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FEATURED REPORTS

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

- [Preliminary Report and Exposure Draft of Supplementary Arbitration Rules for Commercial Finance Transactions – April 1, 2010](#)
- [Report of the Model First Lien/Second Lien Intercreditor Agreement Task Force \(as published in *The Business Lawyer*\) – March 22, 2010](#)
- [Report on UCC Forms Update](#)
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Reports from the Chairs

UNIFORM COMMERCIAL CODE COMMITTEE CHAIR REPORT

Spring Meeting in Denver: The Rain Did Not Stop Us

The interminable rain at the Spring Meeting in Denver made the great content of the UCC Committee’s programs and meetings and the camaraderie among those who attended shine even more notably. Program materials may be found on the [UCC Committee’s website](#) and subcommittee meeting reports and materials may be found at each subcommittee’s website, accessible from the main page of the UCC Committee’s website, which is linked [here](#).

Annual Meeting in San Francisco: Let’s Hope for Sun and No Fog

The UCC Committee will be meeting Friday, August 6, through Sunday, August 8, 2010, at the ABA Annual Meeting at the beautiful Fairmont and Mark Hopkins Hotels in San Francisco. We have a schedule of meetings and programs virtually as extensive as at the Spring Meeting, and, hopefully, the weather will be better. A preliminary schedule is available by link on the main page on our website. Our program offerings for the Annual Meeting are as follows:

- Security Interests, Collateral and Debtors at Home and Abroad: Beyond the DC Filing Office
- We Don’t Need No Stinkin’ Guaranties: The Role of Letters of Credit in Commercial Loans and Bankruptcy, including the ABCs of Letter of Credit Law and Lore
- Never Really Thought About It: Understanding “Miscellaneous” Provisions and Other Background Text in Agreements (co-sponsor)
- The Beginning of the End or the End of the Beginning: Drafting and Negotiating Forbearance Agreements (co-sponsor)
- Conquering the Quagmires: Protecting Creditors’ Rights Without Committing Malpractice (co-sponsor)
- International Financial Reporting Standards: Implications of Accounting Convergence for Business Lawyers (co-sponsor)

The joint committee dinner with the Commercial Finance Committee will be held Friday evening, August 6, 2010, at the very special St. Francis Yacht Club, known for its fabulous location on the water and its stunning views. The dinner reservation form is available [here](#).

Registration information for the annual meeting is available [here](#). Right before the meeting, we will send through the listserv the final schedule with meeting information, CLE programs and topics.

Please join us in San Francisco.

- [Meeting Notes of the Joint Review Committee for Article 9 – March 26-28, 2010](#)
by *Stephen L. Sepinuck*

UCC SPOTLIGHT

USEFUL LINKS AND WEBSITES

MARK YOUR CALENDARS

June 28, 2010 – 1:00 p.m. EDT – Practical Things Every Business Lawyer Should Know About UCC Article 9. Norman M. Powell, Janet M. Nadile, and Kate A. Sawyer will provide an overview of creating and perfecting a security interest, formulating and reviewing UCC searches, and drafting and filing UCC financing statements. Registration information is available [here](#).

July 15, 2010 – 1:00 p.m. EDT – 9th Annual Commercial Law Developments Update – Broadcast CLE. Steven O. Weise, Teresa Wilton Harmon and William C. Holland will review recent commercial law developments, including secured transactions, notes, investment property, sales, commercial lending, bankruptcy, and securitization. Additional information is available [here](#).

August 6-8, 2010 – ABA Annual Meeting – San Francisco, California. Please join us in San Francisco, California this Summer for numerous CLE programs, committee, subcommittee and taskforce meetings and social networking events. Annual Meeting program details and registration and hotel information are available [here](#).

August 6, 2010 – 7:00 to 10:00 p.m. PDT – Joint Committee Dinner – St. Francis Yacht Club. The dinner reservation form for the joint committee dinner is available [here](#).

October 20, 2010 – Joint ComFin and UCC Fall Meeting – Chicago, Illinois. The Joint ComFin and UCC Meeting will be held Wednesday, October 20, 2010, in

Fall Meeting in Chicago: Getting There Before the Cold

The UCC Committee will be hosting a one-day all CLE joint fall meeting with the Commercial Finance Committee on Wednesday, October 20, 2010, in Chicago. We will send registration, hotel and program information after the Annual Meeting.

New Ideas

Please email me at pchristophorou@cgsh.com if you have any ideas for the UCC Committee or wish to participate in any project, subcommittee or leadership role. We have a number of survey projects in process, including a project on the law of guarantees across the U.S. states, a project on the substantive and choice of law rules applicable to securities, securities accounts and deposit accounts in various key non-U.S. jurisdictions and a project with the Commercial Finance Committee for the possible creation of a wiki of commercial law terms. Our subcommittees and task forces also always welcome input and so please do not hesitate to volunteer!

Best wishes for a productive, yet relaxing, summer,

Penny
UCC Committee Chair

COMMERCIAL FINANCE COMMITTEE CHAIR REPORT

Spring has Sprung (aka Denver is Done)

The Spring Meeting in Denver has concluded (complete with snow flurries and thunderstorms) but the content lives on. Please visit the [ComFin Committee's website](#) to access materials from our CLE programs, committee meeting and subcommittee and taskforce meetings. Links to reports from subcommittees and taskforces that held sessions at the Spring meeting appear elsewhere in this newsletter.

The [Ninth Annual Commercial Law Developments Update](#) will be repeated as a broadcast CLE program on July 15, 2010, at 1-2:30 p.m. EDT. The recorded version of the [Restructured Financing: Voluntary and Involuntary Changes to Deal Structures](#) is available for purchase.

If You're Going to San Francisco (for the Annual Meeting)

ComFin and UCC will hold their meetings on Friday, August 6, through Sunday, August 8, 2010, at the ABA Annual Meeting (at the Fairmont Hotel in San Francisco). Our joint committee dinner with UCC will be held on Friday evening. Registration information for the Annual Meeting is available [here](#) and the dinner reservation form is available [here](#). A schedule of CLE programs is available [here](#). We will also circulate a schedule with meeting information, CLE programs and topics in advance of the meeting.

I hope that many of you can join us for CLE programs, thoughtful discussions and meeting your fellow committee members in San Francisco.

Fall Meeting (Save the Date)

ComFin and UCC will hold their joint fall meeting on Wednesday, October 20, 2010, in Chicago. As usual, the meeting will be held on the Wednesday before the start of (and in conjunction with) the [Commercial Finance Association Annual Convention](#). Details regarding registration, hotel and programs will be provided shortly after the Annual Meeting.

There'll Be Some Changes Made

The Annual Meeting will be the end of my term as chair of ComFin. It has been an educational and enriching three years and I'd like to thank all of the members of the committee leadership for all their support and efforts for the benefit of ComFin's committee

the Windy City, in conjunction with the Commercial Finance Association Annual Convention. An entire day of CLE will be provided. More details will become available at the [ComFin](#) and [UCC Committees'](#) websites.

October 20-22, 2010 – CFA Annual Convention – Chicago, Illinois. Additional information about the Commercial Finance Association Annual Convention is available on the CFA's [website](#).

members. The committee has grown in terms of substantive areas covered as well as members, and is a resource on the ups (and lately downs) of commercial finance practice. Please join me in welcoming Jim Schulwolf as the new chair of ComFin. Jim has a long record of service in ComFin leadership and will bring his knowledge of both the committee and the commercial finance industry to his new role. Neal Kling will continue as vice chair of ComFin and support Jim's leadership of the committee.

I hope that you'll communicate to me and to Jim and Neal about what the committee can do to present programming, provide publications and engage in projects of interest and benefit to you and your colleagues.

Lynn
ComFin Committee Chair

VIEW CURRENT REPORTS AND DEVELOPMENTS OF THE ...

UCC SUBCOMMITTEES

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

COMFIN SUBCOMMITTEES AND TASK FORCES

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

Featured Articles

AN ATTEMPT TO “DEMISTIFY” QUEBEC SECURED TRANSACTIONS LAW (PART I)

By [Kiriakoula Hatzikiriako](#), [McMillan LLP](#)

Your client, a U.S.-based financial institution, is financing a company¹ with offices and assets across the U.S. border, in the province of Quebec. Quebec is the only Canadian province under which secured transactions law is regulated by the *Civil Code of Quebec* (“CCQ”).

Your immediate reaction is to engage Quebec counsel to assist with structuring the Quebec security package. The CCQ may be unfamiliar territory . . . and, instinctively, seem quite “foreign.” A closer look however may prove that despite the differences between Article 9 of the *Uniform Commercial Code* (“UCC”) concepts and formalities and those of the CCQ, the functionality is essentially the same: ensuring the “security” of your interest in the financing transaction. Our goal is to “demystify” Quebec secured transactions concepts and demonstrate how they are not so foreign after all. A word of caution before venturing into Quebec secured transactions territory: this article does not purport to cover all the intricacies of the Quebec secured transactions regime, but to highlight some of the most-commonly encountered features in typical cross-border transactions involving Quebec assets or Quebec debtors.

This article is the first of a two part series. This first part will canvass the security vehicles most commonly used in Quebec. The second part will present particular secured transactions issues and how they are dealt with in the Quebec context.²

In contrast to Article 9 of the UCC and the *Personal Property Security Acts* of the Canadian provinces,³ in principle, Quebec does not use a functionalist approach to characterize rights in personal property. In other words, the CCQ does not necessarily apply to any transaction which is intended to create a security interest in personal property. Hence, in principle, sale agreements (e.g. conditional sales contracts) and leases (whether “true leases” or “financing leases,” as such terms are understood under the UCC) are not treated as “security” under the CCQ.⁴ Also, it is notable that “collateral assignments” (assignments of property for the purpose of securing the performance of an obligation) are not valid under the CCQ.⁵

I. Quebec Security Vehicles

Let's take a closer look at the ways creditors can obtain security interests in the province of Quebec. The most common structures are hypothecs and “title retention” devices.⁶ A

UCC AND COMFIN JOINT TASK FORCES

- [Commercial Finance Terms Joint Task Force](#)
- [Deposit Account Control Agreements Joint Task Force](#)
- [Filing Office Operations and Search Logic Joint Task Force](#)
- [Model IP Security Agreement Joint Task Force](#)

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hypothec creates a “real right” in the secured collateral.⁷ At first, the term “hypothec” may seem and sound quite exotic... However, a closer look at its origin reveals yet another reality. The term is actually of Greek origin referring to the “mortgage of property in which the debtor was allowed to keep, but not alienate, the property.”⁸ In contrast, title retention devices are title/ownership-based rights. Leases, leasing contracts and installment sales (conditional sale contracts) are title retention devices.

A. Hypothecs

Hypothecs are the conceptual and functional equivalent of security interests.⁹ Unlike Article 9 of the UCC, the CCQ does not provide for specific collateral categories. Hypothecs can charge a “universality”¹⁰ or specific personal (movable) property, corporeal (tangible) or incorporeal (intangible) and immovable (real) property. An “immovable hypothec” refers to a “mortgage.” Hypothecs can be without delivery (non-possessory) or with delivery (possessory/pledge/control).

Briefly, under Quebec conflict of laws principles, if the debtor financed is “domiciled” in Quebec¹¹ or has assets located in Quebec,¹² Quebec law would govern the creation and perfection of the security.¹³ How are hypothecs created and perfected?

(i) Creation

Attachment

The CCQ does not speak of “attachment” *per se*. However the elements of attachment are found in the CCQ:

- the debtor must have rights in the charged property (the CCQ refers to “title” in the collateral i.e. “right of ownership,” which in turn includes the right to dispose of the property); hence, a hypothec can charge “after-acquired property,” but the hypothec “attaches” when the grantor acquires “title” to the collateral;
- the debtor must agree to grant the hypothec to the secured party; an “act constituting a hypothec” (i.e. written security agreement) is required to create a hypothec without delivery, otherwise the agreement is null. In principle, pledges are created by physical delivery of the property or title to the creditor; however written agreements are customary for evidentiary purposes. In January 2009, “control” was also introduced in the CCQ as a method of creating and perfecting security against securities and security entitlements.¹⁴

Security Agreement

As is the case under Article 9 of the UCC, the security agreement must contain a “sufficient” description of the personal property collateral. In contrast to Article 9 of the UCC, the “sufficiency” is not defined. The CCQ indicates that if the hypothec charges a universality, the agreement must indicate the “nature” of the universality.¹⁵ This can be done using a generic description (i.e. the universality of the grantor’s claims) or referring to a category of assets bearing common characteristics (i.e. the universality of the grantor’s equipment).¹⁶ However, an all present and after-acquired personal property grant clause (i.e. the universality of the grantor’s present and after-acquired movable property) is also considered a “sufficient” description – the criteria being that third parties are able to easily determine the charged property.

The security agreement charging personal property can also charge real property. In that case, the agreement must specifically designate the hypothecated real property,¹⁷ be notarized and bear a Quebec notary’s minute number. A hypothec which secures the payment of bonds or other titles of indebtedness in favour of the person holding the power of attorney of the creditors (known as “fondé de pouvoir,” i.e. agent) must also be in a notarial form. This type of hypothec is often used in syndicated transactions. Further discussion of this

structure will be made in Part II of this series.

- **CONNECT WITH OTHER MEMBERS OF THE COMFIN AND UCC COMMITTEES?**

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

In contrast to UCC and PPSA security agreements, the security agreement creating the hypothec must contain explicit charging language such as “the debtor hereby hypothecates.” The debtor’s intention to create a hypothec is not sufficient. Furthermore, the agreement must indicate the specific sum in Canadian dollars for which it is granted, as well as the interest rate at which the hypothec amount bears interest. If the interest rate is not included, the amount will not bear interest.

Typically, the *hypothec amount* represents the amount of indebtedness (i.e. total credit facility commitment) plus an additional “bump-up” of 20-25% to cover additional enforcement expenses. If the amount of the indebtedness is in a currency other than Canadian dollars, the foreign exchange rates are factored in to establish the hypothec amount in Canadian dollars. In practice, some lenders require a hypothec amount which is much higher than (or two times) the indebtedness amount in view of possible future increases in the credit facilities.

This is to the lender’s advantage since a hypothec can only charge the collateral for the maximum amount set as the hypothec amount in the security agreement. If the credit facility is subsequently amended and the initial amount is increased beyond such amount, a new security agreement would have to be entered into and published by filing (see “(ii) Publication, Methods” below for more detail). If the initial security agreement was amended to increase the hypothec amount, once filed, the additional hypothec would only rank from the date of its filing.

(ii) Publication

Methods

A valid hypothec requires publication (perfection) to render it effective against third parties (including a trustee in bankruptcy). The various methods of publication are very similar to those found under Article 9 of the UCC.

Filing is the most common form of publication for all collateral.¹⁸ Publication with “physical delivery” (pledge) is another method of publication and has been typically used for certificated securities collateral. However, with the recent integration in the CCQ (as of January 2009) of publication through control for investment property (which was modeled on Article 8 of the UCC), control is preferred since it grants better rights to the secured party vis-à-vis third parties than filing. In contrast to the UCC and as previously mentioned, publication by control is not available for security in deposit accounts – this also being the case under the PPSA. Hypothecs on such collateral are published by filing.

Security Continuation after Collateral Disposition

As is the case under Article 9 of the UCC, the CCQ also provides for the secured party’s rights on disposition of the collateral.¹⁹ In the case of a transfer (i.e. sale) of the charged collateral to a buyer in the ordinary course of business, the hypothec granted on a universality of property may subsist and extend to any property of the same nature replacing the property “alienated” (transferred) in the ordinary course of business (e.g. sold inventory replaced by new inventory). Accordingly, the buyer takes the property “free” of the hypothec.²⁰ If the hypothec was granted on specific collateral (not a universality), it may extend to property that replaces it,²¹ if a notice identifying the new property is registered.²² In both cases, if no property replaces the transferred collateral, the hypothec covers the proceeds generated from the transfer, as long as they can be identified.

If the transfer of the charged property occurs outside the “ordinary course of business” (e.g. grantor is in the business of selling raw materials and a hypothec is granted to creditor on a specific piece of equipment; subsequently grantor sells its business to third party; creditor wants to preserve the hypothec on the equipment), then the creditor who wants to preserve the hypothec on the collateral “sold” out of the ordinary course of business and not registered in a file opened under the description of the property²³ must register a notice of “preservation” of the hypothec on such property within 15 days after the creditor is informed in writing of the transfer of the property and the name of the purchaser, or after the creditor consents in writing to the transfer. The creditor must transmit a copy of the notice to the purchaser within the same time containing the name of the debtor or grantor and of the purchaser and a description of the property.²⁴

Filing Procedure and Formalities

Briefly, filings of movable hypothecs are made at the Register of Personal and Movable Real Rights (“RPMRR”) and are valid for 10 years

after the date of their registration, unless renewed. The document filed (electronically or by mail) is called an application for registration. It identifies the debtor and the creditor, describes the charged property, indicates the date and place of signature of the act constituting the hypothec and the hypothec amount. An important issue that arises in many cross-border transactions is the timing of filing. Many creditors need to know that their security is in place, meaning that it is created and filed, prior to funding. To accommodate this concern, UCC and PPSA financing statements are usually filed even before the actual security agreement is executed. Pre-filing is not possible in Quebec: the RPMRR forms require the execution date of the security agreement. Bearing this in mind and the delays in obtaining filing confirmation (it is usually available within a few hours, but can take up to 24 hours, depending on the number of filings that are being processed by the RPMRR on any given day), lenders should consider whether the filing of a Quebec hypothec is a condition precedent to funding based on the Quebec collateral value.²⁵

Filings of hypothecs on real property are made at the land register in the registration division where the mortgaged lot is located and are valid for 30 years after the date of their registration, unless renewed. Registration delays at the land register tend to be a little longer than processing of RPMRR applications (it may take a few days to obtain evidence of filing depending on the registration division), so lenders must once again assess the importance of the collateral in the overall transaction. If the Quebec real property is a significant component of the collateral package, the signing of the deed and filing should occur before funding. If this is not feasible, lenders should consider obtaining title insurance with gap coverage for intervening registrations during the registration “gap” (time between the filing of the documents and the actual registration, which as we noted can be a few days).²⁶

B. Title Retention Devices

(i) Creation

Terminology

Leasing contracts, leases and installment sales (conditional sales) are so-called “title devices.” In 2004, the Supreme Court of Canada held that these transactions are not “security.”²⁷ This ruling opened the door to a looming uncertainty over the application to title devices of CCQ articles relating to hypothecs, namely security conflict of law principles²⁸ and the extension of security to proceeds, which is discussed below.

Briefly, the CCQ defines each of these agreements as follows:

Leasing Contract: “[...] contract by which a person, the lessor, puts movable property at the disposal of another person, the lessee, for a fixed term and in return for payment. The lessor acquires the property that is the subject of the leasing from a third person, at the demand and in accordance with the instructions of the lessee. Leasing may be entered into for business purposes only.”²⁹

Lease: “[...] contract by which a person, the lessor, undertakes to provide another person, the lessee, in return for a rent, with the enjoyment of a movable or immovable property for a certain time. The term of a lease is fixed or indeterminate.”³⁰

Unlike the UCC and the PPSA, the CCQ does not distinguish between “true leases” and “financing leases.”

Instalment Sale (conditional sale agreement): “[...] a term sale by which the seller reserves ownership of the property until full payment of the sale price.”³¹

Determining the nature of the contract is an important step in ensuring that registration is effected in the requisite delays, if and where applicable.

(ii) Publication

As already mentioned, given the uncertainty in applying security conflicts of law rules to title devices, if the contract you are examining has any relation to the province of Quebec (e.g. Quebec is lessee’s/buyer’s domicile, contract is governed by Quebec law, property leased/purchased is located in Quebec), then it is prudent to make the relevant filing at the RPMRR. What are the “relevant” filings for title devices?

Filing Formalities

The lessor’s “rights of ownership” under a leasing contract *must* be registered at the RPMRR to be effective against third parties. Such rights become effective against third parties from the date of the leasing contract provided they are published within 15 days.

The rights resulting from a lease *may* be published. However, leases with a term of more than 1 year in respect of a road vehicle (e.g. personal vehicle, motorcycle, aircraft) or other movable property determined by regulation, or of any movable property required for the service or operation of an enterprise, subject, in the latter case, to regulatory exclusions, must be registered.³² The rights resulting from such leases become effective against third parties from the date of the lease provided they are published within 15 days.

Similar to leases, the instalment seller's ownership rights (known as "reservation of ownership" rights for publication purposes) in respect of a road vehicle or other movable property determined by regulation, or in respect of any movable property acquired for the service or operation of an enterprise, has effect against third persons only if it has been published. Such effect operates from the date of the sale provided the reservation of ownership is published within 15 days.

In all lease, leasing contract or instalment sale filings, the assignment (transfer) of rights under such contracts (e.g. in scenarios where a third party is financing the transaction entered into between the lessor or seller and the lessee or buyer) is also registrable. Such filing is in fact advisable if the assignee wants to make its rights effective against third parties, which includes the buyer. In fact, in most cases, the reservation of ownership right and its assignment to a financier are provided in the same contract and are registered simultaneously.

In transactions where "master" agreements are used to govern the sale, lease (of a term of more than one year) or leasing contract between two businesses of a "universality of movable property of the same kind," the CCQ provides that a single (one-time) registration is available to protect the relevant rights of the lessor or seller. No specific delay is set out in the CCQ for this type of registration. This registration preserves the rights for a period of 10 years; the period may be extended if the registration is renewed.

Registration of rights under a master agreement preserves all the rights of the seller/lessor or transferee (e.g. financier) in the sold or leased property and in the universality of movable property of the same kind that may be involved in sales/leases or transfers in the ordinary course of business between two enterprises³³ following the registration. On the basis of the "buyer in the ordinary course of business" rule, such reservations, rights or transfers do not have effect against a third person who acquires any such property in the ordinary course of business of the seller's enterprise.³⁴

Consequences of No Filing or Late Filing

Lessors and sellers (and their assignees) need to be "awake" to the 15 day delay provided to register the rights relating to title devices. As we will further discuss below, where filing of rights is required, failure to file or late filings (outside the 15 day window) can have a negative impact on the lessor or the seller. Even where filing is not specifically required, filing is recommended in order to make it harder for a third party to assert that it is a "buyer in good faith." Under the CCQ, if tangible property is sold in the ordinary course of business (e.g. an instalment sale buyer sells the property to a third party), the true owner (initial seller who sold property to buyer) must reimburse the third party-buyer in good faith for the price it paid. In contrast to the PPSA and UCC, the CCQ creates a presumption of knowledge of any right that is registered in respect of property that is being acquired by a person.³⁵ Furthermore, the CCQ prevents a person who does not consult the appropriate register from invoking an argument of "good faith" to rebut the presumption.

If not registered where mandatory, rights under a lease or a leasing contract are not effective against third parties. This means that a lessor cannot claim the leased property in the hands of a third party. Curiously, the Supreme Court of Canada has decided that a trustee in the lessee's bankruptcy is not a "third party," enabling the lessor to claim back its property from the hands of a trustee even if the lessor did not file its rights under the lease.³⁶

For instalment sales, if the reservation of ownership had to be filed but was not, the seller or assignee may claim back the property only if it is always in the hands of the original buyer when it is claimed. As with leases, the Supreme Court of Canada³⁷ ruled that a trustee in bankruptcy, in its capacity as representative of the bankrupt-purchaser is not a third party. Accordingly, the seller can claim the property from the hands of the trustee even in the absence of a reservation of ownership filing. However, the Court acknowledged that its ruling would not apply in future cases given the amendments made to the Canadian bankruptcy legislation³⁸ following the facts of the case. As the Court stated, the amendments made to the BIA's definition of "secured creditor" "equate a reservation of ownership in an instalment sale with a security for the trustee's purpose." Practically speaking, vendors must file their reservation of ownership in order to attain the status of "secured creditors" under the BIA and benefit from all the protections afforded to such creditors (e.g. priority in the distribution of property to the various claimants).

Also, if the reservation of ownership had to be filed but filing was made outside the 15 day delay, the seller or assignee may take the property back only if it is in the hands of the original buyer, unless the reservation was published before the sale of the property by the original buyer, in which case, the seller or assignee may take the property back from the hands of a subsequent purchaser. Note however that in all these scenarios, similar to leases and leasing contracts, the seller or assignee takes the property back in the state it is in at the time when it is taking it back, subject to such rights and charges with which the original buyer may have encumbered it at the time of filing of the reservation of ownership and which had already been filed. An example to better illustrate: an instalment sale agreement is

executed between seller (S) and buyer (B) and is registered after the 15 day delay; B granted a hypothec without delivery to creditor (C) on all its property before the execution and registration of the instalment sale agreement. S's right to claw back the property would be subject to C's rights as secured party.

Seeing how registration is an important step in protecting the rights of an instalment sale vendor, a lessor or their respective financiers, it is crucial to advise your clients to provide Quebec counsel with a copy of the signed agreement as soon as possible after execution. The 15 day window is not a lengthy one and should not be missed where applicable!

Extension of Filing Benefits to Proceeds?

Before concluding Part I of this article, there is one more issue that we would like to address with which creditors may struggle: does the publication of the rights arising under a lease, instalment sale or leasing contract extend to "proceeds," as is the case for hypothecs discussed above? Practically speaking, would an equipment or inventory financier be able to argue that its "rights" include any proceeds resulting from the sale of the leased or sold property?³⁹ Unlike the case of hypothecs where the general rule is that a hypothec may extend to proceeds,⁴⁰ such a rule does not exist for instalment sales, leasing contracts and leases. So where does this leave the equipment or inventory financier who registers its rights resulting from the lease or instalment sale agreement, but the subject property is subsequently sold by the purchaser? The Supreme Court of Canada⁴¹ has stated that according to general Quebec civil law principles, there does not exist a real right or a right to follow property which extends to money or proceeds (e.g. trade-ins) of sold property.⁴² However, some case law has recognized the owner's right to claim damages (equivalent to the value of the sold property) against the purchaser. Bottom line: to avoid an endless debate on the subject, the financier should consider obtaining a hypothec on the debtor's "claims" (i.e. accounts) and where relevant and possible, enter into subordination agreements with other secured creditors who benefit from a prior rank on the debtor's claims.

While you are assimilating the above concepts... we leave you with the following questions which we will address in the subsequent part of this article on Quebec secured transactions... so stay tuned for Part II...

- How can you protect your client's interest in goods sold to a Quebec buyer? How is a purchase money security interest treated under Quebec law?
- Have you ever had a consignment agreement governed by New York law with property being consigned to a Quebec-based consignee? How do you protect your client's rights as consignee in Quebec?
- How is security structured in Quebec in the context of a syndicated lending transaction? Are you familiar with the concept of "fondé de pouvoir"?
- Which conflict of law rules should the lender be aware of when structuring a cross-border transaction with significant assets in Quebec?
- How are sales (assignments) of accounts receivables treated and perfected in Quebec?

FORUM SELECTION CLAUSES: WHAT LAW APPLIES

By **Peter M. Haver, Denkl Mirow & Haver**

Given the Supreme Court case law in the 1970s establishing the prima facie validity of forum selection clauses, most U.S. jurists these days do not give the enforceability of these clauses a second thought when preparing commercial agreements.⁴³ However, unbeknownst to many U.S. practitioners, numerous public policy and interpretive issues can lead to an unexpected invalidation of forum selection clauses.⁴⁴ U.S. courts exacerbate this uncertainty by evoking a *lex fori* approach which requires the application of local law, rather than the law governing the contract, in analyzing and interpreting forum selection clauses, even where the contracting parties have selected another law to govern the terms of the agreement.⁴⁵ Nevertheless, in some recent decisions U.S. federal courts have challenged this *lex fori* approach in the hopes of minimizing the current uncertainties surrounding the use of forum selection clauses. After a brief introduction as to the analytical approaches employed by U.S. courts in evaluating forum selection clauses, this article will review these recent federal cases, which either part with or distinguish the *lex fori* rule as traditionally applied to forum selection clauses.

U.S. courts' adoption of the *lex fori* rule in connection with forum selection clauses derives from the premise that since forum selection

clauses can either expand or restrict a court's jurisdictional scope such clauses have a jurisdictional character. This potential impact on jurisdiction initially led U.S. courts to reject categorically forum selection clauses on the grounds they permitted parties to oust courts of jurisdiction attributed to them by their respective legislatures.⁴⁶ Even when courts began to entertain the possibility of recognizing forum selection clauses, the presumed jurisdictional character of forum selection clauses persuaded almost all U.S. courts to apply their local law in analyzing both the enforceability and the terms of forum selection clauses.⁴⁷ At the same time, the inherent contractual nature of forum selection clauses requires U.S. courts to grapple with issues of contract formation in evaluating the underlying enforceability of forum selection clauses. A forum selection clause which qualifies for prima facie enforceability under the Supreme Court's analysis in *Bremen v. Zapata*⁴⁸ will still not bind the contracting parties unless the clause also satisfies the prerequisites of contract formation. This treatment of forum selection clauses as both jurisdictional and contractual imparts to the issue of a forum selection clause's enforceability both a procedural and substantive quality. U.S. courts necessarily apply their local rules to procedural issues such as jurisdiction, but look to the law mandated by their conflicts-of-law rules in analyzing substantive issues such as contract formation. Consequently, this dual characterization of forum selection clauses as both procedural and substantive complicates the issue of which law applies to the enforceability of forum selection clauses by essentially requiring courts to apply simultaneously two conflicting approaches.

Until recently U.S. courts avoided the difficulties posed by this procedural/substantive mix by treating such forum selection clauses as primarily jurisdictional and, thus, applying courts' local rules to issues of enforceability, despite the protestations by individual commentators and a few rogue courts.⁴⁹ In 2006, however, the Tenth Circuit challenged the *lex fori* rule approach in *Yavuz v. 61 MM*, when it held that the law chosen by the parties to govern international commercial agreements should apply to the interpretation of integrated forum selection clauses.⁵⁰ In *Yavuz* the district court had dismissed a lawsuit arising out of a fiduciary agreement on the grounds that the incorporated forum selection clause designating the courts of Fribourg, Switzerland satisfied the prima facie enforceability prerequisites set out in *Bremen v. Zapata*. In reversing, the Tenth Circuit found that the district court had failed to address three subsidiary issues which impacted the enforceability of the forum selection clause: 1) does the forum selection clause qualify as exclusive or permissive?⁵¹ 2) which of the asserted claims fall within the scope of the forum selection clause?⁵² and 3) to what extent does the forum selection clause bind each of the defendants?⁵³ The Tenth Circuit's insistence that the district court apply the law specified by the parties in the respective choice-of-law clause (Swiss law) in determining those three subsidiary issues appeared to constitute a rejection of the traditional *lex fori* approach, whereby U.S. courts applied their local law, both procedural and substantive, to all issues pertinent to the enforceability of a forum selection clause. Nevertheless, dicta in the Tenth Circuit's holding suggests the court intended a more nuanced response, which, rather than compelling a fundamental departure from the *lex fori* rule, proposed a bifurcated analysis⁵⁴ whereby federal courts would continue to apply their *lex fori* to fundamental issues of enforceability,⁵⁵ but would interpret the actual terms of forum selection clauses according to the law chosen by the parties.⁵⁶ This bifurcated approach would appear to accommodate both the procedural and substantive elements inherent in the issue of a forum selection clause's enforceability. In fact, far from dismissing the *lex fori* approach, the Tenth Circuit asserted that federal law actually requires federal courts to apply the law chosen by contracting parties in interpreting the terms of a forum selection clause.⁵⁷

Despite the numerous and diverse follow-up decisions to *Yavuz*, very few courts have either unconditionally reinstated⁵⁸ or rejected⁵⁹ the traditional *lex fori* rule. Instead, most of the decisions subscribe to the bifurcated approach sketched out in *Yavuz*, whereby courts apply their *lex fori* to fundamental issues of enforceability and the law chosen by the parties to subsidiary issues affecting enforceability. In dicta the Second Circuit supported restricting the *lex fori* rule to fundamental issues of enforceability so as to permit the application of the party-chosen law to subsidiary issues concerning the interpretation of a forum selection clause's terms.⁶⁰ In a subsequent decision a district court in the southern district of New York embellished the Second Circuit's analysis by itemizing the various issues which can arise in evaluating the enforceability of forum selection clauses and categorizing each such issue as either procedural or substantive for purposes of determining whether the *lex fori* or the law chosen by the parties applies.⁶¹ Other federal district courts also subsequently embraced the Second Circuit's bifurcated approach, although the decisions differ somewhat as to the designation of the various "enforceability" issues as either procedural or substantive.⁶² In *Brahma Group, Inc. v. Benham Constructors LLC*, the district court inverts the Second Circuit's "bifurcated" approach by applying its *lex fori* to the exclusivity/permissive distinction and the law chosen by the parties to the issue of invalidation of forum selection clauses on public policy grounds.⁶³

The recent Hague Convention on Choice of Court Agreements has gone a long way to harmonize the law in signatory states with respect to forum selection clauses. For example, article 3 of the Convention provides uniform rules as to the exclusive/permissive distinction by injecting a presumption of exclusivity.⁶⁴ That same article also separates the issue of a forum selection clause's enforceability from the issue of the validity of the underlying agreement.⁶⁵ Furthermore, the Convention assures harmonization through "conflict-of-law rules" which stipulate which law member-state courts should apply in determining the enforceability of forum selection clauses.⁶⁶ However, the Convention does not altogether eliminate the disruptive effects caused by U.S. courts' frequent use of the *lex fori* approach, since the Convention does not prevent courts, particularly those not chosen by the parties in the forum selection clause, from applying their local law to subsidiary interpretative issues which can impact the enforceability of the respective forum selection clause.⁶⁷

THE PERILS OF RELIANCE ON UCC SECTION 9-506(c) FOR PERFECTION

By [Paul Hodnefield](#)⁶⁸

Nothing can ruin a UCC filer's day faster than discovering that the debtor name provided on a filed financing statement included a minor error. Perhaps the debtor name contained extra spaces or the name ended in "Inc." when it should have been "L.L.C." Maybe the name simply omitted a comma. These seemingly minor errors can carry harsh consequences for the secured party. Under UCC Section 9-506(b), a financing statement that fails to sufficiently provide the name of the debtor in accordance with Section 9-503(a) is seriously misleading.

The good news is that there is still hope for UCC filers in this situation. Section 9-506(c) provides limited protection for minor errors. If a search of the correct debtor name, using the jurisdiction's standard search logic, would disclose the record, then an incorrect debtor name does not make the financing statement seriously misleading. The standard search logic used by most jurisdictions will ignore minor deviations in spaces, punctuation and certain ending noise words.

Some UCC filers may think perfection under Section 9-506(c) is just as good as getting the debtor name correct in the first place. Unfortunately, Section 9-506(c) carries a big trap for the unwary secured party – changes in filing office standard search logic. This article explains how the standard search logic used by most state-level filing offices operates, why standard search logic can change without notice and, finally, it will offer best practice suggestions to ensure continued perfection following the discovery of a name error currently protected by Section 9-506(c).

Model Standard Search Logic

The standard search logic ("SSL") employed by most state-level filing offices is found in the Model Administrative Rules ("MARS") for Revised Article 9. The MARS search logic returns only exact name matches, but leaves some margin for minor errors as anticipated by Section 9-506(c). MARS accomplished this through a multi-step computer normalization process applied to both the name searched and the names in the UCC index. MARS normalization applies the following rules to debtor names:

1. Equate upper and lower case letters.
2. Delete the character "&" (the ampersand) and replace it with "and."
3. Disregard all punctuation marks and accents.
4. Disregard "Ending Noise Words" to the extent practicable.
5. Disregard the word "the" at the beginning of an organization debtor name.
6. Disregard all spaces.

The results of a search conducted using the filing office's SSL will include only names in the index that *exactly* match the name searched after application of the MARS normalization rules. For example, a search of "THE A & B GROUP, L.L.C." would disclose the following names because they all normalize to "ABGROUP" and the search logic considers them exact matches:

A & B GROUP, INC.
AB GROUP
A&B Group, LP
The A AND B GROUP, LLC
A-B Group, Limited Liability Company

An SSL search would not disclose debtor names with misspellings, omissions or extra words that are not specifically disregarded by the MARS rules.

SSL Programming

MARS merely provides a filing office with the recommended name normalization steps. The rules did not offer model computer programming code. Filing offices use a wide variety of computer hardware, software and operating systems. Thus, no model computer code would work for more than a handful of filing office computer systems. Each filing office was left to program the normalization steps for its own computer system.

Whenever more than fifty separate filing offices independently create complex programming code for unique computer systems, there are certain to be some functional differences between jurisdictions. That proved to be the case with SSL. Also, some of the MARS

normalization rules were open to more than one interpretation of how they should operate. Consequently, filing offices with identical search logic rules may have programmed the normalization steps to function in different ways.

Changes to SSL and Filing Office Rules

Many filing offices have made at least minor changes to SSL since 2001. More plan to implement or upgrade their UCC systems in the future. Sometimes even minor changes to search logic can cause a financing statement that previously showed up on a Section 9-506(c) search to become a hidden lien. In that case, the secured party will likely become unperfected. Secured parties should use advance notice of search logic changes as a trigger to review the sufficiency of already filed debtor names. However, identifying SSL changes is no easy task.

The filing office SSL in most jurisdictions is specified by administrative rule. Changing the SSL normalization steps generally requires amending the administrative rules and that requires a public comment process. A secured party might assume the rulemaking process will provide advance notice of any search logic changes. That would be misguided.

Not all changes to SSL require a corresponding change to the filing office administrative rules. Even an SSL change that affects the status of financing statements effective under Section 9-506(c) can be consistent with the existing rule language. The rule for normalization of ending noise words provides an example.

“Ending noise words” are words, phrases or abbreviations that designate the type or existence of an organization. Examples include “Company,” “Limited Partnership,” and “Inc.” The International Association of Commercial Administrators (“IACA”), an organization whose membership includes the state-level UCC filing office administrators, developed a model ending noise word list. The model list designates sixty-eight words, phrases and abbreviations that should be disregarded during the search process. Most state-level filing offices use the IACA noise word list, but many have added or subtracted items to reflect local business organization law.

Most filing offices have programmed the search logic to disregard all ending noise words. The computer program starts at the end of the name and disregards any identified noise words. The routine repeats until all ending noise words are removed. For example, if the correct debtor name was “ABC COMPANY INC” the search logic would first disregard “INC.,” then repeat the step and disregard “COMPANY.” Only when the routine arrives at “ABC” does the search logic move on to the next normalization step.

The noise word normalization routine can prevent some errors from making the financing statement seriously misleading. Assuming the secured party mistakenly provides the debtor name as “ABC COMPANY” instead of “ABC COMPANY INC”, the search logic would still disclose the record on a Section 9-506(c) search. Where the search logic disregards all ending noise words, “ABC COMPANY INC” would be equivalent to the incorrect name “ABC COMPANY.” Both would normalize to simply “ABC.” The secured party would be perfected under Section 9-506(c) in spite of the error.

Relying on Section 9-506(c) for ongoing perfection, however, could be a serious mistake. A minor change to the ending noise word programming could later change the search outcome. If a filing office reprogrammed its search logic to make a single pass at the noise word step, the search results would change. The correct name, “ABC COMPANY INC,” would then normalize to “ABC COMPANY” because the search logic would only disregard “INC.” However, the incorrect name “ABC COMPANY” would normalize to “ABC.” The normalized names do not match, so a financing statement filed on the incorrect name would no longer be reflected on a Section 9-506(c) search. The result is a seriously misleading financing statement and an unperfected security interest.

In the example described above, the filing office could make the programming change and still be in compliance with the published search logic rules. Only the interpretation of the rule has changed for programming purposes.

Preserving Perfection under Section 9-506(c)

A secured party perfected solely under Section 9-506(c) should consider that nothing more than a temporary reprieve. Without further action the secured party could become unperfected at any time without warning.

Upon learning of any debtor name error, the secured party should file an amendment to add the correct name, even if perfected under Section 9-506(c). However, merely filing an amendment may not be enough to avoid problems. Another party could argue that the financing statement did not become effective until the date of the amendment filing. That could threaten the secured party’s priority. The secured party can follow two simple steps to preserve evidence of perfection and priority.

When a secured party discovers a debtor name error in a filed financing statement, the first step is not to amend the record, but to have the filing office conduct a certified search. A certified search always uses the filing office’s standard search logic. If the search discloses the financing statement, the secured party should immediately file its amendment and save the search results. A search and amendment,

in that order, will provide evidence that the secured party was perfected immediately prior to the amendment and remained perfected thereafter.

Conclusion

The simplest way to avoid the risk of search logic programming changes is for the secured party to file the correct debtor name in the first place. However, even the most diligent secured parties may sooner or later discover a debtor name error after filing the record. Section 9-506(c) will prevent some of these errors from making the financing statement seriously misleading, at least for a time. When that happens, the secured party must act as soon as possible or bear the risk of changes to the filing office's standard search logic.

COURT TESTS A BORROWER'S ABILITY TO BLOCK LOAN TRANSFERS TO COMPETITORS

By [Jon Kibbe](#), [Brian S. Fraser](#) and [Eric S. Rosen](#), [Richards Kibbe & Orbe LLP](#)

A recent decision by the United States District Court for the Southern District of New York, which granted a borrower's motion for a preliminary injunction blocking the sale of a participation in the borrower's loan, seemingly expands borrowers' power to prevent lenders from transferring loans by participation even when the participation is permitted by the governing credit agreement.⁶⁹ This decision has the potential to create uncertainty in the secondary loan market and should cause loan traders and lawyers to tread carefully when interpreting the "plain language" of loan transfer provisions. This article describes the decision and the broader commercial context within which the issues arise in the loan market.

The secondary market for commercial bank loans has expanded exponentially in the last two decades, and the "loan trading model" has, to some extent, supplanted the "relationship banking model" as the paradigm lenders and borrowers use to define their long-term dealings. Within this new model, liquidity is paramount and market participants use time-tested transfer agreements and legal structures to efficiently transfer bank loans from an existing lender to a new lender.⁷⁰ If the transfer is by "assignment," the assignee becomes a new "lender of record" under the credit agreement. As a result, the new lender assumes the rights and obligations of the original lender, and the original lender is released from the contract. Because the contractual relationship between the borrower and the original lender is supplanted by the new contractual relationship between the borrower and the assignee, an assignment normally requires the written consent of the borrower.

Conversely, if the transfer of the loan to the third-party is done as a participation, the contractual relationship between the borrower and the original lender remains intact. The seller of the participation remains the lender of record, and the buyer of the participation is granted a beneficial ownership interest in the loan which includes the right to (i) share in the economic benefits and burdens of the loan, (ii) receive confidential information provided to lenders by the borrower, and (iii) vote on important lender decisions under the credit agreement. Hence, because a participation does not affect the legal relationship between the original lender and the borrower, the borrower's consent to a participation is typically not required. In any event, the ability of the lender to sell assignments or participations in a loan is spelled out in the credit agreement, which is negotiated and agreed upon between the lender and the borrower at the time the loan is made.

Like all syndicated loan agreements entered into between lenders and borrowers, the Credit Agreement at issue in *Cablevision v. JP Morgan* provided two mechanisms by which JP Morgan (the "Lender") could syndicate the \$225 million loan (the "Loan") it made to Cablevision (the "Borrower") in December of 2007 – by selling assignments of the Loan or by granting participations in the Loan. Because any assignment would sever the contractual relationship between Lender and Borrower and replace Lender with a new party, the Credit Agreement provided that Borrower's prior consent was required for any assignment.

The Credit Agreement permitted the sale of participations without the Borrower's consent. As customary, the Credit Agreement provided that any participation agreement would ensure that (i) Lender's obligations and responsibilities under the Credit Agreement remained intact, (ii) Borrower would continue to deal directly with Lender, and (iii) Lender, and not the participant, had the sole ability to enforce the terms and conditions of the Credit Agreement. In essence, the Credit Agreement ensured that if Lender sold a participation in the Loan, it would not alter the existing contractual relationship between Lender and Borrower. These conditions are standard in any syndicated loan agreement.

Because the sale of a loan by assignment or participation is provided for in all syndicated loan agreements, to determine whether a particular assignment or participation is permitted, and under what conditions, the parties must look to the *express* terms and conditions of the governing credit agreement. It is black-letter law that a clear and unambiguous contract should be enforced according to its plain meaning, and the parties to the contract should be able to rely upon those clear and unambiguous terms to avoid a breach and a resulting

damage claim.

It is also clear that, except in rare circumstances, a lender does not owe the borrower a fiduciary duty. *See, e.g.,* ADT Operations, Inc., v. Chase Manhattan Bank, N.A., 173 Misc.2d 959, 963-64 (Sup. Ct., New York Co. 1997); *see also* Bennice v. Lakeshore S&L Ass'n., 254 A.D.2d 731, 732 (N.Y. App. Div. 4th Dep't 1998); Washington Steel Corp. v. TW Corp., 602 F.2d 594, 599-601 (3d Cir. 1979).

Every contract including credit agreements contains an *implied* covenant of good faith and fair dealing, however. This implied covenant requires that “neither party shall do anything which will have the effect of destroying or injuring the right of the other party to receive the fruits of the contract.” Although this implied covenant necessarily introduces some uncertainty into the relationship between the contracting parties, it is very rare for a court to find that, although there was no breach of an express term or condition of a contract, the implied covenant of good faith and fair dealing was breached.

In *Cablevision v. JP Morgan*, however, that is exactly what happened. The Court held that Lender had not breached the express terms of its credit agreement pursuant to which it loaned \$225 million to Borrower.⁷¹ The Court, however, held that Lender had breached its contractual duty of good faith and fair dealing, and the Court enjoined JP Morgan from granting a 90% participation in the loan to a bank that had “common ownership with a major competitor of Cablevision” despite (i) the absence of any term in the Credit Agreement prohibiting such a transaction, and (ii) the fact that the Credit Agreement specifically provided that the Lender could sell participations in the Loan without the Borrower’s consent.

This case is significant for the secondary market in bank loans because, in ruling that the participation challenged here violated the implied covenant of good faith and fair dealing present in every contract, the Court has created uncertainty as to when a participation can be used after the borrower has refused to consent to an assignment. It is also significant because, just as parties to a contract take comfort from the “plain meaning” of the contract to govern their behavior, the secondary loan market relies upon, and takes comfort from, the plain meaning of customary agreements that are uniformly interpreted by market participants. *Cablevision v. JP Morgan* has the potential to disrupt market expectations.

The facts are critical to the Court’s decision. In December 2007, Borrower moved to acquire Mexico’s third-largest fiber-optic company, Empresas Bestel. To finance this acquisition, Borrower borrowed \$225 million from JP Morgan. JP Morgan failed to syndicate the Loan. JP Morgan subsequently tried to assign a substantial portion of the loan to a single lender, Banco Inbursa (“Participant”), a Mexican bank controlled by Carlos Slim Helu and his family (“Slim”). Slim also held a controlling interest in Telemex, a Mexican communications conglomerate that is a primary competitor of Cablevision.

Borrower refused to consent to Lender’s assignment of the Loan to Participant because providing a major competitor with access to confidential and competitively sensitive information or the ability to exert any control over Borrower’s business affairs and business development would cause serious harm to Borrower.

Faced with Borrower’s refusal to consent to the proposed assignment, Lender negotiated a transfer of a 90% participation in the Loan to Participant (the “Participation Agreement”). The Participation Agreement, which was entered into between Lender and Participant on July 15, 2009, contained a number of key provisions: (i) the agreement permitted Participant to request and receive extensive information from Borrower; (ii) the agreement provided that if Borrower defaulted on the loan, the participation would turn into an assignment, and Participant would become the lender; (iii) the agreement gave Participant not only a 90% share of Borrower’s principal and interest payments due under the loan, but it also gave Participant 90% of the fees earned by Lender under the Credit Agreement, and; (iv) the agreement gave Participant the right of first refusal with respect to the transfer of the remaining 10% of the loan held by Lender.⁷²

When it discovered Lender’s plans to sell the Participation, Borrower sued Lender for breach of contract, alleging that the Participation Agreement was really an “assignment,” and that this assignment had been entered into without Borrower’s consent, in violation of the Credit Agreement. In the alternative, Borrower argued that even if the Participation Agreement technically complied with the Credit Agreement, the unusual structure of the Participation Agreement gave Participant the substance of an assignment. This, Borrower argued, undercut the “assignment veto” that it had negotiated for in the Credit Agreement, thereby violating the implied covenant of good faith and fair dealing.

The Court declined to rule that Lender had breached the terms of the Credit Agreement by entering into the Participation Agreement with Participant.⁷³ However, the Court concluded that Lender acted in bad faith by using the “guise of a purported ‘participation’ to effectuate what [wa]s in substance a forbidden assignment.”⁷⁴ If followed, according to the Court, that Lender had deprived Borrower of the benefit of the contract – Borrower’s veto power over assignments.

Of paramount importance to the Court was the fact that Participant was owned by the major shareholder of one of Borrower's major competitors. Indeed, as the Court noted, under "the Participation Agreement, [Participant], a bank under common ownership with [Borrower's] major competitor, was given, at [Participant's] request, rights that were not part of [Lender's] standard participation agreement that enabled [Participant] not just to receive [Borrower's] confidential information, but to use [Lender] as a vehicle for demanding such information on a virtually unlimited basis." Clearly, the Court concluded, the assignment veto, negotiated for by Borrower, was, among other things, designed to prevent sharing of confidential information with Borrower's competitors.

The Court was clearly sympathetic to Borrower's situation. Yet, in ruling for Borrower, the Court overlooked several key considerations. It is well-understood that a borrower's confidential information is only shared with assignees and participants pursuant to a confidentiality agreement restricting the use or dissemination of the information with potential purchasers of the loan or interests in the loan. Indeed, the Participation Agreement negotiated between Lender and Participant required Participant to maintain the confidentiality of any confidential materials it received from Borrower, and other provisions within the Participation Agreement narrowed the specific confidential information to which Participant was entitled.

Most importantly, Participant was merely an affiliate of a competitor (Telemex), and not itself a competitor. The Court did not discuss whether Borrower could reasonably presume or anticipate that Participant would breach Participant's confidentiality obligations by sharing Borrower's confidential information with an affiliate. Moreover, if the plain meaning of a contract controls, then Borrower could have negotiated provisions in the credit agreement prohibiting (i) any sale by the Lender to a "competitor (or affiliate of a competitor)" of the Borrower, or (ii) the sharing of confidential information with "competitors (or affiliates of competitors)."

The Court was obviously troubled by the special terms of the Participation, especially the provision governing the sharing of confidential information. However, the terms of the Participation Agreement that Lender negotiated with Participant, while not boilerplate, are not uncommon in participation agreements generally. The *Cablevision v. JP Morgan* decision creates uncertainty in the market and leaves open the question whether the grantor of a similar participation should attempt to obtain the consent of the borrower notwithstanding clear provisions to the contrary in most credit agreements.

In the wake of *Cablevision v. JP Morgan*, prudent practice in the secondary loan market requires loan transfer provisions and eligible assignee definitions to be read literally *and* in light of the *implied* covenant of good faith and fair dealing, which applies by law to all contracts. A borrower's denial of consent to a proposed assignee who is a competitor, or a credit agreement clause that expressly prohibits transfer by assignment to the borrower's competitors, may mean that a transfer by participation is not available even though such a participation is arguably permitted by the terms of the credit agreement.

On appeal from the Court's grant of a preliminary injunction, *Cablevision v. JP Morgan* is currently headed up to the Second Circuit Court of Appeals, although the case is also scheduled for a full trial on the merits on July 26, 2010. The loan market will continue to watch the case with interest.

THE DOCTRINE OF INDEPENDENT LEGAL SIGNIFICANCE APPLIES TO ALTERNATIVE ENTITIES: SOME THOUGHTS FOR LENDERS

By [Evangelos Kostoulas](#), Young Conaway Stargatt & Taylor, LLP

Recently, the Delaware legislature amended the Delaware Limited Partnership Act (the "LP Act") and the Delaware Limited Liability Company Act (the "LLC Act") to clarify that the doctrine of independent legal significance applies to Delaware limited partnerships ("LPs") and limited liability companies ("LLCs"), respectively. *See* Del. Code Ann. tit. 6. §§ 17-1101(h), 18-1101(h). While the doctrine has long been utilized by Delaware courts in construing provisions of the Delaware General Corporation Law (the "DGCL"), whether the doctrine applied to the construction of alternative entity statutes was an "open question." *Twin Bridges Ltd. P'ship v. Draper*, C.A. No. 2351-VCP, 2007 Del. Ch. LEXIS 136, at *34 n.47 (Del. Ch. Sept. 14, 2007). The legislature's recent amendments have now answered that question, but in so doing, have brought to the fore certain questions for lenders and others who deal with alternative entities.

The Doctrine of Independent Legal Significance

The doctrine of independent legal significance provides that a legal action validly taken under one section of a given statute (traditionally the DGCL) need not satisfy the requirements of another section of that statute to be valid, even if the ultimate result of the legal action would be the same under either section. For instance, while an amendment to the certificate of incorporation that alters the rights of shares of a given class requires approval by a separate vote of that class under DGCL § 242, such an amendment may be accomplished without such a vote by means of a merger under DGCL § 251. *See, e.g., Elliott Assocs., L.P. v. Avatex Corp.*, 715 A.2d 843, 853 n.48

(Del. 1998). Using the same example in the alternative entity context, unless otherwise stated in the agreement, the terms of an LP or LLC agreement may be amended by satisfying the requirements for a merger under the existing agreement, even if the agreement imposes more stringent requirements for amendments. *See also* Del. Code Ann. tit. 6 §§ 17-211(g), 18-209(f).

Amendment via Merger

To the extent that an LP or LLC agreement imposes a less onerous barrier to a merger than to a direct amendment, a merger provides a more viable “backdoor” method of amending the agreement. Because of the remarkable flexibility that alternative entities provide, the ramifications of such an amendment method are perhaps greater than in the case of corporations. Delaware alternative entities can be designed in virtually any manner imaginable, and frequently contain provisions upon which lenders and others rely in entering into transactions with such entities, including provisions related to Uniform Commercial Code (“U.C.C.”) Article 8 opt-in, independent directors, and separateness covenants. While an LLC agreement (or LP agreement) may restrict the ability to amend the terms of the agreement directly, where the possibility of amending the agreement by way of merger was not anticipated and similarly restricted, an amendment by merger might be more easily accomplished than a direct amendment. An unanticipated amendment to an agreement in this manner may result in serious consequences for lenders and others, as illustrated below.

Special Purpose Entities

Special purpose entities (“SPEs”) are used in a variety of contexts, but they appear most often in structured finance and securitization transactions. In such transactions, SPEs typically have the following characteristics:

- The SPE’s purpose is narrowly defined, which limits its authority to engage in activities outside of its intended purpose;
- The SPE’s terms contain separateness covenants to avoid substantive consolidation in the event a related entity files for bankruptcy;
- The SPE has an “independent director” whose consent is necessary for the entity to make a voluntary bankruptcy filing;
- The independent director’s fiduciary duties are limited to protecting the interests of one or more interested parties (typically a lender).

Because of the flexibility permitted by the LLC Act, Delaware LLCs are ideally suited for use as SPEs. LLCs can be structured to have a limited purpose, to prohibit undesirable actions by members or managers, and to tailor the rights and obligations of the independent director to the needs of a particular transaction.

Independent Director

The LLC Act provides that an LLC agreement may grant managers specific rights and duties, including the right to vote. Del. Code Ann. tit. 6 § 18-404(a), (b). As a result, bankruptcy remote LLCs can be created with a special manager – the independent director – who lacks any authority other than to consent to (or decline to consent to, and thereby prevent) the voluntary bankruptcy filing of the LLC. Moreover, fiduciary duties in LLCs, unlike as in corporations, can be expanded, limited, or eliminated by inserting relevant contractual provisions into the LLC agreement. Del. Code Ann. tit. 6 § 18-1101(c). One consequence of such limitation or elimination is that the independent director can focus on its obligations to a lender without fear of conflicting obligations to others who might have an interest in the entity. However, if the LLC agreement permits the LLC to merge without the consent of the independent director, the role of independent director could potentially be eliminated or altered such that the independent director would have potentially conflicting fiduciary duties to both creditors and equity holders under an amended agreement to which he did not consent!

Article 8 Security Opt-In

Although an interest in a limited liability company may be certificated or uncertificated, the mere fact that an interest is certificated does not make it a “certificated security” for purposes of Article 8 of the U.C.C. “An interest in a partnership or limited liability company is not a security unless it is dealt in or traded on securities exchanges or in securities markets, its terms expressly provide that it is a security governed by this Article, or it is an investment company security.” U.C.C. § 8-103(c). Thus, for most limited liability companies, a certificated LLC interest will not be a certificated security for purposes of the U.C.C. unless its terms expressly state that it is governed by Article 8 of the U.C.C. Expressly stating that a certificated LLC interest is governed by Article 8, or “opting in” to Article 8, provides several advantages to purchasers, including secured parties,⁷⁵ such as allowing a party to avail itself of protected purchaser status⁷⁶ and providing alternative, and preferred, methods for perfecting security interests other than the simple filing of a financing statement.

Perfection of Security Interests

Unless a security interest is perfected, a bankruptcy trustee has authority to avoid the security interest and relegate the secured party’s claim to an unsecured claim in bankruptcy. 11 U.S.C. § 544(a)(1). If an LLC has not opted in to Article 8, the LLC interest would likely be a general intangible and a security interest in such could only be perfected by filing a financing statement. U.C.C. § 9-310(a). A security interest in a certificated security, however, may be perfected not only by filing a financing statement, but also by delivery or control. U.C.C. §§ 9-310, 9-312(a), 9-313(a), 9-314(a).

Consequences for Lenders

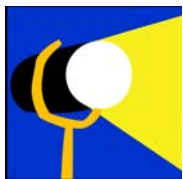
Regardless of whether an LLC opts in to Article 8 initially, the ramifications to secured parties from an unanticipated amendment to the LLC agreement are potentially severe. For example, suppose that Article 8 does not apply to an LLC interest (that is, it is not a security), and a merger occurs whereby the LLC agreement of the surviving LLC contains Article 8 opt in language. Presumably a secured party would have filed a financing statement to perfect its security interest before the merger, but the secured party may be unaware that a merger occurred. Suppose that the surviving LLC issues certificated securities, and a third party obtains a security interest in the LLC interest and perfects by obtaining control. Even though the first secured party had filed a financing statement before the third party perfected its security interest, the third party's security interest would have superior priority. U.C.C. § 9-328. Moreover, the first secured party would not have been able to perfect its security interest by control unless it had required that the LLC opt in to Article 8. Even if the first secured party had taken steps to prohibit amendment of the LLC agreement without its consent to avoid a situation similar to the one described, it would not prevent an amendment by merger unless the prohibition explicitly included an amendment by merger.

A lender may face unintended consequences from a merger even where the lender requires that the LLC initially opt in to Article 8. For instance, if an LLC agreement contains opt in language, and a third party has already filed a financing statement against an LLC interest, a lender might feel confident that he can obtain a senior lien by taking control of the certificated security representing the interest in the LLC, and so long as Article 8 applies to the LLC, he would be correct. *See* U.C.C. § 9-328. However, should the LLC be amended to remove the opt in language, control would no longer be a valid method of perfection. At best, the lender's priority would become subordinate to that of the third party (for example, if the lender had filed a financing statement as well as taking control). At worst, the lender's security interest would be unperfected and subject to avoidance in the event of bankruptcy.

These are just a few examples of how the application of the doctrine of independent legal significance may result in unintended consequences for lenders and others if an agreement has not been structured with the possible application of the doctrine in mind. As illustrated by these examples, whether terms bargained for *ex ante* are more ephemeral than initially believed is an inquiry well worth the attention of lenders. Thus, when dealing with Delaware LLCs or LPs, it is always best to keep in mind that the doctrine of independent legal significance applies, so that even if an agreement restricts the ability of parties to do something directly, it does not necessarily prevent them from doing it indirectly.

UCC Spotlight

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



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

444 W. Ocean, LLC v. Simmax Energy (CA), LLC, **[2010 WL 310775](#) (Cal. Ct. App. 2010)**

The court in this case made a blatant error but still managed to reach what is probably the correct result. In the process, the court provided an interesting take on what it takes to properly identify proceeds by tracing them into a deposit account.

The case arose shortly after *444 W. Ocean, LLC* (“Ocean”) obtained a judgment against DG Cogen Partners LLC (“debtor”) for slightly more than \$500,000. Ocean then levied on one of the debtor's deposit accounts with a \$50,000 balance. Alberta Ltd. intervened. Alberta was the assignee of two loans to the debtor totaling over \$19 million. The loans were secured by the debtor's inventory, accounts, and deposit accounts. The original secured party had filed a financing statement against the debtor and an amended filing listing Alberta as the secured party. The trial court ruled against Alberta on evidentiary grounds. The appellate court reversed, ruling that Alberta's evidence should have been admitted and, if it had been, showed that Alberta was entitled to the balance in the deposit account.

On this latter point, the court made a very unfortunate statement. In referring to the security interest in the debtor's deposit account, the court wrote that “a security interest may be perfected by filing. . . . Ocean advances no reason why the filings presented by Alberta did not suffice to perfect its interest, and we see none.” Obviously, the court did not look very hard. To support its statement, the court

cited to the California version of § 9-310(a). But that provision begins with the statement “[e]xcept as provided in . . . section 9-312,” and that provision in turn provides that, except to the extent a deposit account consists of proceeds of other collateral, perfection in a deposit account requires control; filing a financing statement is ineffective. § 9-312(b)(1). Thus, the court was simply wrong in saying that filing a financing statement works to perfect a security interest in a deposit account and no one should rely on this erroneous statement.

Nevertheless, the court probably was correct in ruling for Alberta. The debtor’s office manager testified that she was responsible for receiving payments from customers and depositing them into the debtor’s deposit account. She further testified that, in the three weeks prior to the levy, the debtor made deposits totaling slightly more than \$161,000 into the deposit account, and all but \$420 consisted of the proceeds of the debtor’s accounts receivables. The court concluded that this was sufficient to show that the \$50,000 balance in the deposit account was proceeds of collateralized accounts and that Alberta had a perfected security interest in it.

This conclusion was probably correct. Checks received in payment of accounts are identifiable proceeds of the accounts. Accordingly, any security interest in the accounts would automatically attach to the checks. § 9-315(a)(2). Such a security interest would be perfected if the security interest in accounts was perfected. § 9-315(c), (d)(2). When the checks are deposited into a deposit account, the deposit account becomes proceeds of the checks. Whether and to what extent the deposit account is and remains *identifiable* proceeds of the checks – a requirement for the security interest to automatically extend to the proceeds – will depend on what withdrawals or other debits are later posted to the deposit account and what tracing rule is used. The most common tracing rule is the lowest intermediate balance rule,⁷⁷ which the appellate court in this case seems to have used. Following that rule, the entire \$50,000 balance was indeed identifiable proceeds of the checks (and therefore of the accounts), and the security interest therefore attached to the deposit account. This security interest was likewise perfected. § 9-315(c), (d)(2).

The most interesting aspect of this was the ease with which the court allowed Alberta, the secured party, to trace the collateral. Apparently the only testimony was the conclusory statement of the debtor’s office manager that all but \$420 from the deposited checks was proceeds of accounts. Not all courts may find such evidence sufficient.⁷⁸ Moreover, secured parties should not count on being able to secure the favorable testimony of the debtor or the debtor’s employees.

Corsair Special Situations Fund, L.P. v. Engineered Framing Systems, Inc.,
2010 WL 958019 (D. Md. 2010)

In this case, the court ignored the non-waivable debtor protections in Article 9 by treating the secured party as the owner of the collateral upon the debtor’s default.

The case began when the debtor, Engineered Framing Systems, Inc. defaulted on a loan from Corsair Special Situations Fund, L.P. The parties entered into a settlement agreement by which the debtor promised to pay five monthly payments of \$75,000 followed by a balloon payment of \$4.5 million. To secure its obligations, the debtor granted Corsair a security interest in a patent. The security agreement provided that, upon default, “the security interest [shall] become an absolute assignment . . . and Corsair is hereby granted an irrevocable power of attorney to so designate such absolute assignment on the records of the U.S. Patent and Trademark Office upon any such default.”

When the debtor defaulted, Corsair filed an assignment of the patent with the United States Patent and Trademark Office. The debtor contested the assignment and Corsair sued, seeking: (i) a judgment for the \$5 million due; (ii) a declaration that it was the owner of the patent; and (iii) an injunction enjoining the debtor from using the patent or patented technology.

In a somewhat cursory analysis relegated to a footnote, the court acknowledged that federal patent law does not address the effectiveness of the parties’ agreement; instead, Article 9 governs. Then, citing to § 9-601, the court stated that “[a]fter default, a secured party has the rights provided in [Subtitle 6] and . . . those provided by agreement of the parties.” Based on this, the court ruled that Corsair was the owner of the patent, although it declined to award damages for or enjoin infringement on summary judgment.

The court’s analysis and conclusion are, unfortunately, off the mark. The court seems to have focused solely on what the agreement said and ignored the rules of Article 9. The rules in § 9-610 on conducting a disposition (*i.e.*, a foreclosure sale) and in § 9-620 on acceptance (*i.e.*, strict foreclosure) cannot be waived in the security agreement. *See* § 9-602(7), (10). The right to require a disposition can be waived only after default. *See* § 9-624(b). While the debtor may have defaulted on the original *loan agreement* when it agreed to the terms of the security agreement, it had not agreed to anything after it defaulted on the *security agreement*. Thus, even though the security agreement purported to make Corsair the owner of the patent upon the debtor’s default and gave Corsair the right to record an assignment of the patent in the Patent Office, Corsair in fact had no such rights. Unless and until Corsair purchased the patent at a disposition or obtained the debtor’s consent to accept the patent in full or partial satisfaction of the debt, the debtor remained the owner of the patent.

Bank of the West, Inc. v. Organic Grain & Milling, Inc.,
2010 WL 995459 (D. Ariz. 2010)

This case is a brief decision about a secured party seeking to collect a collateralized account. Bank of the West, Inc. (the “Bank”) loaned Desert Organics, LLC (the “Debtor”) \$3,000,000 and in return received a security interest in the Debtor’s crops and crop proceeds. At about the same time, the Debtor entered into an output contract with defendant Organic Grain and Milling, Inc. (the “Account Debtor”), whereby the Account Debtor agreed to buy the Debtor’s entire 2008 durum wheat crop. The Debtor defaulted on its obligations under the loan agreement, prompting the Bank to seek payment from the Account Debtor.

The Account Debtor acknowledged the Bank’s security interest in the account and sought the Bank’s consent to pay the harvester and seed supplier out of the money payable to the Bank. The Bank by letter agreed to allow the Account Debtor to pay the harvester and seed supplier a maximum of \$72,000 out of the crop proceeds, and the parties agreed that the remainder of the crop proceeds was to be paid directly to the Bank.

The total value of the harvested crop was about \$243,000, so the Bank expected the Account Debtor to pay it no less than \$171,000. Instead, the Account Debtor sent a check for about \$47,000 and asserted an offset of \$196,000 for damages it claimed to have suffered from the Debtor’s failure to properly irrigate the crop land. The Bank sued.

The District Court granted summary judgment for the Bank, as it should have. Unfortunately, its analysis was off the mark. The court ruled that the Account Debtor was not entitled to offset its damages because the Bank, as secured party, had no duty to provide the funds needed for irrigation and because the Bank was not an “assignee” of the Debtor’s rights under the output contract. Specifically, the court wrote:

We also reject [the Account Debtor’s] counterclaim that the Bank is an “assignee” of [the Debtor] Desert Organics pursuant to [§ 9-404]. The Bank was a lender, and as such had a secured interest in [the Debtor’s] crops and crop proceeds. A security interest in [the Debtor’s] assets does not make the Bank an “assignee” of [the Debtor’s] rights and obligations under the . . . outputs agreement with [the Account Debtor]. . . . There is no express assignment in the instant case. [The Account Debtor’s] claim for recoupment under [§ 9-404] is without merit.

The court’s analysis is wrong, but its confusion may be understandable. For reasons that are not clear, Article 9’s rules regarding a secured party’s right to collect from an account debtor use the term “assignor” for the debtor and “assignee” for the secured party. But this change in terminology does not signify a change in meaning. Any creditor with a security interest in an account is an “assignee” within the meaning of § 9-404 and § 9-406. Therefore, the court should have looked to Article 9 to determine the rights of the parties.

Nevertheless, the court reached the correct result. Normally, a secured party’s (assignee’s) right to collect is subject to all the terms of the agreement between the debtor and the account debtor, and any other defense or claim of the account debtor against the debtor that arose before the account debtor received notification of the security interest (assignment). § 9-404(a). *See also* Restatement (Second) of Contracts § 336 and cmt. b (indicating that essentially the same rule applies under the common law of contracts). However, this rule can be changed by agreement. Article 9 expressly acknowledges that the account debtor may bind itself by agreement with the debtor not to assert defenses against a secured party (assignee). *See* § 9-403(b). If that is true, then the account debtor can surely by direct agreement with the secured party (assignee) waive the right to assert defenses. The Account Debtor in this case did just that. Moreover, the court expressly ruled that this agreement was supported by consideration: the Bank’s promise to allow the crop harvester to be paid first. Thus, the court was right in concluding that the Bank was entitled to payment from the Account Debtor.

Useful Links and Websites

Compiled by Carol Nulty Doody, Uniform Commercial Code Committee Editor

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

1. The UCCLAW-L listserv, which is sponsored by West Group, publisher of the “UCC Reporting Service.” To subscribe to the UCCLAW-L listserv, [click here](#).
2. U. Penn’s archive of NCCUSL final acts and drafts can be accessed [here](#).
3. Pace University’s database of CISG decisions can be accessed [here](#).

4. Gonzaga University's new Commercial Law Center has a variety of links to useful sites and can be accessed [here](#).
5. The International Association of Commercial Administrators ("IACA") maintains links to state model administrative rules ("MARS") and contact information for state level UCC administrators. That information can be accessed [here](#).
6. The Uniform Law Commissioners maintains information regarding legislative reports and information regarding upcoming meetings, including Joint Review Committee for Uniform Commercial Code Article 9. You can access this information [here](#).
7. Information on the work of The United Nations Commission on International Trade Law ("UNCITRAL") (including the work of its working groups on Procurement, International Arbitration and Conciliation, Transport Law, Electronic Commerce and Insolvency Law) is available [here](#).
8. Information on the work of the OAS in the area of private international law and the various Inter-American Specialized Conferences on Private International Law organized by the OAS is available [here](#).
9. Information on The National Law Center for Inter-American Free Trade ("NLCIFT") and its work throughout Latin America to promote secured transactions reform is available [here](#).
10. Information on the Hague Convention and its current status is available [here](#).
11. Information on the UNIDROIT project to enhance the internal adequacy and cross-border compatibility of existing national laws, including the Draft Convention on Substantive Rules Regarding Intermediated Securities, is available [here](#).

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

¹ This article will discuss security granted by a company, not an individual.

² Note that throughout the article, for comparative purposes, next to the CCQ term/concept we provide in parenthesis, the UCC concept which presents the closest similarity.

³ All Canadian provinces and territories (except Quebec) have a Personal Property Security Act. The Acts are essentially similar with some variations. For more on this, see Cuming, Walsh & Wood, *Personal Property Security Law* (Irwin 2005). For the purposes of this article, references to the PPSA are references to the Ontario PPSA, R.S.O. 1990, Chapter P.10 (PPSA).

⁴ Note, however, that there have been cases which re-characterized transactions involving sale or lease agreements as secured transactions. Such discussion is beyond the scope of this article.

⁵ C.C.Q. art. 1801.

⁶ Trusts within the CCQ meaning can also be used as a security vehicle. This form is not discussed in the article. Note that the terms "title retention" are placed in quotation marks because they are the terms that are generally used when referring to leases, leasing contracts and instalment sales (conditional sales), but not specifically employed in the CCQ.

⁷ C.C.Q. art. 2660. The hypothec confers on the creditor the right to follow the property into whosoever hands it may be, to take possession of it or to take it in payment, or to sell it or cause it to be sold and, in that case, to have a preference upon the proceeds of the sale ranking as determined in the CCQ.

⁸ BLACK'S LAW DICTIONARY (8th ed. 2004).

⁹ Hypothecs are consensual or non-consensual (the CCQ lists the "legal" hypothecs which include claims of persons having taken part in the construction or renovation of an immovable (construction liens) and claims under a judgment (judgment liens)). This article focuses on consensual hypothecs.

¹⁰ The CCQ does not define this term. Essentially, parties are free to determine the scope of the universality. In a typical secured transaction with a hypothec on the "universality" of the grantor's (company) assets, the secured party would benefit from security on all of the grantor's business assets. Note that specific universalities can also be created, i.e. a hypothec on the universality of claims (accounts) from a specific account debtor. Curiously, in a 1996 Quebec Superior Court case, the Court refused to characterize 95% of the claims of an assignor from the same account debtor as an assignment of a "universality." Further discussion on the Quebec assignment of claims regime will be made in Part II of this series.

¹¹ The debtor's "domicile" (i.e. head office) is the relevant criteria for the creation and perfection of security on intangible property and mobile goods. See C.C.Q. art. 3015.

¹² *Sims* is the relevant criteria for the creation and perfection of security on tangible property. See Art. 3102 C.C.Q. For investment property, the rules are similar to Article 9 of the U.C.C.; for more on this, see Kiriakoula Hatzikiriakos, *Security on Investment Property: New Quebec Legislation*, Apr. 3, 2009, <http://www.internationallawoffice.com>.

¹³ The CCQ's conflict of law rules address the "validity" (creation), "publication" (perfection) and "effects" of publication (i.e. effectiveness against third parties, the ranking of rights and the protection of third parties in good faith).

¹⁴ Unlike the UCC, "control" is not available for deposit accounts. For more on the new legislation dealing with security in investment property, see Kiriakoula Hatzikiriakos, "Security on Investment Property: New Quebec Legislation," see *supra* note 12.

¹⁵ Compare C.C.Q. art. 2697, with U.C.C. § 9-108.

¹⁶ Note that if certain specific vehicles (i.e. passenger vehicles) are being charged, they must be described by serial number, except if they are caught via a hypothec charging present and after-acquired property.

¹⁷ Under the CCQ, an immovable hypothec is valid only so far as the security agreement specifically designates the hypothecated property. If the security agreement charges all property (real and personal) of the grantor, the hypothec will only rank in respect of each immovable property from the time of the hypothec's filing against each immovable property. If additional real property is acquired after the security agreement is filed, then a notice containing the description of the immovable acquired and a reference to the agreement creating the hypothec is filed at the land register. See C.C.Q. art. 2949.

¹⁸ Note that the CCQ provides some special rules for the effectiveness of a hypothec on claims against the account debtors (the creditor must set up its hypothec against such debtors in the same way as an assignment of claims; this will be further discussed in Part II) and of a hypothec on life insurance policy rights (registration of the hypothec is not sufficient; notice of the hypothec to the insurer renders the hypothec effective against the insurer and third parties).

¹⁹ Compare U.C.C. §§ 9-315, 9-320, with C.C.Q. art. 2674.

²⁰ Note that the CCQ does not use the terms "takes free" as is the case under Article 9-320 of the UCC. The CCQ rules on "sales" oblige the seller to discharge the property sold of all hypothecs, declared or registered, unless the buyer assumes the debt secured.

²¹ This is the principle of "real subrogation."

²² Article 2674 of the Civil Code of Quebec does not impose any delay for registration, in contrast to Article 9, section 315(d) of the Uniform Commercial Code.

²³ The RPMRR is composed of name files and descriptive files. A name file shall be opened for each grantor named in an application for registration. A descriptive file shall be opened only for a road vehicle listed in the Regulation respecting the register of personal and movable *real rights* (e.g. passenger vehicles, motorcycles, and taxis). O.C. 1594/93, G.O.Q.1993.II.6215, as amended by Regulation to Amend the Regulation Respecting a Registration System or the Keeping of a Register, O.C. 907/99, 1999 G.O.Q.II.2719.

²⁴ C.C.Q. art. 2700.

²⁵ For more on the RPMRR, see https://www.rdprm.gouv.qc.ca/rdprmweb/html/engls_publication.asp.

²⁶ For more on the Quebec Land Register, see <http://www.mrnf.gouv.qc.ca/english/land/register/index.jsp>.

²⁷ Ouellet (Trustee of) [2004] 3 S.C.R. 348 (leases); Lefebvre (Trustee of); Tremblay (Trustee of) [2004] 3 S.C.R. 326 (installment sales).

²⁸ See *supra* notes 11-12. The conflict of law rule relating to "real property" rights and their publication is the "situs" (or place of destination if the real rights are in transit). C.C.Q. art. 3097.

²⁹ C.C.Q. art. 1842.

³⁰ C.C.Q. art. 1851.

³¹ C.C.Q. art. 1745.

³² See Register of Personal and Moveable Real Rights, R.P.M.R.R. 15-15.01; see also, *supra* note 23.

³³ The CCQ defines "enterprise" as "the carrying on by one or more persons of an organized economic activity, whether or not it is commercial in nature, consisting of producing, administering or alienating property, or providing a service." C.C.Q. art. 1525.

³⁴ C.C.Q. art. 2961.1. In contrast, there is no similar rule for an installment sale, lease or leasing contract filing (made individually, not pursuant to a "master agreement"). The lessor/seller retains the right to follow the property in the hands of a buyer in the ordinary course of business: see discussion in following paragraphs of text.

³⁵ This principle is not applicable in the case of security on investment property. See Kiriakoula Hatzikiriakos, *Security on Investment Property: New Quebec Legislation*, Apr. 3, 2009, <http://www.internationallawoffice.com>.

³⁶ See *Lefebvre* case cited *supra* note 27.

³⁷ See *Ouellet* case cited *supra* note 27.

³⁸ Bankruptcy and Insolvency Act, R.S.C. 1985, c. B-3 (BIA).

³⁹ Cf. U.C.C. §§ 9-315, 9-324.

⁴⁰ See discussion above *supra* note 20.

⁴¹ *Grondin v. Lefavre* (1931), [1931] S.C.R. 102.

⁴² Despite this decision, there have been subsequent cases extending the owner's rights on the proceeds of sale of the subject property where the contractual relationship between the vendor and the buyer is structured as a "mandate" (vendor mandates the buyer to sell the property; vendor stops being the owner when the property is sold by the buyer; vendor has a right to the proceeds of sale) and even where there was no specific mandate (e.g. cases rendered under article 427 of the *Bank Act*, 1991, c. 46 which provides security available only to Canadian chartered banks and foreign bank subsidiaries incorporated under the Bank Act when lending to manufacturers, wholesale or retail purchasers, shippers or dealers, and farmers, fishers and forestry producers. The bank takes security against the articles the debtor manufacturers, uses or deals in).

⁴³ *M/S Bremen v. Zapata Off-Shore Co.*, 407 U.S. 1 (1972); *Scherk v. Alberto-Culver Co.*, 417 U.S. 506 (1974); *Carnival Cruise Lines, Inc. v. Shute*, 499 U.S. 585, 591 (1991).

⁴⁴ For a recent case invalidating a forum selection clause for violation of public policy, see *Doe 1, Doe 2 and Ramkissoon v. AOL, LLC*, 552 F.3d 1077 (9th Cir. 2009).

⁴⁵ *Roby v. Corp. of Lloyd's*, 996 F.2d 1353 (2d Cir. 1993); *Riley v. Kingsley Underwriting Agencies, Ltd.*, 969 F.2d 953 (10th Cir. 1992).

⁴⁶ *Nute v. Hamilton Mut. Ins. Co.*, 72 Mass(6 Gray) 174 (1856). Negative treatment indicated.

⁴⁷ See *supra* note 45; see also, *Spradlin v. Lear Siegler Mgmt. Servs. Co.*, 926 F.2d 865 (9th Cir. 1991); *Silva v. Encyc. Britannica, Inc.*, 239 F.3d 385, 387 n.1 (1st Cir. 2001); *Gen. Elec. Co. v. G. Siempelkamp GmbH & Co.*, 29 F.3d 1095 (6th Cir. 1994).

⁴⁸ 407 U.S. at 15. ("Thus, in light of present-day commercial realities and expanding international trade we conclude that the forum clause should control absent a strong showing that it should be set aside.")

⁴⁹ Jason Webb Yackee, *Choice of Law Considerations in the Validity & Enforcement of International Forum Selection Agreements: Whose Law Applies*, 9 UCLA J. INT'L L. & FOREIGN AFF. 43, 83 (2004) ("Lex fori is, in most circumstances and for a number of reasons, a poor choice of law to govern an international FSA [forum selection clause]").

⁵⁰ *Yavuz v. 66MM, LTD.*, 465 F.3d 418, 421 (10th Cir. 2006) ("We hold that when an international commercial agreement has both choice-of-law and forum-selection provisions, the forum-selection provision must ordinarily be interpreted under the law chosen by the parties.")

⁵¹ While some forum selection clauses require the parties to bring all respective claims before the designated court (exclusive forum selection clauses), others merely constitute a consent by the contracting parties to the designated court's exercise of jurisdiction over the parties and the related claims (permissive forum selection clauses). For a discussion of exclusive and permissive forum selection clauses, see *Excell, Inc. v. Sterling Boiler & Mech., Inc.*, 106 F.3d 318, 321 (10th Cir. 1997); *TH Agric. & Nutrition, L.L.C. v. Ace European Group Ltd.*, 416 F. Supp. 2d 1054 (D. Kan.).

⁵² In *Yavuz* the plaintiff asserted not only breach of contract claims, but also fraud and racketeering claims.

⁵³ In *Yavuz* only one of the defendants had signed the fiduciary agreement containing the forum selection clause.

⁵⁴ *Yavuz*, 465 F.3d at 43D ("If the parties to an international contract agree on a forum-selection clause that has a particular meaning under the law of a specific jurisdiction, and the parties agree that the contract is to be interpreted under the law of that jurisdiction, then respect for the parties' autonomy and the demands of predictability in international transactions require the courts to give effect to the meaning of the forum-selection clause under the chosen law...").

⁵⁵ Fundamental issues of enforceability include whether a forum selection clause qualifies as reasonable pursuant to the analysis articulated in *Bremen v. Zapata* or violates public policy. Some courts have extended the scope of fundamental issues governed by the *lex fori* to include issues of contract formation. See *Diesel Props S.R.L. v. Greystone Bus. Credit II LLC*, 07 Civ. 9580 (HB), 2008 U.S. Dist. LEXIS 92988 (S.D.N.Y. Nov. 6, 2008). Although courts look to their local law in determining whether a forum selection clause violates public policy, a district court in Utah applied the law chosen by the parties to determine what qualifies as public policy with respect to the invalidation of a forum selection clause. See *Brahma Group, Inc. v. Benham Constructors, LLC*, No. 2:08-CV-970 TS, 2009 U.S. Dist. LEXIS 35310 (D. Utah Apr. 20, 2009). In that case the parties had chosen Texas law, which requires the enforcement of forum selection clauses unless they contravene a strong public policy (not merely a substantive public policy) in the state in which the case is brought.

⁵⁶ Subsidiary issues which require the interpretation of the terms of forum selection clauses typically include the characterization of a forum selection clause as either exclusive or permissive and the determination of which claims and named defendants fall within the scope of the respective forum selection clause. The decision as to which law governs these subsidiary issues often determines the outcome. For example, some federal courts have interpreted "federal common law" as putting great significance on the distinction between the terms "jurisdiction" and "venue" with respect to differentiating between exclusive and permissive forum selection clauses. Under this federal law "distinction" the use of the word "venue" in a forum selection clause qualifies the clause as exclusive, whereas the use of the word "jurisdiction" results in a permissive forum selection clause. See *K&V Scientific Co., Inc. v. Bayerische Motoren*, 314 F.3d 494, 499 (10th Cir. 2002); *TH Agriculture v. Ace European Group Ltd.*, 416 F. Supp. 2d 1054 (D.Kan. 2006); *Hull 753 Corp. v. Elbe Flugzeugwerke GmbH*, 59 F. Supp. 2d 925, 927-28 (1999).

⁵⁷ *Yavuz*, 465 F.3d at 431 ("In other words, just as the Supreme Court has made clear that under federal law the courts should ordinarily honor an international commercial agreement's forum-selection provision, we now hold that under federal law the courts should ordinarily honor an international commercial agreement's forum-selection provision as construed under the law specified in the agreement's choice-of-law provision.").

⁵⁸ In *Ramkisson*, the 9th Circuit appeared to reassert the *lex fori* rule as applied to forum selection clauses when it held "[w]e apply federal law to the interpretation of the forum selection clause." 552 F.3d at 1081. In that decision the 9th Circuit applied federal precedent and federal rules of contract interpretation in determining whether the words "courts of Virginia" in a forum selection clause also included federal district courts located in that state.

⁵⁹ A district court in the southern district of New York applied the law chosen by the parties to all issues related to the enforceability of a forum selection clause, including whether or not a forum selection clause qualified as prima facie enforceable under the *Bremen v. Zapata* analysis. See *U.S. Bank Nat'l Assoc. v. Ables & Hall Builders*, 582 F. Supp. 2d. 605, 613 (S.D.N.Y. 2008).

⁶⁰ *Phillips v. Audio Active Ltd.*, 494 F.3d 378, 383-84 (2d. Cir. 2007) ("We find less to recommend the invocation of federal common law to interpret the meaning and scope of a forum clause.... [W]e cannot understand why the interpretation of a forum selection clause should be singled out for application of any law other than that chosen to govern the interpretation of the contract as a whole.").

⁶¹ *Diesel Props*, 2008 U.S. Dist. LEXIS 92988, #19 ("There is no doubt that the first and fourth steps of the analysis – whether the clause was communicated to the resisting party and whether enforcement would be unreasonable or unjust – are procedural in nature and are analyzed under federal law.... However, the Phillips court was troubled by the application of federal law to the second and third part of the analysis, which concern the meaning and scope of the forum selection clause....").

⁶² In *Tecserve v. Stoneware, Inc.*, a federal district court applied its *lex fori* (federal law) to the issue of prima facie validity, but looked to the law chosen by the parties in determining the scope of the forum selection clause. (No. 2:08-CV-144 TS, 2008 U.S. Dist. LEXIS 58929 (D. Utah, Aug. 4, 2008). A federal district court in *Global Link, LLC v. Karamtech Co., Ltd.*, subjected the issue of distinguishing between exclusive and permissive forum selection clauses to the law chosen by the parties, while applying its *lex fori* in determining the reasonableness of a forum selection clause which required a U.S. plaintiff to sue in Korea. No. 06. 06-CV-14938, 2007 U.S. Dist. LEXIS 33570 (E.D.Mich., May 8, 2007).

⁶³ 2009 U.S. Dist. LEXIS 35310 at 14-22 (D. Utah).

⁶⁴ "[A] choice of court agreement which designates the courts of one Contracting State or one or more specific courts of one Contracting State shall be deemed to be exclusive unless the parties have expressly provided otherwise...." Hague Convention on Choice of Court Agreements art. 3, June 5, 2005.

⁶⁵ "[A]n exclusive choice of court agreement that forms part of a contract shall be treated as an agreement independent of the other terms of the contract. The validity of the exclusive choice of court agreement cannot be contested solely on the ground that the contract is not valid." Hague Convention on Choice of Court Agreements art. 3(d).

⁶⁶ "A court of a Contracting State other than that of the chosen court shall suspend or dismiss proceedings to which an exclusive choice of court agreement applies unless – a) the agreement is null and void under the law of the State of the chosen court; ... c) giving effect to the agreement would lead to a manifest injustice or would be manifestly contrary to the public policy of the State of the court seized...." Hague Convention on Choice of Court Agreements art. 6.

⁶⁷ The *lex fori* rule has a disruptive effect in that a party at the time of contracting cannot anticipate in advance where the other party will commence proceedings. Consequently, the seized court's application of its local law to the issue of the enforceability of the forum selection clause introduces great uncertainty as to the clause's enforceability, even though the clause may readily qualify for enforcement under the law chosen by the parties.

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⁶⁹ *Empresas Cablevision, S.A.B. v. JP Morgan Chase Bank*, 09 Civ. 9972 (JSR), 2010 U.S. Dist. LEXIS 8896 (S.D.N.Y. Jan. 28, 2010).

⁷⁰ Among the benefits of the loan trading model are diversification of a lender's portfolio of loans to avoid overconcentration in specific industry or geographical sectors.

⁷¹ *Empresas Cablevision*, 2010 U.S. Dist. LEXIS 8896, at *12-13.

⁷² Participations are perhaps the least standardized form of transfer agreement in the secondary loan market and are often subject to extensive negotiation of material economic and legal points. The specific resolution of the economic, information flow and governance issues negotiated by Lender and Participant in the Participation Agreement may not be "market-standard," but they do not appear to contravene the requirements of the Credit Agreement, which describe the essence of a participation: (i) Lender's obligations and responsibilities under the Credit Agreement remain intact, (ii) Borrower continues to deal directly with Lender, and (iii) Lender, and not the Participant, has the sole ability to enforce the terms and conditions of the Credit Agreement.

⁷³ Indeed, given that under the participation JP Morgan's rights and responsibilities as the Lender remained intact and JP Morgan retained the sole authority to enforce and amend the loan documents, such a finding would have been contrary to the express terms and conditions of the Credit Agreement.

⁷⁴ Specifically, the Court held that "after failing to obtain Cablevision's consent to an assignment of 90% of the loan to [Participant]," JP Morgan "negotiated an agreement with [Participant] that, while it took the form of a participation, gave [Participant] much of the substance of the forbidden assignment and purposely undercut what JP Morgan knew the assignment veto was designed to prevent."

⁷⁵ The UCC defines the term purchaser to include secured parties. *See* U.C.C. § 1-201(b)(29), (30).

⁷⁶ A purchaser of a certificated interest in an LLC that qualifies as a security under Article 8 will be considered a protected purchaser if (i) the purchaser gives value for the security, (ii) does not have notice of any adverse claim to the security, and (iii) obtains control of the security. U.C.C. § 8-303(a).

⁷⁷ For one of the clearer explanations of how to apply the lowest intermediate balance rule, *see* *Universal CIT Credit Corp. v. Farmers Bank*, 358 F. Supp. 317 (E.D. Mo. 1973). The court's chart is particularly helpful.

⁷⁸ *But see* *In re Mitkem Techs.*, 2009 WL 2843287 at *2 (Bankr. D. Mass. 2009) (allowing proceeds to be traced solely on the basis of the deposition testimony of the debtor's principals and the lack of objection, response, or competing claim to the funds from any other creditors).