for its consent. Of course, there will be a carve out of proceeds to cover the costs and compensation due to the Assignee from the sale proceeds, but these costs would most likely be incurred absent an ABC and in many cases are the subject of negotiation.

In addition and perhaps more important, a joint sale utilizing the Assignee is by statutory definition a "commercially reasonable" sale under the UCC.²³ This provision provides:

- " (c) A disposition ...is commercially reasonable if it has been approved in or by any of the following:....
(4) By an assignee for the benefit of creditors" (emphasis added).

Thus, another potential challenge to the sale (as long as it has been conducted in good faith) is eliminated. Of course, the Assignee must perform its fiduciary duties in connection with the sale and the administration of the ABC and ensure that:

1. If a public sale, it has properly been advertised; and
2. If a private sale, the Assignee should shop the offer from the "friendly parties" and obtain appropriate appraisals or other validation of the fairness of the "Friendly Foreclosure."²⁴
3. In either case all notices, as required by the UCC, have been properly and timely given (unless waived post default as per the Code.²⁵

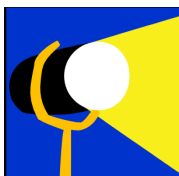
Proceeding as suggested gives a distinct advantage to the secured creditor and in the case of a "Friendly Foreclosure" or a private sale to "Newco", it also benefits the purchaser. The Assignee obviously benefits, earns a fee and the ABC estate may realize a greater return for the assets and perhaps create a distribution to the creditors of the debtor assignor. If such distribution will not be possible, it may result in a negotiation between the assignor and the secured creditor as to what, if anything, should be "left on the table" for creditors. That discussion, however, is beyond the scope of this article.

Conclusion

Summarizing the foregoing, a joint sale by the Assignee who concurrently conducts the sale of the collateral as Assignee in the ABC and as the agent for the secured party, results in the transfer of ownership of the property to the purchaser, discharges the lien of the secured party, all junior liens and by statutory definition constitutes a "commercially reasonable disposition". Thus, the rights to recover the deficiency and proceed against guarantors may be preserved and challenges to the sale minimized. In addition, the purchaser obtains the benefit of a "commercially reasonable" disposition and may avoid future challenges as well. Thus, it may be a "win/win".

UCC Spotlight

By **Stephen L. Sepinuck** and **Kristen Adams**

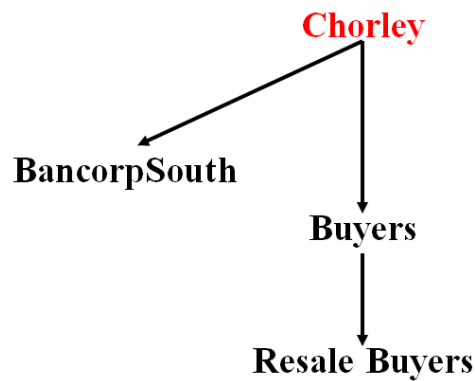


The purpose of this column is to identify some of the most disconcerting judicial decisions interpreting the Uniform Commercial Code or related commercial laws. The purpose of the column is not to be mean. It is not to get judges recalled, law clerks fired, or litigators disciplined for incompetence.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

BancorpSouth Bank v. 51 Concrete, LLC, **[2012 WL 1269180](#) (Tenn. Ct. App. 2012)**

This case involves a conversion action against buyers of collateral. While the court correctly treated the buyers as liable for conversion, it improperly held them responsible for the attorney's fees incurred by the secured party in bringing the action.

The facts are relatively straight forward. The debtor, John Chorley, granted BancorpSouth a security interest in equipment, including a bulldozer, an excavator, and a backhoe. BancorpSouth perfected its interest by filing a financing statement. Subsequently, the debtor sold the three items to two buyers, who later resold the items to their own customers. Chorley defaulted on the debt to BancorpSouth and sought bankruptcy protection. BancorpSouth then brought a claim for conversion against the two buyers.



Included in BancorpSouth's action was a request for attorney's fees. The trial court ruled that there was no statutory or contractual basis for an award of attorney's fees. The Tennessee Court of Appeals reversed, concluding that both a statutory and contractual basis existed for awarding attorney's fees.

For the statutory basis, the court relied on § 9-607(d), which authorizes a secured party to deduct from commercially reasonable collections on collateral the reasonable expenses it incurred in collecting, including attorney's fees. But for several reasons this provision was not properly applicable. First, as comment 3 makes clear, § 9-607 deals with collections from an account debtor or other person obligated on collateral. In other words, it applies only when the collateral consists of a right to payment. Here, the collateral was equipment in the hands of the original debtor and inventory in the hands of the buyers; equipment is not a receivable. Even if § 9-607 had been applicable, subsection (d) would authorize the secured party to subtract its attorney's fees only from the amounts collected. In other words, it allows a secured party to effectively charge *the debtor* for attorney's fees by allowing the secured party to recover those fees from the proceeds of the collateral. Subsection (d) does not impose liability on *the account debtor* for attorney's fees incurred in collecting. Of course, the agreement giving rise to the receivable could provide for recovery of attorney's fees from the account debtor. But if it does not, the account debtor should not be responsible for those fees. After all, an account debtor has no control over whether its creditor – the debtor – uses the receivable as collateral. *See* § 9-406. If the conclusion of the court of appeals were correct, an account debtor that expressly bargained not to be liable to its creditor for attorney's fees would find its bargain undermined by the creditor's unilateral action of using the receivable as collateral. Article 9 does not so lightly interfere with parties' contract rights.

With respect to the contractual basis for awarding attorney's fees, the court relied on § 9-201(a), which provides that "a security agreement is effective according to its terms between the parties, against purchasers of the collateral, and against creditors." The court read this language literally, concluding that it made the debtor's security agreement, which included a provision on attorney's fees, binding on the buyers. But this literalist approach leads to absurd results. It would make a buyer of collateral obligated to perform all kinds of covenants that the debtor promised to perform – such as providing periodic financial information – even though the buyer had no knowledge of the security interest or of the terms of the security agreement. Indeed, the court's literalist approach would bind not only buyers, but all creditors of the debtor, which would include involuntary creditors, such as tort victims.

More important, the court's conclusion is belied by comment 2 to § 9-201. That comment reminds the reader that the "security agreement" referenced in the section is merely "an agreement that creates or provides for a security interest." *See* § 9-102(a)(73). Thus, the only thing that § 9-201(a) makes binding on third parties is the portion of the agreement that creates or provides for a security interest. Indeed, as the comment further explains, § 9-201(a) does not make other terms in a record that constitutes a security agreement binding on third parties. The court of appeals' decision is simply wrong.

In re Negus-Sons, Inc.,
[2012 WL 1110026](#) (Bankr. D. Neb. 2012)

This case involved perfection of a security interest in accessions: that is, in goods that become physically united with other goods in such a way that the identity of the goods is not lost. *See* § 9-102(a)(1). Unfortunately, the court confused rules on priority with rules on perfection and may have reached the wrong result.

Wells Fargo Equipment Finance, Inc. ("Wells Fargo") issued a \$4 million line of credit to Negus-Sons, Inc., a company that performed earth-moving work for construction projects. The debt was secured by numerous items of the debtor's equipment. The debtor used the line of credit to purchase a customized, heavy-duty truck with separately purchased service body and crane attachments. In connection with the draw on the line of credit, the parties amended the loan agreement to add the truck, service body, and crane to the list of collateral and Wells Fargo filed an amendment to its financing statement to cover the truck and "all

attachments, replacements, substitutions, additions and accessions” thereto. The debtor later applied for a certificate of title for the truck. Neither the application nor the certificate indicated Wells Fargo’s security interest.

Two years later, the debtor filed for bankruptcy protection. The truck was sold and litigation ensued between Wells Fargo and the trustee about who was entitled to the sale proceeds. The court treated the case as involving two issues: (i) whether Wells Fargo had a perfected security interest in the truck; and (ii) whether Wells Fargo had a perfected security interest in the service body and crane installed on the truck.

On the first issue, the court correctly ruled that Wells Fargo’s interest in the truck was unperfected because the interest was not noted on the certificate of title. *See* § 9-311(a)(2). Wells Fargo argued that its interest was nevertheless perfected pursuant to a Nebraska statute that provides that “a purchase-money security interest . . . in a vehicle is perfected against the rights of judicial lien creditors and execution creditors on and after the date the purchase-money security interest attaches.” Neb. Rev. Stat. § 60-164(2). However, the court indicated that the purpose of this provision was merely to clarify that lienholders who advance funds for the purchase of a motor vehicle are protected between the time the lien attached and is perfected. More important, the provision was enacted the year *after* Wells Fargo acquired its security interest in the truck and the court concluded that there was no basis for giving the enactment retroactive effect.

On the second issue, Wells Fargo argued that its amended financing statement, by expressly covering the truck and accessions thereto, perfected its security interest in the service body and crane. It is on this issue that the court went astray. The court looked to § 9-335(d), which provides that “a security interest in an accession is subordinate to a security interest in the whole which is perfected by compliance with the requirements of a certificate-of-title statute.” Interpreting this provision, the court ruled that because the truck was titled after the service body and crane were installed and thereby became accessions, “any perfection by title controls so that subsequent creditors need check only the title records, rather than the title records and the U.C.C. records.” Based on this ruling, the court concluded that the bankruptcy trustee’s rights as a lien creditor with respect to the service body and crane take priority.

The court’s analysis is flawed. Section 9-335(d) is a priority rule, not a perfection rule. Indeed, it is about priority among secured parties, not priority between a secured party and a lien creditor. Thus, it has no relevance to a bankruptcy trustee’s rights. Indeed, § 9-335 as a whole says very little about perfection. Its only clause relevant to perfection is subsection (b), which provides that “[i]f a security interest is perfected when the collateral becomes an accession, the security interest remains perfected in the collateral.”

In fact, Wells Fargo argued that subsection (b) applied, claiming that the truck was not subject to perfection under the titling statutes when it filed the amendment to its financing statement because no certificate of title had been issued and no application for a certificate had been delivered to the proper authorities. However, on this point, Wells Fargo confused the rule on governing law with the rule on perfection. Prior to submission of an application for a certificate of title, the law governing perfection is the law of the debtor’s location; after submission of the application, the governing law is the law of the state in which the application is submitted. *See* § 9-303. But in either case, if the applicable law requires compliance with a certificate of title statute, then filing a financing statement will not be effective to perfect the security interest. *See* § 9-311(a)(2). Thus, subsection (b) was simply not relevant to the perfection issue and the court was correct in so ruling.

However, that ruling does not dispose of the issue. Whether Wells Fargo’s security interest in the service body and crane was perfected is actually an interesting and difficult question. The debtor took possession of the truck, with the service body and crane installed thereon, before Wells Fargo filed its amended financing statement. Thus, Wells Fargo’s security interest in the service body and crane would be perfected only if filing remained an effective perfection step after those items of equipment became accessions to the truck. Because Article 9 defers to certificate of title laws only to the extent that those laws require notation on a certificate of title as a condition or result of perfection, *see* § 9-311(a)(2), presumably this is an issue on which Nebraska’s certificate of title statute must be consulted. If the act is silent as to accessions to titled vehicles, then filing a financing statement should remain a proper way to perfect a security interest in those accessions and Wells Fargo’s filing would have been sufficient. Thus, Wells Fargo’s security interest in the service body and crane may or may not have been perfected. What is clear, however, is that nothing in § 9-335 speaks to this issue and certainly not the provision the court relied upon: § 9-335(d).

In re Wilkinson,
[2012 WL 1192780](#) (Bankr. N.D.N.Y. 2012)

In re Miller Brothers Lumber Co.,
[2012 WL 1601316](#) (Bankr. M.D.N.C. 2012)

These two cases concerned the effect of a lapse in perfection of a security interest after the debtor entered bankruptcy. The *Wilkinson* court ruled that priority is settled as of the petition date, and thus the lapse in perfection did not affect priority over a

competing secured party. The *Miller Brothers* court ruled that priority was not settled as of the petition date and that therefore the debtor in possession could use the strong arm powers to avoid the security interest. In fact, despite the seemingly inconsistent rulings, both decisions are wrong. Each court failed to appreciate how a loss of perfection affects priority under Article 9. Specifically, it can affect priority against a competing secured party but has no impact on the rights of a judicial lien creditor whose interest was acquired while the security interest was perfected.

The facts of the *Wilkinson* case can be summarized as follows. The debtor ran a dairy farm on his mother's property. He purchased his mother's dairy herd in 2005 and she retained a purchase-money security interest in the herd to secure the unpaid portion of the purchase price. The mother perfected the security interest by filing a proper financing statement in 2006. In 2009, the Farm Service Agency ("FSA") acquired a security interest in the debtor's herd and also perfected by filing.

The debtor filed for bankruptcy protection in 2010, when both security interests were perfected. In 2011, with the bankruptcy case still pending, the mother's perfection lapsed. A few months later, the debtor sold the cows and an issue arose about who was entitled to the sale proceeds.

The FSA claimed that, under § 9-322(a)(2), it now had the senior security interest. In doing so, the FSA noted that revised Article 9 omitted from § 9-515 the bankruptcy tolling provision that had been included in former § 9-403(2), and that § 362(b)(3) provides that filing a continuation statement does not violate the automatic stay. Thus, nothing in the law prevented the mother from maintaining perfection or insulated her from the consequences of failing to do so. In response, the mother cited judicial opinions for the proposition that bankruptcy principles control priority and fix the rights of the debtor, creditors, and the trustee as of the time of the bankruptcy filing.

The court sided with the mother. In doing so, it relied in part on § 9-515 comment 4, which states that "if the debtor enters bankruptcy before lapse, the provisions of this Article with respect to lapse would be of no effect to the extent that federal bankruptcy law dictates a contrary result (e.g., to the extent that the Bankruptcy Code determines rights as of the date of the filing of the bankruptcy petition)." The court then cited to *In re Bond Enters., Inc.*, [54 B.R. 366](#) (Bankr. D.N.M. 1985), and a case it relied upon, *Lockhart v. Garden City Bank & Trust Co.*, [116 F.2d 658](#) (2d Cir. 1940), for the proposition that priorities are indeed established on the petition date.

What the court failed to realize, however, was that neither of these cases dealt with the rights of a competing secured party. *Lockhart* dealt with the rights of the trustee and *Bond Enterprises* dealt with the rights of the debtor in possession. Thus, each dealt with the rights of a person claiming the status of a lien creditor. But Article 9 itself treats lien creditors and secured parties very differently with respect to a competing secured party's loss of perfection. When perfection lapses, the originally perfected security interest is deemed never to have been perfected as against "a purchaser of the collateral for value." § 9-515(c). A secured party is a purchaser for value but a lien creditor is not. See § 1-201(b)(29), (30). Thus, a person who becomes a lien creditor when a security interest is perfected takes subject to that security interest and remains subject to it even if perfection subsequently lapses. See § 9-515 comment 3, ex. 2. See also § 9-317(a); *In re Stetson & Assocs., Inc.*, [330 B.R. 613](#) (Bankr. E.D. Tenn. 2005). However, a competing secured party will find that its originally junior security interest has moved into a senior position. See § 9-515 comment 3, ex. 1. In short, by citing to and relying upon old and inapposite cases, the *Wilkinson* court misapplied the law.

Moreover, the court's decision creates an anomalous result: the relative priority of the security interests will depend on whether the collateral is sold in bankruptcy or outside of it. According to the court's decision, if the collateral is sold during bankruptcy, priority will be accorded to the senior secured party whose perfection lapsed. Presumably, however, if the case is dismissed or relief from the stay is granted, and one or both of the secured parties disposes of the collateral outside of bankruptcy, Article 9 will control the priority issue, with the result that the senior secured party whose perfection lapsed will lose. Assuming this is correct, the parties will then have incentive to fight in bankruptcy about whether and when to allow the collateral to be sold. If the estate has no equity, which is when priority matters most, then the court has no reason to be involved in the sale and no basis on which to decide whether to sustain or overrule an objection to it.

The facts of the *Miller Brothers* case are even simpler. American Bank had a security interest in some of the debtor's equipment and that interest was perfected by a financing statement filed in October 2006. The debtor filed a Chapter 11 bankruptcy petition in September 2011 and American Bank never filed a continuation statement. When American Bank filed a motion for relief from the stay or adequate protection, the debtor in possession objected.

The court's analysis was quite brief. After noting that nothing in revised Article 9 prevents a financing statement from lapsing during the debtor's bankruptcy and that § 362(b)(3) allows the secured party to file a continuation statement without violating the automatic stay, the court concluded that the bank's perfection had lapsed. The court then added, without any analysis and despite that fact that the matter before it was not an avoidance action, that the debtor "may avoid American Bank's security interest pursuant to its strong arm powers under Section 544."

The court's first conclusion – that perfection had lapsed – was correct. Its second conclusion about avoidance was wrong. The debtor in possession's strong arm powers are based on its status as a lien creditor. *See* §§ 544(a)(1), 1107(a). But, as discussed above, a creditor who acquires a judicial lien on property subject to a perfected security interest does not obtain priority even if the security interest subsequently becomes unperfected.

For these reasons, the decisions in these cases were misguided and should not be relied upon.

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Compiled by Commercial Law Newsletter Co-Editors Annette C. Moore, Carol Nulty Doody, Glen Strong, Celeste B. Pozo, Christina B. Rissler and Rebecca Gelfand

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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 International 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. This 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 the Joint Review Committee for Uniform Commercial Code Article 9. You can access this information at [http://www.uniformlaws.org/Committee.aspx?title=Commercial Code Article 9](http://www.uniformlaws.org/Committee.aspx?title=Commercial%20Code%20Article%209)
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) is 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 is available at http://www.hcch.net/index_en.php

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ENDNOTES

- ¹ See *Guaranty Sav. & Loan v. Ultimate Sav. Bank*, 737 F. Supp. 366, (W.D. Va 1990) and *Bank of the West v. Valley National Bank of Arizona*, 41 F.3d 471, (9th Cir. 1994), discussed below, where the courts noted that without the participation agreements, the lead would not have been able to make the subject loan because of its lending limit.
- ² See *Carondelet S. & L. Ass'n v. Citizens S. & L. Ass'n*, 604 F.2d 464 (7th Cir. 1979), where the court said that unless the agreement imposed an obligation of the lead bank to foreclose in the event of default, the lead bank had no such duty.
- ³ 919 F.2d 510 (9th Cir. 1990).
- ⁴ 811 F.2d 1255 (9th Cir. 1987).
- ⁵ 12 Kan. App. 2d, 788, 758 P.2d 236 (Ct. App. 1988)
- ⁶ 1988 WL 192369 (N.D. Tex.).
- ⁷ 41 F.3d 471 (9th Cir. 1994).
- ⁸ The participation agreement called for Bank of the West to be first-in, last-out. Therefore, Valley National was only called to advance funds after Bank of the West had funded. In October, Valley National brought its share of the total loans up to 50% of the total by funding to Bank of the West an additional \$1.18 million.
- ⁹ Valley National, obviously disturbed, had frozen its line much earlier, in April, 1985.
- ¹⁰ 819 F. Supp. 1282 (S.D. New York 1993)
- ¹¹ All citations are to the California Uniform Commercial Code unless other indicated.
- ¹² Commercially reasonable dispositions are a question of fact and are judged by "hindsight" (UCC 9-627).
- ¹³ UCC 9-610, 9-621-9-623
- ¹⁴ Section 362 of the Bankruptcy Code
- ¹⁵ This article will discuss some unique provisions of the California law but the central theme of a joint sale is applicable to most states (excepting those whose ABC procedure is Judicial and then the Code protects sales accomplished pursuant to a judicial proceeding. See UCC 9-627 (c)(1).
- ¹⁶ Cal. Code of Civil Procedure Section 493.030
- ¹⁷ Cal. Civil Code 1954.1
- ¹⁸ 11 USC 543-Turnover of Property by a Custodian.
- ¹⁹ Sherwood Partners, Inc v. Lycos, Inc., 394 Fed 3rd 1198 (9th Circuit 2005)
- ²⁰ Haberbush v. Charles and Dorothy Cummins Family Limited Partnership, 139 Cal. App. 4th 1630 (2006); Credit Managers Ass'n of Cal. v. Countrywide Home Loans, Inc., 144 Cal. App. 4th 590 (2006)
- ²¹ UCC 9-601-9-627, see generally Thomas R. Zinneker The Default Provisions of Revised Article 9, American Bar Association 1999
- ²² UCC Section 9-625
- ²³ UCC 9-627(c) (4)
- ²⁴ A discussion of "successor liability" is beyond the scope of this article.
- ²⁵ UCC 9-624