Greetings and best wishes for a happy and healthy holiday season. Our Committees have had a very successful 2011 with outstanding programs, CLE sessions, and subcommittee and task force meetings at our Spring, Annual, and Fall meetings. We thank everyone who participated in, and attended, those programs, sessions, and meetings.

We look forward to another successful year in 2012. For those of you who have not already registered, the 2012 Spring Meeting will be held at Caesars Palace in Las Vegas from March 22 through 24. Both the UCC and Commercial Finance Committees have an outstanding series of programs and subcommittee meetings for your education and enjoyment. Our collective programs are as follows:

1. **Current State of Syndicated Loan Markets 2012** -- Thursday, March 22, 2012
2. **Ethical Issues in Commercial Transactions** -- Thursday, March 22, 2012
5. **Commercial Law Developments** -- Saturday, March 24, 2012
6. **Variation of the UCC by Agreement** -- Saturday, March 24, 2012

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 Thursday, March 22 at Piero’s in Las Vegas. Tickets will be available soon on either the UCC or ComFin website, or the ABA Business Law Section website.

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 Legislative Enactment of Revised Article 9 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 State Guaranty Laws, 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, and our Commercial Finance Terms “wiki” Task Force. Please go to the UCC or ComFin website for more information on these task forces.
MARK YOUR CALENDARS

January 10, 2012 – 1:00 to 2:30 p.m. ET – UCC Article 9 Update – Preparing for Pending Changes to Filing and Search Procedures, Lender Due Diligence and More (CLE Webinar). Click here for more information.

January 17, 2012 – 1:00 to 2:30 p.m. ET – Commercial Real Estate Loan Guaranty Enforcement – Maximizing Lender Recovery Upon Borrower Default (CLE Webinar). Click here for more information.

January 19, 2012 – 1:00 to 2:30 p.m. ET – Mortgage Fraud: New Litigation Threats; Asserting and Defending Claims by FDIC and Other Federal and State Agencies (CLE Webinar). Click here for more information.

March 22-24, 2012 – Business Law Section Spring Meeting – Caesars Palace in Las Vegas, Nevada. Please join us in Las Vegas this Spring for numerous CLE programs, committee, subcommittee and taskforce meetings and social networking events. Spring Meeting program details and registration and hotel information are available here!

August 2-7, 2012 – ABA Annual Meeting – Chicago Marriott Downtown in Chicago, Illinois. Save the date!


We continue to seek new members, and in particular new members who would like to become active in the work of our Committees. 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 Penny Christophorou (pchristophorou@cgsh.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 with whom to work.

Upcoming Meetings. We are looking forward to our participation in the 2012 Spring, Annual and Fall meetings. The ABA Annual Meeting is in Chicago this year from August 2 through August 5. Our joint UCC/ComFin Fall Meeting will take place on Wednesday, November 14 in Phoenix, Arizona, from 11:00 a.m. to 4:00 p.m. Hotel 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 Las Vegas in March!

Jim Schulwolf Penny Christophorou
Commercial Finance Committee Chair UCC Committee Chair

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 instruction to high school students within the Junior Achievement program. Check here for more information about the Section’s efforts.

Featured Articles

ENFORCING THE COMMERCIAL GUARANTY AGREEMENT

By Anthony J. Jacob, Aric T. Stienessen and Jeremy D. Duffy, Hinshaw & Culbertson LLP

Over the past few years, there has been increased litigation over the enforcement of commercial guaranties by lenders. As more borrowers default on their loan obligations, lenders have more frequently taken action against guarantors to recover damages due to a borrower’s default. In response, guarantors have raised a variety of defenses.

This article starts with a summary of the basic terms of a commercial guaranty and the purposes for which it is used. This article then examines the topics frequently encountered when enforcing a commercial guaranty agreement and sets forth recent noteworthy cases on each topic.

Terms And Purposes Of A Commercial Guaranty

A guaranty is an agreement made by a third party, whether a person, trust or a business entity, to pay and/or perform the obligations of a debtor for the satisfaction of a debt owed to a creditor upon the occurrence of an event, typically a default by the debtor, under the original loan agreement. A guaranty, like any contract, requires mutual assent, adequate
In the context of a loan transaction, a guaranty serves as a form of collateral to support the debt obligation between the debtor and the creditor. But, the guaranty and the loan agreement evidence separate obligations, and their independence is not affected by the fact that both agreements are written on the same instrument or are contemporaneously executed. The guaranty cannot exist without a primary debt obligation. Thus, if the primary debt obligation has been fully satisfied, is void or is illegal, a guaranty of the debt obligation can also be deemed unenforceable.

Types of Guaranties

By way of background, there are varying types of guaranties.

- **An absolute guaranty** provides that the guarantor promises to pay or perform the obligations of the debtor upon the occurrence of an event of default (typically debtor’s default). If a guaranty does not contain words of limitation or conditions, it is typically construed as an absolute guaranty.

- **A conditional guaranty** requires the happening of some contingent event (other than the default of the debtor) or the performance of some act on the part of the creditor before the guarantor will be liable.

- **A payment guaranty** obligates the guarantor to pay the debt at maturity (which may arise due to an event of default). Upon the occurrence of a debtor’s default, the guarantor’s obligation becomes fixed and the creditor does not need to make a demand on the debtor.

- **A collection guaranty** is a guarantor’s promise that if the creditor cannot collect the claim with due diligence, usually after suit (and exhaustion of remedies) against the debtor, the guarantor will pay the creditor.

- **A performance guaranty** obligates the guarantor to perform some obligation on behalf of the debtor for the benefit of the creditor.

- **A continuing guaranty** is a guaranty that is not limited to a single transaction but contemplates a future course of dealing which may encompass a series of transactions, may be for an indefinite period and/or may be intended to secure payment or performance of an overall debt of the debtor. As such, a continuing guaranty may include subsequent indebtedness without new consideration.

- **A guaranty is a restricted guaranty** when it is limited to a single or limited number of transactions, to a certain part of the debt obligation and/or to a certain period of time.

- **A downstream guaranty** is a guaranty by a parent corporation for the obligations of its subsidiary. In this scenario, a lender will look to the parent corporation to back up the debt of a subsidiary corporation due to the parent corporation’s superior assets and financial condition.

- **An upstream guaranty** is a guaranty by a subsidiary corporation for the obligations of its parent corporation. Typically, a creditor will require an upstream guaranty when debtor’s, i.e. the parent corporation’s, only assets are the stock of a subsidiary, and the subsidiary owns assets used
as collateral to secure the credit obligations.

- A cross-stream guaranty is a guaranty among affiliated corporations, whose stock are both owned by the same parent.

Commercial Guaranty: Topics And Cases

A party’s enforcement of a commercial guaranty, like any other contract, requires the analysis of basic contract principles. What sets a commercial guaranty apart from other contracts is that a commercial guaranty may lie dormant and unattended to by the parties until the occurrence of some subsequent, triggering event. At that time, which may be months or years after the commercial guaranty and the underlying debt documents were originally executed, the party seeking to enforce the guaranty then has to examine the terms of the guaranty, the status and condition of the guarantor and other facts and circumstances existing at the time of enforcement.

Whether a party is seeking to enforce a commercial guaranty or defend against its enforcement, the party needs to start by identifying the particular type of guaranty, the lien placed on the guarantor, whether the guaranty is properly secured and perfected (if intending to do so), the existence and integrity of the guarantor’s assets and collateral used to guaranty of debt, and how best to foreclose upon the guarantor and take possession of the guarantor’s assets. The following sections summarize a few of the topics and current cases a party may need to consider when enforcing a commercial guaranty.

Consideration

A guaranty without consideration is merely an unenforceable gratuitous promise. While some guaranties are founded on separate consideration than the original credit transaction, the guarantor need not receive a direct benefit for consideration to exist. The consideration usually consists of a benefit to the debtor or a detriment to the creditor.

In the case of In re Kraft, LLC, 429 B.R. 637 (Bankr. N.D. Ind. 2010), a bank lent money to a debtor in return for a mortgage and subject to promissory notes signed by individuals, but not by the debtor. The bank sought to foreclose under the mortgage and to collect money under the promissory notes against the debt or.  The debtor argued that because the mortgage was given by an entity which did not execute any of the underlying notes, the mortgage is essentially a guaranty. Under Indiana law, if the guaranty is executed after the underlying debt obligation is incurred, there must be additional consideration given. Because no further consideration was given at the time the mortgage was executed and delivered in debtor’s case, the mortgage (again arguably akin to a guaranty) is voidable.

In its opinion, the court provided a detailed explanation of the laws of guaranties in Indiana. A guaranty is an independent contract to assume the liability for the payment of a debt if the primary obligor defaults in performance or payment. If the obligor subsequently defaults, the guarantor becomes primarily liable on the debt, subject to the terms of the guaranty. A mortgage is different than a guaranty in that a mortgage is a lien which secures an underlying debt, and when the obligation is discharged, the mortgage has no function and is legally extinguished. While additional consideration is necessary for a guaranty that is executed after the primary obligation, a pre-existing debt or liability is sufficient consideration to support a mortgage given as security, and no additional consideration is needed.

In another case, Brown v. Laureniance Properties, LLC, 710 S.E.2d 682 (Ga. Ct. App. 2011), a debtor argued that the parties’ various corrections to a lease term, which lease included a guaranty, amounted to a novation and therefore invalidated the guaranty. The court disagreed. The court stated that a novation requires four essential elements: (1) a previous valid obligation, (2) the agreement of all the parties to the new contract, (3) the extinguishment of the old contract, and (4) the validity of the new contract. In this case, the amendment and assignment of the lease was executed by the guarantor. The guaranty then was continued and extended to the assigned obligations. Therefore, a default on the
guarantor has paid in excess of his or her share of the entire obligation and the amount of contribution he or she is entitled to collect is
the common debt. Rather, under Connecticut law, a guarantor’s right of contribution from a co-guarantor arises only when the
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court concluded that the defendant had a right of recourse and right of contribution from the plaintiff and that the bank’s failure
to obtain jurisdiction over the plaintiff did not impair the implied contract between the plaintiff and defendant as co-guarantors and the
right of contribution between them. In addition, the bank’s release of one guarantor did not impair or release the obligations of any other guarantor.

Release of Co-Guarantors

When two or more persons guarantee the debt of another, they simultaneously enter into an implied promise on the part of each to contribute his or her share if necessary to meet the common obligation between the co-guarantors. The discharge of one co-guarantor’s direct liability to the creditor does not relieve him or her from liability to contribute to the other co-guarantors. In addition, the fact that a creditor sues only some of the co-guarantors, or recovers a judgment against fewer than all of them, does not excuse those not sued or not included in the judgment from paying their part of the joint debt. Accordingly, as a general rule, one or more of the co-guarantors against whom the judgment is recovered may, upon paying the creditor, compel contribution from all other co-guarantors. A creditor's release of one guarantor does not necessarily release the co-guarantors.

In Lestorti v. DeLeo, 4 A.3d 269 (Conn. Super. Ct. 2010), the case dealt with a guaranty agreement whereby the plaintiff, defendant, and Otto Paparazzo and OJP Development Corp. each agreed jointly and severally to guaranty the liability of Pond Place Development II to First Union National Bank under a note. The note was secured by a mortgage. Wachovia Bank, the successor to First Union National Bank, commenced a foreclosure action against Pond Place and the plaintiff and defendant under the terms of the guaranty agreement. The plaintiff and defendant were originally named defendants in the foreclosure action, but that action was dismissed as to the plaintiff for failure to make proper service upon him. The defendant was found liable for the deficiency judgment. The defendant later settled and paid the judgment with Wachovia Bank. Defendant then filed a counterclaim against the plaintiff for half of the judgment. The trial court granted the plaintiff’s motion to strike the counterclaim. The defendant then appealed. The Appellate Court found that Wachovia Bank’s failure to obtain personal jurisdiction over the plaintiff impaired the defendant’s right to contribution from the plaintiff, and thus, the defendant was not entitled to reimbursement from the plaintiff for any amount.

The issue in the case was whether the defendant could recover any portion of the judgment from the plaintiff where the bank failed to properly assert personal jurisdiction over the plaintiff. Under Connecticut law, the right of contribution between co-guarantors is based on the theory of implied contract. A co-guarantor, however, is not entitled to contribution for any amount paid to the creditor toward the common debt. Rather, under Connecticut law, a guarantor’s right of contribution from a co-guarantor arises only when the guarantor has paid in excess of his or her share of the entire obligation and the amount of contribution he or she is entitled to collect is limited to the amount paid in excess of his or her share of the entire obligation. The reason this principle of limitation exists in Connecticut is because a guarantor, as among co-guarantors, is a principal for the portion of the debt which he or she ought to pay and is a secondary obligor for the remainder of the debt. Therefore, when a co-guarantor makes a payment to the creditor in an amount that is less than his or her share of the whole outstanding obligation, the co-guarantor has no right to contribution from the other co-guarantors.

The court concluded that the defendant had a right of recourse and right of contribution from the plaintiff and that the bank’s failure to obtain jurisdiction over the plaintiff did not impair the implied contract between the plaintiff and defendant as co-guarantors and the right of contribution between them. In addition, the bank’s release of one guarantor did not impair or release the obligations of any other guarantor.

Joint and Several Liability

A guarantor of a debt obligation is liable upon a default, and the person to whom the guaranty is made is not required to first resort to recover from the primary obligor. A guarantor of a promissory note may be held jointly and severally liable with the primary obligor, although the extent of the guarantor’s liability depends upon the terms of the guaranty agreement.

In Wachovia Bank, National Ass’n v. Horizon Wholesale Foods, LLC, No. 09-0072-KD-8, 2009 WL 3526662 (S.D. Ala. Oct. 23, 2009), the bank sought to enforce a loan default against the guarantors at the first instance. Three individuals executed unconditional guaranties. Each guaranty provided that it was a continuing and unconditional guaranty of the payment and performance and that the guarantor in each instance was jointly and severally liable with the debtor. The court enforced the guaranties against the guarantors finding the guarantors liable for the principal, interest, miscellaneous fees and attorneys’ fees.

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, Carol Nulty Doody, Kelly L. Kopryt, Christina B. Rissler, or Rebecca Gelfand.
Impracticability/Frustration of Purpose

In *Twin Holdings of Delaware LLC v. CW Capital, LLC*, 906 N.Y.S.2d 784, 2010 WL 309022 (Sup. Ct. 2010) unpublished table decision, a guarantor claimed that the decline in the real estate market, a factor outside its control, made it more difficult to lease out space in its building. The guarantor also alleged that the financial crisis in the real estate market made it more difficult for the debtor and guarantor to refinance the loan. In another case, *Flathead-Michigan I, LLC v. Penninsula Development, LLC*, No. 09-14043, 2011 WL 940048 (E.D. Mich. Mar. 16, 2011), a guarantor claimed that the economic fallout in 2008 frustrated the terms of the guaranteed obligations.

For similar reasons, the courts in both cases held that the guarantors were not excused from performance of the guaranteed obligations on the ground of impracticability or frustration of purpose. Both courts found that the guarantors were sophisticated entities with knowledge of the pertinent business industry and they were aware of the possibility of volatility in the financial markets.

Misrepresentation

A guarantor may make a claim of fraudulent inducement of an agreement in response to the enforcement of a guaranty agreement, but must show the following: (1) a misrepresentation of material fact by the creditor, (2) the creditor knew the statement was false at the time or made the assertion without regard to its falsity, (3) the creditor intended the guarantor to act, (4) that the guarantor reasonably relied upon the statement, (5) that the guarantor acted to its detriment, and (6) that the guarantor incurred actual damages.


Lack of Notice to Guarantor

In certain instances, a creditor must provide the guarantor with notice of a default or triggering event under the primary debt obligation before seeking to enforce a guaranty agreement. However, the language of the guaranty is controlling in determining whether the creditor is under a duty to notify the guarantor of a default, and notice need not be given when the terms of the guaranty expressly dispense with the need for the notice.

In a Michigan Appellate Court case, *Comerica Bank v. Cohen*, 291 Mich. App. 40 (2010), the court found a guarantor to be liable for a portion of the guaranteed debt even though the creditor did not give timely notice of a default. The court held that a failure to give notice of the default or negligence in giving such notice, in a case where the guarantor is entitled to notice, does not of itself discharge the guarantor from liability and bar a recovery upon the guaranty. Essentially, there must be not only a want of notice within a reasonable time, but also some actual loss or damage thereby caused to the guarantor. If such loss or damage does not go to the whole amount of the guaranteed claim, but is only in part of the claim, the guarantor is discharged only *pro tanto*.

In another case, *Vision Bank v. 145, LLC*, No. 10-00521-KD-B, 2011 WL 5289070 (S.D. Ala. Nov. 4, 2011), a debtor applied for a loan from a bank and an individual executed an unlimited continuing guaranty agreement in favor of the bank. In the guaranty, the individual expressly waived notices of every kind. The individual later executed a second unlimited individual guaranty and again, waived notices of every kind. The debtor failed to satisfy the promissory note by its maturity date. The bank mailed a notice of foreclosure and a copy of the foreclosure publication only to the debtor.

The guaranty agreement in this case did not require notice to the guarantor. In fact, the guaranty agreement stated that all notices were waived, including notice of presentment for payment, demand, default, and non-payment pertaining to the primary debt obligation and the guaranty. As such, the bank was able to enforce the guaranty.

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**KEY ELEMENTS OF THE REVISED MODEL CREDIT AGREEMENT PROVISIONS**

By Jason Kyrwood, Rachel Kleinberg and Brian Radigan, DavisPolk

In August 2011, the Loan Syndications and Trading Association ("LSTA") through its Primary Market Committee ("PMC") published its revised Model Credit Agreement Provisions 2011 ("Revised MCAPs"). This represented the first major over-haul of the MCAPs since 2005, and followed a more than 12-month process of discussion by the PMC and consultation with the LSTA’s membership. The Revised MCAPs have quickly become, with certain variations, standard market terms in many bank forms. In this note we review key elements of the Revised MCAPs.
Defaulting Lender Provisions

Although defaulting lender provisions are not new, the dramatic increase in bank failures (including Lehman) following the credit crisis focused the attention of market participants on the issue of defaulting lenders, and highlighted some of the weaknesses of typical defaulting lender provisions. The PMC sought to address those weaknesses in the Revised MCAPs. A key objective of that effort was to craft a set of provisions that were crisp enough to address with certainty issuing lenders’, swingline lenders’ and borrowers’ exposure to defaulting lenders, but flexible enough to address issues that might arise in the bankruptcy or receivership of the defaulting lender (e.g., the automatic stay).

Under the Revised MCAPs, a lender will be a defaulting lender if:

- it fails to fund borrowings or to meet its funding obligations to the administrative agent, issuing bank or swingline lender within two days of the date when due;
- it delivers a written notice to the borrower, the administrative agent or any issuing bank or swingline lender that it does not intend to comply with its funding obligations (or makes a public statement to that effect);
- it fails to confirm its intention to comply with its prospective funding obligations following written request by the administrative agent or the borrower (the “Failure to Confirm Limb”); or
- it or its parent becomes subject to any bankruptcy or receivership proceedings.

Note three things about the defaulting lender definition. First, a lender will not be a defaulting lender due to its failure to fund borrowings or its delivery of a notice of intent not to fund (or public statement to that effect) if it expressly states that such failure or notice is the result of its determination that one or more conditions precedent have not been satisfied (the so-called “Good Faith” exception). Second, the Failure to Confirm Limb is designed to be a useful self-help tool. For example, many earlier formulations would have rendered a lender a defaulting lender if it failed to satisfy its obligations under, or was a defaulting lender for the purpose of, other credit facilities. The PMC dropped that difficult-to-pin-down limb and took comfort that if there was any question of a lender’s willingness to fulfill its prospective obligations, the Failure to Confirm Limb would offer the agent and the borrower a mechanism for clarifying that lender’s status. Finally, the list of criteria for defaulting lenders is an objective one (rather than, as was the case in many prior formulations, one that is dependent on an agent and/or the borrower determination). However, to settle any uncertainty that might arise, the agent may determine that, applying the limbs referred to above, a lender is a defaulting lender, and such determination will be conclusive.

The consequences of becoming a defaulting lender have also been clarified and expanded. A defaulting lender may be replaced, its vote will not be counted with respect to majority vote items, and it will not be entitled to receive certain fees. Furthermore, any fronting exposure of a letter of credit issuer or swingline lender to a defaulting lender will, subject to satisfaction of normal borrowing conditions, be reallocated to non-defaulting lenders up to the amount of such non-defaulting lenders’ unused commitments. To the extent that the letter of credit issuer or swingline lender has any fronting exposure to a defaulting lender following such reallocation, the borrower is required to repay (in the case of swingline loans) or cash collateralize (in the case of letters of credit) that exposure. Letters of credit need not be issued, and swingline loans need not be made, if after giving effect thereto there would be any remaining uncollateralized fronting exposure to a defaulting lender. It should be noted that there is a continuing debate about the extent to which the reallocation of exposure should be subject to conditions, and the market practice on this is not yet settled.

The Revised MCAPs also require that payments otherwise due to a defaulting lender be diverted to support the defaulting lenders’ present and future funding obligations pursuant to a detailed waterfall. To address concerns that this might run afoul of various bankruptcy/receivership regimes, certain safety valves were included to ensure that the agent would not be required to apply amounts in accordance with the waterfall if that would be contrary to law, and to enable the agent to place an administrative hold on funds pending receipt of a court order.

Tax Provisions

The Revised MCAPs divides the universe of taxes into those imposed on payments, which are covered by the tax gross-up and tax indemnity, and those that are not, which are addressed instead by the increased costs provision. Thus, subject to various exclusions, typical withholding taxes are covered by the tax gross-up and tax indemnity, while bank taxes on a lender’s capital or liabilities are covered by the increased costs provision.

Scope of the Tax Gross-up and Tax Indemnity

Consistent with prior versions of the MCAPs, certain taxes are excluded from the tax gross-up and tax indemnity. Some of the exclusions did not change; others are new to, or have been modified in, the Revised MCAPs.

The PMC broadened slightly the exclusion for net income taxes. As in the prior version, the Revised MCAPs excludes net income taxes, franchise taxes and branch profits taxes, but rather than merely excluding such taxes to the extent they are imposed by the
jurisdiction of the lender, the lender's principal office or the lending office, the Revised MCAPs excludes such taxes to the extent they result from any connection between the lender and the taxing jurisdiction.

The PMC also excluded taxes imposed under the recently enacted FATCA regime, under which a U.S. withholding tax will be imposed on interest and gross proceeds paid to certain foreign entities that fail to comply with new U.S. tax reporting requirements. For purposes of this exclusion, FATCA is limited to the statutory provisions as of the date of the agreement or any amended or successor version that is “substantively comparable and not materially more onerous to comply with” and any current or future regulations or official interpretations thereof. Thus, the LSTA struck a balance between protecting borrowers in the event of minor future amendments and protecting lenders from an unknown, potentially onerous modification to the statute.

The Revised MCAPs now allow a participant to receive a greater payment under the tax gross-up and tax indemnity than the participating lender would have received, provided that the additional tax is due to a change in law that occurred after the participant acquired its participation interest. The revised tax sections also acknowledge that the administrative agent, rather than the borrower, will often be the withholding agent, and include more extensive tax forms provisions.

Increased Costs

One of the most significant tax changes to the Revised MCAPs, the new increased costs provision, was drafted with an eye to protecting lenders from the various proposed bank taxes. The PMC took the view that a newly imposed bank tax is similar to an increased cost resulting from a regulatory change and, therefore, should be similarly covered by the increased costs provision.

While the increased costs provision has some complicated cross-references, essentially the provision covers taxes that (i) are not imposed on payments and (ii) are not net income or franchise taxes imposed because of a lender's connection with the taxing jurisdiction.

Participation Register

Also new to the Revised MCAPs is the inclusion of a participation register. Non-U.S. lenders that are not in treaty jurisdictions or engaged in a U.S. trade or business rely on the “portfolio interest” exemption to receive interest without U.S. withholding tax; this exemption requires that the debt be in registered form for U.S. federal tax purposes. For this reason, it has long been market practice for the administrative agent to maintain a register of assignments.

More recently, parties to credit agreements have been concerned that a register may also be required for participations on the theory that participations may represent beneficial ownership in the underlying loan for U.S. federal tax purposes. The Revised MCAPs requires lenders to maintain a register of their participations. Because lenders are typically reluctant to reveal the identity of participants, the provision only requires lenders to disclose the information contained in the register when necessary to establish that the loan is in registered form.

Lender Tax Indemnity

The Revised MCAPs also requires each lender to indemnify the administrative agent for taxes attributable to the lender or taxes attributable to the lender's failure to maintain a participation register.

Other Provisions

The PMC also made certain modifications in the Revised MCAPs designed to update the form for recent regulatory developments and market trends. The increased cost protections provided to lenders now expressly include Basel III and Dodd-Frank, to address uncertainties regarding implementation and timeline of those new regulations and standards. In response to cases like Clear Channel and Hexion, and consistent with now standard market practice, the borrower's submission to jurisdiction has been modified to be exclusive (typically New York). The indemnification provisions were modified to ensure that the lenders’ obligation to indemnify the agent in connection with suits by lenders was clear, in part driven by arguments raised in the Harbinger case. Other provisions, such as agency, assignment and electronic communications, have also been augmented and modernized, including by adding a mechanism in the agency provision for the removal of an agent that has become subject to bankruptcy or receivership proceedings (addressing a challenge many faced following the Lehman bankruptcy).
FIXATED ON FIXTURES: AN OVERVIEW OF PERFECTING AND ENSURING PRIORITY OF SECURITY INTERESTS IN FIXTURES

By Brennan Posner, Sutherland Asbill & Brennan LLP

More than half a century after the Uniform Commercial Code (“UCC”) was first adopted, courts, creditors, attorneys and scholars still find themselves puzzling over what constitutes a “fixture.” How to define “fixture” has been analyzed extensively and is only summarized briefly here.1 The goal of this article is not to add to that discourse, but instead to provide a foundation for creditors and practitioners to determine how best to protect their or their clients’ interests when confronted with collateral that may consist of fixtures. This article begins with an overview of how fixtures are defined—or, perhaps more appropriately, are undefined—under the UCC and state law. It then summarizes the methods to perfect a security interest in fixtures and the special rules that apply if the debtor is a “transmitting utility.” The article concludes with a description of the priority rules contained in Section 9-334 of the UCC, and concludes with practical advice for protecting the priority of security interests in fixture collateral.

I. What is a “fixture”?

Fixtures are defined in Article 9 of the UCC to include “goods that have become so related to particular real property that an interest in them arises under real property law.”2 “Goods” is a broad category of property under the UCC that includes “all things that are movable when a security interest attaches.”3 Since state law governs whether or not a real property interest may arise in a particular piece of property, the UCC definition of “fixture” is not a definition so much as it is a nod to the real property law of each state to determine if a “good” constitutes a fixture. Most states have looked to the factors established by the Supreme Court of Ohio in Teaff v. Hewitt to determine whether or not a good is a fixture. Those factors include the following: (1) whether the good is attached to the real property, (2) whether the good has been adapted for the use of the real property, and (3) whether the party making the annexation intended the good to be permanently attached to the real property.4 Of those factors, intent is regarded as the most important, and must be evidenced by some objective manifestation so as to put third-parties on notice.5 Courts often look for evidence of intent in how firmly the goods are attached to the real property and how difficult it would be to detach and remove them.6

Under the “half-inch formula” proposed by Professors White and Summers, “anything which could be moved more than a half inch by one blow with a hammer weighing not more than five pounds and swung by a man weighing not more than 250 pounds would not be a fixture.”7 Unfortunately, the line between fixture and non-fixture is no more certain than the amusing image presented by this analogy. Since the UCC defers to state real property law to define fixtures, what may or may not be a fixture is not uniform amongst the states. Moreover, because the attachment of the goods and their adaptation for the use of the real property are considered together with, and may be overridden by, the intent of the annexing party, it is difficult to predict whether or not a good is or may become a fixture based on the characteristics of the good alone. A sampling of case law illustrates this predicament. Examples of property that have been determined not to constitute fixtures include a machine weighing 45,000 pounds, measuring approximately 10.5 feet wide by 8 feet long, anchored in place by two or three leg screws on each side, and connected to a 220 volt electrical line; a five bedroom house constructed by the lessee of land; a grain bin measuring 30 feet in diameter with a 14,000-bushell capacity which was bolted to a concrete slab; and a modular building used as a drive-through fast-food restaurant.8 On the contrary, a court determined that a mobile home was a fixture where “[t]he bankrupt's actual intention pointed definitely toward affixing the mobile home to the land as a permanent residence, as seen in his application for a building permit (which, by law, required him to erect a concrete slab as a permanent foundation within one year), his purchase of a homeowner's insurance policy, and his requests made to the seller to have the wheels of the home removed.”9 In attempting to determine whether or not collateral consists of goods that are or may become fixtures, the best a creditor can do is make an educated guess.

II. Perfecting a Security Interest in Fixtures

Section 9-334 of the UCC provides that a security interest under Article 9 “may be created in goods that are fixtures or may continue in goods that become fixtures.”10 There are three principal methods to perfect a security interest in goods that are fixtures. A creditor may file a financing statement with the applicable Secretary of State or such other office where it would normally file a financing statement covering personal property.11 Alternatively, the creditor may file a “fixture filing” in the local office where it would normally record a mortgage to encumber the related real property.12 A fixture filing contains the same contents as a personal property filing, and in addition it must also (i) specify that the collateral includes fixtures, (ii) indicate that it is to be filed in the real property records, (iii) provide a description of the related real property (a complete and recordable description is not necessary, but advisable), and (iv) provide the name of the record owner if the debtor does not have an interest of record.13 The third method, available in most jurisdictions, is to record a record of mortgage in the real property records that identifies the goods that it covers and meets the requirements of a fixture filing.14 In practice, however, a lender that obtains a real estate mortgage that covers fixtures will typically still file a separate fixture filing.
Each of the foregoing methods will result in the creditor having a perfected security interest in the fixtures of the debtor covered by such filing or recording. However, there are two principal distinctions that result from the manner of perfection. First, the personal property filing and the fixture filing will both lapse after five years unless properly continued. A record of mortgage on the other hand will remain effective to perfect against fixtures until the mortgage is satisfied or expires by its own terms or state real property law. Second, the personal property filing only gives protection against subsequent (and sometimes prior) personal property filings, whereas the fixture filing only gives protection against subsequent (and sometimes prior) lien creditors, and “certain other claimants where the fixture involved is not considered to be important to mortgagees and the like.” On the other hand, a fixture filing or record of mortgage may also provide protections against certain parties with interests in the real property to which the fixture is attached. These priority issues are examined in Part III below.

Special rules for perfecting security interests in fixtures are available to creditors when the debtor is a “transmitting utility.” There is some variation among the states as to what constitutes a transmitting utility, and very little case law on the issue, but generally the definitions include rail transportation operators, telecommunication operators, persons that transmit goods by sewer or pipeline or producers and transmitters of electric, gas, steam or water. Most jurisdictions allow a creditor to perfect against a transmitting utility’s fixtures by filing a financing statement in the same office where the creditor would file to perfect against personal property. The obvious advantage is that a single filing supplants the multitude of fixture filings that may be required to perfect against all of a debtor’s fixtures within a state. However, since the local law of the jurisdiction where the fixtures are located governs perfection of a security interest in goods by filing a fixture filing, a central transmitting utility filing will be required in each state where goods that are or are to become fixtures are located. Another significant advantage of a transmitting utility filing is that, in most states, the filing remains effective until it is terminated. The only requirements to obtain transmitting utility status for a financing statement are that the debtor must satisfy the definition of “transmitting utility” and the filing must indicate such status of the debtor.

III. Priority Issues

Among dueling creditors with security interests in the same fixture but without interests in the realty to which such fixture is attached, the normal rules in Article 9 governing the priority of competing claims to personal property apply. However, between the fixture creditor and an owner or encumbrancer of the real property to which a fixture is affixed, the priority of these competing interests begins at the “residual rule” that “a security interest in fixtures is subordinate to a conflicting interest of an encumbrancer or owner of the related real property other than the debtor.” Fortunately for the fixture creditor, this rule is subject to a number of exceptions. The priority afforded to purchase-money fixture creditors is subject to an exception for the interest of a mortgagee under a construction mortgage. A construction mortgage is defined as a mortgage that “secures an obligation incurred for the construction of an improvement on land, including the acquisition cost of the land, if a recorded record of the mortgage so indicates.” A purchase-money security interest in fixtures is subordinate to a construction mortgage if a record of the mortgage is recorded before the goods become fixtures, and the goods become fixtures before the construction is completed.
mortgage will be afforded the same priority as the original mortgage.\textsuperscript{31} The preference given to this class of mortgagees does not apply to the other exceptions to the residual rule. Thus, a fixture creditor may prevail over the interest under a construction mortgage if, for example, it is first to file in the real property records or, as discussed below, the fixture creditor is perfected in certain readily removable goods.

Priority is also provided to the fixture creditor in certain readily removable goods. White and Summers describe such goods as "‘non fixture’ fixtures", and the drafters of the 1972 version of Article 9 classified them as “items that are ‘fixtures’ under state law [but] would never be relied upon by a mortgagee.”\textsuperscript{32} Goods that fall within this exception must be “readily removable” and constitute factory or office machines, equipment that is not primarily used or leased for use in the operation of the real property, or replacements of domestic appliances that are consumer goods.\textsuperscript{33} A security interest in such goods may be perfected by any method permitted pursuant to Article 9, but must be perfected before the goods become fixtures. This rule is also an exception to the first to file principle, and affords priority over prior and subsequent owners or encumbrancers of the related realty.\textsuperscript{34}

There are three other priority rules in Section 9-334 of the UCC that warrant mention. A security interest perfected by any method permitted by Article 9 will have priority of a later lien obtained by legal or equitable proceedings, including a trustee in bankruptcy.\textsuperscript{35} Thus, a perfected security interest in fixtures may not be avoided by a trustee in bankruptcy under Section 554(a) of the Bankruptcy Code.\textsuperscript{36} A security interest in a “manufactured home” obtained in a “manufactured home transaction” (each as defined in Article 9) that is perfected pursuant to a certificate of title statute has priority over prior and subsequent interests of encumbrancers and owners of the related real property.\textsuperscript{37} Finally, perfected and unperfected security interests in fixtures have priority over an owner or encumbrancer of the related real property if the encumbrancer or owner, in an authenticated record, consents to the interest or disclaims an interest in the goods as fixtures, or if the debtor has a right to remove the goods as against the encumbrancer or owner.\textsuperscript{38} Thus, a fixture creditor, regardless of whether its security is perfected, may rely on the debtor’s right to remove a fixture to establish priority over the landlord of the debtor or such landlord’s creditor.

IV. Conclusion: Belt-and-Suspenders Protection is Best

When collateral consists of goods that might be or become fixtures, “belt-and-suspenders” protections should be the creditor’s guiding principle. A creditor cannot conclusively determine in many instances whether a good is or is not a fixture, and it cannot predict or prevent all circumstances under which that good might become a fixture. As a result, the creditor must analyze the competing claimants that exist in the case of non-fixture goods and in the case of fixtures, and take steps to protect itself in either result. Where collateral might be or becomes fixtures, it is generally advisable to file both a fixture filing and a personal property filing. Both filings will result in perfection in the fixtures, but without the personal property filing the creditor will likely be unperfected if the goods turn out not to be fixtures. Moreover, the fixture filing is required for the creditor to obtain first to file and purchase-money priority over owners and encumbrancers of the related real estate.\textsuperscript{39} If the debtor may be a transmitting utility, it would be advisable to file a fixture filing in addition to the central transmitting utility filing so that the creditor will be protected if it is determined that the debtor is not a transmitting utility. In each instance, an unnecessary fixture filing is unlikely to impair the creditor’s position, since “[c]ourts should not infer from a fixture filing that the secured party concedes that the goods are or will become fixtures.”\textsuperscript{40}

In addition to covering all of the bases for filing, the fixture creditor should consider existing real and personal property claimants and consider whether steps are necessary to obtain a subordination of those interests. In order to identify competing personal property interests, the creditor should obtain a lien search from the Secretary of State or other appropriate office in the jurisdiction where the debtor is “located.”\textsuperscript{41} Identifying parties with interests in the related real property could be more difficult. To identify owners of the real property, the creditor must either rely on information from the debtor or search the real property records where the subject collateral will be located. A local fixture filing search will be helpful in identifying mortgagees of the related real property, but these searches might omit a mortgagee that did not file a fixture filing separate from its mortgage. The extent to which a creditor should go to identify such interests will depend on the value and importance of the collateral.

Earlier owners and encumbrancers of real property will generally prevail over later creditors, so once such competing interests are identified the fixture creditor must consider how to protect its security interest against such parties. The creditor might seek to obtain subordination agreements from prior real and personal property claimants. The creditor should consider whether a lessor or mortgagee has already subordinated any interest in the debtor’s fixtures by disclaiming an interest in the goods as fixtures in the lease or mortgage or providing therein that the debtor has a right to remove fixtures. If feasible, the creditor should include a clause in its loan agreement providing that the debtor agrees not to affix goods to any real property. Such a provision will help prove that the debtor did not intend for the goods to become fixtures if a court ends up analyzing the issue. The creditor should also consider whether it can prime such earlier interests through one or more of the priority rules set forth in Section 9-334 of the UCC. If it can, the creditor must study the rule carefully to ensure compliance with each discrete requirement.

In approaching fixtures, creditors must remember that “[p]erfection is not perfect; it gives the secured party the most that it can gain in a priority dispute but does not assure victory.”\textsuperscript{42} If a fixture creditor determines the most that it can gain before it extends credit, it will be in the best position to ensure that it realizes the benefit of its bargain if it must look to the collateral to be made whole.
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.

In re Ruiz,
455 B.R. 745 (B.A.P. 10th Cir. 2011)

The Spring edition of this column heavily criticized the decision, currently on appeal, in In re Mwangi, 432 B.R. 812 (B.A.P. 9th Cir. 2010). In that case, the court ruled that Wells Fargo Bank violated the automatic stay by refusing to release to the debtor funds on deposit that the debtor had claimed as exempt, even though the time for objecting to the claimed exemption had not yet expired. In making the ruling, the court repeatedly referred to the “account funds,” as if they were a res at issue in the case, and ignored the true nature of a deposit account: merely the unsecured promise of the bank to repay the deposit. Well, Tenth Circuit BAP has now committed the same analytical error, but this time quite deliberately.

The case involved several checks that the individual debtors had written pre-petition but which the drawee bank honored post-petition. Instead of suing the payees under § 549 to recover unauthorized post-petition transfers, the trustee moved for an order under § 542 requiring the debtors to turn over the amount that had been on deposit on the date of the petition. The bankruptcy court denied the motion, concluding that the debtor’s checking account was merely a debt owed by the bank to the debtors, and it was this receivable, rather than the funds themselves, that constituted property of the estate. The court then concluded that the debtors had no duty to collect on that promise for the benefit of the estate and that they had constructively turned over this property by disclosing it in their schedules. See In re Ruiz, 440 B.R. 197 (Bankr. D. Utah 2010). The trustee appealed.

The BAP began by acknowledging that the Supreme Court’s language in Citizens Bank of Maryland v. Strumpf, 516 U.S. 16 (1995), supported the position of the debtors and the bankruptcy court. However, the BAP then noted that the context of that case – which involved whether freezing a deposit account violated the automatic stay’s prohibition on setoff – was different, and thus the case was not dispositive. True, but that does not mean that the Supreme Court’s observations about the nature of a deposit account were incorrect or irrelevant.

The BAP then stated that the debtors’ relationship with their bank was “considerably different than the typical debtor-creditor relationship” because the debtors maintained the right to withdraw the funds at any time, to direct the bank to deliver the funds to a third party, or to leave the funds on deposit. In fact, these rights are not all that different from those possessed by the holder of a demand note. The holder can demand payment at any time, negotiate the note to a third party (to whom the maker would then be obligated to remit payment), or simply refrain from making a demand while interest accumulates on the obligation. In short, none of the debtors’ rights as depositors against their bank are inconsistent with a debtor-creditor relationship. More to the point, nothing about depositors’ rights in any way gives depositors ownership of funds in the bank’s possession. Indeed, as a group, depositors cannot possibly “own” their deposited funds because no bank retains 100% of its deposits on hand; instead banks loan out the great percentage of what they take in as deposits. The bulk of banks’ assets are secured and unsecured receivables, not “funds.”

Nevertheless, without any real explanation or any discussion of how banking actually works, the BAP concluded that these rights of depositors somehow rendered the deposited funds property of the estate. As a result, the debtors could be ordered to turn over the amount on deposit even though those funds had since been dissipated by the bank’s honor of the checks.

The correctness of the BAP’s ultimate ruling – that the debtors could be ordered to turn over the account balance as of the petition date – is beyond the scope of this critique. It may be, although it seems unlikely, that § 542 can properly be used to order a debtor to “turn over” the obligation owed by a third party. But cf. In re Falzerano, 2011 WL 3477218 (B.A.P. 8th Cir. 2011) (§ 542(b), not turn over under § 542(a), is the appropriate provision to use to recover a debt owed to the estate). Certainly the court went on at length as to why its decision was sound as a matter of policy. However, the fact remains that depositors do not own the funds on deposit and courts need to stop analyzing legal problems as if they did.
This case involved a mortgagee’s right to funds forfeited by realty purchasers. The debtor was a condominium developer that entered into contracts to sell units to numerous purchasers. The purchasers paid deposits of approximately $3 million, which were put in escrow pending completion of construction and consummation of the sales. Subsequently, the debtor borrowed $16 million to finance construction and gave the lender a mortgage on the real estate. Neither the mortgagee nor its assignee ever filed a financing statement or entered into a control agreement.

After the debtor filed for bankruptcy protection, the bankruptcy court determined that several purchasers had forfeited their deposits, totaling $550,000. The debtor moved to avoid the mortgagee’s lien on the escrowed deposits, claiming that the lien was an unperfected security interest governed by UCC Article 9.

The bankruptcy court ruled for the mortgagee, concluding that the mortgagee’s interest extended to the escrowed deposits. In doing so, the court relied heavily on the Eleventh Circuit’s decision in In re Aldergate Foundation, Inc., 878 F.2d 1326 (11th Cir. 1989). In that case, the bankruptcy trustee contracted to sell some of the bankruptcy estate’s mortgaged real property. Two purchasers defaulted and the issue was whether the forfeited deposits were proceeds of the real property and subject to the mortgage. The court, relying partly on the definition of “proceeds” in Article 9, concluded that they were. Based on that precedent, the bankruptcy court in this case concluded that the mortgagor’s lien reached the escrowed deposits.

Unfortunately, while that was all the court needed to say, the court said much more. The court began its analysis by stating that the threshold question was whether the escrowed deposits were proceeds of the condominium units themselves, “taking them outside the scope of the Uniform Commercial Code and . . . making them . . . subject to [the] Mortgage,” or non-realty collateral subject to the Uniform Commercial Code. This was a false choice. The escrowed deposits – or more precisely, the debtor’s interest in the escrowed deposits – may well be proceeds of the real estate and subject to the mortgage. Whether they are or are not is a question of the applicable real property law and the language of the mortgage documents. Given the Eleventh Circuit’s decision in Aldergate, the court in this case was probably correct that the mortgage did cover the escrowed deposits. However, the debtor’s interest in the escrowed deposits was unquestionably personal property. There is therefore no reason why a security interest in them could not also be obtained and perfected pursuant to Article 9. In short, assets can be both personal property and proceeds of real property. There is nothing inconsistent in those two classifications.

The court’s remaining discussion was even more troublesome. In discussing whether Article 9 would apply, and specifically whether the debtor’s right to the deposits would be an “account,” the court correctly noted that revised Article 9 expands the definition to include rights to payment from the sale of “property,” rather than merely rights to payment from the sale of “goods.” See § 9-102(a)(2) & cmt. 5a. However, the court suggested that this was irrelevant because § 9-109(d)(11) still excludes from the scope of Article 9 the creation or transfer of an interest in or lien on real property. In this the court was confused, again failing to appreciate the difference between a lien on real property and a lien on the personal property proceeds of real property. Nothing in § 9-109 excludes from the scope of Article 9 a security interest in personal property merely because it happens to be proceeds of real estate.

Finally, as an apparent alternative holding, the court indicated that even if Article 9 did apply, the mortgagee was perfected by possession because the escrow agent had acknowledged, in an authenticated record, that it was maintaining possession of the deposits for the benefit of the mortgagor. In connection with this, the court stated expressly that “money, when deposited into a bank account, is still money and therefore perfection can be achieved through possession.” This is patently incorrect. The depositor’s interest in a deposit account is not “money” within the meaning of § 1-201(b)(24), which defines money as a medium of exchange authorized or adopted by a domestic or foreign government.” The depositor’s interest is a “deposit account,” see § 9-102(a)(29), and the only way a security interest in it as original collateral can be perfected is by control. See § 9-312(b)(1). Indeed, the escrowed deposits were likely never “money” within the meaning of the UCC. In all probability, the purchasers had paid their deposits by check (an instrument) or by funds transfer, not in coin or paper currency. While it may be that the mortgagee’s interest was perfected by control under § 9-104(a)(3) – because the escrow agent was both the bank’s customer and the acknowledged agent of the mortgagee – perfection by possession was not possible. See also Laborers Pension Trust Fund-Detroit and Vicinity v. Interior Exterior Specialists Co., 2011 WL 5211481 (E.D. Mich. 2011) (improperly characterizing as “money” a special account created and funded by a judgment defendant to provide a source for payment of the judgment the defendant lost on appeal, and ruling the judgment creditor was perfected by possession).

In re Westbay,
2011 WL 2708469 (Bankr. C.D. Ill. 2011)

This is a fairly simple case in which the court reached the correct result but its analysis was far more complex than it needed to be.

The debtor in the case was a member of an LLC. He had pledged his LLC interest to secure a loan used to finance the LLC. Within the preference period, the debtor sold his LLC interest and the loan proceeds were paid to the lender. During the bankruptcy, the
trusted to recover the payment as a preference, claiming that the lender had no security interest in the debtor's LLC interest because the LLC agreement required the unanimous written consent of all members to any transfer of a member's interest and no such written consent was provided.

The court decided the matter based on waiver, holding that requirement of written consent had impliedly been waived because all the members knew of and benefitted from the transaction, which was in exchange for a loan of working capital to the LLC. However, there was a far simpler approach. Section 9-408(a) overrides contractual terms that restrict or require consent to the transfer of or creation of a security interest in a general intangible. Although a member's interest in a closely-held LLC can qualify as a security, see § 8-102(a)(15), it is far more commonly a general intangible. Because the LLC was apparently created under Illinois law, and Illinois has enacted the uniform text of § 9-408, see 810 Ill. Comp. Stat. ¶ 5/9-408, the consent requirement was invalid and it should not have been necessary to inquire into whether the parties had waived it.

*In re American Cartage, Inc.,* 656 F.3d 82 (1st Cir. 2011)

This is the first of two cases that significantly misconstrue the term “proceeds.” The essential facts are as follows. The debtor, a waste-disposal firm, granted a security interest in virtually all its personal property to Financial Federal Credit, Inc. (“FFC”). After the debtor went into bankruptcy, FFC obtained relief from the stay and sold the collateral to a buyer who later re-sold it to City Sanitation LLC (“City”). City brought four tort claims against an individual and a business that the bankruptcy trustee had hired to manage the debtor’s assets. The claims were for (i) conversion; (ii) breach of fiduciary duty; (iii) interference with contract; and (iv) civil conspiracy. After the trustee learned of the pending action, the trustee intervened claiming that the claims were estate property. City objected, asserting that the claims were proceeds of the collateral it had purchased. The bankruptcy and district courts ruled for the trustee and City appealed.

The circuit court treated the case as raising a broad question: whether a commercial tort claim can ever be proceeds of other collateral. The court ruled that it could not be. While it agreed that the right to a tort *recovery* can be proceeds of other collateral, the commercial tort *claim* itself – and hence standing to pursue a commercial tort claims – cannot be proceeds of other collateral.

To reach its conclusion, the court reasoned that “treating commercial tort claims themselves as proceeds would blur any meaningful distinction between the two categories.” Yet it offered no reason why these two categories are supposed to be mutually exclusive. It also ignored § 9-102(a)(64)(D), which defines “proceeds” to include “claims arising out of the loss, . . . interference with the use of, . . . or damage to, the collateral” (emphasis added).

Certainly many of Article 9's classifications of collateral are mutually exclusive. While a piece of machinery can be both “goods” and “equipment,” for example, it cannot be both “equipment” and “inventory.” See § 9-102(a)(33) (defining “equipment” to be goods other than inventory, farm products, or consumer goods). Similarly, a receivable can be an account, chattel paper, or payment intangible, but cannot be more than one of them. See § 9-102(a)(2), (42), (61) (defining “account” to exclude “chattel paper” and defining “payment intangible,” a type of general intangible, to exclude anything qualifying as an account or chattel paper). However, “proceeds” is a term that cuts across the classifications of collateral. All proceeds must also fall into one of the Article 9 classifications and no classification is inconsistent with the scope or definition of proceeds. It was the court’s understanding of Article 9 that has blurred, not the false distinction the court tried to preserve.

Still, the court’s ultimate conclusion may be at least partially correct. The court never identified precisely what property FFC had sold and City had acquired. The court also did not specify whether the tort claims related to conduct that occurred before or after the sale. Therefore, it is difficult to evaluate whether the tort claims were in fact either: (i) proceeds of the collateral that City had previously purchased; or (ii) generated prior to and included in the assets sold. If the tortious conduct predated the sale but the sale did not purport to include the tort claims, then the court was probably correct in concluding that the claims did not belong to City. Moreover, while it seems likely that the conversion claim was proceeds of the property converted and the inference with contract claim was proceeds of the contract rights to which it related, it would be more difficult to conclude that the breach of fiduciary duty and civil conspiracy claims were proceeds of any of the debtor’s assets. Therefore, the court was likely correct as to those claims.

Putting the ultimate conclusion aside, the fact remains that the court’s analysis leads to very troubling results. In the normal course of events, collateral that becomes subject to a claim for conversion could be expected to transmute as follows:

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original collateral ——> claim for conversion ——> recovery
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The court indicates that the middle step is not proceeds, only the last step is. But it is not clear that the last step can be proceeds of the original collateral if it is not proceeds of the claim. If the security interest has in fact been lost when the collateral is converted, can it really magically reappear – that is, re-attach – when the recovery is obtained? The concept of proceeds and the rule of § 9-315(a)(2) are designed to provide continuity; the loss of continuity implies a loss of attachment. Even if this metaphysical problem can be resolved, the court's conclusion unquestionably – and unnecessarily – results in a period in which there is no collateral, leaving the secured party vulnerable to preference attack if the recovery is obtained in the preference period. That may not be a major problem if
the court’s conclusion is limited to claims for conversion or other torts. However, if the court’s conclusion were to apply to insurance – so that the claim against the insurer is not proceeds, only the later recovery is, then the potential preference problem becomes much more serious.

**In re Young,** 2011 WL 3799245 (Bankr. D.N.M. 2011)

This is the other case that adopts a miserly interpretation of the term “proceeds.” While much was going on in the case, for the purposes of this column, the facts are simple. Post-petition, the debtors received member withdrawals from an LLC they owned. The issue was whether these withdrawals were proceeds of a bank’s prepetition security interest in the debtors’ general intangibles, which encompassed their LLC interests. The court expressly regarded the withdrawals as “a form of distribution on account of their equity interests,” but nevertheless concluded that they were not proceeds. The court treated as “dispositive” the Tenth Circuit’s ruling in *In re Hastie,* 2 F.3d 1042 (10th Cir. 1993), which held that corporate dividends were not proceeds of the stock in the corporation.

What the court overlooked was the fact that *Hastie* – questionable when decided – has since been legislatively overruled. The definition of “proceeds” in revised Article 9 expressly includes “whatever is collected on, or distributed on account of, collateral.” § 9-102(a)(64)(B). Someone involved in this case – the lawyers, the judge, the law clerks – needs to be more careful.

**In re Palmdale Hills Property, LLC,** 457 B.R. 29 (B.A.P. 9th Cir. 2011)

This is a rather lengthy case about who has authority to file a proof of claim in bankruptcy. The court reached the correct result but its analysis of repurchase agreements was significantly off the mark.

The facts of the case can be simplified as follows. Lehman Commercial Paper, Inc. sold SunCal mortgage loans to Fenway Capital, Inc. pursuant to a repurchase agreement. Fenway then, indirectly, pledged the loans as collateral to Lehman Brothers Holdings, Inc. (“LBHI”).

When SunCal went into bankruptcy, the Lehman entities filed a proof of claim. SunCal objected to the claim, arguing that the Lehman entities were neither creditors nor a creditor’s authorized agent as required by Bankruptcy Rule 3001(b). Lehman responded that it was the creditor because the repo transaction with Fenway was really a secured loan. Alternatively, it argued that it was, as the servicer of the loans, Fenway’s authorized agent.

The bankruptcy court ruled that Lehman was not the creditor because it had sold the loans to Fenway under the repurchase agreement. However, it ruled that Lehman, as an agent of Fenway, did have authority to file the proofs of claim. SunCal appealed the agency rule and Lehman appealed the ruling that the repurchase agreement was a true sale.

The BAP began its analysis by examining whether the repurchase agreement was a true sale. Its analysis was rather brief. The court concluded that the repurchase agreement was unambiguous in describing the parties as buyer and seller, and thus the parties “intended the transaction to be a sale.” Because of that, the bankruptcy court was not required to look beyond the four corners of the agreement to determine the parties’ intent.

The problem with this analysis is that the characterization of the transaction should be based on its economic substance, not the parties’ intent. This is evidenced most clearly by § 9-109(a)(1), which provides that Article 9 applies to any transaction, regardless of its form, that creates a security interest in personal property by contract. See also § 1-203 (distinguishing a lease from a sale with a retained security interest). This language is notably different from the language of old Article 9, which covered “any transaction (regardless of its form) which is intended to create a security interest in personal property.” § 9-103(1)(a) (repealed) (emphasis added). Even under this
original phrasing, the matter was supposed to be determined based on an objective review of the transaction, not the subjective intent of the parties. That is because the rights of third parties can be greatly affected by whether Article 9 applies, and the two parties to the transaction should not have unfettered discretion to avoid Article 9. The revision to Article 9, by removing all reference to intent, made this even more clear. Unfortunately, the BAP never even cited to § 9-109.

More to the point, the court overlooked some rather simple points. In a true sale, the buyer gets and keeps the property; the seller does not get it back. If one of the parties has an obligation to reverse the transaction – that is, if the seller has an obligation to sell the property back or the buyer has an obligation to repurchase it – the transaction may or may not still be a true sale. If there is a reasonable chance that the buyer may keep the property (i.e., there is a realistic possibility that whoever has the option to reverse the transaction will not exercise that option), then the form of the transaction as a sale will be respected. If, however, it can be predicted at the outset that the buyer will in fact return the property to the seller, then the transaction really does not look like a sale at all, but like a loan by the buyer to the seller with the property as collateral. In a repurchase agreement where both the buyer and the seller have an obligation to reverse the transaction, there is no doubt that the transaction will be reversed. That is not a sale; it is a secured loan.

Other facts in this specific case made this conclusion even more appropriate. The repurchase agreement expressly provided that Fenway’s rights on default were limited to selling the underlying assets in a commercially reasonable manner under § 9-610, applying the proceeds to the repurchase price, and turning over any surplus. In addition, Fenway was obligated to transfer back identical securities, and because the securities were unique mortgage loans, that meant Fenway had to return the original securities. The court rejected these points as not determinative. Perhaps they are not, but they are both individually and collectively highly probative of the true nature of the transaction. The court, however, entertained no real analysis of the substance of the transaction. It offered no explanation of why it was a real sale instead of a loan. It basically concluded that because the parties called it a sale, then it must be one. That is overly simplistic and simply not what the UCC says.

Because the court also affirmed the agency ruling, it ruled that Lehman’s claims were authorized. Thus, the court did reach the correct result. Unfortunately, it left a bad precedent that raises form over substance.

In re Knowling,
2011 WL 2632153 (Bankr. D. Or. 2011)

This is a case about attachment of a security interest in which the court was led to the wrong result apparently because of some rather poor lawyering.

In return for a loan, the debtor signed a security agreement purporting to grant the lender a security interest in, among other things, a boathouse. Probably because neither party was represented by counsel, the lender took no steps to have his interest noted on the certificate of title for the boathouse. Three months later, the lender learned that, contrary to the debtor’s representations, the debtor’s wife had an interest in the boathouse. The lender assigned the loan to a corporation he owned and corporate counsel prepared a revised security agreement. The debtor signed the new security agreement, which gave the corporation a security interest in certain equipment. The corporation promptly perfected that interest. Less than 90 days later, the debtor went into Chapter 7 bankruptcy and the trustee sought to sell the security interest in the equipment as a preference. The court rejected these points as not determinative. Perhaps they are not, but they are both individually and collectively highly probative of the true nature of the transaction. The court, however, entertained no real analysis of the substance of the transaction. It offered no explanation of why it was a real sale instead of a loan. It basically concluded that because the parties called it a sale, then it must be one. That is overly simplistic and simply not what the UCC says.

The bankruptcy court rejected the new value defense after concluding that the corporation did not in fact have a security interest in the boathouse. This conclusion was, remarkably, based on the language of the revised security agreement itself, which included as a recital a statement that “the [d]ebtor was not able to grant a security interest in a boathouse.”

It is difficult to imagine why such a recital would be included in the revised security agreement. It could not possibly be of benefit to the corporate secured party, whose counsel had prepared the agreement. More to the point, the recital would seem to be incorrect. Even if the debtor did not have full ownership of the boathouse, presumably the debtor could have granted – and had in fact granted – a security interest in his co-ownership rights in the boathouse. Perhaps he could have, through agency principles, also encumbered his wife’s interest.

Beyond all this, it is not clear why that statement in the security agreement should matter at all. The statement was merely a recital, not an operative provision. What’s more, the debtor was presumably the only one who signed the security agreement; secured parties do not normally sign security agreements. Thus, the statement might qualify as a representation by the debtor, but it would not be a representation to the debtor by the corporate secured party. If a basis for estoppel existed, given that the agreement was prepared by the secured party’s counsel, the court never discussed what that basis might be.
This is another case largely about attachment. Much of the court’s analysis is sound, but two egregious errors render the entire decision suspect.

The debtor in the case was a financial service company specializing in financing sales of used motor vehicles. The debtor’s business thus generated a large amount of chattel paper. RCG was one of the debtor’s principal lenders and had purported to conduct a foreclosure sale of chattel paper. After an involuntary bankruptcy petition was filed against the debtor, RCG sought a determination that much of the chattel paper was its property or, in the alternative, for relief from the stay. The court ruled against RCG.

RCG’s original security agreement and financing statement described the collateral to be chattel paper “purchased by Debtor with the proceeds of loans from Secured Party.” A subsequent loan agreement required the debtor to assign all chattel paper to RCG, thereby apparently removing the limitation that RCG provide the financing for the chattel paper. The court correctly concluded that the original security agreement did not cover chattel paper financed by lenders other than RCG. With respect to the subsequent agreement, the court concluded that although the parties attempted to grant RCG a security interest in chattel paper financed by other lenders, because RCG did not make any further advances, it gave no value for that additional collateral and hence the security interest did not attach. This second conclusion is patently incorrect.

Section 9-203(b) identifies three requirements for a security interest to attach. One of those is that “value has been given.” § 9-203(b)(1). For this purpose, § 1-204 provides that a person gives value for rights if the person acquired the rights “as security for . . . a preexisting claim.” While Massachusetts has not yet enacted revised Article 1, virtually identical language appears in old § 1-201(b)(44). In short, antecedent debt is value that supports the attachment of a security interest. Therefore, RCG had given value for the additional collateral and, so long as the language of the agreement so provided, the security interest did in fact cover the chattel paper financed by other lenders.

The court’s alternative holding is even more problematic. Turning to RCG’s foreclosure sale, the court noted several irregularities: (i) the first and third notifications contained the wrong date and the second was sent only two days before the date of sale; (ii) the secured party’s attorney was unaware whether the debtor was in default and did not cause notification of default to be sent to the debtor; (iii) and no effort was made to solicit bids from individuals or entities in the industry by placing advertisements in trade publications, instead only two notices were published in the Boston Herald. From this, the court concluded that RCG’s foreclosure sale was not commercially reasonable. Because of that, the court ruled, the chattel paper remained property of the estate.

There are two main errors in this analysis, one minor and one major. The minor error deals with the bases for the court’s conclusion that the sale was not commercially reasonable. Two of the three irregularities noted simply are not relevant to this conclusion. The first irregularity – the errors with the sale notifications – does not relate to the commercial reasonableness of the sale at all. Article 9 has two independent rules relating to dispositions: (i) all aspects of the disposition must be commercially reasonable, see § 9-610(b); and (ii) notification of the disposition must normally be provided to the debtor, secondary obligors, and other creditors who have filed a financing statement against the collateral, see § 9-611. The court’s discussion improperly conflated these two requirements. Failure to provide proper notification may subject a secured party to liability, but it does not mean the sale itself was commercially unreasonable. The second irregularity is completely irrelevant. What the RCG’s attorney knew or did not know is immaterial. There was no dispute that the debtor was actually in default and nothing in Article 9 requires that the secured party provide the debtor with notification of default. If the security agreement contained such a requirement, the court did not mention it. Thus, there was really only one basis for concluding that the sale was commercially unreasonable, not three.

The court’s major error was in thinking that the failure to provide proper notification or to conduct a commercially reasonable sale invalidates the sale. In fact, Article 9 says almost the exact opposite: a transferee that acts in good faith takes free of the debtor’s interest in the collateral even if the secured party fails to comply with Article 9 when conducting the disposition. § 9-617(b). While RCG did err in several important respects, those errors do not necessarily mean that it failed to act in good faith. Good faith is about honesty and fair dealing. See §§ 1-201(b)(20); 9-102(a)(43). A failure to provide proper notification or to conduct a commercially reasonable sale does not imply either dishonesty or unfairness. More to the point, the court did not even discuss whether RCG lacked good faith. So, the commercial unreasonableness of the sale was not, by itself, sufficient to show that the debtor still owned the chattel paper on the petition date.

In re Moberg,
2011 WL 3745889 (Bankr. D.N.M. 2011)

This is a brief decision about whether a creditor who had not filed a claim had standing to object to the debtors’ Chapter 13 plan. The creditor claimed to have a security interest in both some vehicles and some business equipment that the debtor was proposing to sell. As to the equipment, the court correctly ruled that a factual issue remained as to who owned the collateral: the individual debtors,
who had not signed the security agreement, or the corporation they owned, which had.

As to the vehicles, the creditor submitted into evidence certificates of title showing the corporation as the owner and the creditor as the lienholder. The debtors responded with subsequent certificates showing themselves as the owner, free and clear. From this the court concluded, without any analysis, that the debtors were subsequent transferees who owned the vehicles free and clear. For several reasons, this is not correct.

First, if, as is likely, the creditor’s interest was perfected when the debtors acquired the vehicles from the corporation, then the debtors took subject to the security interest. See § 9-201. Second, if for some reason the creditor’s interest was unperfected even though noted on the certificates of title, the debtors would still take subject to it unless they gave value and received delivery without knowledge of the security interest. See § 9-317(b). The court did not discuss whether the debtors gave value or what they knew, but it seems likely that they did know about the security interest granted by the corporation they apparently owned and controlled. In any event, under no possible interpretation of Article 9 could the debtors’ ownership of the vehicles free and clear be so evident that no factual issue remained.

Admittedly, the security interest in the vehicles would presumably now be unperfected by the issuance of clean certificates of title, although to confirm that one would need to consult the applicable certificate of title statute. But that should not interfere with the creditor’s standing. Unless and until an adversary proceeding to avoid the security interest is brought and won, the creditor’s security interest would remain intact. Moreover, it is far from clear that Chapter 13 debtors have the authority to bring such an adversary proceeding. While the Bankruptcy Code expressly grants the trustee’s avoiding powers to a Chapter 11 debtor in possession, see § 1107(a), there is no such grant of authority to a Chapter 13 debtor, a fact which has prompted several courts to rule that the debtor has no such power. See In re Knapper, 407 F.3d 573 (3d Cir. 2005) (Chapter 13 debtor could not invoke trustee’s strong-arm powers); In re Stangel, 219 F.3d 498 (5th Cir. 2000) (debtor lacked standing to bring § 545 action); In re Hanson, 332 B.R. 8 (B.A.P. 10th Cir. 2005). Contra In re Dickson, 427 B.R. 399 (B.A.P. 6th Cir. 2010) (debtor has derivative standing to pursue avoidance claims under §§ 544 and 547 when the trustee declines to do so); In re Cohen, 305 B.R. 886 (B.A.P. 9th Cir. 2004) (debtor has standing to use trustee’s § 544 strong-arm powers).

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ENDNOTES:

1 For an extensive examination of how “fixtures” are defined in law, see generally Marc L. Roark, Groping Along Between Things Real and Personal: Defining Fixtures in Law and Policy in the UCC, 78 U. CIN. L. REV. 1437 (2010).


3 See id. § 9-102(44); see also id. § 9-104 cmtg. 4.a. (identifying goods as consisting of consumer goods, equipment, farm products and inventory).

4 1 Ohio St. 511, 529-30 (1853).


6 Id. at 342.


8 In re Park Corrugated Box Corp., 249 F. Supp. 56, 58-59 (D.N.J. 1966) (determining that machine could be moved easily, without damage to the structure to which it was affixed and without preventing such structure from being used for the purposes for which it is constructed).

9 Bank of Valley v. U.S. Nat’l Bank of Omaha, 341 N.W.2d 592, 594 (Neb. 1983) (holding that a lease clause allowing the lessee to remove all improvements made by the lessee on the land evidenced the parties’ intention that the house remain the personal property of the lessee).

10 Fed. Land Bank of Omaha v. Swanson, 438 N.W.2d 765, 769 (Neb. 1989) (concluding that the grain bin could be removed from the realty and that the debtor intended that it remain personal property).

11 In re Hot Shots Burgers & Fries, Inc., 169 B.R. 920, 925 (Bankr. E.D. Ark. 1994) (finding persuasive, among other factors, that the modular building had been previously moved to other locations).

12 George v. Commercial Credit Corp., 440 F.2d 551, 554 (7th Cir. 1971).

13 U.C.C. § 9-334(a) (2001). Note, however, that a security interest under Article 9 of the UCC may not be created in ordinary building materials incorporated into an improvement on land. Id.

14 Id. § 9-501(a)(2).

15 Id. § 9-501(a)(1)(B).

16 Id. § 9-502(b).

17 Id. § 9-502(c); see GA. CODE ANN. § 11-9-502(c) (2001) (providing that a real estate mortgage may not be filed as a fixture filing), LA. REV. STAT. ANN. § 10:9-502 (2001) (omitting the model provision allowing a record of mortgage to constitute a fixture filing).

18 Id. § 9-515(g).

19 4 White & Summers, supra note 4, § 33-5, at 340.
20 See ALA. CODE § 7-9A-102(a)(80) (2001) (including “owning, operating, leasing or controlling a ‘utility’ as defined in Section 37-1-30.”), ARK. CODE ANN. § 4-9-102(a)(81) (West 2001) (minor variation to clause (D) of the model code), LA. REV. STAT. ANN. § 10:9-102(a)(80) (2001) (including as a transmitting utility any combination of clauses (A) through (D) of the model code), MINN. STAT. § 336.9-102(a)(80) (2000) (including as a transmitting utility any “person filing a financing statement under this article and under the authority of sections 336B.01 to 336B.03, 507.327, and 507.328”), MONT. CODE ANN. § 30-9A-102(1)(bbbb) (1999) (minor variation to clause (B) of the model code), NEV. REV. STAT. § 104.9102(1)(bbbb) (1999) (including as a transmitting utility a person “providing sewerage” as opposed to one that transmits “goods by pipeline or sewer”), OR. REV. STAT. § 79.0102(1)(aaaa) (2001) (substituting an “organization” for a “person” in the lead-in of the definition).


22 Id. § 9-501(b).

23 See id. § 9-301(3)(a).

24 Id. § 9-515(f) (2001); but see GA. CODE ANN. § 11-9-515 (2001) (omitting the model code provision allowing transmitting utility filings to remain effective until terminated).


26 Id. § 9-334 cmt. 6.

27 Id. § 9-334(e)(1).

28 Id. § 9-334(d).

29 Id. § 9-334(b).

30 Id.

31 4 White & Summers, supra note 4, §33-5, at 345.


33 Id. § 9-334 cmt. 8.

34 Id. § 9-334 cmt. 9.

35 Id. § 9-334(e)(3); see also id. § 9-334 cmt. 9.

36 Id. § 9-334 cmt. 9.

37 U.C.C. § 9-334(f) (2001); see also 4 White & Summers, supra note 3, §33-5, at 345 (discussing the interpretive issues likely to arise in defining the boundaries of “manufactured home”).


39 The fixture creditor should also be mindful that the first to file and purchase-money priority rules require that the debtor have an interest of record in the related real property or be in possession of it. If the debtor leases the property, the creditor should consider requiring that the lease or a memorandum thereof is recorded to prevent issues that may arise if the tenant vacates the property.

40 Id. § 9-334 cmt. 3.

41 See generally id. § 9-301(1) and § 9-307(b).