

Commercial Law Newsletter

Joint Newsletter of the Commercial Finance and Uniform Commercial Code Committees



March 10, 2014

Spring 2014

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Joint Report from the Chairs

Dear Members:

In a few short weeks, many of us will gather in Los Angeles for the Business Law Section's spring meeting (Thursday, April 10-Saturday, April 12, JW Marriott Los Angeles at L.A. Live and the Ritz-Carlton Los Angeles). You'll recall that our Section will not offer CLE or committee meetings at this summer's American Bar Association annual meeting. Instead, we'll participate in the first offering of BLS's stand-alone annual meeting. Patterned on our spring meetings, the first such annual meeting will be held on Thursday, September 11 to Saturday, September 13 in Chicago.

At this year's spring meeting, Com Fin and UCC are prime sponsors of six CLE programs: (i) Current State of the Syndicated Loan Market (Thursday, April 10, 10:30-12:30), (ii) Advanced Issues in Guaranties and Suretyship (Thursday, April 10, 2:30-4:30), (iii) Choice of Law Rules for Cross-Border Disputes (Friday, April 11, 8:00-10:00), (iv) The Nuts, Bolts, and Widgets of Asset-Based Lending (Friday, April 11, 8:00-10:00), (v) Commercial Law Developments 2013-2014 (Saturday, April 12, 10:30-12:30), and (vi) Do I Have a Choice: Bank-Customer Commercial Account Deposit and Payment Agreements (Saturday, April 12, 2:30-4:30). As always, our committees and the vast majority of our subcommittees and task forces will be meeting. Schedules are being finalized. If you're able, consider joining us, whether in person or via conference phone. We'll provide detailed schedules and dial-in information as the dates draw nearer.

In this edition of the newsletter, we offer five (5) diverse articles. Matthew C. Brown, Susan M. Kennedy, and Joseph W. Martini explore termination for convenience, from its historical beginnings to its refection in UCC Article 2. Their insightful article tells you what you need to know before ending up on either side of this interesting issue. Scott Burnham considers determining the weight to be given different authority in commercial cases. Using as his springboard differences in state and federal court decisions, he considers the interests of unity, reasoning, and underlying purposes and policies. Paul Hodnefield offers insights into the often overlooked administrative rule requirements of Article 9. These rules establish the procedures for acceptance or refusal of records, indexing practices, and search logic, specifying permissible methods of delivery for records and search requests, the calculation of filing times for records delivered by each method, calculation of the six-month continuation window, and the rules applied to search requests. David A. Surbeck explains the requirement that anyone providing credit support for swap obligations qualify as an "eligible contract participant," and summarizes market responses as commercial lenders and borrowers have needed to limit who can provide credit support for swap obligations. The Loan Syndications and Trading Association looks back on 2013's enthusiastic markets, and ahead to 2014's regulatory challenges. Additionally, as a featured note, the Loan Syndications and Trading Association shares with us its recent Market Advisory considering the transfer of administration of the London Interbank Offered Rate (LIBOR) from the British Bankers' Association to ICE Benchmark Administration.

We hope you enjoy this issue, and invite you to get involved in your committee(s).

[Neal J. Kling](#)

Commercial Finance Committee Chair
NKling@Shergarner.com

[Norman M. Powell](#)

UCC Committee Chair
NPowell@ycst.com

MARK YOUR CALENDARS

March 19, 2014 – 12:00 p.m. to 1:30 p.m. Central – Financial and Non-Financial End User Issues Under Dodd-Frank (CLE Webinar). Click [here](#) for more information.

March 20, 2014 – 1:00 p.m. to 2:30 p.m. EDT – Agents & Co-Lenders in Syndicated Facilities: Structuring Agreements to Balance Differing Rights and Obligations (CLE Webinar). Click [here](#) for more information.

March 20, 2014 – 1:00 p.m. to 2:30 p.m. EDT – Negotiating Financial Covenants in Non-Recourse Guaranties: Balancing the Interests of Borrowers, Lenders, and Guarantors (CLE Webinar). Click [here](#) for more information.

March 20, 2014 – 1:00 p.m. to 2:30 p.m. EDT – Bankruptcy Credit Bidding After Fisker Automotive: Warning for Lenders and Distressed Debt Investors (CLE Webinar). Click [here](#) for more information.

March 27, 2014 – 1:00 p.m. to 2:30 p.m. EDT – Third-Party Legal Opinions in Corporate Transactions (CLE Webinar). Click [here](#) for more information.

April 3, 2014 – 1:00 p.m. to 2:30 p.m. EDT – Structuring Covenants in Leveraged Loans and High Yield Bonds for Borrowers and Lenders (CLE Webinar). Click [here](#) for more information.

April 10-12, 2014 – ABA Business Law Section Spring Meeting – JW Marriott Los Angeles at L.A. Live and the Ritz-Carlton Los Angeles Los Angeles, California. Click [here](#) for more information.

April 29, 2014 – 1:00 p.m. to 2:30 p.m. EDT – Commercial Law Developments in 2013 (CLE Webinar). Click [here](#) for more information.

Please join us at the Spring meeting in Los Angeles. The Commercial Law Newsletter Editors will be holding a meeting at the Spring Meeting on Friday, April 11, 2014, from 12:30 pm -1:00 pm. in the Diamond Ballroom Salon 6, Fourth Level, of the JW Marriott Los Angeles. Current members of the Articles Advisory Board, as well as anyone interested in becoming involved with the Commercial Law Newsletter, whether by suggesting topics, writing articles or assisting with publication, are invited to attend.

UCC/ComFin Joint Dinner. Our UCC/ComFin Joint Dinner will be held in the evening on Thursday, April 10, 2014 at [Riviera Restaurant](#) in downtown Los Angeles, which is only two blocks away from the Spring Meeting location. Please plan to join us for some excellent Latin cuisine along with fabulous conversation. Additional details and ticket information to come.

LSTA MARKET ADVISORY ON LIBOR

By [Bridget K. Marsh](#)

LIBOR Administration Transfers to IBA

From time to time, the Loan Syndications and Trading Association (“LSTA”) publishes Market Advisories, which provide guidance on certain legal developments and loan market practices, for our members and others who are active participants in the primary and secondary syndicated loan market. We recently published a Market Advisory on the transfer of the administration of the London Interbank Offered Rate (“LIBOR”) from the British Bankers’ Association (“BBA”) to ICE Benchmark Administration (“IBA”) on February 1, 2014, following authorization by the Financial Conduct Authority in the UK.

The IBA LIBOR Market Advisory describes how the administration transfer could impact certain secondary loan trades entered before June 2013. The Advisory also discusses how references to BBA LIBOR in existing credit agreements may be interpreted by a New York court and encourages parties to update their credit agreement forms by replacing any references to the BBA as the body administering the determination of LIBOR with reference to the IBA. A copy of the LSTA’s Advisory which was distributed to our membership on January 29, 2014, is set forth below.

LSTA Market Advisory on IBA LIBOR

IBA has announced in a press release dated January 17, 2014 that it is scheduled to take over administration of the London Interbank Offered Rate (“LIBOR” or the “LIBO Rate”) from the BBA on February 1, 2014. The LSTA is issuing this advisory as guidance for interpretation of references to LIBOR in extant trade confirmation forms that may refer to BBA as the administrator of LIBOR and not expressly provide for succession of administration.

The current version of the LSTA’s Standard Terms and Conditions for Par/Near Par Trade Confirmations and for Distressed Trade Confirmations contain a definition of “LIBO Rate” that contemplates that the BBA could be replaced as the body administering the process of determination of LIBOR. The language in use in these forms now reads as follows:

“LIBO Rate” means, for any day, the 1-month London Interbank Offered Rate for deposits in the applicable currency as set by the British Bankers Association (or the successor thereto if the British Bankers Association is no longer making a London Interbank Offered Rate available) (“BBA”) and published by the BBA at approximately 11:00 a.m. London time on such day. For any day that is not a Business Day, the LIBO Rate for such day shall be the rate published by the BBA on the immediately preceding

September 11-13, 2014 – ABA
Business Law Section Annual
Meeting – Hyatt Regency Chicago,
Chicago, Illinois. Click [here](#) for more
information.

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AND DEVELOPMENTS OF THE
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Business Day.” The express reference to a successor to the BBA as LIBOR administrator was added in both forms of Standard Terms and Conditions for confirmations on June 28, 2013. The forms in effect prior to such date referred to the “London Interbank Offered Rate for deposits in the applicable currency as set by the British Bankers Association”, without indicating how the reference should be interpreted in the event that the BBA were to be replaced as the body administering the determination of LIBOR.

Because it is possible that certain loan trades entered into on the earlier version of these Confirmations may not have settled by February 1, 2014, the question may arise as to the appropriate interpretation of the reference to London Interbank Offered Rate in the Confirmations with respect to periods after February 1, 2014. We understand that IBA has confirmed, in its January 17 press release referred to above, that it does not currently intend to make any change to the methodology of calculation of LIBOR from that now used by BBA. Because we believe that the purpose of referring to “BBA” in the definition on the Confirmations was to identify an agreed-upon source of and process for determining LIBOR, we also believe that, absent unusual circumstances, the transition of administration from BBA to IBA should not represent a material change in the expectations of the parties to the Confirmation. After consultation with counsel, we believe that, absent some clear contrary intent as manifested by the words of the parties to a particular Confirmation, a New York court would likely interpret such references to the LIBO Rate as references to LIBOR as determined by IBA as successor administrator to BBA.

We are planning to update our forms of Standard Terms and Conditions for confirmations to reflect this development.

Although the LSTA's Model Credit Agreement Provisions do not contain a definition of LIBO Rate, a vast majority of the credit agreements in the syndicated loan market provide for loans that may accrue interest at a rate calculated by reference to LIBOR. The credit agreement forms in use by many lenders define LIBOR by reference to the British Bankers' Association Interest Settlement Rates (“BBA LIBOR”) for deposits in a certain currency. Consistent with our view expressed above, we believe that in the context of syndicated bank credit facilities, absent unusual circumstances, a New York court should interpret references to BBA LIBOR in existing credit agreements as a reference to LIBOR as determined by IBA. Nevertheless, we would encourage our members to update their credit agreement forms by replacing any references to the British Bankers' Association as the body administering the determination of LIBOR with references to ICE Benchmark Administration.

We intend to provide additional guidance as market practice evolves to reflect the developments in connection with LIBOR.

Bridget K. Marsh is Deputy General Counsel at The Loan Syndications and Trading Association. She can be reached at (212) 880-3004, or bmarsh@lsta.org with questions or comments.

Featured Articles

**TERMINATION FOR CONVENIENCE UNDER THE
UNIFORM COMMERCIAL CODE**

By [Matthew C. Brown](#), [Susan M. Kennedy](#), and [Joseph W. Martini](#)

Between suppliers and manufacturers, planning for the termination of a supply agreement during its negotiation may seem counterintuitive, awkward, or perhaps insignificant. Termination discussions often take a back seat in the conference room where the negotiating energy is spent primarily on price, quality, and delivery terms. As one court observed, termination is typically “of little interest or concern to the parties” so long as they execute the agreement and are “getting along.”¹ Why then should commercial parties burden their negotiations with ominous talk of termination related events? Does it make sense to even review that peculiar “termination for convenience” clause located at the end of a standard boilerplate agreement?

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Not only are termination for convenience provisions enforceable, they are becoming increasingly popular in supply agreements across diverse markets. Commercial parties have invoked them to reduce inventory, switch suppliers, and address plant shutdowns. Thus, before you agree to the possibility of being terminated for convenience, or have occasion to enforce a convenience provision, we consider how courts treat these terms and why addressing the end of a business relationship even at its beginning is sound business planning.

Termination for Convenience, Historically

Essentially, in an “at will” business agreement, termination for convenience permits “one party to terminate a contract, even in the absence of fault or breach by the other party, without suffering the usual financial consequences of breach of contract.”² The Union Government first used these clauses when unilaterally terminating vendor contracts during the Civil War in response to changing battlefield strategies.³ In World War II, the government used them in its standard fixed-price military supply contracts, utilizing the following contract language: *Termination for the Convenience of the Government. (a) The Government may, at any time, terminate this contract, in whole or in part by a notice in writing from the Contracting Officer to the Contractor that the contract is terminated under this Article.*⁴ After World War II, the government expanded convenience clauses beyond war time exigencies and they are now widely incorporated into federal military and civilian contracts.⁵

Termination for Convenience, Service Agreements

Private parties soon realized the benefits of convenience clauses and began using them in the construction and service industries. In deciding how they should be treated under the common law, the majority of courts have chosen not to extend the government’s “near *carte-blanc* power to terminate”.⁶ The rationale behind these decisions is that while the government’s broad ability to terminate may be seen as incidental to its sovereign immunity, a more stringent limitation on the right of private parties to terminate is required to render a contract non-illusory.⁷ Accordingly, courts – in service cases – have held that termination for convenience clauses must be exercised in accordance with implied contractual obligations of good faith and fair dealing.⁸ Exactly what constitutes good faith and fair dealing in the service context is defined largely by the agreement and underlying state law. For example, a Maryland state appellate court held that a contract is rightfully terminated for convenience if continuing with the contract would result in meaningful financial loss or other similar difficulty; on the other hand, termination merely to “recapture” an opportunity that the terminating party voluntarily lost constitutes bad faith.⁹ By contrast, Florida state courts have broadly held that convenience clauses may be exercised after reasonable notice, for nearly any reason, including the existence of profitable business relationships elsewhere.¹⁰

Termination for Convenience, the UCC

Courts have addressed termination for convenience clauses differently under the UCC than in the service context. At the outset, Section 2-309(2) of the UCC provides that contracts of indefinite duration are terminable at will by either party, even if not explicitly set forth in the agreement.¹¹ This section further states that when a contract is terminable at will (whether by operation of the code or explicit agreement of the parties), the terminating party has the right to terminate, for any reason, so long as it provides “reasonable” advance notification.¹² As set forth in comment 8 to Section 2-309, the rule requiring reasonable notification recognizes that good faith and sound commercial practice normally call for advance notification.

Based on these provisions, courts have enforced a reasonable notification requirement in UCC cases, but have not imposed the additional obligation of terminating in good faith.¹³ In short, the general rule is that, as long as reasonable notification under Section 2-309 is provided, broad termination for convenience clauses under the UCC allow one party to arbitrarily and unilaterally terminate a contract at will.¹⁴

Glen Strong
Editor (UCC)
Skadden, Arps, Slate, Meagher &
Flom LLP
(312) 407-0608

Celeste B. Pozo
Editor (UCC)
Hughes Hubbard & Reed LLP
(305) 379-7230

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Parties opposing termination for convenience have argued that an arbitrary termination violates UCC Section 2-304, which provides that “[e]very contract or duty within [the Uniform Commercial Code] imposes an obligation of good faith in its performance and enforcement.” Several courts, however, have rejected this argument. The Fifth Circuit, in the seminal case dealing with convenience clauses, held that the UCC’s good faith provisions do not override either the more specific requirement allowing termination at will, limited only by reasonable notification, or the parties’ freedom of contract.¹⁵ The Second and Sixth Circuits have taken similar positions.¹⁶

Negotiating Termination for Convenience Clauses: Why it Matters

Courts broadly enforce convenience clauses under the UCC. Accordingly, manufacturers and suppliers alike should understand their benefits and risks, and negotiate accordingly. Many supply agreements allow for work in progress payments, or “pipeline” payments, assuming termination for convenience occurs. Some suppliers simply hold their breath. Either way, placing these clauses on the front-burner of your negotiations will help set contract expectations, and may limit the nature of litigation disputes.

DETERMINING THE WEIGHT OF AUTHORITY IN COMMERCIAL CASES

By **Scott J. Burnham**

In *State Bank of Cherry v. CGB Enterprises, Inc.*,¹⁷ plaintiff bank sent defendant buyer notice of its security interest in farm products pursuant to the Food Security Act (“FSA”), but the notice did not include, as required by the FSA, “the name of each county or parish in which the farm products are produced or located.”¹⁸

The issue was simple enough: Is strict compliance with the statute required or is substantial compliance sufficient? But the trial court was faced with a dilemma – there were two conflicting authorities, one state and one federal. In *First National Bank in Toledo v. Effingham-Clay Service Co.*,¹⁹ the Illinois Appellate Court had held that substantial compliance was sufficient. But in *Farm Credit Midsouth, PCA v. Farm Fresh Catfish Co.*,²⁰ the Eighth Circuit Court of Appeals had held that strict compliance was required.

Reasoning that the decision of a superior state court was binding while the decision of a federal court was persuasive, the trial court felt compelled to follow the state court decision and held that substantial compliance was sufficient.²¹

On appeal, the Illinois Appellate Court reversed the trial court, stating that “neither [decision] is controlling on this court.”²² *First National Bank* was not binding because it was a decision of the Fourth District while this case arose in the Third District. In a prior case, the Third District had stated, “we are not required to follow decisions of other districts.”²³ In any event, *First National Bank* was distinguishable. In that case, neither the attorneys nor the court realized that the transaction was governed by the FSA and had argued the case under Article 9, which provided that substantial compliance with the requirements for an effective financing statement is sufficient unless the error makes the statement “seriously misleading.”²⁴

The Appellate Court held that the rule of *Farm Fresh* governed, not because it was binding authority, but because it was more persuasive for two reasons: (1) the issue involved the interpretation of a federal statute that had not been resolved by the United States Supreme Court, and (2) it was a well-reasoned opinion. The *Farm Fresh* court reasoned that unlike Article 9 and the central filing provision of the FSA, the notice provision of the FSA did not contain language permitting substantial compliance; therefore, the legislature must have intended strict compliance.²⁵ A dissenting judge agreed that *Farm Fresh* was not binding authority, but was not convinced by its reasoning.²⁶

The Illinois Supreme Court affirmed, summarizing its discussion of the weight of authority as follows:

Thus, uniformity of the law continues to be an important factor in deciding how much deference to afford federal court interpretations of federal law. While we are *bound* only by the United States Supreme Court, if the lower federal courts are uniform on their interpretation of a federal statute, this court, in the interest of preserving unity, will give *considerable weight* to those courts' interpretations of federal law and find them to be highly persuasive. However, if the federal courts are split, we may elect to follow those decisions we believe to be better reasoned.²⁷

Recognizing that Illinois is in the Seventh Circuit, the court added, "Further, we may afford a Seventh Circuit decision more persuasive value than we would the decisions of other federal courts, provided it is reasonable and logical."²⁸

Two concurring judges thought the majority's opinion might prove confusing since it had emphasized the importance of uniformity in a situation where there was only one precedent that was directly on point. The opinion concluded, "In my view, a single on-point decision, even if uncontradicted, does not constitute a 'uniform' body of precedent."²⁹

The statement of the majority opinion on the weight of authority seems correct when a state court is applying federal law. But what happens when the shoe is on the other foot, and a federal court is applying state law? Most of the time, a commercial matter governed by state law is litigated in federal court because of diversity jurisdiction. Under the Erie doctrine, the federal court must apply the law of the state that governs after the application of principles of choice of law.

In a number of jurisdictions, the federal court may certify the question to the highest court in the state, but more often the federal court will decide the issue as if it were a court of the state from which the matter arises. If there is precedent, either state or federal, then the rules articulated in *State Bank of Cherry* would apply. If the state has determined the issue, the court should follow the precedent of that state, and if it has not, then both federal precedents and precedents from other states can be considered.

A good example of the kind of analysis in which a federal court applying state law might engage is found in Judge Posner's opinion in *Northrop Corp. v. Litronic Industries*.³⁰ The issue involved the notorious gap in UCC § 2-207 – how should Illinois resolve the problem of different terms in the forms? Judge Posner asserted that the best solution was to treat different terms the same as additional terms. But he recognized that Illinois tended to adopt majority rules, which furthered the Code goal of uniformity found in what is now § 1-103(a)(3). He therefore held his nose and declared that Illinois would likely go along with the "knockout rule" that had been adopted by most jurisdictions, a solution he found to be "imperfect (but not downright bad)."³¹

The legal researcher has to be careful when researching the applicable law, for many search engines queried for authority on a topic in a particular state will return decisions from both the state courts and the courts in the federal system of which that state is a part. However, the engine probably does not discriminate among the federal cases, and will include those in which the court was applying the law of a state other than the state in issue. For example, a search for Montana cases in Westlaw will produce Ninth Circuit cases, but the Ninth Circuit cases may well involve the application of the law of states other than Montana. Presumably a federal district court applying Montana law would be bound by a Ninth Circuit precedent that applied Montana law. However, if the Ninth Circuit precedent had applied California law, the precedent would be merely persuasive.

On the other hand, when the case is heard in state court, the court is free to regard even the federal case applying its own law as merely persuasive. The federal court is in effect saying, "This is what we think your court would do," and the state court is free to respond by saying, "No we wouldn't." For example, in *AM International, Inc. v. Graphic Management Associates, Inc.*,³² Judge Posner was again tasked with resolving an issue under Illinois law, this time involving the interpretation of contract language. He reasoned that "[o]bjective' evidence is admissible to demonstrate that apparently clear contract language means something different from what it seems to mean."³³ Nevertheless, because the Illinois Supreme Court subsequently reaffirmed the more restrictive four corners rule in *Air Safety, Inc. v. Teachers Realty Corp.*,³⁴ the federal district court in *Kinesoft Development Corp. v. Softbank Holdings Inc.*,³⁵ stated that "Seventh Circuit decisions that express a different view of Illinois law than *Air Safety* – such as *AM International Inc.*... – do not control."³⁶

One final caveat. In *State Bank of Cherry*, the court stated that "we are *bound* only by the United States Supreme Court."³⁷ But before concluding that a Supreme Court case is binding, a practitioner must determine why the Court had jurisdiction over a commercial law matter that usually arises under state law. The Court, for example, held that strict tort liability did not apply to purely economic loss in *East River Steamship Corp. v. Transamerica Delaval, Inc.*³⁸ and held that a choice of forum clause was enforceable in *Carnival Cruise Lines, Inc. v. Shute*.³⁹ However, because these cases were decided pursuant to the Court's *admiralty law* jurisdiction, the precedent is binding only in matters of admiralty law. When a state court, or a federal court applying state law, faces these issues, the precedent is merely persuasive – perhaps highly persuasive, given the source.

In conclusion, when briefing a court, it is important not only to provide the court with relevant authority but to assist the court by indicating the weight of that authority. In matters governed by the UCC, an added wrinkle is the Code's "underlying purposes and policies." A decision that advances one of those policies⁴⁰ – such as modernizing the law or making it more uniform – can be given greater weight than other authority.

THE STATE OF FILING OFFICE ADMINISTRATIVE RULES FOR UCC ARTICLE 9

By [Paul Hodnefield](#)

Filing office administrative rules play a key role in the UCC search and filing process. The rules not only establish the filing office procedures to implement Article 9, they also provide critical information for those who file or search UCC records. The rules are so essential to the process that the official text of Article 9 specifically requires filing offices to adopt them.

Despite the importance of UCC rules, a surprising number of state-level filing offices⁴¹ continue to operate under outdated rules, do not publish their rules, or have never formally adopted UCC rules. This article explains the administrative rule requirements of Article 9, how filing offices originally implemented the rules and examines the current level of filing office compliance with the statutory requirements.

UCC § 9-526. Filing Office Rules

Revised Article 9, which took effect in most states in 2001, changed many longstanding filing office practices, including acceptable forms, indexing practices and the role of the filing office generally. The drafters of Revised Article 9 recognized the need for UCC rules to help guide filing officers through the transition and beyond. Consequently, Revised Article 9 included a provision, § 9-526, to address UCC rules.

Under § 9-526(a), the filing office "*shall adopt and publish rules to implement this article.*" (Emphasis added). The publication requirement was included to ensure that filing office stakeholders have access to the rules.

The drafters also recognized the importance of uniformity in UCC rules. To achieve and maintain the highest-possible degree of rule uniformity, § 9-526(b) requires the filing office to consult with filing offices in other states and with the Model Administrative Rules ("MARS") promulgated by the International Association of Commercial Administrators ("IACA") to harmonize the rules across jurisdictions. The official comments, however, recognize that some differences will be necessary due to particular state laws and filing office capabilities.

IACA MARS

To help filing offices implement Revised Article 9, a team consisting of IACA members and other filing office stakeholders drafted MARS. MARS sets forth policies and procedures consistent with the new law to serve as a guide for filing offices. Rule 200, for example, advises the filing office that its role with respect to the administration of the UCC is ministerial. Other rules establish the procedures for acceptance or refusal of records, indexing practices, and search logic.

MARS also includes critical information for filing office customers. Topics of particular interest for UCC customers include the permissible methods of delivery for records and search requests, the time of filing assigned for records delivered by each method, and how the filing office calculates the six-month continuation window. Perhaps most importantly, MARS sets forth the rules applied to search requests so interested parties are better able to interpret the search results.

Enactment & Adoption of Rules

The vast majority of states either enacted Revised Article 9 with the official text of § 9-526 or included substantially the same requirements. Most filing offices adopted UCC rules in 2001 to comply with § 9-526. However, more than 12 years after the law took effect, a few state-level filing offices in jurisdictions that enacted § 9-526 have either not adopted UCC rules or not published the rules under which they operate.⁴² The result is less guidance for those who file or search UCC records in those jurisdictions.

Five states enacted a non-uniform version of § 9-526 that made adoption of rules permissive or omitted the section entirely. Nevertheless, the filing offices in three of those states have adopted and published UCC rules.

Most filing offices have used MARS as the starting point for their UCC rules. More than 35 state filing offices adopted MARS without any substantial non-uniform deviations. Another seven state-level filing offices adopted an abbreviated version of MARS. Filing offices in the remaining states and territories did not base their UCC rules on MARS or failed to adopt any rules at all.

The widespread adoption of MARS does not mean the rules are entirely uniform from state to state. Even filing offices that adopted MARS often made minor changes. In some cases, those changes can have a big impact, especially when they affect the filing office's standard search logic.

Only 23 filing offices adopted the search logic rules exactly as set forth in MARS. Another 16 filing offices largely adopted the MARS search logic, but with modifications that generate slightly different results than would be the case if the same search were run using the uniform search logic. The remaining filing offices either have not published the standard search logic or use different search logic from that provided in MARS. As a result, standard search logic as contemplated for determining the sufficiency of a debtor name under § 9-506(c) is far from uniform.

Effect of the 2010 Amendments on UCC Rules

The 2010 Amendments to UCC Article 9 ("2010 Amendments") included statutory changes that rendered some existing UCC rules obsolete. Therefore, changes were necessary to avoid conflicts with the new law. For example, following the 2010 Amendments, filing offices no longer have statutory authority to reject a financing statement that fails to provide a debtor's type of organization, jurisdiction of organization, or organizational ID number. However, the rules adopted by some filing offices for Revised Article 9 specifically require the filing office to refuse a record that omits the organizational information. In such cases, the filing office faces a predicament. It can either disregard the outdated published rules and accept the record in compliance with the new law or follow the published rules and reject the record for a reason not permitted under the new law. Fortunately, the filing offices in jurisdictions that enacted the 2010 Amendments tend to follow the new law rather than conflicting obsolete rules.

Likewise, the 2010 Amendments changed the forms in a way that requires filers to provide long individual debtor names on the addendum form instead of the financing statement. Without updated UCC rules to provide documented procedures for dealing with excessively long individual debtor names there is an increased risk of filing office indexing errors or wrongful rejections.

The 2010 Amendments also use new terminology that makes the language used in prior versions of the rules outdated and potentially confusing. For example, the new forms, instructions and relevant statutes all refer to an individual debtor's "surname," "first personal name," and "additional names/initials." The rules in effect for most filing offices simply refer to these name components by their old terms of "last," "first," and "middle" names.

IACA recognized the need to update the UCC rules well before the new law took effect. At its 2012 annual meeting, IACA approved a new version of MARS that reflected the new terminology and revised procedures to help filing offices implement the 2010 Amendments.

Despite more than a year of lead time, most filing offices failed to adopt or publish updated rules by the time the 2010 Amendments took effect. In fact, as of January 2014 only 10 states have adopted and published updated rules. Nevertheless, most filing offices are operating in compliance with the 2010 Amendments despite published rules to the contrary.

One reason for the delay in adopting updated rules is that the law in many states requires the filing office to follow an often lengthy rulemaking process. In some cases, that process can take many months.

The good news is that several filing offices are currently in the midst of the rulemaking process. However, until all filing offices have completed the process there will continue to be apparent conflicts between the published rules and the 2010 Amendments. The result will be continuing uncertainty in certain situations for those who rely on the published rules for filing or searching UCC records.

Other Non-Uniform Rules & Practices

One ongoing concern with filing office UCC administrative rules is that some states adopted non-uniform provisions that appear to conflict with the statutory requirements of Article 9. Merely updating the rules to implement the 2010 Amendments may not resolve those issues.

The Missouri administrative rules provide a representative example. The filing office may reject a UCC record when it determines that the record is not created pursuant to Article 9, or is otherwise intended for an improper purpose.⁴³ However, Missouri enacted the uniform text of § 9-516(b) and § 9-520(a). These provisions prohibit the filing office from rejecting a record for the reasons listed in the rule. Moreover, the rules require the filing office to "cancel" a previously filed record that it later determines should have been rejected as improper. Nothing in Article 9 as enacted by Missouri grants the filing office such authority. While these rules may have been adopted with good intentions to address the problem of fraudulent UCC filing, they appear to directly conflict with the filing office's statutory duties.

Missouri is not alone. Other states have adopted non-uniform UCC rules under dubious statutory authority. The UCC rules adopted by the District of Columbia cite § 28:9-502 as authority for a provision that grants the Recorder of Deeds discretionary authority to refuse to file a document which is determined to be in non-compliance under D.C. law.⁴⁴ However, § 28:9-502 only addresses the requirements for sufficiency of a financing statement and § 28:9-520(a) generally prohibits the filing office from rejecting a record on that basis.

Conclusion

The majority of filing offices have yet to update their UCC administrative rules to reflect Article 9 following the 2010 Amendments. A few filing offices have not adopted or published rules at all. This state of affairs has the potential to increase the risk of inconsistent filing office operations and offers less guidance for those who file or search UCC records.

Fortunately, a number of state-level filing offices can be expected to adopt updated UCC administrative rules over the next year. Nevertheless, those who file or search UCC records need to be aware that the UCC rules of a particular filing office may be outdated and might not reflect current practices. If there is any question, interested parties should contact the filing office to verify whether a published rule still applies and, if not, how the filing office currently addresses the situation.

Paul Hodnefield is Associate General Counsel at Corporation Service Company. Please feel free to contact him with questions or comments at phodnefi@cscinfo.com or (800) 927-9801, ext. 62375.

PROVIDING CREDIT SUPPORT FOR SWAP OBLIGATIONS – DODD-FRANK REQUIREMENTS FOR COMMERCIAL LENDERS AND BORROWERS

By [David A. Surbeck](#)

March 31, 2014 marks the first anniversary of the end of a no-action period established by the Commodity Futures Trading Commission (“CFTC”) with respect to the requirement that any person or entity providing credit support for obligations of counterparties under a swap (“swap obligations”) qualify as an eligible contract participant (an “ECP”). This article provides a summary of the status of those requirements and some of the market responses to these requirements as commercial lenders and borrowers have needed to limit who can provide credit support for swap obligations.

Section 723(a)(2) of the Dodd-Frank Wall Street Reform and Consumer Protection Act, amended Section 2(e) of the Commodity Exchange Act (the “CEA”), making it “unlawful for any person, other than an eligible contract participant, to enter into a swap unless the swap is entered into on, or subject to the rules of a board of trade designated as a contract market under section 5.”⁴⁵ The definition of “swap”⁴⁶ was further interpreted, in a joint final rule (the “Final Rule”), by the CFTC and the Securities and Exchange Commission (“SEC”) to “include a guarantee of such swap, to the extent that a counterparty to a swap position would have recourse to the guarantor in connection with the swap.”⁴⁷ Finally, in October of 2012, the CFTC’s Office of General Counsel (“OCG”) issued its Letter No. 12-17, No-Action and Interpretation (the “No-Action Letter”), addressing the implementation of a number of amendments to Section 2(e) of the CEA, and providing further guidance, importantly for commercial lenders and borrowers, both (i) as to who can be an ECP and (ii) that (a) swap guarantors generally must be ECPs and (b) a non-ECP generally may not be jointly and severally liable for swap obligations. The No Action Letter left open a question as to whether providers of credit support other than guarantees (such as non-recourse pledges of assets) need to qualify as ECPs when providing credit support for swap obligations.⁴⁸

Since the end of the no-action period, lenders have needed to make sure to take certain steps when documenting and amending loan facilities and swaps to insure that they do not violate the CEA by accepting credit support for swap obligations from a non-ECP. These steps include determining:

- when credit support exists;
- when to verify the ECP status of an obligor;
- whether the entity or individual is an ECP at such time; and
- whether to seek credit support other than a guaranty from a non-ECP.

When Credit Support Exists

Currently, the guidance setting forth what actions or activities constitute a level of credit support that could require verification of ECP status is incomplete. As noted above, a guaranty is sufficient credit support, even when, as discussed in the Final Rule, the guaranty is fairly limited.⁴⁹ It is not surprising, absent further guidance from the CFTC, that some lenders elect to treat the pledge of collateral similar to a limited guaranty for the purposes of requiring ECP compliance. However, what is less clear is whether this logic

should or could be extended to general partners of partnerships or others in situations where no express agreement to provide credit support exists but where the person in question could be viewed as an obligor (i.e., by operation of law as where general partners are obligated for the obligations of their partnerships). Such an interpretation could raise issues for certain corporate structures (i.e., general partnerships and limited partnerships where the general partner is a single purpose entity), though express liability carve-outs could be added to documentation as a method to address this concern.

When to Verify ECP Status

An obligor of swap obligations must be an ECP at the time that it enters into the swap. Because an amendment to a swap could be viewed as a new swap, the prudent approach is to verify ECP status at the time the swap is entered into and at the time of any amendment to the swap. In addition, verification of ECP status of each guarantor (or other provider of credit support) should occur at the time the guaranty (or credit support) is provided for the swap obligations in question. Thus, verification of ECP status of potential obligors should be made at the time that:

- a swap is entered into;
- a swap is amended; and
- an obligor of swap obligations is being added to swap or loan documents.

While verification of ECP status should not be difficult for most borrowers, verification of ECP status for lenders, and particularly for agents on agent transactions, can be more problematic, particularly in existing facilities where borrowers (a) have an obligation or a right to join obligors (such as newly formed or acquired entities) as additional parties, or (b) can, without the consent of the agent, enter into swaps that obtain the benefit of guarantees and collateral. To address these and other concerns, lenders have been demanding representations from obligors, sometimes in stand-alone certificates, and adding “savings clause” style provisions, often based on language proposed by the Loan Syndications and Trading Association (“LSTA”) or by the International Swaps and Derivatives Association (“ISDA”) to their loan and swap documents (see further discussion below).

Determining Whether an Obligor is an ECP

Section 1a(18) of the CEA defines an ECP as a person that satisfies specific criteria set forth therein as implemented by CFTC Rule 1.3(m).⁵⁰ Commercial lenders and borrowers should be aware that different qualifications apply to entities and to individuals and be prepared to verify these qualifications at the time any person becomes an obligor with respect to a swap obligation.

Where the obligor is an entity (i.e., a corporation, partnership, proprietorship, organization, trust or other entity), there are three primary ways that it may qualify as an ECP: (i) under a total assets test; (ii) under a net worth test; and (iii) as the beneficiary of a guarantee of its obligations by certain ECPs.

A. Total Assets Entity ECPs

The total asset test is set forth in Section 1a(18)(v)(I) of the CEA, which provides that an obligor is an ECP if it “has total assets exceeding \$10 million” (a “Total Asset Entity ECP”). Total assets should be measured at the time the guaranty or other credit support is provided for the swap obligations, but, where the obligor is a borrower, the parties may consider the OCG’s additional guidance set forth in the No-Action Letter, allowing for “the cash proceeds of a loan [to] count toward the \$10 million in total assets threshold.” This interpretation permits the entering into of simultaneous loans and swaps where, without inclusion of the loan proceeds, the obligor would not otherwise qualify as an ECP, but would qualify upon inclusion of such proceeds. The OCG then extended this guidance to address circumstances where the parties desired to enter into the swap prior to distribution of some or all of the proceeds of a loan, by also granting, in the No-Action Letter, no-action relief that allows a borrower to count the proceeds of an anticipated loan towards its total assets prior to receiving such proceeds, as long as certain conditions, including the following, are met:

- the swap for which ECP status is necessary is intended to manage the borrower’s floating interest rate risk on the loan;
- the borrower has received a bona fide loan commitment for such loan, with the further clarification that a loan commitment will be bona fide if: (i) it is in writing; (ii) the loan closing is subject only to the satisfaction of commercially reasonable conditions to closing; and (iii) the loan commitment is entered into solely for business purposes unrelated to qualifying as an ECP; and
- in the case of a construction loan or other loan disbursed in stages, the lender intends at the time of making the loan, or commitment, to fund the entirety of the loan, subject only to satisfaction of commercially reasonable closing, and funding, conditions, provided that the failure of any such condition are not designed to permit the lender to fail to fund the loan while leaving the swap in place.

Lenders expecting to include future loan proceeds in total assets in order to qualify a borrower as an ECP should structure the related swap to terminate automatically or contemporaneously with the termination of the related loan as the CFTC raised concerns about the use of the no-action relief described in the No-Action Letter for purposes of evading the statutory requirement that only ECPs can enter into swaps.⁵¹

B. Net Worth Entity ECPs

Section 1a(18)(v)(III) of the CEA provides that an entity can qualify as an ECP if it “has a net worth exceeding \$1 million and enters into the transaction in connection with the conduct of its business or to manage the risk associated with an asset or liability owned or incurred or reasonably likely to be owned or incurred in the conduct of its business” (a “Net Worth Entity ECP”). When measuring the net worth of an entity, CFTC Rule 1.3(m)(7) allows an entity to count the net worth of its owners, subject to several technical requirements.

C. Guaranteed Entity ECPs

Section 1a(18)(v)(II) of the CEA provides that an otherwise non-ECP entity can obtain ECP status if its swap obligations “are guaranteed or otherwise supported by a letter of credit or other keepwell, support or other agreement by” one of various entities listed in the statute, including, for most commercial lending purposes, a Total Asset Entity ECP. In addition, in the No-Action Letter the OGC provided certain circumstances where it will not take action when a Net Worth Entity ECP or an individual ECP seeks to confer its ECP status onto a non-ECP entity by guaranteeing the swap obligations of such non-ECP entity.⁵²

D. Individual ECPs

Where the guarantor is an individual, there are two primary ways that the individual may qualify as an ECP based on the individual’s level of discretionary investments. In the No-Action Letter, the OGC has indicated that it would not recommend action where the determination of the “amounts invested on a discretionary basis” relied on the standards set forth by the SEC in the Investment Company Act of 1940 Rule 2a51-1. Rule 2a51-1 contains a list of “investments”, including (a) various categories of assets held for investment purposes (e.g., real estate and cash) and (b) securities in certain investment vehicles, public companies and in certain companies (e.g., “family” businesses) “with shareholders’ equity of not less than \$50 million”.⁵³

Section 1a(18)(xi)(I) of the CEA provides an individual can qualify as an ECP if he/she has amounts invested on a discretionary basis in excess of \$10 million. In addition, Section 1a(18)(xi)(II) of the CEA provides that an individual with discretionary investment in excess of \$5 million can also qualify as an ECP, as long as he/she is entering into the swap in connection with the conduct of her/his business or to manage the risk associated with an asset or liability owned or incurred or reasonably likely to be owned or incurred by her/him in the conduct of her/his business.

Whether to Seek Credit Support Other Than a Guaranty

As noted above, in the No-Action Letter the OGC left open the possibility that it would not view non-guarantee credit support (such as pledges of collateral without corresponding guarantees) as meeting the definition of a “swap” and would not, therefore, take action with respect to non-ECPs which provide credit support other than recourse guarantees. The need to obtain additional credit support for a related swap when credit support is already available for an underlying loan (including, e.g., the interest on the loan which is subject to such swap) is not often required for middle market and larger transactions, but in certain instances the lender may need to have credit support which extends to payments of swap obligations as well, and will need to evaluate whether the language in the No-Action Letter provides them sufficient comfort to obtain non-recourse credit support from non-ECP entities (such as small business owners).

Documentation

Prior to entering into a swap (or a loan which includes a swap), lenders will need initially to evaluate each obligor’s ECP status and determine whether revisions are required to any of the swap documents or loan documents to address any non-ECP obligors. Some lenders will require a separate certification from the obligors as to their ECP status, particularly if they are relying on the full credit support of all obligors to support the swap obligations. In these instances the lenders sometimes decide not to include “savings clause” terms in the documents because they have performed all the verification they believe is necessary to assure compliance with the CEA. However, where the documentation providing credit support for swap obligations is flexible enough to anticipate future obligors or future swaps, lenders regularly incorporate “savings clause” terms into the documentation, the effect of which are generally intended to both (a) exclude swap obligations from those obligations guaranteed by and/or secured by collateral of non-ECP entities, even if the result would be that some obligors provided support for a lesser portion of “obligations” than other obligors, and (b) take advantage of the keepwell provisions described above and in Section 1a(18)(v)(II) of the CEA. These saving clause terms take the form of additional and revised definitions (often revising the definition of “obligations” or “secured obligations”) and changes to clarify what obligations are supported by the guaranty or collateral of any non-ECPs.

The two forms of proposed terms most commonly added to documentation are based on the ISDA model terms set forth in publications “ISDA Non-ECP Guarantor Exclusionary Terms” and “ISDA ECP Guarantor Keepwell Terms,” each dated April 18, 2013 (collectively, the “ISDA Terms”) and the LSTA proposed terms set forth in their Market Advisory, dated February 15, 2013 (the “LSTA Terms”).

ISDA Terms

The ISDA Terms are designed so they may be incorporated by reference in any agreement, amendment or other writing (such as the trade confirmation of the swap or, alternately, in the schedule to the master agreement) and includes both exclusionary terms and keepwell terms.

The exclusionary terms are designed to remove non-ECP entities as guarantors of swap obligations, but are not intended to affect pledges of collateral from non-ECP entities that are not guarantors. In addition, the ISDA Terms treat any entity as an ECP if it has made a written representation to the effect that it is qualified as an ECP on the “Eligibility Date” (as defined therein, the “date on which a [guaranty] becomes effect with respect to [a swap]”) in question. However, such a written representation would need to be added separately, either within the agreement or with an additional document, and is not included in the ISDA Terms.

The keepwell terms are designed to allow for the identification of specific “Qualified Keepwell Providers” (or if none are specified, to treat all qualified guarantors as such), so long as they are Total Asset Entity ECPs or otherwise would qualify as an ECP on the Eligibility Date under Section 1a(18)(A)(v)(II) of the CEA. These Qualified Keepwell Providers lend their ECP status to guarantors of the swap obligations in question by agreeing to provide funds necessary to support the guarantor’s swap obligations (subject to fraudulent transfer limits).

LSTA Terms

The LSTA Terms are designed as additional definitions and provisions to add into loan documents and also include both exclusionary terms and keepwell terms.

The exclusionary terms are designed to exclude swap obligations supported by any guaranty or pledge of collateral made from non-ECP entities (whether or not a guarantor). They also clarify that not all swap obligations arising under a “Master Agreement” (as defined in the LSTA Terms) would be automatically excluded merely because some swap obligations must be excluded. Adding the LSTA’s “Excluded Swap Obligation” definition will also require changes to any “Guaranteed Obligation” or “Secured Obligation” definitions which appear in any of related loan documents (i.e., in any loan agreement, guaranty or security document).

The keepwell terms are designed to automatically treat as “Qualified ECP Guarantors” all Obligor in the transaction that otherwise qualify in such capacity as being able to “share” their ECP status as a keepwell obligor. These Qualified ECP Guarantors lend their ECP status to any guarantor of swap obligations in question (but not to the actual counterparties) by agreeing to provide funds necessary to support such guarantor’s obligations with respect to the swap obligations in question (subject to fraudulent transfer limits). The keepwell terms are intended to be added to the applicable guaranty and/or collateral security documents.

Waterfall Provisions

In addition to adding definitions and the other changes discussed above, a number of lenders have included adjustments to waterfall provisions in loan documents to account for the need to apply certain funds in a non pro-rata manner. Such a collateral allocation style mechanism may be incorporated within or added to the end of a waterfall provision. An example of a provision that could be added to the end of a waterfall provision may read as follows: “...excluded swap obligations with respect to any guarantor shall not be paid with amounts received from such guarantor, but appropriate adjustments shall be made with respect to payments from other obligors to preserve the allocation to obligations otherwise set forth above in this section.”

Conclusion

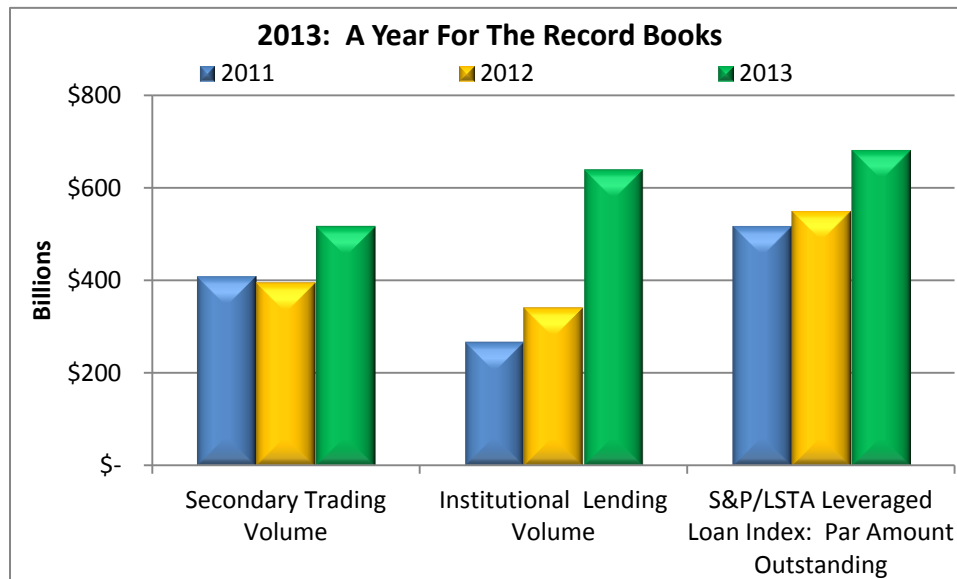
Commercial lenders and borrowers seeking to add credit support to swap obligations will need to be mindful of the requirements under the CEA, the Final Rule and the items covered by the No-Action Letter, as well as any further interpretations that may be forthcoming from the CFTC. While the initial focus for many has been verification of ECP status and revisions to documentation forms for new facilities, the parties should also look to update older facilities when opportunities arise.

LSTA MARKET ADVISORY ON THE 2013 MARKET

By [Ted Basta](#) and [Tess Virmani](#)

2013 Was A Year For The Record Books, But Regulatory Pressures Loom Large

2013 was certainly a year for the record books in the senior secured corporate loan market. Leveraged lending reached an all-time high of \$1.1 trillion, surpassing 2012's prior record by more than 50%. On the institutional side, record levels of refinancing activity drove institutional lending to an all-time high of \$639 billion, surpassing 2012's prior record by almost 90%. Refinancings were not the whole story, as lenders also financed a massive amount of new paper, including a number of mega sized deals such as Heinz and Dell. Due to new issuance, the size of the secondary loan market reached an all-time high as demonstrated in the chart below. By the end of June, S&P/LSTA Leveraged Loan Index (LLI) outstandings once again totaled \$595 billion (its previous record high from late 2008). By year-end 2013, the LLI had grown by a total of \$133 billion to a fresh record of \$682 billion on its way to returning 5.3% on the year.



These record levels of supply were matched by record levels of demand. CLOs still clearly dominated institutional lending activity in the primary leveraged loan market in 2013, accounting for 55% of non-bank institutional lending. But perhaps the more interesting take away is the jump in retail loan fund presence, with retail funds accounting for a record one-third of lending activity in 4Q13. CLO 2.0s now manage roughly half of the \$300 billion in U.S. CLO assets under management (AUM). On the retail side, investors poured \$63 billion into retail loan funds in 2013 as they sought low duration, floating-rate assets. To put that figure in perspective, 2013's bounty exceeded three times that of 2010's previous record \$18.3 billion. Indeed, 2013's figure represented a post-recession high that was only \$3 billion shy of 2007's all-time record high of \$520 billion. In all, it was a very good year for loan trading.

While there certainly was much to cheer about in the loan market in 2013, regulatory pressure (directly on leveraged lending and also on one of its key demand streams, CLOs) continues to concern loan participants in 2014. CLO formation faces threats on two Dodd-Frank fronts, Risk Retention and the Volcker Rule. The elimination of CLOs would leave a sizeable gap in the syndicated loan market, which may not easily be filled by banks in light of the regulators' Guidance on Leveraged Lending in effect as of May 2013.

On the CLO front, Dodd-Frank's Volcker Rule is the immediate threat. Released in December 2013, the final implementing rules have a number of wins for the loan market. Namely, loans were exempted from the proprietary trading restrictions imposed on banks for most other assets, and a clear path was set out for a complete exemption for CLOs. However, in order to qualify for the exemption, CLOs may not hold *any securities or structured products* other than short-term cash equivalents. Moreover, if a CLO does not qualify for the exemption and is indeed a "covered fund" for purposes of the Volcker Rule, banks would be prohibited from holding its ownership interests. Because the final rules define ownership interest to include debt securities that have "indicia of ownership", such as the right to participate in the removal or replacement of the investment manager of the covered fund, it may not be possible for banks – the traditional owners – to hold CLO debt tranches. While the LSTA continues to actively campaign for relief from the agencies, as it stands, banks may be required to divest or restructure these debt securities by July 21, 2015.

At least two years in the distance, but potentially far more damaging, is Risk Retention. Dodd-Frank requires securitizers of CLOs to retain five percent of the credit risk of securitized assets. The reproposed risk retention rules released in August 2013 tag the CLO manager with this obligation. CLO managers would presumably be required to retain CLO securities equal to five percent of the fair value of the CLO on their balance sheet for the life of the vehicle, without the ability to sell or hedge, which is an impossible requirement for all but a handful of CLO managers. Although the LSTA has urged an exemption for CLOs, the LSTA has also worked extensively to craft an alternative retention scheme that would apply to CLOs subject to certain restrictions and protections where a manager would only have to purchase and retain five percent of the equity, not of the fair value of the deal. Without relief, CLO formation could drastically shrink.

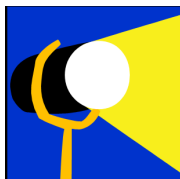
Unfortunately, CLOs are not the only regulatory target. Banks too face new challenges. In addition to the increased capital requirements to be implemented under Basel III, the bank regulators' issued final Guidance on Leveraged Lending in connection with their annual bank examinations which could materially impact banks' ability to underwrite and hold certain types of leveraged loans. The Guidance allows banks to craft their own definitions of "leveraged lending" based on a number of enumerated criteria, such as companies which engage in an acquisition or recapitalization transaction and companies with total leverage greater than four times, or senior leverage greater than three times, debt/EBITDA. The Guidance seeks to address not only loans arranged by banks, but also loans held by banks and takes a step further than any earlier guidance by addressing pipeline risk. Based on the language in the Guidance, the size of banks' leveraged loan portfolios stands to increase, but also the number of criticized loans a bank holds may increase. The Guidance provides that a loan to a company that cannot show the ability to amortize all its senior debt or half its total debt from free cash flow within five to seven years will likely be criticized by the bank regulators. The Guidance also looks skeptically at loans to companies that would have leverage levels of six times or more after planned asset sales and loans which lack meaningful maintenance covenants. Loan market participants will surely monitor how this Guidance impacts bank behavior and loan structure going forward.

It remains to be seen whether 2013's market enthusiasm continues this year as loan market participants continue to grapple with regulatory challenges. For more on market developments and these regulatory topics, you may attend the "Current State of the Syndicated Loan Market" CLE panel moderated by Bridget Marsh of the LSTA on April 10th at the ABA Business Law Section's Spring Meeting in Los Angeles, CA.

Ted Basta is Senior Vice President of Data & Analytics at The Loan Syndications and Trading Association. He can be reached at tbasta@lsta.org with questions or comments. Tess Virmani is Associate General Counsel at The Loan Syndications and Trading Association. She can be reached at tvirmani@lsta.org with questions or comments.

UCC Spotlight

By **Stephen L. Sepinuck**



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.

BancInsure, Inc. v. Highland Bank,
[2013 WL 5340887](#) (D. Minn. 2013)

In this case, an insurer sought a declaratory judgment that the loss of its insured – Highland Bank – was not covered by the policy the insurer had issued. The bank had loaned about \$4 million to First Premier Capital, LLC to finance First Premier's acquisition of equipment to be leased. In return, First Premier assigned to the bank its right to rental payments under the lease along with its residual interest in the leased equipment. It later turned out that bank had been defrauded: the leased equipment did not actually exist and a guaranty of the lease was likely forged. The bank obtained an uncollectible judgment against First Premier and the lease guarantor filed for bankruptcy, declaring assets of \$5,400 and liabilities in excess of \$100 million.

The bank sought recovery of about \$2 million from the insurer pursuant to the policy's coverage of losses resulting from forgery: in this case, the lease guaranty. In ruling for the insurer, the court made two principal rulings. First, that the bank knew that the putative guarantor had a negative net worth, and thus the loss did not result from the forgery. Second, that the bank's security interest in the equipment lease did not give it a security interest in the guaranty of the lessee's obligations.

The first rationale might well be correct and justify the court's ruling. The second is not. The court looked only at the language of the documents and concluded that did not purport to grant the bank an interest in the guaranty. However, pursuant to § 9-203(f), the attachment of a security interest in collateral – in this case, chattel paper – automatically also gives the secured party an attached security interest in any supporting obligation, such as a guaranty. The court never cited to § 9-203(f).

In re Wade,
501 B.R. 870 (Bankr. D. Kan. 2013)

This is one of numerous cases in which a court was asked to determine whether a lease or personal property was a true lease or a disguised sale with a retained security interest. Section § 1 203 contains some rather detailed rules to aid courts in making this decision. Subsection (a) states the general rule that resolution depends not on the labels used in the agreement but on the facts of the case. More guidance is found in subsection (b), which lays out four circumstances in which a transaction definitively creates a security interest. Each of those circumstances requires that the lease not be subject to early termination by the lessee. The court in this case ruled – in a discussion consuming a single paragraph – that because the lease was subject to termination by the lessee, and subsection (b) was therefore inapplicable, the transaction was a true lease.

This is wrong. If the circumstances in subsection (b) are not present, that does not mean that the transaction is a lease; it merely means that the analysis falls back to the general, fact-specific standard of subsection (a). See, e.g., *In re Grubbs Construction Co.*, [319 B.R. 698](#) (Bankr. M.D. Fla. 2005); *Coleman v. Daimlerchrysler Services of North America, LLC*, [623 S.E.2d 189](#) (Ga. Ct. App. 2005). Moreover, a transaction subject to termination by the lessee can qualify as a sale and security arrangement if the lessee: (i) made a significant up-front payment that would be forfeited by terminating; (ii) must pay a significant fee for terminating; or (iii) would have strong economic incentive to exercise an option to buy, say perhaps because all of the lessee's business equipment is subject to the lease, and the lessee would have to find alternative goods or go out of business if it failed to exercise the option. See, e.g., *In re Grubbs Construction Co.*, [319 B.R. 698](#); *In re Triple Marine Maintenance, Inc.*, [258 B.R. 659](#) (Bankr. E.D. Tex. 2000). The court might nevertheless have reached the correct result, but because it did not mention what the terms of the lease were, it is impossible to know.

In re Shapiro,
2014 WL 68998 (9th Cir. 2014)

In the last few years, this column has criticized three different bankruptcy appellate panels for improperly analyzing issues involving deposit accounts by treating the depositor as the owner of the funds on deposit. See *In re WEB2B Payment Solutions, Inc.*, [488 B.R. 387](#) (B.A.P. 8th Cir. 2013) (criticized in the [summer 2013 column](#)); *In re Ruiz*, [455 B.R. 745](#) (B.A.P. 10th Cir. 2011) (criticized in the [winter 2011 column](#)); *In re Mwangi*, [432 B.R. 812](#) (B.A.P. 9th Cir. 2010) (criticized in the [spring 2011 column](#)). Well, now a circuit court has fallen into the same analytical abyss.

In this case, Bank of America honored post petition several checks that the debtor had drawn prepetition. Instead of pursuing the payees under § 549, the Chapter 7 trustee brought a turnover motion action against the bank under § 542(a) to recover the funds. The bankruptcy court denied the motion and the district court affirmed. However, the Ninth Circuit reversed. Noting that § 542(a) expressly authorizes recovery of “the value” of estate property in a person's “possession, custody, or control,” not merely the property itself, the court ruled that the bank was liable for the amount of the checks even though the bank lacked possession, custody, or control at the time the action was brought.

The bulk of the decision dealt with the timing issue: that the bank allegedly held property of the estate when the bankruptcy petition was filed but did not hold it when the trustee sought turnover. What the court failed to appreciate, however, was that the bank *never* had “possession, custody, or control” of estate property. A deposit account is not a trust or a bailment. A depositary bank has neither possession nor custody of the depositor's money. A deposit account is merely the depositor's loan to the bank. Consequently, § 542(a) was simply not applicable.

This is not to say that the court reached the wrong result on liability. The bank might well have been liable under § 542(b), which requires someone who owes a debt that is estate property to pay it to the trustee. *In re Falzerano*, [454 B.R. 81](#) (B.A.P. 8th Cir. 2011) (§ 542(b), not turnover under § 542(a), is the appropriate provision to use to recover a debt owed to the estate). However, subsection (b) is expressly subject to subsection (c), which provides a defense to an obligor who, in good faith and without knowledge of the bankruptcy case, pays someone else. By improperly analyzing this issue under subsection (a), the court relied on a textual argument that had no relevance and denied the bank a defense to which it might have been entitled.

The first footnote in the decision indicates that the judges unanimously concluded that oral argument was unnecessary. Perhaps if they had taken the time to listen to counsel, the court would not have issued such a fundamentally flawed opinion.

1st Source Bank v. Wilson Bank & Trust,
735 F.3d 500 (6th Cir. 2013)

And now for the best – or worst – decision. In this case, 1st Source Bank acquired a security interest in the accounts and rigs of two trucking companies. However, the bank's financing statement failed to include accounts in its description of the collateral, although it did specifically mention "proceeds" of the described rigs. After the debtor defaulted and went into bankruptcy, a priority dispute arose with another secured party over the bank's security interest in accounts. The district court ruled that the bank was not perfected in the debtors' accounts because accounts were neither mentioned in the financing statement nor proceeds of the rigs. As the district court noted, "[u]se is not a disposition of the collateral within the meaning of the definition of 'proceeds.'" [2012 WL 4711989](#) at *3. The Sixth Circuit affirmed.

Had the circuit court confined its analysis and discussion to the rationale adopted by the district court, it would have been on solid ground. That is because using equipment to generate receivables does not result in proceeds of the equipment because use of equipment is not a "sale, lease, license, exchange, or other disposition" of the equipment. *See, e.g., In re Premier Golf Properties, LP*, [477 B.R. 767](#) (B.A.P. 9th Cir. 2012); *In re Wright Group, Inc.*, [443 B.R. 795](#) (Bankr. N.D. Ind. 2011). The court would have been on solid ground if in fact the debtors *operated* the rigs (*i.e.*, their employees drove the rigs to haul cargo for customers who promised pay for that service). However, if the debtors *leased* the rigs to customers, the resulting rights to payment would have qualified as "proceeds" *see* U.C.C. § 9 102(a)(64)(A), and the court's ruling would be incorrect. Unfortunately, neither the district court opinion nor the circuit court opinion makes clear how the debtor conducted its business to generate the accounts.

More unfortunate than this omission is what the circuit court also wrote. In language that is both confused and confusing the court seems to suggest that "accounts" can never be "proceeds" because both are defined terms:

A foundational rule of statutory construction is to give effect to the intent of the Legislature by giving words their "natural and ordinary" meaning. Where two statutory provisions potentially conflict, "a specific statutory provision controls over a more general statutory provision." Here, [Article 9] provides a comprehensive definition of the term "proceeds." . . . Although the statutory definition of the term "proceeds" appears admittedly broad, accepting [the bank's] interpretation of the statute would render the term "accounts" – a category defined separately in [Article 9] – meaningless. Because we are required "to construe statutes, whenever possible, in a way which gives meaning to every portion of the statute," we decline to expand the definition of the general term, "proceeds," in such a way that it would subsume the specific term, "accounts." 735 F.3d at 504.

This language is quite disturbing "Accounts" undeniably can be proceeds of other collateral. *See* U.C.C. §§ 9-102 cmt. 5.i; 9-322 cmt. 6; 9-324 cmts. 8, 9 & 10; 9-509 cmt. 4 (all expressly contemplating that accounts can be proceeds (and vice-versa)); *see also Sixth Circuit Rules That "Proceeds" Don't Include Accounts Receivable Generated by Use of Equipment*, 29 CLARKS' SECURED TRANSACTIONS MONTHLY 1, 3 (Nov. 2013) (commenting on the case). Indeed, billions of dollars in inventory and other financing rests on the belief that accounts can be and are proceeds of other collateral. To the extent that the court suggested otherwise, it was clearly wrong.

In a letter to Chief Judge Batchelder, the author of this column urged the court to modify its opinion. Noting that in the first game of the last World Series, the umpires congregated and then reversed a clearly incorrect call by the second base umpire, the author urged the court to similarly confer and correct its misstatements. The Chief Judge did not respond.

[Stephen L. Sepinuck](#) is a Professor at Gonzaga University School of Law, Co-Director of the Commercial Law Center and former Chair of the ABA Business Law Section's Uniform Commercial Code Committee. Stephen can be reached at sspinuck@lawschool.gonzaga.edu.

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¹ *Corenswet, Inc. v. Amana Refrigeration, Inc.*, 594 F.2d 129, 132 (5th Cir.1979).

² *Harris Corp. v. Giesting & Assocs., Inc.*, 297 F.3d 1270, 1272-73 (11th Cir. 2002).

³ See generally *United States v. Speed*, 75 U.S. 77 (1868); *Tornello v. United States*, 681 F.2d 756, 764 (Ct. Cl. 1982).

⁴ *Tornello*, 681 F.2d at 765.

⁵ *Tigerswan, Inc. v. United States*, 110 Fed. Cl. 336, 344 (Fed. Cl. 2013).

⁶ *Questar Builders, Inc. v. CB Flooring, LLC*, 978 A.2d 651, 669-70 (Md. 2009).

⁷ See, e.g., *id.*

⁸ E.g., *Questar*, 978 A.2d at 674; *EDO Corp. v. Beech Aircraft Corp.*, 911 F.2d 1447, 1453, fn 6 (10th Cir. 1990); but see *Handi-Van, Inc. v. Broward Cnty.*, 116 So. 3d 530, 539 (Fla. Dist. Ct. App. 2013) (holding that private parties have a unilateral right to cancel a contract under an expressly agreed upon termination for convenience provision as long as there was consideration since the “courts may not rewrite a contract or interfere with the freedom of contract or substitute their judgment for that of the parties thereto in order to relieve one of the parties from the apparent hardship of an improvident bargain.”).

⁹ *Questar*, 978 A.2d at 675. Notably, the *Questar* opinion suggests that a party may be allowed to exercise its power to terminate even more broadly if the specific contract language at issue explicitly allowed termination “at any time for any reason.” *Id.* at 673 (citing *Niagara Mohawk Power Corp. v. Graver Tank & Mfg. Co.*, 470 F. Supp. 1308 (N.D.N.Y. 1979)).

¹⁰ *Vila & Son Landscaping Corp. v. Posen Constr., Inc.*, 99 So.3d 563, 569 (Fla. Dist. Ct. App. 2012). The termination for convenience clause at issue stated:

TERMINATION FOR CONVENIENCE. The performance of the Work may be terminated at any time in whole, or from time to time in part, by Contractor for its convenience. Any such termination shall be effected by delivery to Subcontractor of written notice specifying the extent to which performance of the Work is terminated and the date upon which termination becomes effective.

¹¹ See U.C.C. § 2-309 (2) (“Where the contract provides for successive performances but is indefinite in duration it is valid for a reasonable time but unless otherwise agreed may be terminated at any time by either party.”).

¹² *Id.* § 2-309(3) states “Termination of a contract by one party except on the happening of an agreed event requires that reasonable notification be received by the other party and an agreement dispensing with notification is invalid if its operation would be unconscionable.”

¹³ See, e.g., *Grand Light & Supply Co. v. Honeywell, Inc.*, 771 F.2d 672, 679 (2d Cir. 1985).

¹⁴ *Id.*; *Corenswet*, 594 F.2d at 132.

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- ¹⁵ *Id.*
- ¹⁶ *Grand Light & Supply Co., Inc.*, 771 F.2d at 679 (“U.C.C. good faith provision may not be used to override explicit contractual terms.”); *Cardinal Stone Co., Inc. v. Rival Mfg. Co.*, 669 F.2d 395, 396 (6th Cir. 1982).
- ¹⁷ 984 N.E.2d 449 (Ill. 2013).
- ¹⁸ 7 U.S.C. § 1631(e)(1)(A)(ii)(IV) (2008).
- ¹⁹ 633 N.E.2d 67 (Ill. App. Ct. 1994).
- ²⁰ 371 F.3d 450 (8th Cir. 2004).
- ²¹ *State Bank of Cherry*, 984 N.E.2d at 454.
- ²² 964 N.E.2d 604, 607 (Ill. App. Ct. 2012).
- ²³ *Id.* at 609 (quoting *Stein v. Kristlov*, 939 N.E.2d 518 (Ill. App. Ct. 2010)).
- ²⁴ Former U.C.C. § 9-402(8) (1998). The language is now found in U.C.C. § 9-506(c) (2013).
- ²⁵ 964 N.E.2d at 607-12 (citing 17 U.S.C. § 1631(e)(2) (2012)).
- ²⁶ *Id.* at 612-14 (Holdridge, J., dissenting).
- ²⁷ *State Bank of Cherry*, 984 N.E.2d at 459 (citations omitted) (emphasis in original).
- ²⁸ *Id.* at 464-65.
- ²⁹ *Id.* at 470 (Freeman, J., concurring).
- ³⁰ 29 F.3d 1173 (7th Cir. 1994).
- ³¹ *Id.* at 1178.
- ³² 44 F.3d 572 (7th Cir. 1995).
- ³³ *Id.* at 575.
- ³⁴ 706 N.E.2d 882 (Ill. 1999).
- ³⁵ 139 F. Supp. 2d 869 (N.D. Ill. 2001).
- ³⁶ *Id.* at 889 n.8 (citing *Air Safety, Inc. v. Teachers Realty Corp.*, 706 N.E.2d 882 (Ill. 1999)).
- ³⁷ *State Bank of Cherry*, 984 N.E.2d at 459 (emphasis in original).
- ³⁸ 476 U.S. 858 (1986).
- ³⁹ 499 U.S. 585 (1991).
- ⁴⁰ U.C.C. § 1-103(a)(3) (2013).
- ⁴¹ The term “filing office,” as used in this article, means the office designated in U.C.C. § 9-501(a)(2) as the central filing office for a state.
- ⁴² The status of U.C.C. administrative rules by state is available at <http://csctransactionwatch.com/amendments/>.
- ⁴³ See MO. CODE REGS. ANN. tit. 15 § 30-90.090(7). House Bill 1412, which is currently pending in the Missouri legislature, would amend Article 9 to substantially codify these rules.
- ⁴⁴ See D.C. MUN. REGS. tit. 9, § 513.12. The applicable D.C. statutes cited in this paragraph all reflect the uniform text of Article 9.
- ⁴⁵ 7 U.S.C. § 2(e).
- ⁴⁶ The definition of “swap” can be found in the CEA, 7 U.S.C. § 1a(47)(A)(ii).
- ⁴⁷ See Further Definition of “Swap,” “Security-Based Swap,” and “Security-Based Swap Agreement”; Mixed Swaps; Security-Based Swap Agreement Recordkeeping, Final Rule, 77 Fed. Reg. 48208, 48226 (Aug. 13, 2012).
- ⁴⁸ In Footnote 12 to the No-Action Letter, the OGC stated that its “interpretation is limited to guarantees of swaps and does not address any other credit support arrangements or other issues Thus, for example, a non-ECP may provide collateral to support a third party’s swap obligations [and] [t]he [CFTC] or its staff . . . may address such issues in the future.” CFTC OGC Letter No. 12-17, No-Action and Interpretation, 2012 WL 4919782, at *9 n.12 (Oct. 12, 2012).
- ⁴⁹ See Further Definition of “Swap,” “Security-Based Swap,” and “Security-Based Swap Agreement,” 77 Fed. Reg. at 48226 (providing that, “the CFTC anticipates that a “full recourse” guarantee would have a greater effect on the price of a swap than a “limited” or “partial recourse” guarantee; nevertheless, the CFTC is determining that the presence of any guarantee with recourse, no matter how robust, is price forming and an integral part of a guaranteed swap”).
- ⁵⁰ 17 C.F.R. § 1.3(m).
- ⁵¹ See No-Action Letter, 2012 WL 4919782, at *9 n.56.
- ⁵² No-Action Letter 2012 WL 4919782.
- ⁵³ *Id.*