Dear Members:

With this summer edition we once again meet the goal of releasing up-to-date content immediately before the American Bar Association’s annual meeting (in San Francisco; for the Business Law Section (“BLS”), Friday, August 9 to Sunday, August 11). As many of you know, this will be the last year in which the BLS fully participates in an ABA-wide annual meeting. In 2014, BLS will launch a separate Section-focused meeting, complete with subcommittee and task force meetings and CLE, patterned largely on our spring meetings. The first such meeting will be Thursday, September 11 to Saturday, September 13, 2014 in Chicago.

At this year’s annual meeting, Commercial Finance (“ComFin”) and UCC are prime sponsors of two CLE programs: (i) Venture Lending: I’ve Got the “Next Big Thing,” Can Somebody Loan Me a Dime?, and (ii) Making the Case: Tips for Using (or Being) a UCC Expert Witness. There will also be committee, subcommittee, and task force meetings for those in attendance, whether in person or via conference phone. Beyond that, we continue to explore other initiatives to bring us together and facilitate the exchange of ideas other than at in-person meetings. Look for more information on podcasts, webinars, and conference calls in the time ahead.

This month marks the end of Jim Schulwolf’s tenure as Chairman of the ComFin Committee. Jim’s efforts and contributions are many and significant, including laying the groundwork for a smooth transition for his successor, Neal Kling. If you’re able to join us in San Francisco, be sure to take part in the joint ComFin/UCC dinner (Friday, August 9, McCormick & Kuleto’s) as we thank Jim and welcome Neal.

The targeted effective date for the 2010 Amendments to UCC Article 9, July 1, 2013, is now behind us. The Amendments took effect on such date in no fewer than 46 jurisdictions. A great many of our members, acting in a variety of capacities, did a great deal to facilitate such enactment. We cannot list them all here, but extend a special “thank you” to Tom Buiteweg and John McGarvey, co-chairs of our Joint Task Force on Legislative Enactment of the amendments.

In this edition of the newsletter, our Recent Developments editors (Scott Burnham, Hilary Sledge, and Shadi Enos) provide an update on enactment of UCC Revised Article 1. In a separate article, Hilary Sledge considers the fraud exception to the parol evidence rule and the California Supreme Court’s Riverisland decision. Sutherland Asbill & Brennan LLP’s Carol P. Tello provides her third installment discussing the Foreign Account Tax Compliance Act’s effect on commercial lenders and borrowers. A team of Finance editors at Practical Law, Maria Barclay, Tim Fanning, Sarah Mital, and Peter Washkowitz provide a mid-year summary of trends in Large Cap and Middle Market Loans. Young Conaway’s Norm Powell and John Paschetto summarize this year’s legislative amendments to Delaware’s corporations and alternative entity laws. Finally, in the Spotlight column Steve Sepinuck considers a case that confuses bank accounts and money, an unnecessary determination of the commercial reasonableness of a secured party’s decision to abandon its collateral, a confusion of contract formation and modification, and the challenge of describing collateral acquired from time to time on a consumer credit card.
MARK YOUR CALENDARS

August 13, 2013 – 1:00 p.m. to 2:30 p.m. EDT – Minimizing UDAAP Risks for Consumer Financial Services (CLE Webinar). Click here for more information.

August 14, 2013 – 1:00 p.m. to 2:30 p.m. EDT – Equity Interests as Collateral in Commercial Lending (CLE Webinar). Click here for more information.

August 15, 2013 – 1:00 p.m. to 2:30 p.m. EDT – Supply Chain Risk Assessment and Compliance Strategies (CLE Webinar). Click here for more information.

August 20, 2013 – 10:00 a.m. to 11:30 p.m. PDT – Make-Whole Provisions of Loan Agreements in Bankruptcy: Enforcement Challenges (CLE Webinar). Click here for more information.

August 27, 2013 – 1:00 p.m. to 2:30 p.m. EDT – Bankruptcy Risks for Second Lienholders (CLE Webinar). Click here for more information.

September 17, 2013 – 1:00 p.m. to 2:30 p.m. EDT – Requirements Contracts: Clarifying Ambiguities to Create Win-Win Deals (CLE Webinar). Click here for more information.


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

Norman M. Powell
UCC Committee Chair
NPowell@ycst.com

James C. Schulwolf
Commercial Finance Committee Chair
JSchulwolf@goodwin.com

Featured Notes

RECENT DEVELOPMENTS:
REVISED ARTICLE 1 ENACTMENTS

By Scott J. Burnham

Revised Article 1 was first promulgated in 2001. A good overview of its provisions, emphasizing the changes from former Article 1, is found in Keith A. Rowley, The Often Imitated, But (Still) Not Yet Duplicated, Revised UCC Article 1. A more expansive analysis can be found in Scott J. Burnham, The ABC's of the UCC – Article 1: General Provisions ABA 2ded, 2013).

Revised Article 1 has been enacted in every state and the District of Columbia except for Georgia, Missouri, New York, South Carolina, and Wyoming. Legislation is pending in New York (see http://assembly.state.ny.us/leg/?bn=S05901&term=2013) and South Carolina (see http://openstates.org/sc/bills/2013-2014/S376/). Curiously, the text of the South Carolina bill includes the Official Comments. No state has previously codified the Official Comments, although in Kentucky, KRS § 355.1-103(3) states that the Official Comments “represent the express legislative intent of the General Assembly and shall be used as a guide for interpretation of this chapter.”

One of the significant changes in Revised Article 1 is the definition of good faith. Former Article 1 defined it in § 1-201(19) as “honesty in fact in the conduct or transaction concerned.” Revised Article 1 expanded the definition in § 1-201(b)(20) to include “the observance of reasonable commercial standards of fair dealing.” However, a number of jurisdictions that enacted Revised Article 1 kept the former standard. Those jurisdictions are Alabama, Arizona, Hawaii, Idaho, Illinois, Maryland, Nebraska, Rhode Island, Utah, Virginia, and Wisconsin. Michigan initially enacted the former standard, but replaced it with the new standard effective July 1, 2013. The bill pending in New York contains the former standard while the South Carolina bill contains the new standard.

Of course, each state may have made other changes to the uniform version. So an attorney will need to carefully examine the text in the appropriate jurisdiction.

The Recent Developments column is edited by:

Scott J. Burnham
Curley Professor of Commercial Law
Gonzaga University School of Law
sburnham@lawschool.gonzaga.edu

Hilary Sledge
Sidley Austin LLP
hsledge@sidley.com

Shadi J. Enos
Buchalter Nemer
senos@buchalter.com

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.
WHAT'S MARKET: 2013 MID-YEAR TRENDS IN LARGE CAP AND MIDDLE MARKET LOAN TERMS

By Maria Barclay, Tim Fanning, Sarah Mital and Peter Washkowitz

Despite concerns expressed early in the year that tax-driven activity in late 2012 may have negatively impacted 2013 activity, the U.S. loan market was remarkably active through the first half of 2013. Total U.S. syndicated lending reached $446.75 billion in the first quarter of 2013, a 29% increase over the same period in 2012, according to Thomson Reuters LPC.

This article provides an overview of the large corporate (large cap) and middle market loan markets in the first half of 2013. It examines:

- Key trends in middle market and large cap loan terms.
- Regulatory developments that affected the loan markets.
- Certain factors that have led to changes in loan documentation drafting.
- Loan term trends that emerged or evolved in recent years that have remained in the first half of 2013.
- A look ahead at the loan markets in the second half of 2013.

Overview: Refinancings Dominate

A closer look reveals that by far the largest share of deals were refinancings of existing debt, principally repricings and dividend recapitalizations. With the exception of a handful of large, high profile transactions (such as Heinz, Dell and BMC Software), deal flow from M&A activity and other new money issuances remained relatively light. In fact, 75% of the $447 billion of loan issuances in the large cap and middle markets were for refinancings of existing facilities.

The dramatic comeback of collateralized loan obligations (“CLOs”) has driven the demand for refinancings, with CLO issuance through April 2013 totaling $39.5 billion. This has combined with improving market sentiment, historically low borrowing costs and an influx of capital from investors seeking yields to create very favorable conditions for borrowers. Since refinancings are often arranged on a “best efforts,” rather than “committed” basis, arrangers are increasingly willing to test the market with more aggressive terms, further accelerating the trend towards more borrower-friendly terms.

While activity in the large cap market dominated during the first half of 2013, deal volumes in the middle market proved disappointing for lenders looking to put money to work. Middle market loan issuance totaled $36.54 billion in the first quarter of 2013, a steep decline from the $62 billion record set in the fourth quarter of 2012, according to Thomson Reuters LPC. As in the large cap market, refinancings comprised the majority of middle market deals, with only $13.66 billion of new money deals in the first quarter of 2013.

Market participants point to a number of factors that may have affected middle market credits disproportionately, stifling middle market activity in the first half of 2013. These include:

- Continuing economic uncertainty.
- Lack of meaningful M&A activity.
- Lack of opportunities to lend to quality credits.
- Concerns about excessive leverage.

However, looking forward to the second half of 2013, market observers predict that middle market loan activity will increase. With private equity sponsors showing greater interest in new acquisition opportunities, high demand being pushed by business development company money and more borrower-friendly large cap terms becoming available in the
middle market, practitioners are hopeful that deal flow (particularly in acquisition financing) will start picking up in the second half of 2013.

Key Trends

In the first half of 2013:

- Covenant-lite loan issuance remained strong and covenant-lite features have begun to appear in large middle market deals.
- Certain other large cap terms were increasingly included in middle market deals.
- Second lien loan volume continued to grow on a year-over-year basis.

Covenant-lite Loan Issuances and Features

Covenant-lite loan volume surged in the first quarter of 2013, totaling $78.31 billion, according to Thomson Reuters LPC. One potential driver of this trend may be that CLOs have recently been permitted to hold higher percentages of covenant-lite loans (up from between 30% and 40% to between 50% and 60%), according to Leveraged Finance News.

As covenant-lite loan issuances have reached record highs in the large cap market, covenant-lite features have also recently begun to appear in large middle market deals. While middle market covenant-lite deals are riskier than large cap covenant-lite deals, in the current lending environment many lenders are attracted by the increased pricing of middle market covenant-lite deals.

In addition to becoming accessible to more borrowers, covenant-lite loans are also becoming more borrower-friendly, with terms:

- Excluding letters of credit from outstanding loans for purposes of triggering testing of springing financial covenants. (For a summary of a loan agreement with this exclusion, search Weight Watchers International, Inc. in PLC What’s Market.)
- Including higher thresholds for triggering testing of springing financial covenants.
- Including financial covenant levels set at higher cushions above the borrower’s financial model (from the traditional 25% to 35% in certain recent deals).
- Including equity cures that allow the borrower to reduce revolver outstandings to below the testing threshold, rather than increasing EBITDA.
- Sometimes not requiring the financial covenant to be tested on a “look back” basis upon each borrowing.

Search Tesoro Corporation and Auxilium Pharmaceuticals, Inc. in PLC What’s Market for summaries of recent middle market covenant-lite loan agreements.

The market has also seen a general loosening of certain other negative covenants, providing maximum flexibility for borrowers to:

- Restructure their balance sheet.
- Incur incremental debt.
- Enter into other strategic transactions.

These features are largely borrowed from the bond market, and include loosening restrictions on intercompany investments, increasing flexibility for market buybacks on a non-pro rata basis, and permitting “portability,” which allows a credit facility to survive a change of control in certain circumstances.
Publishing an article with the Commercial Law Newsletter is a great way to get involved with the UCC Committee and the ComFin Committee. Articles can survey the law nationally or locally, discuss particular UCC or Commercial Finance issues, or examine a specific case or statute. If you are interested in submitting an article, please contact one of the following Commercial Law Newsletter Editors Annette C. Moore, Glen Strong, Celeste B. Pozo, Christina B. Rissler, Suhuyini Abudulai or Harold J. Lee.

### Large Cap Terms in Middle Market Deals

In addition to more covenant-lite features, other large cap loan terms have begun to appear in middle market deals based in part on the presence of middle market borrowers backed by top-tier private equity sponsors.

#### Continuing Trends

Large cap terms that are now commonly seen in middle market commitment letters include:

- **SunGard conditionality.** The availability of commitments at closing is subject only to certain limited representations and warranties and collateral requirements set out in the commitment letter (referred to as a SunGard provision). For summaries of middle market commitment letters with SunGard provisions, search Hecla Mining Company and Ignite Restaurant Group, Inc. in PLC What’s Market.

#### Large Cap Terms in Middle Market Deal Terms

- **Limited collateral required at closing.** Although the collateral required as a condition to closing is limited, unlike in large cap commitment letters where certain exclusions are typical, the limitations in middle market deals are negotiated on a deal-by-deal basis and the requirement for execution of account control agreements (often excluded in large cap deals) is still common. For summaries of middle market commitment letters requiring execution of account control agreements as a condition precedent, search Hecla Mining Company and ACP Tower Holdings, LLC in PLC What’s Market.

- **Arranger’s flex rights.** Arranger’s flex rights covering pricing, covenants and the ability to add new tranches of debt are negotiated on a case-by-case basis. In middle market deals, arrangers generally are getting more flexibility than in large cap deals.

Large cap terms that are now commonly seen in middle market loan agreements include:

- **Immaterial and unrestricted subsidiaries.** A borrower’s immaterial subsidiaries are excluded from guaranteeing the loan. Additionally, the borrower can also designate unrestricted subsidiaries that are not required to provide guarantees. For summaries of middle market loan agreements allowing the borrower to designate unrestricted subsidiaries, search Speedway Motorsports, Inc. and PGT, Inc. in PLC What’s Market.

- **Equity cures.** Middle market loan agreements are often allowing borrowers to exercise equity cures either once or twice in any four-quarter period and between three and five times throughout the term of the loan agreement. In middle market deals, there may also be a cap on the contribution amount, a restriction on exercising cures in consecutive quarters and a requirement for the borrower to prepay debt with the new equity proceeds (although the prepaid debt is typically included in the calculation of the fixed charge coverage ratio). For summaries of middle market loan agreements with equity cures, search Taylor Morrison Communities, Inc. and Mitel US Holdings, Inc. in PLC What’s Market.

#### Recent Developments

The following terms are standard in large cap deals and, although traditionally resisted, have begun to appear in middle market commitment letters:

- **Contingent expense reimbursement.** The arrangers’ expenses are reimbursed only if the deal closes. For a summary of a middle market commitment letter with contingent expense reimbursement, search ACP Tower Holdings, LLC in PLC What’s Market.

- **No financial ratio closing condition.** Commitments are not conditioned on the borrower’s pro forma compliance with certain financial ratios at closing (for example, a minimum EBITDA requirement or a leverage ratio).

- **Fully negotiated covenant levels.** The term sheet contains fully negotiated negative covenant levels, including basket amounts, and financial covenant calculations and ratios. For summaries of middle market commitment letters containing fully negotiated covenant levels, search Hecla Mining Company and Ignite Restaurant Group, Inc. in PLC What’s Market.

- **Bifurcated governing law provisions.** Some middle market acquisition financing commitment letters provide for bifurcated governing law provisions, with the commitment letter-specific provisions being governed by New York law and the referenced acquisition agreement provisions being governed by the laws of the state governing the acquisition agreement. For summaries of middle market commitment letters with a bifurcated governing law provision, search Ignite...
In addition, the following large cap loan terms are beginning to appear in some middle market loan agreements:

- **Affected lender standard for amendments.** Traditionally, middle market deals typically require unanimous consent for “sacred rights” amendments (such as maturity date extensions or reductions of principal or interest). However, recently, middle market deals are moving towards requiring the consent of only the lenders impacted by these amendments (affected lender standard), which is more common in large cap deals. For summaries of middle market loan agreements using the affected lender standard, search BlackRock Kelso Capital Corporation and EarthLink, Inc. in PLC What’s Market.

- **Incremental facilities permitted with caps.** Incremental facilities may be available, subject to there being no default on a pro forma basis. However, unlike in most large cap deals, middle market incremental facilities are still usually capped at specified dollar values. For summaries of middle market loan agreements allowing for incremental facilities, search Pennsylvania Real Estate Investment Trust and Sun Communities Operating Limited Partnership in PLC What’s Market.

- **Flexibility to conduct loan buybacks.** Borrowers and, subject to a cap, sponsors, are being provided increased flexibility to conduct loan buybacks. However, middle market loan agreements usually do not allow borrowers to make open market purchases (as opposed to purchases through Dutch auctions). For summaries of middle market loan agreements permitting loan buybacks, search PGT, Inc. and Orbitz Worldwide, Inc. in PLC What’s Market.

There are a few additional large cap terms that some middle market borrowers have been seeking to include in their deals, but continue to be resisted by lenders:

- **No sponsor precedent.** Middle market commitment letters do not typically specify a sponsor precedent for the loan documentation.

- **Restriction on refinancing facilities.** Middle market loan agreements do not typically include refinancing facilities, which are common in large cap deals.

- **Builder basket restrictions.** Middle market borrowers typically are not permitted to make restricted payments, fund investments or prepay junior debt using a basket (builder basket) based on the borrower’s retained excess cash flow and any equity issuances (or, if such flexibility is included, it is much more restrictive than in large cap deals).

- **Application of default interest.** In large cap deals, default interest generally is only charged on overdue amounts and can often be waived with a majority lender vote. In most middle market deals, default interest generally applies following certain defaults to all amounts outstanding, and often can only be waived with unanimous lender consent.

**Second Lien Loans**

Second lien loan volumes reached $6.77 billion in the first quarter of 2013, a dramatic increase from the $1.34 billion during the same period in 2012, according to Thomson Reuters LPC. Despite second lien loan documentation being substantially similar to the related first lien loan documentation, issues that continue to be the focus of negotiations between first and second lien lenders include:

- The standstill period (usually between 90 and 180 days) during which second lien lenders cannot exercise their rights against the borrower or the collateral, notwithstanding a default by the borrower under the second lien loan documents.

- The amount of additional first lien debt the borrower can incur after closing that still has the benefit of the intercreditor agreement’s terms.

- The rights of each group of lenders to amend their respective loan documents.

Search Travelport LLC and Mitel US Holdings, Inc. in PLC What’s Market for summaries of second lien loan agreements.

Search What’s Market: Intercreditor Agreements for more on intercreditor agreement terms and recent precedent.

**Regulatory Developments**

Regulatory issues continued to affect the loan markets and documentation drafting in the first half of 2013.
**Leveraged Lending Guidelines**

The new leveraged lending guidelines remain a concern for lenders. The guidelines were issued by federal regulators in March 2013 in response to concerns that lenders’ underwriting practices did not adequately address risks in leveraged lending with appropriate allowances for losses. Lenders were required to be in compliance with the guidelines by May 21, 2013. Compliance with the guidelines, however, may prove to be costly and time consuming and may eventually dampen lender appetite for leveraged loans and their ability to put money to work in the loan markets. In addition, lenders face uncertainty due to the subjective, and often vague, framework around certain components of the guidelines, including:

- The definition of leveraged lending.
- The underwriting standards.
- The reporting and analytics requirements.

Search **Regulatory Uncertainty Continues to Threaten Bank Lending** for more on the leveraged lending guidelines.

**FDIC Insurance Assessment**

As part of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (“Dodd-Frank Act”), the Federal Deposit Insurance Corporation (“FDIC”) was required to shift banks’ insurance assessment base from a deposit-based to an asset-based calculation. The pricing included a higher assessment for “high risk” commercial and industrial loans, generally including loans for M&A and recapitalizations that meet a specified leverage threshold.

While the new rates went into effect on April 1, 2013, their impact on the ability of regional banks to participate in leveraged loans is not yet clear.

**ECPs and Swap Guarantees**

As of March 31, 2013, under the Commodity Exchange Act (“CEA”), as amended by the Dodd-Frank Act, swap guarantors and pledgors of assets used to secure swap obligations must be eligible contract participants (“ECPs”). Generally, this means they must have more than $10 million in total assets.

Borrowers often enter into swaps in connection with their loan facilities to hedge certain related risks. As part of the guarantee and collateral obligations required by the lenders under the loan documents, the borrower’s subsidiaries generally guarantee all loan agreement and related obligations, including the swaps. Therefore, the ECP requirement has forced lending professionals to focus on guarantee language in loan documents to ensure their enforceability in the new regulatory environment, as guarantees provided by non-ECP subsidiaries would be unenforceable under the new requirements.

To avoid the risk of loan guarantees being rendered unenforceable, parties can incorporate into their loan documents proposed language from either the Loan Syndications and Trading Association (“LSTA”) or the International Swaps and Derivatives Association, Inc. (“ISDA”) that address this issue:

- The LSTA language excludes from the guarantee and security arrangements any guarantee or grant of security that is or becomes illegal under the CEA or any related rule or interpretation. For more information on the LSTA language, search **Dodd-Frank ECP Swap Guarantor Rule** on PLC’s website.
- The ISDA language clarifies that any subsidiary guarantee made under a guarantee and security agreement does not include swap obligations for any subsidiary that is not an ECP at the time the parties entered into the guarantee or the swap (whichever is later). For more information on the ISDA language, search **ISDA Publishes ECP Swap Guarantor Provisions** on PLC’s website.

Search **Constellation Energy Partners LLC** and **Regency Gas Services LP** in PLC’s What’s Market for summaries of loan agreements that contain language addressing non-ECP subsidiaries.

**Drafting Changes**

**LIBOR Definition**

Typically, the definition of London Interbank Offered Rate (“LIBOR”) used in loan agreements has been based on the rate as provided by the British Bankers’ Association (“BBA”). In the wake of the 2012 LIBOR scandal, in January 2013, the LSTA proposed revisions to the definition of LIBOR in their secondary trading documents to provide for a successor to the BBA, in the event the BBA would no longer make a LIBOR rate available.
This language has become standard in many banks forms. In addition, the elimination of certain interest periods for which LIBOR is quoted (including nine-month LIBOR) has resulted in certain changes to loan agreement forms.

Search Autodesk, Inc. and United Parcel Service, Inc. in What's Market for summaries of loan agreements with the revised definition of LIBOR.

**Agency Amendment Provisions**

In syndicated loan transactions, when a borrower wants to amend its loan agreement, the process is typically led by the administrative agent, who negotiates the documentation with the borrower and organizes lender approval and execution.

In some recent deals, borrowers that want to amend their loan agreements are seeking consent from only a select group of lenders and are successfully amending their loan agreements without the knowledge or consent of the administrative agent. This trend has been seen in distressed scenarios where a group of lenders address issues with the borrower directly and do not involve the administrative agent.

To ensure that the administrative agent has knowledge of any changes or proposed changes to the loan agreement, some arrangers seek language in loan agreements requiring that the administrative agent either execute an acknowledgement or receive notice of any amendment for it to be effective.

**Cashless Rolls**

One emerging issue driven by the large volume of refinancings is “cashless rolls.” A lender in an existing credit facility who wants to participate in the refinanced or repriced loan may elect to roll over its loan into the new facility, rather than having its existing loan prepaid and then funding a new loan under the refinanced facility.

A lender may be motivated to do that particularly if it is a CLO that is at the end of its reinvestment period. Loan market participants are increasingly focused on developing, and potentially standardizing, appropriate language to implement this rolling exposure.

**Ongoing Trends**

The following are other loan term trends that have emerged or evolved in recent years and that have remained through the first half of 2013:

- **Negotiation of financial performance measurements.** For example, EBITDA add-backs that were once capped at between 10% and 15% of EBITDA are frequently either not capped or capped at higher levels than in the past. In the middle market, this trend is less pronounced, and more restrictive add-backs than are found in large cap deals are still the norm.

- **Negotiation of OFAC and FCPA representations.** Increased regulatory scrutiny in these areas has continued to sharpen lenders’ focus on knowledge and materiality qualifiers, as well as whether these representations should be specified representations in the commitment letters or made in the acquisition agreement.

- **Convergence of term B loan and high-yield bond terms.** A changing investor base in the syndicated loan market, as well as an emphasis on trading over holding loans, has resulted in term B loan facilities with a number of bond-like features. For example, some term B loan facilities now have more flexible, incurrence-type covenants, greater refinancing flexibility and the erosion of “pro rata” protections (such as by permitting open market buybacks by borrowers) that were once a staple of the syndicated loan market.

- **Foreign borrowers in the U.S. loan market.** In European borrower acquisition financings “certain funds” requirements can necessitate that full loan documentation be executed when the acquisition agreement closes. Alternately, European deals have sometimes used interim funding agreements, which are signed up when the acquisition agreement closes and are effective for 60 to 90 days until the full loan documentation can be negotiated and executed. Although interim funding agreements are not common in the U.S., they have been used in some recent deals with European borrowers.

- **More unitranche financing.** A unitranche loan is structured as a single debt instrument (one tranche of loans) that combines senior and subordinate tranches of debt into one facility with a blended interest rate (which is often less than the combined rate the borrower would pay for two separate facilities). The unitranche loan is divided into first and second lien components, with lenders agreeing among themselves how to handle priority issues. Unitranche financing has emerged as an attractive financing solution for middle market borrowers because it offers speed and certainty of closing, as well as greater simplicity of decision-making for lenders during the life of the loan.
• **Issues around disqualified lender lists.** Large cap borrowers continue to push for the inclusion of competitors and their affiliates on disqualified lender lists, as well as for the ability to add to the list after the date of the commitment letter and even post-closing. In several recent transactions, lenders have pushed back and even walked away from transactions in which the borrower has broad discretion to designate additional disqualified lenders post-closing. While disqualified lender lists are typically only available in large cap deals, they have also been appearing in recent middle market deals, though they are generally less of an issue because of investors’ predominant buy and hold strategy in the middle market.

• **Inclusion of precap provisions.** Precap (portability) provisions continue to be available for top-tier sponsors in large cap deals and, increasingly, in some middle market deals. Negotiations continue around:
  - the minimum threshold of assets under management required for the buyer (usually $1 billion);
  - the minimum equity contribution required (usually 30% to 35%);
  - the recalculation of certain financial metrics;
  - know-your-customer checks;
  - the borrower’s management team that will remain in place;
  - increased pricing (usually 25 to 75 basis points); and
  - the specified time horizon for the deal (usually two years).

**Looking Ahead**

In the years since the financial crisis, the demand-driven loan market has been characterized by short periods of high activity and sudden reversals of sentiment, including in response to broader macroeconomic concerns. By contrast, the loan markets have remained remarkably positive and stable in the last six months.

However, this steadiness is unlikely to last indefinitely. Even at press time, there are reports of increased “choppiness” in the market. Some deals are being pulled and in others, the borrower has dropped its request to loosen financial covenants. To the extent that there is a pullback in the market, and as M&A activity grows (so that more transactions are being done on a committed, rather than best efforts, basis), we can expect more lender pushback against the more aggressive features currently sought by borrowers.

Maria Barclay, Tim Fanning, Sarah Mital and Peter Washkowitz are Finance editors at Practical Law. For a copy of this article published on the Practical Law website which includes links to recent examples of loan agreements, see *Practice Note, What's Market: 2013 Mid-year Trends in Large Cap and Middle Market Loan Terms, Practical Law*, at [http://us.practicallaw.com/2-532-9265](http://us.practicallaw.com/2-532-9265).

---

**RECENT AMENDMENTS TO DELAWARE’S ENTITY LAWS:**

**DELAWARE SIMPLIFIES TWO-STEP CORPORATE TAKEOVERS AND CONFIRMS THAT DEFAULT FIDUCIARY DUTIES APPLY TO LLCs, AMONG OTHER CHANGES**

By Norman M. Powell and John J. Paschetto

The Delaware legislature recently adopted what may be the most significant amendments to the state’s corporation law since its current “anti-takeover” statute, 8 Del. C. § 203, was added in 1987. The amendments include (i) a new provision that will make so-called “top-up options” unnecessary in two-step corporate takeovers; (ii) two new sections creating procedures by which defective corporate acts, including the unauthorized issuance of stock, can be cured; and (iii) an entire new subchapter enabling the creation of Delaware public benefit corporations. In addition, the Delaware Limited Liability Company Act has been amended to make clear that the managers and possibly members of a limited liability company may owe fiduciary duties unless the company’s operating agreement provides otherwise.

**Simplifying Two-Step Takeovers**

In recent years, the top-up option has been accepted as one of the tools available to transactional lawyers in structuring acquisitions of Delaware corporations. When included in a merger agreement, a top-up option typically provides that if the acquirer makes a tender offer for the target corporation’s shares, and the number of shares tendered into the offer give the acquirer a controlling stake, the acquirer will then have the option of buying, in exchange for a note, a sufficient number of shares from the target to bring the acquirer’s ownership percentage to at least 90%. Following a successful tender offer and exercise of the option, the acquirer will then hold a large enough stake in the target to be able to cash out any remaining target stockholders without a stockholder meeting or

The use of a top-up option to avoid a stockholder vote in the second step of a traditional two-step, tender-offer-plus-merger takeover has not been viewed unfavorably by the Delaware Court of Chancery, despite invitations to the contrary. See, e.g., Olson v. ev3, Inc., 2011 Del. Ch. LEXIS 34, at *2-5 (Del. Ch. 2011). The court thus has impliedly acknowledged that no purpose is served by requiring a stockholder vote before a cash-out merger where the acquirer has just purchased enough shares to control the outcome of the vote.

This reasoning is reflected in new subsection (h) of Delaware’s basic merger statute, § 251 of the DGCL. The new provision will enable merger agreements entered into after July 31, 2013, to eliminate the stockholder-vote requirement in a two-step takeover if the target’s charter does not provide otherwise, the target’s shares are publicly traded (or held of record by more than 2,000 stockholders), and six other requirements are met. First, the parties must expressly provide in their merger agreement that the second-step, cash-out merger will be governed by § 251(h), and that the merger will be effectuated “as soon as practicable” if the acquirer’s tender offer is successfully consummated. Second, the tender offer must be for any and all shares of the target’s outstanding stock that would otherwise be entitled to vote on the merger. Third, after the tender offer, the acquirer must own at least the number of shares that would otherwise need to be voted for the merger to be approved under the DGCL and the target’s charter. This ensures that § 251(h) will not enable an acquirer to avoid a stockholder vote on the cash-out merger unless, as a result of its tender offer, the acquirer owns enough shares to control the outcome of such a vote. Fourth, at the time the merger agreement is approved by the target’s board, no party to the agreement may be an “interested stockholder” of the target under the anti-takeover statute § 203 of the DGCL. This requirement should prevent parties from using the new § 251(h) procedure as a way of circumventing the default defensive measures built into § 203. The fifth and sixth requirements are that the acquirer actually merge with the target following the tender offer, and that the stockholders who were cashed out in the merger receive the same consideration that was paid to the stockholders who tendered their shares. The amendments do not specify that a certificate of merger filed with the Delaware Secretary of State to effectuate a merger under § 251(h) be different in form from those commonly used under § 251.3

Curing Defective Corporate Acts

The Delaware Supreme Court’s holding in STAAR Surgical Co. v. Waggoner, 588 A.2d 1130 (Del 1991), created a challenge for advisers of Delaware corporations. In that case, the court held that stock issued without board authorization was void, not merely voidable. Under settled Delaware jurisprudence, a void corporate act (unlike a merely voidable act) cannot be cured through ratification. Thus, when a corporation has discovered long after the fact that its issuance of outstanding shares was not properly authorized, there has been no clear path toward remedying the problem. The predicament is particularly awkward when shares of doubtful validity have been traded or have affected the outcome of a stockholder vote.4

New §§ 204 and 205 of the DGCL will give practitioners two procedures by which a corporation can cleanse the unauthorized issuance of shares and similar unauthorized corporate acts. Section 204 details a cleansing procedure that will not require a court proceeding, while § 205 makes available a proceeding in the Delaware Court of Chancery that may, among other things, achieve the same result. Both sections, along with conforming amendments to other sections of the DGCL, will take effect on April 1, 2014.

Sections 204 and 205 pertain to “putative stock” and “defective corporate acts.” Putative stock is either stock that was not properly authorized (but would otherwise be valid) or stock whose validity simply cannot be determined by the issuer’s board. A defective corporate act is, in essence, an issuance of shares beyond what is authorized in the issuing corporation’s charter, an election of directors without due authorization, or any corporate act or transaction that was within the corporation’s power but was not authorized or effected in accordance with the DGCL, the corporation’s charter and bylaws, and other applicable documents.

According to § 204, no putative stock or defective corporate act “shall be void or voidable solely as a result of a failure of authorization” if it is either “ratified” under § 204 and not challenged in the Court of Chancery within 120 days thereafter, or “validated” by the Court of Chancery under § 205. The ratification procedure of § 204 requires, first, that the board of directors adopt a resolution setting forth certain details of the defective act and that the board “approve[] the ratification” of the act. The resolution must then be submitted to a stockholder vote, unless (1) no such vote was required when the defective act was taken or would be required if the defective act were taken today, and (2) the defective act was not the result of “a failure to comply with § 203 [i.e., the anti-takeover statute].”

The quorum and voting requirements at both the board and stockholder levels are those that would have applied to the defective act at the time the act was taken, unless the currently applicable quorum or voting requirements are greater. No approval is needed, however, from any class or series of shares, or from any person, that was required to give approval but is now no longer outstanding or a stockholder, respectively, or from any director that such a class, series, or person was entitled to elect or nominate. In addition, if the defective act to be ratified is the election of a director, the ratification must be approved by a majority of the shares present at the stockholder meeting and entitled to vote (or such greater proportion as the charter or bylaws may require now or may have required when the defective act was taken). In the case of a defective act resulting from a failure to comply with § 203 of the DGCL, ratification will require the vote specified in § 203, even if such a vote would not have been required otherwise.
Notice of a stockholder meeting to vote on ratification under § 204 must be given to each current record stockholder, including holders of putative stock and nonvoting stock. The notice must also be given to anyone who was a record holder, including a holder of putative stock or nonvoting stock, at the time of the defective act. Importantly, however, § 204 does not require that notice be given to “holders whose identities or addresses cannot be determined from the records of the corporation.” The lengths to which the corporation must go to locate former stockholders are thus reasonably circumscribed. If no stockholder meeting is required for ratification, then a similar notice must be provided promptly after the board ratifies the defective act.

If the defective act is one that would have required the filing of a certificate with the Delaware Secretary of State, then, regardless of whether such a certificate was previously filed, a “certificate of validation” must be filed containing certain information specified in § 204. The fee to be charged by the Secretary of State for such a filing has been set at $2,500, in addition to any amount that may otherwise be due if the certificate of validation causes the corporation’s number of authorized shares to be increased. 8 Del. C. § 391(a).

The notice required under § 204 shall state that any challenge to the ratification must be commenced within 120 days after the later of (a) the effectiveness of an associated certificate of validation, and (b) the stockholders’ ratifying vote or, where no stockholder vote is needed, the giving of post-ratification notice. Proper notice will be crucial because, after the 120-day period, no claim may be brought asserting that the ratified stock or act is void by reason of the subject failure of authorization, except for a claim asserting that § 204 itself was not complied with or a claim brought by a person who was required to be given notice under § 204 and “to whom such notice was not given.”

Section 205 gives the Delaware Court of Chancery exclusive jurisdiction to determine the validity of ratification under § 204, along with jurisdiction to determine the validity of any corporate act, transaction, stock, or rights to acquire stock. Application for such a determination may be made by the corporation or any successor entity, any director, any record or beneficial owner of valid or putative stock either currently or at the time of a defective act ratified under § 204, and any person “claiming to be substantially and adversely affected” by ratification under § 204. The Court of Chancery is given broad authority by § 205 to validate defective acts or putative stock, to review § 204 ratifications, and to take other remedial measures in connection with defective corporate acts. Service of process in an action under § 205 needs to be made only on the corporation’s registered agent in Delaware, but the court may require that notice be provided to others if the corporation itself is the applicant.

The potential attractiveness of the new procedures under §§ 204 and 205 is enhanced by a provision that a “failure of ratification” under those sections will not “create a presumption that any such [underlying] act or transaction is or was a defective corporate act or that such stock is void or voidable.” In addition, when a defective corporate act or putative-stock issuance has been duly ratified under § 204 and not successfully challenged under § 205, the cleansing effect of the ratification will relate back to the time when the defective act was taken or the putative stock was issued. The nunc pro tunc effect of ratification should make the new procedures a welcome means of untangling the knot of interrelated problems that can arise when unauthorized stock has been in the market for some time and has been bought, sold, and voted as if valid.

Delaware Public Benefit Corporations

On August 1, 2013, Delaware became the thirteenth state to permit the formation of benefit corporations under its laws. Benefit corporations are, generally speaking, for-profit corporations that have as one of their purposes the promotion of some social good. The social good to be promoted may be, depending on the jurisdiction, the good of society as a whole pursuant to an enabling statute, a particular social concern specified in the corporation’s charter, or both. In managing a benefit corporation, directors are bound to consider the interests of not only the corporation’s stockholders but also others who may be affected by the corporation’s activities.

B Lab, a Pennsylvania non-profit entity, has been at the forefront in promoting benefit corporations. 5 It has promulgated model benefit-corporation legislation whose organization and language are reflected to varying degrees in the benefit-corporation statutes currently in effect in other states. 6 The provisions adopted in Delaware are on the whole more permissive than the model legislation, leaving it largely up to the parties to decide whether to adopt or reject the governance tools that the statutory provisions make available to a Delaware public benefit corporation (a “DPBC”).

The special provisions governing DPBCs are found in new §§ 361-368 of the DGCL (forming new DGCL subchapter XV). DPBCs are subject to all the provisions of the DGCL, except that the provisions of §§ 361-368 will govern when they “impose[] additional or different requirements.” 8 Del. C. § 361. A DPBC is defined as a Delaware for-profit corporation “that is intended to produce a public benefit or public benefits and to operate in a responsible and sustainable manner.” 8 Del. C. § 362(a). The DPBC’s charter must include within its statement of business purpose (required of all Delaware corporations under § 102(a)(3)of the DGCL) “one or more specific public benefits to be promoted by the corporation.” Id. “Public benefit” is defined broadly as “a positive effect (or reduction of negative effects) on one or more categories of persons, entities, communities or interests (other than stockholders in their capacities as stockholders).” 8 Del. C. § 362(b).
A DPBC’s name must include “public benefit corporation,” “P.B.C.,” or “PBC.” 8 Del. C. § 362(c). Its stock certificates and notices of the issuance or transfer of uncertificated stock must note “conspicuously” that the issuer is a DPBC formed under subchapter XV of the DGCL. 8 Del. C. § 364. Every notice of a meeting of the DPBC’s stockholders must contain a similar statement. 8 Del. C. § 366(a).

In terms of governance, the central differences between a DPBC and other for-profit Delaware corporations are found in § 365, which sets forth the duties of DPBC directors and certain limitations on their potential liability. The board of a DPBC must manage its business and affairs “in a manner that balances the pecuniary interests of the stockholders, the best interests of those materially affected by the corporation’s conduct, and the specific public benefit or public benefits identified in its certificate of incorporation.” 8 Del. C. § 365(a). However, a director shall not, by virtue of serving on the board of a DPBC, have a duty to “any person on account of any interest of such person in the public benefit [specified in the charter] or on account of any interest materially affected by the corporation’s conduct.” 8 Del. C. § 365(b). Moreover, while derivative actions may be brought to enforce the directors’ duty to balance stockholder and public interests, such an action may be instituted only by stockholders owning at least 2% of the DPBC’s outstanding shares or, in the case of a publicly traded DPBC, the lesser of 2% of the outstanding shares and shares with a market value of at least $2 million. 8 Del. C. § 367.

Provision has also been made in the new DPBC sections to connect the directors’ balancing duty to fiduciary-duty concepts with which practitioners are likely more comfortable. Thus, as regards a decision “implicating the balance requirement,” directors will be deemed to have satisfied their fiduciary duties to the DPBC and its stockholders if the decision “is both informed and disinterested and not such that no person of ordinary, sound judgment would approve.” 8 Del. C. § 365(b). A DPBC may afford still further protection to its directors by providing in its charter that “any disinterested failure to satisfy § 365 shall not . . . constitute an act or omission not in good faith, or a breach of the duty of loyalty,” for purposes of indemnification or an exculpatory charter provision (as permitted by § 102(b)(7) of the DGCL). 8 Del. C. § 365(c).

Like B Lab’s model legislation, the DPBC provisions include a reporting requirement, although the Delaware requirement calls for biennial, rather than annual, reporting and is narrower in its mandatory disclosures. A DPBC must provide to its stockholders at least once every two years a statement that includes (i) the “objectives” set by the board to promote the DPBC’s public benefit and “the best interests of those materially affected by the corporation’s conduct”; (ii) the “standards” adopted by the board to measure the DPBC’s “progress in promoting” such public benefit and interests; (iii) “objective factual information based on those standards regarding the corporation’s success in meeting the objectives”; and (iv) an “assessment” of the DPBC’s success in meeting the objectives. 8 Del. C. § 366(b). The DPBC’s charter or bylaws may, but need not, require that a “third party standard” or “third party certification” be employed in connection with the DPBC’s promotion of its objectives. 8 Del. C. § 366(c).

An existing corporation may become a DPBC by merger or by amending its charter. 8 Del. C. § 363(a). But if the corporation has received payment for any of its stock, such a merger or amendment must be approved by the holders of 90% of the outstanding shares, including nonvoting shares. Id. In addition, any stockholder that does not vote in favor of the merger or amendment will have appraisal rights under § 262 of the DGCL, to which a conforming amendment has been made (adding new paragraph (b)(4)). 8 Del. C. § 363(b).

A DPBC may likewise become a standard for-profit corporation by amending its charter or through a merger. 8 Del. C. § 363(c). Doing so will require approval by two-thirds of the outstanding shares, including nonvoting shares. Id.

Other Amendments to the DGCL

The above amendments, significant as they may turn out to be, are not the only noteworthy changes made to the DGCL in the latest legislative session. Section 152—the source of the requirement that consideration to be paid for newly issued stock be determined by the issuing corporation’s board of directors—has been amended to make clear that boards are permitted to “determine the amount of consideration by approving a formula by which the amount of consideration is determined.” 8 Del. C. § 152. In addition, an important change affecting non-Delaware corporations doing business in Delaware has been made to the provisions regarding the deemed appointment of the Delaware Secretary of State as an agent to receive service of process. 8 Del. C. § 382(a). Newly added language states that any foreign corporation that consents in writing to the jurisdiction of any state or federal court in Delaware shall be deemed to have thereby appointed the Secretary of State as its agent for service of process if the agreement or other document containing the consent to jurisdiction does not specify how process may be served on the corporation. Id.

Changes have also been made to certain provisions of the Delaware Code relating to the corporation franchise tax. Under 8 Del. C. § 502(a), as amended, the annual franchise tax report that Delaware corporations are required to file with the Secretary of State may no longer be signed by a corporation’s incorporator, with the exception of the corporation’s “initial report” and a report filed in connection with the dissolution of a corporation before the issuance of shares (under § 274 of the DGCL). The primary purpose of this amendment is to deter the formation of so-called “shelf” corporations, i.e., corporations formed with the intention that they will have no stockholders or directors for several years.
Default Fiduciary Duties Apply to LLCs

During the past few years, courts and practitioners have been increasingly focused on the question of whether managers or members of a Delaware limited liability company (an “LLC”) can have fiduciary duties if the LLC’s operating agreement is silent on the subject. The Delaware Court of Chancery, for example, has held that default fiduciary duties do apply to LLC managers. Feeley v. NHAOGC LLC, 62 A.3d 649, 663 (Del. Ch. 2012). The state’s Supreme Court, however, has observed (without ruling) that “reasonable minds could differ” on the issue and has invited a legislative solution. Gatz Props., LLC v. Arriga Capital Corp., 59 A.3d 1206, 1219 (Del. 2012).

Accordingly, an express reference to fiduciary duties has been added to § 18-1104 of the Delaware Limited Liability Company Act (the “DLLCA”). Whereas the section previously stated that “the rules of law and equity, including the law merchant, shall govern” in any case not provided for in the DLLCA, it now provides that “the rules of law and equity, including the rules of law and equity relating to fiduciary duties and the law merchant, shall govern.” 6 Del. C. § 18-1104 (emphasis added). The precise scope of such duties remains to be developed on a case-by-case basis, just as the law of fiduciary duties has developed in the corporate context. The Feeley opinion cited above provides an example of the Court of Chancery’s application of fiduciary duties in the context of an LLC. It should be remembered, as well, that parties remain free to restrict or eliminate fiduciary duties in an LLC agreement, pursuant to 6 Del. C. § 18-1101.

Additional Amendments to the Alternative-Entity Statutes

Finally, several other substantive amendments to Delaware’s statutes governing LLCs and limited partnerships (“LPs”) should be noted. Two amendments have been made to the DLLCA to make clear that its provisions should not fail to be applied on the grounds that an LLC has only one member rather than multiple members. A general statement of this principle has been added as new subsection (j) of 6 Del. C. § 18-1101: “The provisions of this chapter shall apply whether a limited liability company has 1 member or more than 1 member.” The specific application of this principle in the case of a charging order against an LLC interest has also been made through an amendment to 6 Del. C. § 18-703(d). That subsection now provides, in relevant part, that “attachment, garnishment, foreclosure or other legal or equitable remedies are not available to the judgment creditor, whether the limited liability company has 1 member or more than 1 member.” Thus, to the extent that a court might be inclined to read the DLLCA as permitting a judgment creditor to step into a debtor’s shoes when the debtor is the only member of an LLC—on the theory that a single-member LLC does not implicate the “pick one’s partner” policy—these amendments should make such an interpretation unavailable. The charging-order provisions of the DRULPA have been amended to make clear that “attachment, garnishment, foreclosure or other legal or equitable remedies are not available to the judgment creditor.” 6 Del. C. § 17-703(d). Lastly, amendments have been made to two sections of the DRULPA to clarify how the provisions of the Delaware Revised Partnership Act relating to limited liability partnerships should be applied to limited liability limited partnerships. 6 Del. C. §§ 17-104(d), 17-104(j)(4), 17-214. These amendments are not intended to change the substance of the applicable law.

RIVERISLAND – A NEW PARADIGM IN CALIFORNIA

By Hilary Sledge

Although the importance of the written contract has always been emphasized over that of the oral agreement, with phrases such as “an oral contract isn’t worth the paper it’s written on,” the legal outlook in this arena is constantly evolving. The California Supreme Court’s recent decision in Riverisland Cold Storage, Inc. v. Fresno-Madera Produce Credit Ass’n indicates a shift toward leveling the playing field between oral and written agreements. This can seem alarming, particularly to sophisticated commercial parties that enter into a multitude of agreements and rely on the certainty of written contracts. While this article focuses on the current state of the fraud exception to the parol evidence rule in California, the ruling in Riverisland is in line with case law in many jurisdictions throughout the United States and there are certainly lessons to be learned in a review of Riverisland by sophisticated and non-sophisticated parties alike.
The Parol Evidence Rule

The established maxim of giving precedence to written contracts over oral agreements is represented in contract law by the parol evidence rule, found in the California Code of Civil Procedure at § 1856. The parol evidence rule provides that if parties enter into a written agreement, extrinsic evidence may not be relied upon to alter or add to the terms of the writing. The written terms, therefore, supersede oral statements made during negotiations. Because the examination of prior oral agreements can often turn into a battle of “he-said, she-said,” it is beneficial to have a rule. The rule provides predictability as to how a court will rule where one party alleges a prior oral agreement is inconsistent with a subsequent written contract. This certainty in interpretation reduces the risk of disputes and the cost of dispute resolution. The policy behind the parol evidence rule is to enforce later in time writings because most parties intend for later agreements to supersede earlier agreements pertaining to the same subject matter.

The Fraud Exception

Like many seemingly “bright line rules” in contract law, there are some exceptions to the parol evidence rule. Subdivisions (e), (f), and (g) of the California Code of Civil Procedure § 1856 set forth exceptions to the parol evidence rule, those being generally: mistake, duress, fraud, or other illegality. Here, our discussion centers on the fraud exception to the parol evidence rule. This exception allows extrinsic evidence to be introduced with the purpose of proving, or disproving, the validity of a written agreement. In other words, this exception was created in accordance with the principle that the parol evidence rule should not bar extrinsic evidence when a party is challenging the validity of the agreement itself. “[Evidence of fraud] does not contradict the terms of an effective integration, because it shows that the purported instrument has no legal effect.” The main concern for courts has been with applying the fraud exception to the parol evidence rule is that it gives undue protection to non-drafters, while leaving drafters exposed to unfair results due to misrepresentations by non-drafters during the judicial process. Any non-drafting party to a contract can argue that the contents of the contract were represented to be something other than what is set forth in the contract. It became easy for non-drafting parties to take advantage of situations where they signed contracts they later realized were unfavorable to them. In turn, drafters of contracts were found by courts to have fraudulently induced completely valid contracts.

Pendergrass in California

After realizing some of the problems noted above, the California Supreme Court placed a limitation on the fraud exception in Bank of America v. Pendergrass. In Pendergrass, the defendants were borrowers who fell behind on their payments on a loan from Bank of America. The defendants then executed a new promissory note with the bank, which was secured by additional collateral and payable on demand. Soon after the new note was signed, Bank of America seized the new collateral property and sued on the note. In defense, the borrowers alleged that Bank of America orally promised that the loan was being extended for two years and that two ranches were the only additional collateral. The defendants claimed that the bank never intended to perform these oral promises, but made them for the sole purpose of acquiring the new note and additional collateral from the defendants.

The issue for the court, then, was to decide whether extrinsic evidence of these promises should be admitted for purposes of proving the invalidity of the note itself. In coming to a decision, the court noted, in pertinent part, “[o]ur conception of the rule which permits parol evidence of fraud … is that it must tend to establish some independent fact or representation … not a promise directly at variance with the promise of the writing.” The ultimate decision of the Pendergrass court is that if a party seeks to introduce extrinsic evidence to add to the terms of a written agreement, such evidence is only admissible if it does not directly contradict the terms of the written contract.

Subsequent treatment of the Pendergrass decision varied widely and was inconsistent among courts of appeal in California. The courts found an unclear distinction between promises deemed consistent and those deemed inconsistent with a writing. Some courts resisted applying it altogether, finding various ways to get around Pendergrass. The most common method that courts used to skirt the Pendergrass rule was to draw a line between false promises at variance with the terms of a contract and misrepresentations of fact about the contents of the document. In other words, courts found that if a party was fraudulently induced into signing the contract with false or inconsistent promises, then Pendergrass applied; but if one party made false representations of fact to the other regarding the content of the document at the time of the signing, then it was considered a factual misrepresentation outside the scope of the Pendergrass rule. Courts also felt, more generally, that the rule engendered fraudulent practices by not allowing evidence of fraud that was not contained in the writing, because, naturally, the last place one would find evidence of fraud is within the four corners of a document. The Pendergrass rule had essentially the polar opposite effect of the fraud exception - where the fraud exception gave too much advantage to non-drafters, the Pendergrass rule gave excessive advantage to drafters.

Riverisland

Although California courts adhered to the Pendergrass rule, albeit loosely, for more than 75 years, the California Supreme Court finally overruled it in the Riverisland decision released in early 2013. The facts of this case are similar to those in Pendergrass – so much so, in fact, that the California Supreme Court would have had a very difficult time dodging the rule if it intended to leave Pendergrass in tact. In Riverisland, the plaintiffs fell behind on their loan payments to the defendant Fresno-Madera Production Credit Association and met with the defendant to restructure their loan facility. In the resulting loan agreement, the defendant agreed not to take enforcement action for three months and, in exchange, the plaintiffs pledged eight parcels of real property as collateral. Of note is that the plaintiffs...
Eventually, the plaintiffs did not make the required payments, and after three months, the defendant initiated foreclosure proceedings for the eight parcels of property that were pledged as collateral. Eventually, the plaintiffs repaid the loan and the defendant dismissed the foreclosure action.

After the foreclosure proceedings were dismissed, the plaintiffs brought suit alleging fraud and negligent misrepresentation on the basis that the defendant made factual misrepresentations to them regarding the contents of the loan agreement they signed. The plaintiffs claim that the defendant made prior representations that the defendant would extend the loan for two years, instead of three months, in exchange for additional collateral consisting of two ranches, rather than eight parcels of land. The plaintiffs allege that the defendant not only made this representation to them two weeks prior to the signing, but when the plaintiffs asked about this information again at the signing, the defendant reassured them that the terms of the contract were a two year extension in exchange for two ranches as collateral.

The trial court granted the defendant’s motion for summary judgment because the plaintiffs’ only evidence of the oral promises was extrinsic evidence which was prohibited under the *Pendergrass* rule since it contradicted the terms of the writing. The court of appeal, however, found that because the defendant made factual misrepresentations regarding the contents of the document to the plaintiffs, the statements made by the defendant at the signing were outside the scope of the *Pendergrass* rule, which only applied to cases of promissory fraud. In contrast, had the plaintiffs relied primarily on the representations made two weeks prior to the signing, the court likely would have found that this was fraudulent inducement, not factual misrepresentation, and thus, would have found the *Pendergrass* rule to apply.

The California Supreme Court begins its opinion with a discussion of the parol evidence rule, emphasizing that “[t]he purpose of the rule is to ensure that the parties’ final understanding, deliberately expressed in writing, is not subject to change.” After describing the facts of the *Pendergrass* case, as well as the resulting rule, the court goes on to examine subsequent treatment of the decision by California courts. The court cites several California cases in which *Pendergrass* has not been followed. The fact that courts have found several ways to avoid the “harsh consequences” of the *Pendergrass* rule, which has led to uncertainty in the case law, seems to be a particularly troubling fact for the court. A more heavily noted factor in the court’s decision is the oft cited problem that *Pendergrass’* limitation on evidence of fraudulent practices may itself further fraudulent practices. The court cites an Oregon case for the point that oral promises made without the intent to perform is an effective means of deception if evidence of those promises is not admissible only because it contradicts the subsequent written agreement. These considerations make clear that the ambiguity, various interpretations, and inconsistent application of *Pendergrass* were themselves cause for concern. What seemed to inform the court’s decision more, however, was that the *Pendergrass* limitation was actually at odds with the purpose of the fraud exception itself.

In deciding whether to overrule *Pendergrass*, the court had to overcome the principle of *stare decisis* by showing that the decision departed from an established general rule at the time it was decided and, as such, its weight as precedent is diminished. California law at the time *Pendergrass* was decided permitted introduction of parol evidence in proving fraud. After citing several cases before *Pendergrass* in which the fraud exception was applied unconditionally, the court overrules *Pendergrass*, further stating that it was an “aberration … inconsistent with the terms of the statute, and with settled case law as well.”

The court also set forth parameters for the application of the fraud exception, noting that something more than a promise that is not honored is required, as well as proof of the party’s intent not to perform. Because the element of reliance is not addressed in the courts below, the court remands the case for consideration of that issue.

**Court Decisions Following Riverisland**

Since the *Riverisland* decision in the beginning of this year, very few cases have been decided based on the holding in *Riverisland*.

One case that has followed the decision, however, is *Julius Castle Restaurant, Inc. v. Payne,* in which the owners of a restaurant brought suit against the owner of the premises, alleging fraudulent misrepresentation. The basis of the claim is that, in the lease agreement, the owner of the premises omitted certain material facts, including disclosure of unpermitted improvements to the property. The plaintiffs also allege that the defendant orally misrepresented that the property was in good condition, and that he would fix anything that was not in poor condition. The extrinsic evidence of the oral assurances of the owner was admitted at trial, and the jury found for the plaintiffs. On appeal, the defendants contend that the extrinsic evidence of the oral assurances should have been excluded under the parol evidence rule. The appellate court agreed with the defendants that the oral assurances constitute parol evidence, but ruled that the *Riverisland* case dictates that the evidence is admissible under the fraud exception.

By the time the *Riverisland* decision was published, the *Julius Castle* trial had concluded and briefs for appeal had been filed. The defendants, therefore, relied heavily on *Pendergrass* in their appellate briefs. After the *Riverisland* decision was released, but before oral arguments commenced on the appeal, the court asked the parties to brief how *Riverisland* would affect their case. The defendants argue that the court should consider the relative bargaining power of the parties because *Riverisland* made distinctions between sophisticated and unsophisticated parties, noting that “sophisticated parties can rarely invoke the fraud exception.” However, the court was not persuaded by the defendants’ interpretation. Quoting the holding of *Riverisland*, the court concludes that, “[w]ith such blunt language, the court did not shield sophisticated parties from the reach of its holding.” The court goes on to note, more
generally, that “[i]n the post-Riverisland world,” parties defending against fraud claims should focus on the heightened burden for the plaintiff in proving fraud instead of the level of sophistication or amount of bargaining power of the parties.40

Solutions and Practical Advice

While Riverisland overruled an exception that made proving fraud onerous, the law in California is now back in a position where, some would argue, it is too easy to prove fraud. Many scholars have suggested that Riverisland is unlikely to materially change the legal landscape as it relates to the fraud exception to the parol evidence rule.41 Timothy Murray, an author of contract law books and supplements, notes that “the Riverisland decision made it clear that the plaintiffs have several significant hurdles before they can evade the plain language of their contracts in favor of alleged extra-contractual promises.”42 Specifically, it can be difficult to enforce a promise that is honest, but just not kept or performed and plaintiffs also have a large hurdle to overcome in justifying their failure to read an agreement.43 Some practical practice tips for drafters include plainly drafting contracts to make them airtight against competing claims of oral promises and requiring consumers to acknowledge important terms by initialing and dating.44 Some have gone as far as to suggest it might be prudent to record interviews with the non-drafting party wherein they acknowledge the terms of the agreement.45 In any case, prudent practitioners should strive to make the obligations of the consumer painstakingly clear.46

Another scholar who has examined this problem has come up with a potential solution that seeks to protect drafting and non-drafting parties fairly equally. Russell Korobkin refers to the dilemma at issue in Pendergrass and Riverisland as the “Borat Problem,” named for the litigation following the 2006 film.47 After realizing that most courts use either a Riverisland or a Pendergrass type rule, both of which usually leave either the drafting or non-drafting party at risk, Korobkin devises a solution that may not be completely even-handed, but is at least moving in the right direction. Korobkin suggests a two-pronged approach, with one prong putting protections in place for the non-drafting party and the other for the drafting party.48 In the first prong, in order to guard against claims of fraud, the drafter must satisfy the “Specific Assent Requirement,” which provides that the contract terms in contention must be “clear statements” and that “realistic notice” must be given to the non-drafting party of their presence. To satisfy the clear statement requirement, the drafter should ensure that the text of the contract clearly indicates that it supersedes all prior specific representations.49 One method is for the drafter to enumerate or specifically identify which representations the writing takes precedence over.50 The realistic notice requirement will be satisfied if the non-drafter was, or should have been, on notice of any written terms that contradict prior representations.51 Ways to meet the realistic notice requirement include, active negotiation of the terms at issue, review of the terms by sophisticated parties, or directing the attention of the non-drafting party to terms that may be of particular interest.52

The second prong suggested by Korobkin is a heightened evidentiary requirement, which is designed to protect drafting parties from false or mistaken claims of fraud.53 The heightened evidentiary standard requires an issue to be proven by clear and convincing evidence.54 This means that a non-drafting party could not merely cite their recollection of conflicting prior oral exchanges, but instead would need to corroborate these assertions with other evidence, such as recorded evidence of the misrepresentations, third-party testimony confirming the same, or even proof of a pattern of similar conduct in other transactions.55 This heightened evidentiary standard would need to be satisfied before a court allows introduction of the extrinsic evidence.56 Although there may be difficulty in applying and enforcing such standards, this framework is particularly helpful because it offers a level of protection to both drafting and non-drafting parties.

Conclusion

The Riverisland decision marks a milestone in the judicial history of California in overruling a 78-year-old limitation on the fraud exception to the parol evidence rule. After concluding that the judicial limitation set forth in Pendergrass was inappropriate, the California Supreme Court reaffirmed the maxim established before Pendergrass that, regardless of the circumstances, extrinsic evidence of prior oral agreements is always admissible to prove the fraud, duress, mistake, or other illegality of a written agreement. Although it may seem that overruling such an established limitation will have enormous impact on the practice of contract law, we should be reminded that this decision simply brought California into alignment with the majority of other jurisdictions within the United States,57 as well as the view of California before Pendergrass. Generally, parties are bound by the agreements they sign, and the decision in Riverisland will not likely change this practice.58

---

**FATCA UPDATE FOR COMMERCIAL LENDERS AND BORROWERS – FINAL REGULATIONS AND LATER GUIDANCE PROVIDE EXPANDED GRANDFATHER RULES, EXTENDED TIMELINE, AND OTHER RELIEF PROVISIONS**

By Carol P. Tello

Two previous articles discussed the effect of the Foreign Account Tax Compliance Act (“FATCA”) on commercial lenders and borrowers.59 This article provides an update on the latest developments that potentially have the greatest impact on commercial
lenders and borrowers. Although FATCA becomes effective on January 1, 2014, a number of delayed implementation provisions provide some relief. Most significant for commercial lenders and borrowers is the extension of the grandfather provision to cover obligations outstanding on July 1, 2014, as extended by Notice 2013-43 (July 12, 2013). For those covered obligations, no withholding tax will be required on any payments unless there is a material modification of the obligation.

To summarize the FATCA statutory provisions, FATCA imposes a 30% withholding tax on a payment of interest (as well as other types of payments) made to a foreign financial institution ("FFI") unless the FFI enters into an agreement with the U.S. Internal Revenue Service ("IRS") under which the FFI agrees to report the names and other relevant information about its U.S. account holders to the IRS.60 FFIs include depositary institutions (generally banks), custodial institutions (generally brokers), life insurance companies that issue cash value and annuity contracts, and investment entities. Foreign entities that are not FFIs are nonfinancial foreign entities ("NFFE") that must identify their status to a withholding agent or FFI. Passive NFFE that are not publicly traded must identify their U.S. account holders to a withholding agent or FFI that then reports those U.S. account holders to the IRS.

The final FATCA regulations were published on January 28, 2013, in the Federal Register.61 Subsequently, additional timing relief was announced by Notice 2013-43 on July 12, 2013, which generally extends many implementation dates by six months. To alleviate administrative and economic burdens, the final regulations adopt a “risk-based” approach to the implementation of FATCA that effectively addresses policy considerations, eliminates unnecessary burdens and, to the extent possible, builds on existing practices and obligations.62

The Treasury Department responded by: (i) phasing-in completion dates for identification of an FFI’s existing account holders;63 (ii) expanding the scope of existing accounts to accounts opened prior to July 1, 2014;64 (iii) delaying initial reporting on U.S. account holders to March 2015 and eliminating reporting for 2014; and (iv) delaying withholding until July 1, 2014, except for gross proceeds, foreign pass-thru payments, and U.S. source FDAP payments on offshore obligations, which is delayed until January 1, 2017.65

**Expansion of the Scope of the Grandfather Rule**

The expansion of the scope of accounts subject to the grandfather rule should be a positive development for commercial lenders and borrowers because it means payments made under a lending agreement that is in effect on July 1, 2014 will not be subject to FATCA withholding—no matter when the payments are made — unless a material modification to the agreement is made. By contrast, the proposed regulations had only extended the grandfather provision to obligations in existence on January 1, 2013. However, payments made under a grandfathered obligation will be subject to reporting.

In addition to extending the grandfather provision period, the final regulations expand the scope of the grandfather provision to apply to dividend equivalent payments under § 871(m),67 to payments or repayments on collateral for derivatives contracts and securities loans, and to collateral posted to secure a grandfathered obligation.68 The grandfather rule for dividend equivalent payments will extend to obligations executed on or before the date that is six months after which obligations are treated as giving rise to dividend equivalents. For purposes of a foreign passthru payment, a grandfathered obligation also includes any obligation that is executed on or before the date that is six months after the date on which final regulations defining the term “foreign passthru payment” are filed with the Federal Register.69

The modifications to the scope of the term “grandfathered obligation” were made in response to requests to facilitate market transition and allow additional time for adapting master agreements and collateral arrangements as a result of the intergovernmental agreements, future guidance under § 871(m), and other anticipated developments.70 In addition to extending the scope of the definition, the final regulations both clarify that the term “grandfathered obligation” means any legally binding agreement or instrument71 as well as provide a list of legal agreements or instruments that are included within the scope of a grandfathered obligation. Significantly, for commercial lenders and borrowers, a line of credit or revolving credit facility is included within such list of obligations, provided that the applicable agreement on the date of issue fixes the material terms, including a stated maturity date, under which the credit will be provided.72 Also included are: (i) a bond, guaranteed investment certificate, or term deposit;73 (ii) a derivatives transaction entered into between counterparties under an ISDA Master Agreement that is evidenced by a confirmation;74 (iii) a life insurance contract payable at death;75 and (iv) an annuity payable for a certain period or for the life of the annuitant.76

Certain legal obligations and instruments do not come within the scope of the grandfather provision. Those obligations or instruments include (i) any obligation or instrument treated as equity for U.S. federal income tax purposes;77 (ii) an instrument without a stated expiration or term such as a demand deposit or a savings deposit;78 (iii) a brokerage or a custodial agreement;79 or (iv) a master agreement that merely sets forth standard terms and conditions intended to apply to a series of transactions between parties, but not specific terms necessary to conclude a specific contract.80

The final regulations also clarify that the outstanding date of a debt instrument that is reopened in a qualified reopening under Treas. Reg. § 1.1275-2(k) is based on the issue date of the debt. As a result, whether debt issued in a qualified reopening will be treated as a grandfathered obligation depends on the issue date of the original debt, which is the issue date of the debt issued in the qualified
reopening.

A grandfathered obligation that is materially modified is treated as a newly issued obligation as of the date of the modification. A debt obligation is treated as materially modified if the debt obligation is significantly modified under Treas. Reg. § 1.1001-3(e). In the case of other grandfathered obligations, whether an obligation has been subject to a material modification is determined by the facts and circumstances.

A withholding agent other than the issuer of the obligation (or an agent of the issuer) may, absent actual knowledge, rely on a written statement by the issuer of the obligation to determine if the obligation qualifies for treatment as a grandfathered obligation. A withholding agent that relies upon such a written statement must retain the written statement for the applicable statute of limitations, which is generally three years. Furthermore, a withholding agent is required to treat a modification as material only if the withholding agent knows or has reason to know that a material modification has occurred. A withholding agent (other than an issuer) has reason to know that a material modification has occurred if this fact was disclosed to the withholding agent by the issuer.

**LSTA Model Agreement FATCA Provisions**

The LSTA Model Agreement FATCA provisions were last amended in August 2012. The term “excluded taxes” continues to include any U.S. federal withholding taxes imposed under FATCA. Excluded taxes are not within the scope of “indemnified taxes.” Thus, a borrower will not be required to indemnify the lender for any FATCA withholding taxes imposed on an interest payment. Section 2(d) of the LSTA Model Agreement requires indemnification by the borrower only for “indemnified taxes.”

The LSTA Model Agreement does not include FATCA withholding taxes within the definition of indemnified taxes because a lender has control over whether withholding is required by providing a Form W-8BEN-E to demonstrate the lender’s FATCA status. The ISDA Master Agreement contains similar provisions.

Section 2(g) of the LSTA Model Agreement requires a lender that is entitled to an exemption or reduction of withholding tax to provide the appropriate documentation for such claim, which generally includes IRS Form W-8BEN. Although FATCA will require a new version of the Form W-8BEN that was to be collect beginning on January 1, 2014, Notice 2013-34 announced that withholding certificates and documentary evidence that would otherwise expire on December 31, 2013 will expire on June 30, 2014 unless a change in circumstances occurs that would render the withholding certificate or documentary evidence incorrect or unreliable.

**Intergovernmental Agreements**

One of the most significant FATCA developments is the development of bilateral intergovernmental agreements (IGAs) that address the privacy law issues presented by FATCA. Many countries have enacted data privacy laws that prohibit the collection and reporting of information unless expressly permitted. Thus, a lender that is an FFI must report to the IRS its U.S. account holders in addition to information about the account but is legally constrained to do so by its residence country law. Data privacy laws restrict reporting of information about residents to the government of another country, but generally permit such reporting to the residence country government.

The U.S. Treasury Department initially developed the IGA solution in conjunction with the tax administrators of the United Kingdom, Germany, France, Italy, and Spain. The IGA concept was first announced in a Joint Statement issued on February 7, 2012, and was announced in conjunction with the proposed FATCA regulations. The IGA is designed to resolve the conflicts of law problem by requiring local FFIs to provide their FATCA reports to their country’s tax authorities rather than the IRS. The local tax authority agrees to pass any required enabling legislation to permit its FFIs to collect the information. The IGA under which the local tax authority acts as an intermediary is referred to as a Model I IGA. Under the reciprocal version of Model I, the United States agrees to provide similar information on the U.S. accounts of the FATCA partner’s residents.

Japan and Switzerland also initiated discussions with the Treasury Department, and a second type of IGA, named Model II, was announced under which a FATCA partner would permit its FFIs to enter into FFI agreements with the IRS and directly report U.S. account information.

Notice 2013-43 announced that Treasury will maintain on its website a list of IGAs, which have been signed, that will be treated as in effect for FATCA purposes, even if they are not officially in effect because not all of the local legislature and procedures requirements have been completed.

Treasury also updated on July 12, 2013 the Model IGAs on its website to conform to the new FATCA effective dates announced in Notice 2013-43. The website address is [http://www.treasury.gov/resource-center/tax-policy/treaties/Pages/FATCA.aspx](http://www.treasury.gov/resource-center/tax-policy/treaties/Pages/FATCA.aspx).
New SEC FATCA Rules

Recently, the U.S. Securities and Exchange Commission (“SEC”) issued new rules that address the implementation of FATCA. Although separate rules were issued for the Depository Trust Company, the Fixed Income Clearing Corporation, and the National Securities Clearing Corporation, the rules are similar. Generally, the rules require all existing and any new non-U.S. entity members to be FATCA compliant and to certify to the appropriate agency that they are FATCA compliant. New applicants are required to deliver a FATCA certification to the relevant agency as part of its membership application. The rules assume that all of the members will be classified as FFIs for FATCA purposes and that withholding would be required on payments made to FATCA noncompliant members.

The rules were adopted to prevent a negative impact on the agencies and its members. The cost of developing a withholding system for a small number of nonparticipating members was considered to be substantial and disproportionate. Concerns also were raised about taking liquidity out of the system if 30% withholding were required, or nonparticipating members were required to make deposits in anticipation of 30% withholding, resulting in an increased risk of member failure and increased financial instability. Finally, the SEC Releases note that the rule changes should not create business issues or be onerous to their membership because the requirement to certify FATCA status is becoming standard market practice in the United States. For example, credit agreements routinely require foreign lenders to agree to provide certifications of FATCA status on IRS forms.

Conclusion

The final regulations provide helpful rules for commercial lenders and borrowers, particularly with respect to the grandfather rules. Because the LSTA has provided FATCA language for the Model Credit Agreement, which is being incorporated into commercial lending documents, the FATCA issues with respect to interest payments to non-U.S. entities have been largely resolved.

In general, FATCA has facilitated the vigorous march toward global automatic information exchange. The G-8 issued a statement on June 18, 2013, at the beginning of its meeting, which declared: “Tax authorities across the world should automatically share information to fight the scourge of tax evasion.” In its communiqué of June 19 at the conclusion of the meeting, the G-8 further declared:

We commit to establish the automatic exchange of information between tax authorities as the new global standard, and will work with the Organisation for Economic Cooperation and Development (OECD) to develop rapidly a multilateral model which will make it easier for governments to find and punish tax evaders.

Although the OECD initially had begun work on information exchange, the movement toward global automatic information exchange has started to snowball since the enactment of FATCA.

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.

In re WEB2B Payment Solutions, Inc.,
488 B.R. 387 (B.A.P. 8th Cir. 2013)

In 2011, the spring and winter editions of this column sharply criticized two Bankruptcy Appellate Panel decisions – In re Ruiz, 455 B.R. 745 (B.A.P. 10th Cir. 2011), and In re Mwangi, 432 B.R. 812 (B.A.P. 9th Cir. 2010) – for treating a bank account as “funds” or “money” rather than what it is: a loan from the depositor to the bank. Unfortunately, yet another Bankruptcy Appellate Panel has fallen into that abyss.

The case involved a debtor that provided check clearing and payment processing services to its clients. The debtor in turn maintained a deposit account with North American Banking Company (the “Bank”). The debtor’s contract with the Bank authorized the Bank to charge back items that failed to clear or were fraudulent and expressly granted the Bank both a security interest in the deposit account and the right to setoff any of the debtor’s obligations to the Bank against amounts the Bank owed to the debtor on the deposit...
account. When the debtor filed for bankruptcy, the Bank froze the deposit account, which then had a credit balance of $933,000. The trustee requested that the Bank turn over the funds and the Bank, with the trustee’s permission, held back $50,000 to cover future chargebacks. The Bank did not otherwise seek adequate protection.

Unfortunately for the Bank, the holdback proved woefully inadequate, as the Bank later had to pay more than $500,000 for items that did not clear or were fraudulent. So, nine months after it paid the trustee, the Bank sought return of the funds. The trustee resisted and the bankruptcy court ruled that the Bank had: (i) lost its contractual right to setoff when it turned the money over, since there were no longer any funds in its possession to setoff; and (ii) lost its “possessor[y] lien” in the funds turned over to the trustee because the Bank failed to obtain a court order granting adequate protection of its possessor[y] lien. The Bank appealed the second ruling.

The Bankruptcy Appellate Panel affirmed. The court began its analysis by stating that “it is undisputed that [the Bank] had a contractual security interest in the account funds and that the security interest was perfected by possession as of the petition date.” The court then ruled that this possessor[y] lien was “by definition,” released when the Bank relinquished possession of the collateral. Finally, the court rejected the Bank’s argument that it maintained an interest in the proceeds of the deposit account, and thus had not needed an adequate protection order by perfunctorily stating: “[t]he funds at issue here are not proceeds.”

The court’s conclusion might well be correct but its analysis bordered on utter nonsense. The Bank did not have a possessor[y] lien because a deposit account is not something that can be possessed: it is an intangible asset. Indeed, to support its statement that the bank’s security interest was perfected by “possession,” the court itself cited to Article 9’s rules on “control.” It is hard to understand how a court can cite to the relevant provisions and yet so mischaracterize what they say.

In essence, the court treated the deposit account as money and the Bank’s security interest as one for which possession was necessary. As a result, the court did not clearly distinguish between loss of perfection and loss of attachment and gave inadequate consideration to the Bank’s argument that it maintained a security interest in the funds turned over to the trustee as proceeds of the deposit account.

A more thorough analysis would proceed as follows. Upon the filing of the bankruptcy petition the debtor’s deposit account became property of the estate and upon, appointment of the bankruptcy trustee, the trustee became the owner of the deposit account. In the language of Article 9, therefore, the trustee became the “debtor.” See § 9-102(a)(28). When the Bank responded to the trustee’s turnover demand by paying the trustee, presumably by check deposited at or funds wire transferred to another bank, the trustee’s resulting deposit account at that other bank was presumptively proceeds of the Bank’s original collateral. See § 9-332 cmt. 2, ex. 2. Moreover, the Bank’s security interest in that new deposit account would, despite the absence of control, remain perfected under § 9-315(d)(2). The only way around this analysis is if, by remitting payment to the trustee, the Bank had waived its security interest. Given the Bank’s request for a $50,000 holdback, it is entirely plausible that the Bank did waive its security interest in the portion turned over.

**FDIC v. Moore Pharmaceuticals, Inc.,**

2013 WL 1195636 (D. Nev. 2013)

This is a fairly simple case about enforcement of a security interest. The court reached the correct result but for the wrong reason.

After the FDIC took over the Community Bank of Nevada, the FDIC sought to collect on a $250,000 secured loan the bank had made to Moore Pharmaceuticals. After selling some of the collateral for its appraised value of $500, the FDIC abandoned the remainder of the collateral, concluding that the cost of removing and transporting it would exceed the likely sale price. The FDIC then brought an action for the deficiency against the borrower and its owner who had guaranteed the debt.

The defendants challenged the commercial reasonableness of the FDIC’s actions, claiming that the cost of the collateral was $54,000 and criticizing the FDIC for its failure to adequately market or advertise the property and its failure to conduct an auction sale. The court rejected these arguments in a single paragraph. Noting that the only credible evidence of the collateral’s value was an independent appraisal valuing it at $2,000 to $5,500, the court deemed reasonable the FDIC’s conclusion that the cost of selling the remaining collateral would exceed the proceeds from such a sale.

The court’s conclusion and ruling were undoubtedly correct. However, it was a mistake to subject the FDIC’s decision not to sell most of the collateral to the requirement of commercial reasonableness. Article 9 mandates that every aspect of a disposition of collateral be commercially reasonable. § 9-610(b). But that requirement applies only to an actual disposition. The secured party remains free to bring an action on the debt and reduce its claim to judgment without having proceeded against the collateral. See § 9-601(a). See also, e.g., General Electric Capital Corp. v. John Carlo, Inc., 2010 WL 3937313 (E.D. Mich. 2010); In re King, 2010 WL 4290527 (Bankr. N.D.N.Y. 2010). Thus, the commercial reasonableness of the FDIC’s decision to abandon most of the collateral was irrelevant. While abandonment of collateral might, absent an effective waiver of suretyship defenses, release a guarantor or other secondary obligor, see Restatement (Third) of Suretyship and Guaranty § 42, it has no bearing on the liability of the debtor or other principal obligor.
This case is a fairly simple one about a potato supplier’s claim against a wholesaler for interest on overdue payments and attorney’s fees incurred in collecting such payments. Each of the transactions proceeded as follows. First, the wholesaler sent the supplier a purchase order describing the item it sought to purchase, the quantity it needed, the rate it was willing to pay, and the place of delivery. If the supplier chose to fill the order, the supplier responded by sending a message via email that confirmed the product to be shipped, the price, and the shipping terms. After the wholesaler agreed to these terms, the supplier shipped the produce pursuant to the delivery schedule stated in the purchase order and confirmed in the email message. Immediately afterwards, the supplier sent an invoice listing the quantity and description of the produce shipped, the price, the delivery location and date, and a provision regarding interest and attorney’s fees.

After concluding that the UCC, and not The United Nations Convention on Contracts for the International Sale of Goods (“CISG”), controlled the parties’ relationship, the court looked to § 2-207 to determine if the term in the invoice providing for interest and attorney’s fees became part of the parties’ agreement. Given that the wholesaler had never, over the course of its dealings with the supplier, objected to the terms in the invoice, and uncontroverted testimony that such charges were normal in the produce industry, the court concluded that the terms in the invoice were not an unreasonable surprise or material alteration, and thus became part of the parties’ agreement under § 2-207(2).

The problem with the court’s analysis is that it gave no thought to when the agreement was formed. Section 2-207(2) lays a process for dealing with proposals for additional terms. However, the reference in § 2-207(2) to “the additional terms” is a reference back to subsection (1), which speaks to additional terms stated in “[a] definite and seasonable expression of acceptance or written confirmation.” In other words, § 2-207 deals with the contract formation process. Subsection (1) forms agreements when none would have existed under the common law (because of the mirror-image rule). Subsection (2) then provides rules regarding the terms of such a resulting agreement. Neither subsection has any relevance to how an agreement – once reached – is thereafter modified. Because the supplier and wholesaler in this case had reached their agreement before the supplier sent the invoice, the court’s reliance on § 2-207 was erroneous. Not only was it erroneous, it is dangerous. The court’s analysis suggests that any party to a sales contract may, at any time, add terms to the contract simply by sending a communication that adds them, provided the terms are not material and the other party fails to object.

This is not to say that the court reached the wrong result. Perhaps the terms on interest and attorney’s fees are so ubiquitous in the produce industry that they would be part of the usage of trade, and thus supplement the express terms to which the parties agreed. See § 1-201(b)(3) (defining “Agreement” to include usage of trade). Without more evidence on that, however, it is difficult to know.

In re Cunningham,

This case involves an issue of great concern to issuers of consumer credit cards and revolving lines of credit: if the debt is to be secured by the assets purchased on credit, how to describe the collateral in the agreement. Article 9 of the UCC requires a “reasonable,” not a “specific,” description of the collateral. § 9-108(a). It goes on to provide that, generally, a description by Article 9 classification, such as “inventory,” “equipment,” or “accounts” is sufficient. § 9-108(b). However, in a consumer transaction, a description of consumer goods “only by type of collateral” is insufficient. § 9-108(c)(2). This presents a bit of a problem for those that provide revolving secured credit to consumers because there is no way to know at the time the debtor authenticates the agreement what items the debtor will purchase on credit months or years later.

In the cited case, the debtors used a Best Buy credit card, issued by Capital One, to purchase consumer electronics in twelve separate transactions. The cardholder application, in the form of an application and authenticated by the debtors, provided that “you grant the Bank a purchase money security interest in the goods purchased on your Account.” After filing a Chapter 7 bankruptcy petition, the debtors sought a declaration that Capital One did not have a security interest in the items purchased with the card.

The court ruled for the debtors. It concluded that the description on the cardholder agreement was insufficient under the rule of § 9-108(c)(2). 489 B.R. at 606-08. It then refused to read the signed sales receipts for each transaction with the cardholder agreement because nothing in the sale receipts referenced the cardholder agreement. Id. at 608. Moreover, the receipts were not sufficient by themselves because they lacked language purporting to grant a security interest. Id.

The court suggested in distinguishing earlier cases, that the result would have been different if the receipts contain granting language. While it may be possible with modern technology to include granting language on the sales receipts, it is worth noting that in many instances the credit card will not be issued by the retailer. Indeed, that was the situation in this case. The debtors used a Best Buy credit card to purchase goods from Best Buy, but the card was issued by a bank, not by the retailer. Moreover, when consumers use a
Visa or MasterCard, the card issuer will never be the retailer. Because not all card issuers seek to obtain a security interest in the goods purchased with the card, retailers may not have the technological ability to determine when to include granting language on a sales receipt and when to not.

The UCC is supposed to facilitate commercial transactions, not to frustrate them. See § 1-103(a)(2). For that reason, the court's ruling would be proper only if it were compelled by the statutory language or, perhaps, by the policy underlying that language. It was not. As for the statutory text, § 9-108(e)(2) invalidates a description of collateral “only type of collateral.” However, the description in this case was not only by type. The description did not say merely “goods” or “consumer goods,” it said the goods purchased with your Account.” 489 B.R. at 608 (emphasis added). The court ignored the import of those additional words. Put another way, that statute does not invalidate a description of collateral “by type,” it invalidates a description “only by type.” §9-108 (e)(emphasis added). The court paid no attention to that crucial adjective, which is also italicized in the official comments. See § 9-108 cmt. 5.

Similarly, the policy underlying § 9-108(e)(2) does not support the court’s ruling. The reason for the heightened description requirement in consumer transactions is not to make sure the collateral is identifiable. There is no reason to think “all consumer goods” is any more difficult to interpret or apply than “all inventory” or “all equipment.” Instead, the concern underlying § 9-108(e)(2) is with overreaching: taking a security interest in items that the debtor did not expect. See § 9-108 cmt. 5. “Goods purchased with your card” does not result in such overreach. Debtors can readily understand that language.

Fortunately, in just over two months after Judge Berger issued the Cunningham decision, two contrary rulings were issued, including one by another judge in the same court dealing with the same creditor and the same contractual language. See In re Murphy, 2013 WL 1856337 (Bankr. D. Kan. 2013) (signed credit card application in which the debtors purported to grant the card issuer a security interest in the goods purchased with your Card,” was an adequate description of the collateral because it was not a description only by collateral type); In re Thrun, 2013 WL 2585636 (Bankr. W.D. Wis. 2013) (customer’s signed Consumer Lending Plan with credit union providing that credit union would have a security interest in “all goods, property, or other items purchased under this Plan . . . either now or in the future” was sufficient to cover motor vehicle purchased with an advance under the plan even without considering the unsigned advance receipt referencing the plan and describing the vehicle); see also In re Estate of Wheeler, 2013 WL 3440953 (Colo. App. 2013) (commercial real estate lease that purported to grant the landlord a security interest in “all property now owned or hereafter acquired by [the tenant] which shall come in or be placed upon the Premises,” was a sufficient description of the collateral); In re Dalebout, 454 B.R. 158 (Bankr. D. Kan. 2011) (language in cardholder agreement providing for a security interest in the merchandise purchased on your account” together with language on the charge slip providing for a security interest in “any goods, described in this charge slip” was sufficient). But cf. In re Gene Express, Inc., 2013 WL 1787971 (Bankr. E.D.N.C. 2013) (commercial real estate lease that purported to grant the landlord a security interest in “any personal property belonging to Tenant and left on the Premises” did not adequately describe the collateral because “personal property” is not a permissible description and because it refers to property that may be abandoned in the future, rather than property that is presently identifiable). Perhaps, if given the opportunity, Judge Berger will reconsider.

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 ssepinuck@lawschool.gonzaga.edu.

### Useful Links and Websites

Compiled by Commercial Law Newsletter Co-Editors Annette C. Moore, Glen Strong, Celeste B. Pozo, Christina B. Risler, Sabujini Abudulai and Harold J. Lee.

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

1. [www.lexology.com](http://www.lexology.com) – In cooperation with the Association of Corporate Counsel, Lexology provides articles and practical tips relating to the practice of law.


3. The UCCLAW-L listserv is sponsored by West Group, publisher of the “UCC Reporting Service.” The listserv is an e-mail discussion group focusing on the Uniform Commercial Code. To subscribe to the UCCLAW-L listserv, go to [http://lists.washlaw.edu/mailman/listinfo/ucclaw-l](http://lists.washlaw.edu/mailman/listinfo/ucclaw-l)


6. Gonzaga University’s new Commercial Law Center has a variety of links to useful sites and can be accessed at [http://www.law.gonzaga.edu/Centers-Programs/commercial_law_center/default.asp](http://www.law.gonzaga.edu/Centers-Programs/commercial_law_center/default.asp)
7. The International Association of Commercial Administrators (IACA) maintains links to state model administrative rules (MARS) and contact information for state level UCC administrators. This information can be accessed at http://www.iaca.org

8. The Uniform Law Commissioners maintains information regarding legislative reports and information regarding upcoming meetings, including the Joint Review Committee for Uniform Commercial Code Article 9. You can access this information at http://www.uniformlaws.org/Committee.aspx?title=Commercial Code Article 9


11. The Secretariat of Legal Affairs (SLA) develops, promotes, and implements the Inter-American Program for the Development of International Law. For more information, go to http://www.oas.org/DIL/

12. The National Law Center for Inter-American Free Trade (NLCIFT) is dedicated to developing the legal infrastructure to build trade capacity and promote economic development in the Americas. For more information, go to http://www.natlaw.com


14. International Factoring Association magazine has a variety of articles and can be accessed at http://www.factoring.org/index.cfm?page=information_news

With your help, our list of electronic resources will continue to grow. Please feel free to forward other electronic resources you would like to see included in future editions of the Commercial Law Newsletter, by sending them to Annette C. Moore, Glen Strong, or Celeste B. Pozo, the Uniform Commercial Code Committee Editors or Christina B. Rissler, Suhuyini Abudulai or Harold J. Lee, the Commercial Finance Committee Editors.

ENDNOTES:
1 The views expressed in this article are those of the authors, and not necessarily those of any organization with which either author is affiliated.

2 At the risk of gross oversimplification, an “interested stockholder” of a corporation is defined in DGCL § 203 as any person that, directly or indirectly, owns or has the power to vote at least 15% of the outstanding voting shares of the corporation. 8 Del. C. § 203(c)(5).

3 The § 251(h) procedure is also available in mergers of Delaware and non-Delaware corporations, pursuant to an accompanying amendment to § 252 of the DGCL.

4 For an insightful discussion of the relevant issues and the then-applicable caselaw, see C. Stephen Bigler & Seth Barrett Tillman, Void or Voidable—Curing Defects in Stock Issuances Under Delaware Law, 63 BUS. LAW. 1109 (2007-2009).

5 Briana Cummings, Note, Benefit Corporations: How to Enforce a Mandate to Promote the Public Interest, 112 COLUM. L. REV. 578, 594 n.111 (2012).

6 A copy of the model legislation, with commentary, can be downloaded at http://benefitcorp.net/for-attorneys/model-legislation.

7 55 Cal. 4th 1169 (2013).

8 CAL. CIV. PROC. CODE § 1856 (West 2007).

9 Riverisland, 55 Cal. 4th at 1174.


11 Id.

12 Id.

13 CAL. CIV. PROC. CODE § 1856.

14 Riverisland, 55 Cal. 4th at 1175.

15 4 Cal. 2d 258 (1935).

16 Id. at 263.

17 Timothy Murray, California Supreme Court Says Fraud May Challenge Validity of Written Agreement, 2013 EMERGING ISSUES 6896 (2013).

18 Id.

19 Id.

20 Riverisland, 55 Cal. 4th at 1172.

21 Id. at 1172-73.

22 Id.

23 Id.

24 Id. at 1173.
[25] Id. at 1174.
[26] Id. at 1176-77.
[27] Id. at 1177.
[28] Id.
[29] Id. (quoting Howell v. Oregonian Publ’g Co., 735 P.2d 659, 661 (Or. Ct. App. 1987)).
[30] Id. at 1180.
[31] Id.
[32] Id. (citing Martin v. Sugarman, 218 Cal. 17, 19 (1933); Ferguson v. Koch, 204 Cal. 342, 347 (1928); Mooney v. Cyriaks, 185 Cal. 70, 80 (1921); Maxson v. Llewelyn, 122 Cal. 195, 199 (1898); Hays v. Gloster, 88 Cal. 560, 565 (1891); Brison v. Brison, 75 Cal. 525, 528 (1888)).
[33] Id. at 1183 (citing Tenzer v. Superscope, Inc., 39 Cal. 3d 18, 39 (1985) (discussing the application of promissory fraud claims in the context of the statute of frauds)).
[35] Id. at *5.
[36] Id. at *30.
[37] Id. at *32.
[38] Id.
[39] Id. at *33-34.
[40] Id.
[41] Murray, supra note 11, at 3.
[42] Id.
[43] Id.
[44] Id.
[45] Id.
[46] Id.
[47] Korobkin, supra note 4, at 52.
[48] Id. at 92.
[49] Id. at 93.
[50] Id. at 93-94.
[51] Id. at 94.
[52] Id. at 94-95.
[53] Id. at 99.
[54] Id. at 101.
[55] Id. at 101-03.
[56] Id.
[57] Id.
[58] Murray, supra note 11, at 3.
[59] I would like to give special thanks to Ashley Nance for her contributions to this article.
[60] See FATCA Proposed Regulations Confirm Revolving Credit Facilities Covered by “Grandfather” Provision, Commercial Law Newsletter, Spring 2012 and The New FATCA Tax Withholding Rules – Practical Considerations For Drafting Credit Agreements, Commercial Law Newsletter, Fall 2010 (Nov. 8, 2010).
[61] See FATCA Proposed Regulations Confirm Revolving Credit Facilities Covered by “Grandfather” Provision, Commercial Law Newsletter, Spring 2012 and The New FATCA Tax Withholding Rules – Practical Considerations For Drafting Credit Agreements, Commercial Law Newsletter, Fall 2010 (Nov. 8, 2010).
[63] See FATCA Proposed Regulations Confirm Revolving Credit Facilities Covered by “Grandfather” Provision, Commercial Law Newsletter, Spring 2012 and The New FATCA Tax Withholding Rules – Practical Considerations For Drafting Credit Agreements, Commercial Law Newsletter, Fall 2010 (Nov. 8, 2010).
84 Treas. Reg. § 1.1471-2(b)(4)(i).
85 Treas. Reg. § 1.1471-2(b)(4)(iii). The statute of limitations may be extended to six years in cases where 25% or more of gross income was omitted in an income tax return.
86 Treas. Reg. § 1.1471-2(b)(4)(ii). This provision protects a withholding agent from any potential liability for 30% withholding.
87 Id.
88 Section III.F., Notice 2013-43.
90 See id.
91 See, e.g., Data Protection Act, 1998, ch. 29 (Eng.).
93 Section IV, Notice 2013-43. The effect of this treatment of an IGA will be to permit FFIs to register on the FATCA registration website as a compliant FFI. This, in turn, will permit such FFIs from being subject to withholding after July 1, 2014.
97 Footnote 7 of the Releases.