Commercial Law Newsletter

Joint Newsletter of the Commercial Finance and Uniform Commercial Code Committees

AMERICAN BAR ASSOCIATION Business Law Section

August 18, 2015 Summer 2015

IN THIS ISSUE

Joint Report from the Chairs

Dear Members:

In this final Joint Report of my term as Chair, I depart from our tradition of taking turns as primary author, without attribution. Mindful that not a few of our members will be unable to join us for the annual meeting next month in Chicago, I do so to express my thanks, to share a few reminiscences, and to encourage all of you to get the most out of your membership in either or both committees. I follow with a brief mention of some offerings at the annual meeting.

A Look Back.

Let me begin with thanks. To have been entrusted with the chairmanship of the UCC committee has been an honor, and my rich reward consists of the wonderful friendships I've made with so many of you. Neal Kling, my counterpart with the ComFin committee, has been a great collaborator. As the demands of my day job have ebbed and flowed, Neal was always there to be sure our shared goals were achieved. I can only hope I had his back half as much as he had mine. Kristen Adams, who will succeed me as UCC chair in September, has lined up a fantastic and forward-looking slate of officers. Others, too numerous to name here, assure the continued vitality and preeminence of the UCC committee.

I started attending Section meetings in 2000, and haven't missed one in the years since. My greatest opportunities – and the ones that have proven the most fun - have resulted from random conversations with many of you – in formal meetings, in the hallways, over coffee, or on walks to and from committee dinners. Woody Allen famously remarked that eighty percent of success is showing up. Not a bad start, but only a B- on most grading charts. Back in business school, they taught me that the best measure of a leader is the accomplishments of those in his organization. If that's true, then I have the good fortune to benefit from the talents and generosity of the officers and members who've put up with me these three years, producing cutting-edge content, welcoming those new to our community, and making membership more valuable than ever before.

Some are able and inclined to serve our committees in formal roles. Others' participation is more limited, but no less important. Whether you produce our content, or use it to inform your practice, your teaching, your judging, or otherwise, you're helping to maintain, even enhance, the reputation our organization has earned under the guidance of those who have gone before us. So, whatever your relationship with our committees, I encourage you to enjoy and make the most of it. Truly, the more you give, the more you get.

MARK YOUR CALENDARS

August 11, 2015 – 1:00 p.m. to 2:30 p.m. EDT – Commercial Loan Guaranties: Drafting and Enforcing Corporate and Personal Guaranties and Non-Recourse Carve-Outs (CLE Webinar). Click here for more information.

August 26, 2015 – 1:00 p.m. to 2:30 p.m. EDT – Lending to Series of LLCs: Navigating UCC and Bankruptcy Code Risks and Providing Closing Opinions (CLE Webinar). Click here for more information.

September 2, 2015 – 1:00 p.m. to 2:30 p.m. EDT – Structuring Agent and Co-Lender Agreements in Multi-Lender Deals: Balancing Differing Rights and Obligations (CLE Webinar). Click here for more information.

September 17-19, 2015 – ABA Business Law Section Fall Meeting – Hyatt Regency, Chicago, IL Click here for more information.

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

COMFIN SUBCOMMITTEES AND TASK FORCES

- Subcommittee on Agricultural and Agri-Business Financing
- Subcommittee on Aircraft Financing
- Subcommittee on Creditors' Rights
- Subcommittee on Cross-Border and Trade Financing
- Subcommittee on Intellectual Property Financing
- Subcommittee on Lender Liability
- Subcommittee on Loan Documentation
- Subcommittee on Loan Workouts
- Subcommittee on Maritime Financing
- Subcommittee on Past Chairs Advisory
- Subcommittee on Programs, Meetings and Communications
- Subcommittee on Real Estate Financing

Annual Meeting Preview.

The Business Law Section's second stand-alone annual meeting will occur September 17-19 at the Hyatt Regency Chicago. Your ComFin and UCC committees are the primary presenters of seven CLE programs. It starts Thursday morning, when Jennifer Martin and Colin Marks co-chair a program highlighting UCC Article 2 remedies and contractual limitations. Thursday afternoon Jeremy Friedberg chairs a program on international financing of goods. Thursday evening we'll break for our traditional joint committee dinner. This year's venue, Petterino's, is at 150 N. Dearborn, about six blocks from the Hyatt. Friday's CLE offerings begin with Peter Carson's program on legal opinions regarding security interests, true sale, and non-consolidations, and continue with Paul Hodnefield's "Weapons of Mass Harassment" presentation on the growing (and varied) responses to fraudulent UCC filings. Saturday, as hopefully our smartphones settle into a somewhat quieter weekend mode, we offer three programs. Ramona Lampley and Mike Ferry start us off with a consideration of fairness in arbitrating the sales of consumer products and services, followed by this year's installment of commercial law developments with Teresa Wilton Harmon. Then, Rick Goldfarb wraps things up with a cutting-edge consideration of the legal, ethical, and financial hurdles to representing clients in the medical and recreational marijuana businesses now legal under the laws of certain states. And, as always, throughout the meeting our many subcommittees and task forces will gather to consider issues of particular importance to their members.

We hope you to see a great many of you in Chicago. If you go, please enjoy our CLE offerings and various meetings. But also linger in the hallways and receptions, having as many "random conversations" as you can. Because that's where the magic, and the friendships, start.

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

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- Subcommittee on Secured Lending
- Subcommittee on Syndications and Lender Relations
- ADR Task Force
- Model Intercreditor Agreement Task Force

UCC SUBCOMMITTEES AND TASK FORCES

- Subcommittee on Annual Survey
- Subcommittee on Article 7
- Subcommittee on Commercial Law Newsletter
- Subcommittee on General Provisions and Relations to Other Law
- Subcommittee on International Commercial Law
- Subcommittee on Investment Securities
- Subcommittee on Leasing
- Subcommittee on Letters of Credit
- Subcommittee on Payments
- Subcommittee on Recent Developments
- Subcommittee on Sale of Goods
- Subcommittee on Secured Transactions
- Forms Under Revised Article 9 Task Force
- Cleared Swaps Task Force

COMFIN AND UCC JOINT TASK FORCES

- Commercial Finance/UCC Online Discussion Forum Joint Task Force
- Deposit Account Control Agreements Joint Task Force
- Filing Office Operations and Search Logic Joint Task Force
- Legislative Enactment of Article 9
- Model IP Security Agreement Joint Task Force
- Security Interests in LLC and other Unincorporated Entity Interests Joint Task Force
- Survey of Commercial Lending Laws

COMMITTEE LEADERSHIP ROSTERS

- Uniform Commercial Code Committee
- Commercial Finance Committee

Featured Articles

Secured Lending to Series of LLCs: Beware What You Do Not (and Cannot) Know- Part II

By Norman M. Powell

Editor's Note: This article is the second of three installments focusing on "series LLCs". This second part focuses on the UCC consequences of series LLCs. The first part (which was published in the Spring 2015 edition of the Commercial Law Newsletter) provided an introduction and overview of series LLCs. The third part (in the upcoming Fall 2015 edition of the Commercial Law Newsletter) will focus on the Bankruptcy Code implications for series LLCs.

Series LLCs and UCC Article 9.

Where series are not, or might not be, entities, they may fall outside the scope of UCC Article 9.[1] When lending to series of an LLC, secured parties must be particularly careful in identifying the "debtor" and addressing each consideration that follows. By definition, the "debtor" is the person having an interest in the collateral at issue within the meaning of UCC RA9 § 102(a)(28). LLCs are generally acknowledged to be "registered organizations." Thus LLCs are "located" in their formation jurisdictions under UCC RA9 § 9-307(e), and a financing statement on form UCC1 identifying an LLC as "debtor" must feature the LLC's name (only) in box 1a and be filed in such jurisdiction. But things may be different for assets associated with a series. LLC acts permitting series generally provide choices for how assets associated with a series may be held. These choices include holding associated assets in the name of the limited liability company, through a nominee, or in the name of the series. Thus, when dealing with a security interest granted on behalf of a series of an LLC, secured parties must determine what, in fact, is the debtor within the meaning of UCC RA9.

Series LLC as Debtor. If a series LLC is the debtor, UCC RA9 requires an ordinary filing against and naming the series LLC as debtor, in the series LLC's location as determined under UCC RA9 § 9-307. Matters unique to the series might be addressed in the collateral description, or in box 17 (miscellaneous) of a financing statement addendum on form UCC1Ad, as appropriate.

Nominee as Debtor. If a nominee is the debtor, the secured party must determine whether the nominee is an organization, a registered organization, or an individual. An effective filing would be filed in the nominee's location [2]and name the nominee in box 1a or 1b, as appropriate. Note that a nominee's location may differ from that of the series LLC or a given series (assuming that the series is an organization whose location can be determined under UCC RA9).

Series as Debtor. If a series is the debtor, the secured party must determine whether it is sufficiently clear that the series is an organization within the meaning of the Uniform Commercial Code. UCC RA9 does not define the term "organization," but instead utilizes the definition appearing in Article 1 (2001 version) of the Uniform Commercial Code. Article 1 § 1-201(b)(25) defines "organization" as "a person other than an individual." Article 1 § 1-201(b)(27) of

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WRITE FOR AN OFFICIAL ABA PUBLICATION?
GET PUBLISHED, WITHOUT TOO MUCH OF A TIME COMMITMENT?
CONNECT WITH OTHER MEMBERS OF THE UCC OR COMFIN 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 UCC Committee and the ComFin Committee. Articles can survey the law nationally or locally, discuss particular UCC or Commercial Finance issues, or examine a specific case or statute. If you are interested in submitting an article, please contact one of the following Commercial Law Newsletter Editors **Sidney Simms**, **Harold Lee**, **Suhuyini Abudulai**, **Hilary Sledge-Sarnor**, **Glen Strong**, or **Christina Goebelsmann**.

the 2001 version of Article 1 defines "person" as:

> an individual, corporation, business trust, estate, trust, partnership, limited liability company, association, joint venture, government, governmental subdivision, agency, or instrumentality, public corporation, *or any other legal or commercial entity*.

(Emphasis added.) For the reasons discussed above,[3] it may be unclear whether a given series is a legal or commercial entity at all, arguable that some series simply are not, and quite clear that a series of a Texas LLC is not. Equally clear, but widely misunderstood, is that no series is a registered organization, with the exception of a series of an Illinois LLC which satisfies each of the statutory prerequisites to internal liability shields.

UCC RA9 § 102(a)(71) defines a registered organization as:

> an organization formed or organized solely under the law of a single state or the United States by the filing of a public organic record with, the issuance of a public organic record by, or the enactment of legislation by the State or the United States.

This definition simply does not fit most currently available series. Under current series LLC statutes, the Secretaries of State need not receive, let alone maintain, any record showing a given series to have been *organized*. Nor will the Secretary of State in Alabama, Delaware, Iowa, Nevada, Oklahoma, Puerto Rico, Tennessee, Texas, or Utah necessarily have any record of the name, if any, associated with any given series.

Even for series of LLCs established under the laws of the District of Columbia, Kansas, and Montana, the required series-specific filing is not a precondition to establishment of a series, but only a precondition to a series having internal shields. Thus, such series are not themselves registered organizations. They are analogous to limited liability partnerships. LLPs are a subset of general partnerships, formed without the need for any filing, but acquire limited liability features only by way of filing. LLPs are not registered organizations.[4] For the same reasons, neither are most series of LLCs.

The Illinois statute speaks, variously, in terms of "series" and "series with limited liability," suggesting either that (i) the latter is a subset of the former, or (ii) the two are completely distinct.[5] Under the Illinois statute, an operating agreement may "establish"[6] or "create"[7] a series. A series with limited liability is to be "treated as a separate entity," and its existence begins upon the filing of a certificate of designation with the Secretary of State.[8] Thus, it appears such a series is intended to be a registered organization for purposes of UCC RA9.[9]

A Suggested Approach. Under current series LLC statutes, the surest way to facilitate perfection of security interests by filing is to vest title to collateral associated with a series of an LLC in the series LLC itself (or in the name of a registered organization nominee). The series LLC (or the nominee) is then the debtor. Its name can be determined from its certificate of formation (or other public organic record).[10] Its location will be its formation jurisdiction. The secured party will complete a UCC1 financing statement by specifying the series LLC's (or nominee's) name in box 1, and file in the series LLC's (or nominee's) location.

Conclusion.

Many series fall outside the definitional requirements to be debtors under UCC RA9 or for clear application of Section 9-

307 to determine their locations for filing purposes. Some statutes allow alternative methods for the holding of property, some of which align more easily than others with UCC RA9. Part Three considers the utterly unknown reception series will receive in bankruptcy court, and the limited comfort lenders might derive from closing opinions on series.

Norman M. Powell is a partner in the Delaware law firm of Young Conaway Stargatt & Taylor, LLP, where his practice includes formation of and service as Delaware counsel to corporations, limited liability companies, and statutory trusts, and the delivery of legal opinions relating to such entities, security interests, and other matters of Delaware law. He can be reached via email at npowell@ycst.com. This article first appeared in 46 UCC L.J. 95 (2015), and appears here through rights retained by the author. Certain of this article's topics are further explored in Mr. Powell's articles Series LLCs, the UCC, and the Bankruptcy Code—A Series of Unfortunate Events?, 41 UCC L.J. 103 (2008), and Opining on Limited Liability Company Series, PRAC. LAW., Aug. 2014, at 19. Mr. Powell is grateful to his colleague John J. Paschetto for his editorial and analytical assistance.

Commitment Letters: Trends in Selected Provisions (March 1, 2014 through March 31, 2015)

***By** Tim Fanning **and** Ikhlas Rashid*

The terms contained in commitment letters continue to evolve as the market responds to the competing demands of borrowers seeking to maximize their operational flexibility and lenders wanting to protect their interests while offering loans on competitive terms.

Many provisions that are discussed in commitment letter negotiations concern the economic and other business terms of the loan (usually contained in the term sheet). However, certain terms are typically included in the commitment letter and address:

- The form of documentation to be used to document the loan.
- Closing date conditionality (so-called SunGard clauses).
- Responsibility for the lenders' transaction expenses.
- Lender indemnities.
- The disqualification of certain lenders from the bank group.

These matters often fall to the borrower's and lenders' attorneys to resolve according to what is customary for a deal of the size and type of the one being negotiated.

Practical Law Finance analyzed commitment letters that were signed between March 1, 2014 and March 31, 2015 to determine market trends for the following commitment letter provisions:

- Documentation principles.
- SunGard clauses.
- Expense reimbursement.
- Carve-outs from indemnities.
- Disqualified lender lists.

Methodology

The analysis in this article is based on a selected, representative sample of 61 commitment letters filed with the SEC, dated between March 1, 2014 and March 31, 2015. Based on deal size, the selected sample includes:

- Five commitment letters (8%) for small cap deals (loans valued under $75 million).
- 13 commitment letters (21%) for middle market deals (loans valued over $75 million and up to $500 million).
- 43 commitment letters (71%) for large cap deals (loans valued over $500 million).

The table below shows the number of commitment letters (included in the selected sample) as a percentage of the total number filed with the SEC.

SEC Filed Commitment Letters Reviewed by Practical Law (as a percentage)

Month	Reviewed by Practical Law
Mar. '14	63%
Apr. '14	60%
May '14	100%
Jun. '14	47%
Jul. '14	42%
Aug. '14	67%
Sept. '14	75%
Oct. '14	45%
Nov. '14	25%
Dec. 14	67%
Jan. '15	40%
Feb. '15	100%
Mar. '15	100%

Documentation Principles

Loan documentation should be drafted to accommodate the particular operational and strategic requirements of the borrower and its subsidiaries that the lenders are prepared to accept. Commitment letters, however, sometimes provide that the loan documentation will be drafted so that its terms are consistent with those in similar deals or the terms of an earlier loan that the borrower obtained.

Of the 61 commitment letters analyzed by Practical Law:

- 25 commitment letters (41%) required the loan documentation to be based on terms contained in an existing credit agreement.
- 11 commitment letters (18%) required the loan documentation to be based on terms contained in an existing credit agreement and on terms usual and customary for similar financings.
- seven commitment letters (11%) required the loan documentation to be based on terms usual and customary for similar financings.
- four commitment letters (7%) required the loan documentation to be based on terms contained in the commitment letter and in the term sheet only.
- two commitment letters (3%) required the documentation to be based on terms contained in a sponsor's precedent.
- 12 commitment letters (20%) required the loan documentation to be based on terms determined by some other standard, generally a combination of two of the standards specified above.

Of the five small cap deals:

- Two deals (40%) required the loan documentation to be limited to terms contained in the term sheet.
- One deal (20%) required the loan documentation to be based on terms contained in an existing credit agreement.
- One deal (20%) required the loan documentation to be based on terms usual and customary for similar financings.
- One deal (20%) required the loan documentation to be based on terms contained in the borrower's existing credit agreement and other provisions acceptable to the lenders.

Of the 13 middle market deals:

- One deal (8%) required the loan documentation to be limited to terms contained in the term sheet.
- Two deals (16%) required the loan documentation to be based on terms contained in an existing credit agreement.
- Three deals (23%) required the loan documentation to be based on terms usual and customary for similar financings.
- Three deals (23%) required the loan documentation to be based on both terms contained in the borrower's existing credit agreement and terms usual and customary for similar financings, one of which required the loan documentation to be based on terms usual and customary for similar financings, with representations and warranties to be based on the borrower's existing credit agreement and covenants and defaults to be based on

the indenture governing certain of the borrower's notes and the term sheet (for an example, search Consolidated Communications, Inc Commitment Letter in What's Market).

- Two deals (15%) required the loan documentation to be based on terms contained in a specified sponsor precedent (for an example, search Mitel Networks Corporation Commitment Letter in What's Market).
- Two deals (15%) required the loan documentation to be based on a standard other than one specified above, where:
    - one deal (7.5%) required the loan documentation to be negotiated in good faith (search Aceto Corporation Commitment Letter in What's Market); and
    - one deal (7.5%) required the loan documentation to be mutually agreed (search What's Market, Horizon Pharma, Inc. Commitment Letter in What's Market).

Of the 43 large cap deals:

- One deal (2%) required the loan documentation to be limited to terms contained in the term sheet, subject to customary carve-outs and exceptions to be mutually agreed.
- 22 deals (51%) required the loan documentation to be based on terms contained in an existing credit agreement, where:
    - 17 deals (40%) required the loan documentation to be based on terms contained in the borrower's existing credit agreement (for an example, search AbbVie Inc. Commitment Letter in What's Market);
    - one deal (2%) required the loan documentation to be based on terms contained in the target's existing credit agreement;
    - one deal (2%) required the loan documentation to be based on terms contained in the borrower's existing credit agreement, but if the borrower did not obtain certain investment grade corporate credit ratings and debt credit ratings by the closing date, the loan documentation would be based on terms contained in a precedent credit agreement specified by the majority of lead arrangers with the borrower's reasonable consent;
    - one deal (2%) required the loan documentation to be based on terms contained in the borrower's existing credit agreement, with representations and warranties, affirmative, negative and financial covenants, mandatory prepayments and commitment reductions and defaults to be limited to terms contained in the term sheet (search Exelon Corporation Commitment Letter in What's Market);
    - one deal (2%) required the loan documentation to be based on terms contained in a bank facility to be agreed, but if requested by the borrower, the loan documentation would be based on terms contained in the borrower's existing credit agreement; and
    - one deal (2%) required the loan documentation to be based on terms contained in both the borrower's existing credit agreement and an indenture governing certain of the borrower's existing notes.
- Three deals (7%) required the loan documentation to be based on terms usual and customary for similar financings.
- Eight deals (19%) required the loan documentation to be based on both the terms contained in an existing credit agreement and terms usual and customary for similar financings (for an example, search Reynolds American Inc. Commitment Letter in What's Market).
- Nine deals (21%) required the loan documentation to be based on a standard other than one specified above, where:
    - three deals (7%) required the loan documentation to be limited to the terms specified in the term sheet and terms usual and customary for similar financings;
    - one deal (2%) required the loan documentation for the revolving facility to be based on terms contained in the borrower's existing credit agreement and terms usual and customary for similar financings, and the loan documentation for the term loan facility was required to be based on terms contained in the term sheet, with other terms to be negotiated in good faith (for an example, search Staples, Inc. Commitment Letter in What's Market);
    - two deals (5%) required the loan documentation for the revolving and term loan facilities to be limited to terms contained in the term sheet, and the loan documentation for the bridge facility was required to be based on terms usual and customary for similar financings (for an example, search What's Market, Kindred Healthcare, Inc. Commitment Letter in What's Market);
    - one deal (2%) required the loan documentation to be based on terms contained in the term sheet and the borrower's existing credit agreement and other terms to be mutually agreed; and
    - two deals (5%) required the loan documentation to be based on both terms contained in an indenture

governing certain of the borrower's notes and terms contained in the term sheet (for an example search, AK Steel Corporation Commitment Letter in What's Market).

SunGard Clauses

A SunGard clause limits the representations and warranties made by the loan parties as a condition to closing to a subset of the representations and warranties in the credit agreement, and a subset of the representations and warranties about the target in the acquisition agreement. The purpose of the SunGard clause is to provide the borrower (or its sponsor) with greater certainty that the lenders will fund the loan to pay for the acquisition at closing. This is important to the buyer because it improves the strength of its bid. The seller wants to be sure that prospective buyers have the funds available to close the acquisition, and conditional financing may make a bid less attractive to the seller.

One negotiated point is whether the selected representations in the acquisition agreement that are material to the lenders are required to be made, or to be accurate, on the closing date before the lenders will make the loan. Recently, the trend is to require the material selected representations to be accurate on the closing date. Of the 61 commitment letters reviewed, 55 commitment letters (90%) required the selected representations to be accurate. The lenders can decline to honor funding requests if the inaccuracy of the representations gives the borrower the right to terminate the acquisition or decline to consummate the acquisition.

Another negotiated point is the definition of specified representations, which are certain representations made by the borrower in the credit agreement. These are generally representations on matters that are within the control of the borrower and therefore less likely to be untrue (or can be corrected by the borrower) on the closing date. Following a recent escalation in sanctions and fines issued in connection with the enforcement of sanctions laws (including the Office of Foreign Assets Control (OFAC) rules), lenders are increasingly including representations related to sanctions laws and anti-bribery statutes (for example, the Foreign Corrupt Practices Act (FCPA)) in the definition of specified representations. Of the 61 commitment letters reviewed, the specified representations definition in 53 commitment letters (89%) included specific representations regarding sanctions laws, and anti-money laundering and anti-bribery statutes.

Expense Reimbursement

Traditionally, borrowers were required to reimburse the arrangers for expenses incurred in connection with negotiating and documenting the deal, regardless of whether the deal closed. However, more recently, some large cap borrowers have negotiated more limited expense reimbursement obligations by either:

- Making the obligation contingent on the deal closing (known as a contingent expense reimbursement).
- Limiting the number of primary, local or specialty counsel an arranger may retain.

Middle market borrowers are more likely to have an obligation to reimburse their arrangers regardless of whether the transaction closes. However, contingent reimbursement obligations and other limitations have begun to appear in middle market deals, particularly if the borrower is owned or controlled by a private equity sponsor.

Of the 61 commitment letters analyzed, eight commitment letters (13%) had contingent reimbursement obligations. Of those eight commitment letters, three commitment letters (38%) were for borrowers owned or controlled by a private equity sponsor. Conversely, 53 commitment letters (87%) required expense reimbursement irrespective of the deal closing.

On the other hand, of the 61 commitment letters reviewed, 41 commitment letters (67%) had provisions that limited the number of primary, local or specialty counsel. Lenders have countered this limitation by including a carve-out that requires borrowers and their sponsors, if any, to reimburse the expenses of additional counsel in cases of actual or potential conflicts of interest. Of the 41 commitment letters in which the number of counsel was limited, 18 commitment letters (30%) had a carve-out in the case of actual or potential conflicts of interest.

Indemnification Carve-outs

Commitment letter indemnification provisions require the borrower to indemnify the administrative agent, the arrangers, the lenders and their related parties (the indemnified parties) for costs and liabilities they incur as a result of entering into the loan transaction. There are certain circumstances, however, when the borrower's indemnification obligation is limited by carve-outs which specify when the borrower is not obligated to indemnify an indemnified party because of:

- The gross negligence, willful misconduct or breach of contract in bad faith by the indemnified party (misconduct carve-outs).

- A material breach by an indemnified party of its obligations under the commitment letter.
- Disputes between or among the lenders and agents if the borrower is not involved in, or the cause of, the dispute.

Of the 61 commitment letters reviewed, 59 commitment letters (97%) included misconduct carve-outs (two small cap deals had no indemnification carve-outs (for an example, search Rand Worldwide, Inc. Commitment Letter in What's Market). While a majority of these 59 commitment letters also included carve-outs for material breaches and disputes among indemnified parties, some of them included one of these carve-outs but not the other.

Disqualified Lender Lists

A borrower uses a disqualified lender list to prevent lenders from assigning commitments and the related loans to parties that the borrower does not want to include within its lending syndicate, such as competitors of the borrower or investors that the borrower does not wish to deal with. These disqualified lender lists are used to prevent sensitive non-public information about the borrower or its business from falling into the hands of competitors and other excluded investors.

In the past, administrative agents resisted the notion of disqualified lender lists because they created significant administrative burdens. More recently, however, disqualified lender lists have become more common. Moreover, disqualified lender lists are sometimes heavily negotiated, as borrowers seek a more expansive definition of a "disqualified lender" and the ability to supplement the disqualified lender list after the closing date. Some borrowers have successfully negotiated for the disqualified lender list to include "competitors" (in some cases, without specifically defining the term) and for the borrower's ability to add to the list all affiliates of any competitor already on the list.

Of the 61 commitment letters reviewed, 31 commitment letters (51%) included provisions permitting the borrower to restrict the lending group through a disqualified lender list. Of the 31 deals in which disqualified lender lists were permitted:

- 12 deals (39%) required the list to be disclosed on or before the closing date.
- 19 deals (61%) permitted the borrower to add competitors to the list after the closing date.
- 10 deals (32%) permitted the borrower to add affiliates of competitors already on the list.

For more information on disqualified lenders, search LSTA 2014 Publications Explained: Revised MCAPs, Cashless Rolls and Fronting Letters in Practical Law Finance.

WHAT'S MARKET: 2015 MID-YEAR TRENDS IN LARGE CAP AND MIDDLE MARKET LOAN TERM

By Kenneth M. Anderson, Stephanie Backes, Michael S. Goldman, Stephen M. Kessing and William Reindel

This year began with a more muted performance after another strong year in the US loan market in 2014 when syndicated lending reached $2.11 trillion. One of the key factors affecting the current lending environment is regulatory pressures, as the Leveraged Lending Guidance has taken center stage. The impact of the Leveraged Lending Guidance is expected to continue this year, influencing both loan providers and loan terms.

OVERVIEW

Total US syndicated lending reached $828.5 billion through May 2015, a 2.1% decrease from the same period in 2014. Although M&A activity in the investment grade space accelerated, with an increase of 40% over last year, there was less impact felt in the leveraged loan market and leveraged lending volumes decreased from record levels. M&A leveraged loan issuance fell by 10.4% and currently stands at $103 billion as of May 2015. At the same time last year, M&A leveraged loan issuance was at $115 billion.

A driving force behind this decrease is the Leveraged Lending Guidance, which went into effect on May 21, 2013. Although originally structured as guidance for banks, not regulation, its impact on loan market activity this year has been strong. The Leveraged Lending Guidance discourages banks from making loans to companies with debt/EBITDA ratios of over 6x or that cannot demonstrate the ability to repay all their senior secured debt, or 50% of their total debt, within five to seven years. As a result, leverage multiples have generally declined at the end of 2014 and the beginning of 2015, and the number of deals with leverage ratios of 6x or more decreased from last year. However, there have been recent signs in the second quarter of 2015 that leverage ratios may again be rising in the large cap market and the middle market.

Additionally, this more stringent regulatory environment has given non-bank institutions an advantage in the loan market, as they do not face the same regulatory constraints as banks. In the first quarter of 2014, Jefferies LLC was the only non-bank to be included in the top ten lenders by deal volume in the leveraged buyout (LBO) bookrunner league table. In the first quarter of 2015, there were three non-banks in the top ten. Macquarie Group Limited and Nomura Holdings, Inc. have inched their way into the fifth and seventh spots, respectively, climbing higher than Jefferies, which has dropped to eighth place.

This shift demonstrates the increased presence of non-bank lenders in the leveraged loan market as they take lead arranger positions and shows the less favorable negotiating position of commercial banks as borrowers are able to look elsewhere for funding.

The volatility of activity in the oil and gas industry and the recent drop in oil prices is another potential factor influencing leveraged loan activity. Although it appears to depend on the borrower and the type of oil and gas assets, lenders seem to be taking a cautious approach in oil and gas loan transactions to see where oil prices are headed.

Refinancing activity has been off to a slow start in 2015. Through May 2015, refinancings totaled $463 billion compared to $567.7 billion in the same period in 2014, a decrease of 18.4%. Refinancings have accounted for just under half of institutional volume in 2015, down from 61% at the same time last year. The downturn has been more pronounced in the middle market, with a drop of 55.6% from the level of refinancings last year. Repricing activity, by contrast, surged in the second quarter of 2015.

Large cap lending levels remained largely unchanged, with $771.9 billion of large cap loan issuance through May 2015. This represents a slight increase above the level seen at the same time last year. Middle market lending, on the other hand, declined significantly. Total issuance is down to $56.6 billion, compared to $79 billion at this time last year, representing a decrease of 28.4%. In addition to a decrease in refinancings, middle market new money issuance fell to $25.3 billion, a drop of 31.4%, and less than half of middle market volume so far this year.

The Leveraged Lending Guidance has also curbed the issuance of sponsor-backed leveraged loans. Regulators are taking a more cautious approach and lenders seem hesitant to fund buyouts above the debt level that regulators consider risky. As a result, loan volumes backing these types of sponsored buyouts is at its lowest level in years. Sponsored leveraged loan issuance totaled $128.7 billion through May 2015, a decrease of 40.1% compared to the level at this time last year.

Covenant-lite loan levels have seen a marked decline in the first half of this year, although there was a spike in covenant-lite deals in May 2015. As of the end of May 2015, $78.1 billion of covenant-lite loans were issued, representing a 61.2% decrease over the same period in 2014. Dividend recapitalizations, however, have increased to $10.1 billion, a 23.5% increase from last year.

Second lien loan issuance dropped sharply to $5 billion at the end of May 2015, down from $19.2 billion in the same period a year ago, representing a staggering 73.8% decline.

Collateralized loan obligations (CLO) issuance has held firm in the first half of this year, totaling $47.3 billion through May 2015, a roughly 1% increase over the same period in 2014. CLO issuance is expected to slow down in the second half of 2015 due to the impact of risk retention. CLOs currently hold roughly 48% of institutional loan outstandings.

Unitranche loans had a strong showing in 2015. An increasingly popular structure in the middle market over the last few years, these loans typically combine first and second lien debt into one financing with a combined interest rate. Unitranche loans are increasingly complex and the structure has now been tested in court in the high-profile RadioShack bankruptcy (Search RadioShack Corporation in What's Market for a summary of RadioShack's unitranche loan agreement).

The 2014 *Pontiac General Employees Retirement System v. Ballantine* (*Healthways*) case highlights the controversy surrounding proxy puts. The Delaware Court of Chancery declined to dismiss a claim of aiding and abetting a breach of fiduciary duty brought against SunTrust, as administrative agent, in connection with the "dead hand proxy put" provision in the company's credit agreement.

Typically, credit agreements contain a "change of control" event of default which, among other things, gives the lender certain rights in connection with a change in the constituents of the borrower's board within a certain time period. The purpose of a proxy put is arguably to allow the lender to reevaluate the new situation at that time. Because of the concerns borrowers have regarding proxy puts, market practice may shift towards exclusion of this clause in 2015 (Search Pontiac GERS v. Ballantine: Chancery Court Declines to Dismiss Claims Against Board and Lenders Based on Loan Agreement

Proxy Put for more on this decision).

Despite a slower start to 2015, market observers are hopeful that leveraged loan deal flow will pick up in the second half of 2015 as borrowers adjust to the constraints imposed by the Leveraged Lending Guidance and continue to seek more flexibility in loan structure.

2015 Mid-year Loan Trends

The following trends were seen in the large cap market and middle market in the first half of 2015:

- Flexible covenant packages that allow borrowers increased opportunity to include more borrower-friendly baskets, including a "freebie" basket with a "grower" component in their incremental financing and more relaxed dividend and investment covenant fall-away thresholds (for examples of credit agreements with a grower component, search Quintiles Transnational Corp. and Black Knight Infoserv, LLC in What's Market).
- A more expansive definition of disqualified lenders and the ability to add competitors to the list and prevent them from acquiring interests in loan transactions (for examples of commitment letters that allow competitors to be added to the disqualified lender list, search Staples, Inc. and Mitel Networks Corporation in What's Market).
- Portable capital structures in refinancings and dividend recapitalizations when an exit is contemplated.
- Increased focus on the change of control provision in credit agreement negotiations in response to the *Healthways* case, relating to proxy put protection and the dead hand feature (for examples of credit agreements that contain a dead hand proxy put, search Hudson Pacific Properties, L.P. and HSN, Inc. in What's Market).
- More negotiation around closing date leverage and EBITDA add-backs (for an example of a credit agreement that contains EBITDA add-backs, search Dave & Buster's, Inc. in What's Market).

These trends are discussed further in detail below. Additionally, this article highlights some of the issues facing borrowers in the oil and gas industry, as well as some potential developments in this industry in the second half of the year.

A Look Ahead

The Leveraged Lending Guidance is expected to continue to drive the market entering the second half of 2015, as borrowers and lenders continue to adjust to this increased regulatory scrutiny. The trends seen in the beginning of the year, including the surge in repricings and dividend recapitalizations, and financing from non-bank institutions, are also anticipated to continue. The boom in large investment grade M&A activity should also continue in the second half of the year and market observers are optimistic that leveraged loan activity will pick up as well, although not to the levels previously seen.

The market statistics cited in this article were provided by Thomson Reuters LPC.

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Michael and Stephen share their thoughts on current issues in leveraged lending:

Given the leverage limits contained in the Leveraged Lending Guidance, what is happening in negotiations of EBITDA add-backs in loan agreements?

The definition of EBITDA and the scope of add-backs to EBITDA in loan agreements have been the subject of significant focus and negotiation between borrowers and lenders in leveraged loan transactions for many years. As "leverage" for these purposes is generally defined as the ratio of "total debt" to trailing four-quarter EBITDA, any definitional change that has the effect of increasing EBITDA has a multiplier effect when used for purposes of measuring or regulating debt capacity. The concerns over high leverage contained in the Leveraged Lending Guidance, and the regulators' admonition that definitional "enhancements" to EBITDA will be criticized if they do not have reasonable support, have further increased the attention that these provisions receive in the negotiation of loan agreements.

While we have not seen fundamental changes in EBITDA definitions in loan agreements over the past year, certain common add-backs to EBITDA have been subject to additional scrutiny by both borrowers and lenders. While add-backs for actual costs and expenses (such as transaction fees and expenses, restructuring and integration costs, and certain other non-recurring costs and expenses) continue to be commonly included without significant change from historical practice, add-backs for projected improvements in operating results (such as anticipated synergies and cost savings) are now frequently the subject of greater discussion and negotiation between borrowers and lenders.

Borrowers continue to negotiate for significant flexibility with respect to both the amount of cost savings and synergies that are permitted to be added back to EBITDA, as well as the period of time during which projected amounts may be added back before they are required either to be realized or dropped from the EBITDA calculation.

Lenders, on the other hand, are increasingly looking to shorten time periods for realization and to introduce caps on amounts that can be added back (which are often expressed as a percentage of unadjusted EBITDA). In our experience, these caps vary widely and range from 5% to 25% of unadjusted EBITDA. In the context of acquisition financings, borrowers are frequently asking to include a schedule of specific add-backs for periods after the closing of the transaction, which are often based on quality of earnings reports or projections prepared by the borrower or the related financial sponsor and made available to the private lenders during the syndication of the loans.

Finally, we have seen an increasing focus on the determination of closing date leverage, particularly in leveraged acquisitions. This is generally accomplished by the borrower and the lenders agreeing on historical EBITDA (adjusted as per the model) for the most recent four quarters ended prior to the closing of the transaction. These "deemed" EBITDA amounts are used to determine the borrower's closing date leverage for purposes of the loan agreement. Historically, the deemed EBITDA numbers were most important for determining compliance with financial maintenance covenants during the first year after closing. They are now, however, more important for setting closing date leverage levels that are often used as the ceiling for the borrower's ability to incur incremental or additional debt after the closing date, a concept that is a direct response to the Leveraged Lending Guidance's increased focus on leverage levels in the market.

So far in 2015, loans financing M&A activity have been largely concentrated in the investment grade space. Do you anticipate leveraged loan M&A activity picking up in the second half of the year?

We have seen a number of large loan transactions during the first half of 2015 to support M&A activity. Two recent examples are Heinz's $60 billion merger with Kraft and the $66 billion acquisition by Actavis plc of Allergan, Inc. Both of these transactions were in the investment grade space and there have been numerous similar transactions consummated or announced since the end of 2014. We expect to see more of these types of transactions this year.

On the leveraged side, we are continuing to see some M&A activity, but the last six months have been slower in this area than in comparable time periods in recent years. The deterrent effect of the Leveraged Lending Guidance has certainly contributed to this slowdown in activity, as both financial sponsors and arranger banks evaluate new transactions in light of the regulators' published concerns.

Financial sponsors, in particular, appear to be adjusting to the regulatory environment and finding new ways to finance leveraged acquisitions. This includes seeking financing from unregulated institutions and changing deal structures to allow the regulated institutions to participate. All of these factors are likely to lead to an increase in leveraged loan M&A activity in the second half of the year, although we do not believe the activity will approach recent historic levels.

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Bill examines developments in the loan market, including the impact of the Healthways *case on change of control provisions:*

What are some of the most borrower-friendly terms you have seen included in recent loan agreements?

The first half of 2015 saw borrowers seeking increased flexibility generally for loan terms and in particular for incremental financing capacities. A more borrower-friendly version of the now common combination of a "ratio" basket for incremental loans subject to a leverage test with a "freebie" basket for incremental loans up to an agreed dollar amount enables the borrower to ignore concurrent usage under the freebie basket for the purpose of calculating leverage under the ratio basket. This increases the amount of incremental capacity available in a single transaction. Some borrowers have sought to extend a "grower" component to the freebie basket, so that the dollar amount is the greater of EBITDA at closing and EBITDA for the most recent 12-month period.

The designation of categories of "disqualified lenders" who are excluded from eligible syndicates has further expanded. In addition to forbidding assignments to debt funds known to be aggressive in work-outs or otherwise, borrowers increasingly look to keep their competitors from obtaining interests in their loans. A common exception to the prohibition on assignments to a borrower's competitors is for "bona fide debt fund affiliates" of those competitors who invest in commercial debt in the ordinary course of business.

Lenders have also demonstrated an increased tolerance for relaxation of covenants. In the bond market, covenants may not begin to fall away until a bond issue achieves investment grade status. In some bank deals, however, borrowers have set dividend and investment covenant fall-away thresholds at levels as low as 1.00 to 1.75 times below opening total leverage.

Finally, borrowers seeking refinancing or dividend recaps at a time that an exit may be contemplated are seeking a "portable" capital structure, meaning that the list of transactions that will trigger the change of control provision will exclude sales to certain types of buyers (such as a well-capitalized corporate buyer or private equity buyer). These exclusions will create challenges to debt investors, including their comfort levels regarding Office of Foreign Assets Control (OFAC) and PATRIOT Act compliance. In addition, these provisions may have limited efficacy unless the incumbent leverage ratio is sufficient for the buyer or the target, with built in dividend capacity to fund the acquisition.

What developments in the loan market do you expect to see in the second half of 2015?

Borrowers in new and existing deals will likely continue to push for tighter pricing and looser covenants as investor demand outstrips availability. Market participants are hopeful that borrowers and lenders will bridge the disconnect between high valuations on the one hand, and the constraints imposed by the Leveraged Lending Guidance on the other, which slowed M&A financing activity in the first half of 2015.

The trends toward repricings and dividend recaps show no immediate signs of slowing, which will likely contribute to a debt market that remains very active in the second half of the year. Business development companies (BDCs) and private debt funds continue to expand their middle market lending activities (as evidenced by CPPIB's acquisition of the sponsor finance business of GE Capital).

In light of *Healthways*, have you seen an increased focus on change of control provisions in loan agreement negotiations?

Yes. The *Healthways* case created some uncertainty about the validity of one type of change of control protection in loan agreements, the so-called "dead hand proxy put." In addition, apparently in response to *Healthways*, the plaintiffs' bar has been conducting a litigation campaign against dead hand proxy puts in public company debt. As a result, there has been increased attention during loan agreement negotiations on change of control provisions.

A proxy put permits the lender to accelerate debt if a majority of the borrower's board becomes comprised of "non-continuing directors" over a short period of time (usually one or two years). The dead hand feature provides that any director elected as a result of an actual or a threatened proxy contest will be considered a non-continuing director for purposes of the proxy put. Therefore, with a dead hand proxy put, a board cannot approve a dissident slate of nominee directors to avoid triggering the proxy put.

In *Healthways*, Vice Chancellor Laster indicated his general skepticism as to whether, when a dead hand proxy put is included, the primary motivation is protection of the bank's legitimate commercial interests. On the one hand, a bank has an obligation to "know its borrower" and wants to ensure continuation of the basic business approach upon which the bank's credit decision was made. On the other hand, the provision may instead create a potential entrenchment effect on the borrower's directors. Set against this, however, are concerns that a decision by stockholders to replace a majority of the board could necessitate a refinancing of the debt (or, through cross-acceleration provisions, possibly all of the company's debt).

The reaction of individual banks and companies has varied. Some banks are retaining a dead hand proxy put in their form credit agreements, based on the view that *Healthways* was grounded in the narrow facts of the case. In particular, as stressed by Vice Chancellor Laster in later remarks about the ruling, Healthways Inc. added the dead hand feature to a longstanding proxy put provision at a time that the company faced stockholder pressure and the realistic potential of a proxy contest. Other banks, seeking to minimize the litigation risk, are eliminating the dead hand feature or the entire proxy put. I expect that the focus on these provisions will continue until there is further judicial clarification.

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Ken discusses loan transactions in the oil and gas industry:

What effect has the recent drop in oil prices had on the ability of a borrower in the oil and gas industry to enter into new loan transactions, renegotiate debt with lenders or request loans under existing reserve-based loans?

The effect of falling oil prices will vary significantly across borrowers depending on several factors. Some of these include:

- The strength of the borrower's balance sheet going into the price downturn.
- The breakeven point for the borrower's drilling programs.
- The remaining production life of the borrower's reserves.
- The existence and tenor of commodity hedges.

Of course, the longer the downturn lasts and the lower the prices go, the more borrowers will be affected. Many existing first-lien facilities are now, or may in the future become, over-advanced. Borrowers in this position are not able to borrow under their facilities, so they may need to repay the amount of any borrowing base deficiency and may need to find other sources of liquidity.

There has been a significant amount of capital raised in anticipation of this situation. To date, a number of oil and gas companies have established second-lien/mezzanine or preferred convertible equity financings to provide needed liquidity. Borrowers whose assets justify these investments are likely to continue to see their capital structures rebuilt to provide liquidity and a cushion to the first-lien lenders. However, this additional capital will not come cheap.

In the first half of 2015, what are the most significant developments in loan agreements and commitment letters in the oil and gas industry? What do you expect to see in the second half of the year?

In the first half of 2015, lenders mostly chose to kick the can down the road by affirming existing borrowing bases or making relatively small reductions. In the second half of the year, as hedges roll off, I expect there will be more (and more significant) borrowing base reductions. This will result in adjustments to capital structures with more second-lien or mezzanine debt as:

- First-lien lenders require a cushion underneath them.
- Borrowers need additional liquidity to address borrowing base deficiencies and working capital needs.

In addition, I expect that there will be an increase in compliance with leverage ratio covenants being very tight or missed. Often this will result in a negotiated relaxation (or temporary waiver) of these covenants or, in more difficult cases, a default on the loan.

Finally, with the current rebound of prices above $60 per barrel of oil, there may be increased hedging requirements to protect against a return to $40 per barrel.

For a copy of this article published on the Practical Law website which includes links to recent examples of loan agreements, see Practice Note, What's Market: 2015 Mid-year Trends in Large Cap and Middle Market Loan Terms, Practical Law, at http://us.practicallaw.com/7-616-8546.

The Right to Credit Bid in Bankruptcy Sales Faces Renewed Challenges After the Supreme Court's *RadLAX* Decision

By Tim Brink

The question whether a secured creditor has a right to credit bid in a bankruptcy sale has received considerable attention over the last six years. During that time, a circuit split developed between the Courts of Appeals for the Third and Fifth Circuits on the one hand and the Seventh Circuit on the other hand; the Supreme Court resolved the circuit split in favor of secured creditors' credit bidding rights; and two bankruptcy courts issued decisions limiting secured creditors' credit bidding rights for reasons not previously seen.

The purpose of this article is to provide an introduction to credit bidding in bankruptcy, review the conflicting circuit-level opinions and the Supreme Court's *RadLAX* decision resolving this circuit split in a pro-secured creditor fashion, discuss the notable post-*RadLAX* opinions that have once again limited secured creditors' credit bidding rights, and offer some thoughts about the future of credit bidding in bankruptcy sales.

The Right to Credit Bid in Bankruptcy Sales

"The term 'credit bid' . . . is a colloquial term used to express a secured creditor's right to bid at the sale of its collateral and then, at closing, offset the purchase price by the value of its outstanding claim secured by the collateral being purchased."[11] While credit bidding is a familiar concept in bankruptcy law, the term is not defined or even found in the Bankruptcy Code.[12] Nor is the right to credit bid uniquely a feature of the Code, as it is inherent in the default and enforcement sections of Article 9 of the Uniform Commercial Code, and it is expressly or implicitly recognized in many states' real property foreclosure laws.[13]

Nevertheless, the right to credit bid is an important feature of modern chapter 11 bankruptcy practice—one which may be exercised in connection with a debtor's sale of assets both under Code § 363 (a "§ 363 sale") and through a chapter 11 plan of reorganization (a "chapter 11 plan"). The right to credit bid at a § 363 sale is expressly authorized by Code § 363(k), which provides that at a sale of property of the debtor that is subject to a secured claim, unless the court orders otherwise "for cause," the secured creditor may bid at such sale and may offset its allowed claim against the purchase price.[14] If the debtor seeks to confirm a chapter 11 plan over the objection of a secured creditor whose claim is impaired—a process referred to colloquially as "cramdown"—it may sell the property free and clear of the secured creditor's liens with the liens attaching to the sale proceeds, subject to the secured creditor's right to credit bid pursuant to Code § 363(k).[15]

The Supreme Court Reaffirms the Right to Credit Bid in Bankruptcy Sales in *RadLAX*

Until 2009, a secured creditor's right to credit bid at a sale pursuant to a chapter 11 plan had not seriously been questioned. This changed abruptly, however, when the Courts of Appeals for the Fifth and Third Circuits issued their *Pacific Lumber* and *Philadelphia Newspapers* opinions.

In *Pacific Lumber*, the lender to one of the debtors proposed a plan that transferred timberland pledged as collateral to another debtor's creditors free and clear of those creditors' liens and paid the creditors the value of their collateral but denied the creditors the right to credit bid.[16] The bankruptcy court confirmed the plan, holding that payment to the objecting creditors of the value of their collateral constituted the indubitable equivalent of their claims, thereby satisfying the fair and equitable test of Code § 1129(b)(1).[17] The Fifth Circuit Court of Appeals affirmed, explaining that the free and clear sale aspect of the plan did not prevent confirmation under the indubitable equivalent alternative of Code § 1129(b)(2)(A)(iii).[18]

In *Philadelphia Newspapers*, the debtors proposed a plan in which their assets would be sold to insiders and, while the sale would be subject to competing bids, the prepetition lenders would receive cash and other property worth only a fraction of their debt and would be prohibited from credit bidding.[19] The bankruptcy court refused to approve the bid procedures, and on the debtors' appeal the Third Circuit Court of Appeals affirmed the district court's reversal, holding in a divided opinion that a plan in which a free and clear sale of the debtor's assets is proposed but the secured creditor is denied the right to credit bid may still satisfy the fair and equitable test of Code § 1129(b)(1) if it provides the secured creditor with the indubitable equivalent of its secured claim.[20] Unlike the Fifth Circuit in *Pacific Lumber*, however, the Third Circuit did not decide whether the secured creditors in *Philadelphia Newspapers* would in fact realize the indubitable equivalent of their claims under the proposed plan.[21]

A circuit split soon emerged when the Seventh Circuit Court of Appeals issued its *River Road* decision rejecting the approaches taken by the Fifth and Third Circuits and holding that a plan proposing to sell encumbered assets free and clear of liens must provide lienholders with the right to credit bid in order to satisfy the fair and equitable test for confirmation of a cramdown plan.[22] In *River Road*, the debtors proposed a plan under which they would sell substantially all of their assets pursuant to sale procedures under which an initial "stalking horse" bidder offered less than half of the $149 million in debt secured by the debtors' assets. If the debtors' bank wished to obtain the property, however, it would be forced to bid in cash rather than credit bid. Anticipating that the bank would object, the debtors sought to confirm the plan under the cramdown provisions of Code § 1129(b).[23] The bankruptcy court denied the debtors' motion to approve the proposed sale procedures and certified the matter for direct appeal to the Seventh Circuit, which affirmed, holding that a plan involving the free and clear sale of the debtors' assets but denying a secured creditor the right to credit bid cannot satisfy the indubitable equivalent test of Code § 1129(b)(2)(A)(iii) and that a plan involving the free and clear sale of the debtors' assets must comply with the free and clear sale test of Code § 1129(b)(2)(A)(ii).[24]

To resolve this circuit split, the Supreme Court granted certiorari in *RadLAX*, the companion case to *River Road*, and in a unanimous 8–0 ruling held that a debtor may not confirm a chapter 11 plan that provides for the sale of a secured creditor's collateral free and clean of liens but does not permit the secured creditor to credit bid at the sale.[25] In what is described as "an easy case," the Supreme Court quickly disposed of the argument that the debtors could sell the bank's collateral free and clear of the bank's liens and repay the bank with the sale proceeds—as contemplated by Code § 1129(b)(2)(A)(ii)—by seeking to confirm a plan under Code § 1129(b)(2)(A)(iii),which does not expressly incorporate the right to credit bid. Focusing almost exclusively on statutory interpretation, the Supreme Court applied the principle that "the specific governs the general" and reasoned that to avoid the "superfluity" of the specific provision—subsection (ii)—being swallowed by the general one, subsection (iii),the general provision must be interpreted as a "residual provision" that governs plans other than ones under subsections (i) and (ii). In contrast, the Supreme Court found "the debtors' reading of § 1129(b)(2)(A)—under which clause (iii) permits precisely what clause (ii) proscribes—to be hyperliteral and contrary to common sense."[26] Because it found no ambiguity in the statute, the Supreme Court declined to look to the purposes underlying the Bankruptcy Code, pre-Bankruptcy Code practice, or the merits of credit bidding, stating that "the pros and cons of credit-bidding are for the consideration of Congress, not the courts."[27]

Post-*RadLAX* Courts Place New Policy-Driven Limitations on the Right to Credit Bid in Bankruptcy Sales

After the Supreme Court's *RadLAX* decision, many commentators suggested that any remaining doubts about a secured creditor's right to credit bid at a bankruptcy sale had been resolved. However, the right to credit bid never had been absolute, as Code § 363(k) expressly contemplates that the right may be limited for "cause."

Foreshadowing post-*RadLAX* developments, in discussing "cause" to limit a secured creditor's right to credit bid, the Third Circuit in *Philadelphia Newspapers* opined that Code § 363(k) authorizes bankruptcy courts to "deny a [secured creditor] the right to credit bid in the interest of any policy advanced by the Code, such as to ensure the success of the reorganization or to foster a competitive bidding environment."[28] Notwithstanding the breadth suggested by the Third Circuit, "cause" to limit a secured creditor's right to credit bid under Code § 363(k) traditionally has been limited to situations where there was a dispute as to the validity, priority, or amount of the secured creditor's claim[29] or the secured creditor had engaged in improper or inequitable conduct.[30] For this reason, the recent *Fisker Automotive* and *Free Lance-Star Publishing* decisions, in which bankruptcy courts placed limits on a secured creditor's right to credit bid in part to further the policy of fostering a competitive bidding environment, came as a surprise.

The debtor in *Fisker Automotive* was a hybrid electric vehicle manufacturer that had obtained a secured loan from the U.S. Department of Energy (the "DOE"). After the DOE announced that it would stop funding, Hybrid Tech Holdings, LLC (Hybrid") purchased the DOE's $168 million secured loan for $25 million, and Fisker and Hybrid entered into an agreement by which Hybrid would acquire Fisker's assets at a private § 363 sale for a partial credit bid of $75 million.[31] After Fisker filed its chapter 11 bankruptcy case and sought approval of the sale to Hybrid, the creditors' committee objected to the proposed sale, requested that the court approve a competitive auction process involving another interested bidder, and disputed Hybrid's right to credit bid.[32] In ruling on the debtor's and committee's motions,[33] the court held that Code § 363(k) entitled Hybrid to credit bid its allowed claim but that it would limit Hybrid's credit bid to $25 million "for cause," explaining that otherwise "bidding will not only be chilled . . . [it] will be frozen."[34] While the court may have considered this fact alone to be sufficient to justify limiting Hybrid's right to credit bid, it also criticized Hybrid's insistence on an "unfair [sale] process, i.e, a hurried [sale] process" and observed that the validity of Hybrid's liens had not yet been determined.[35]

In *Free Lance-Star Publishing*, the debtors defaulted on their $50 million secured loan, which their lender sold to DSP Acquisition, LLC ("DSP"). DSP immediately informed the debtors that it wanted to purchase the debtors' assets at a bankruptcy sale and, while negotiations were ongoing, recorded UCC financing statements on certain of the debtors' assets that it knew were not subject to its liens.[36] When negotiations collapsed over the debtors' refusal to accept an unnecessary post-petition loan from DSP, the debtors filed chapter 11 bankruptcy cases and a motion for approval of bidding procedures for the sale of the debtors' assets.[37] Thereafter, DSP filed a complaint seeking a declaration that it had valid and perfected liens on substantially all of the debtors' assets and that it had the right to credit bid its claim at the sale. In response to DSP's motion for summary judgment, the debtors filed a cross-motion requesting that the court limit DSP's right to credit bid.[38] In ruling on the cross-motions, the court held that DSP did not have a valid perfected security interest in all of the debtors' assets,[39] that DSP engaged in inequitable conduct in furtherance of its "overly zealous loan-to-own strategy" to acquire the debtors' business,[40] and that limiting DSP's right to credit bid would foster a fair and robust sale.[41] Describing the confluence of these factors as creating the "perfect storm," the court held that cause existed "to limit [DSP's] credit bid amount in order to foster a robust and competitive bidding environment."[42]

Only months after the *Fisker* and *Free Lance-Star Publishing* decisions, however, the bankruptcy court in *RML Development* declined to hold that "the mere 'chilling' of third party bids is sufficient cause to justify modifying or denying a secured creditor's [credit bidding] rights."[43] After the court entered orders granting the debtor's motions to sell two residential apartment complexes under Code § 363, the mortgagee filed a motion to amend the sale orders to confirm its right to credit bid the amount of its secured claim.[44] The debtor objected to the mortgagee's claim, arguing not that it should be disallowed entirely but only that the mortgagee incorrectly calculated the total amount of its claim. Finding that the secured creditor had an allowed secured claim but that a bona fide dispute existed with respect to the amount of the claim, the court estimated the secured creditor's claim at the undisputed amount and found "cause" under Code § 363 to modify the secured creditor's right to credit bid accordingly.[45]

Aside from *RML Development*, only one other decision subsequent to *Fisker* and *Free Lance-Star Publishing* appears to have been presented with an opportunity to decide whether the possibility that bidding will be chilled constitutes "cause" to limit a secured creditor's right to credit bid.[46] In *Charles St.*, however, notwithstanding its contention that its secured creditor's ability to credit bid would chill bidding or depress interest in the assets to be sold, the debtor expressly disavowed any reliance on *Fisker* and its rationale, and the court therefore elected not to independently address the *Fisker* rationale and the types of "cause" at issue in that case.[47]

What Is the Future of Credit Bidding in Bankruptcy Sales?

In *RadLAX*, the Supreme Court abruptly closed a loophole by which a debtor could sell its assets free and clear of liens pursuant to a chapter 11 plan while denying the secured creditor the right to credit bid at the sale. While this was a resounding victory for secured creditors it was short lived, as little more than eighteen months later the bankruptcy court in *Fisker* found "cause" to limit a secured creditor's right to credit bid in a § 363 sale in part on the policy grounds that to do otherwise would chill the bidding process. When the *Fisker* decision was quickly followed by the *Free Lance-Star Publishing* decision reaching a similar result on similar grounds, concerns once again began to mount about the sanctity of secured creditors' right to credit bid.

Whether these concerns are well founded is debatable, however, as neither *Fisker* nor *Free Lance-Star Publishing* limited credit bidding rights solely on account of the bankruptcy policy of fostering a competitive bidding process. Rather, the outcome in each case reflected the presence of facts supporting the traditional grounds for limiting credit bidding rights under Code § 363(k) as well. Furthermore, the subsequent *RML Development* decision expressly rejected the proposition that the mere "chilling" of third party bids is sufficient cause to justify modifying or denying a secured creditor's credit bidding rights.

Rather, the *Fisker* and *Free Lance-Star Publishing* decisions appear to be a reaction to efforts to exert undue control over debtors and the bankruptcy process by distressed debt investors, whose motivations often are very different than those of traditional secured lenders. As such, these decisions signal that investors who acquire a company's secured debt—often at a deep discount—as part of a "loan-to-own" strategy must anticipate that their conduct both pre- and post-petition will be carefully scrutinized to determine not only whether allowing unfettered credit bidding will chill the bidding process but also whether the more traditional grounds to limit credit bidding for cause are present. What effect this will have on the market for secured debt of distressed companies remains to be seen.

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UCC Spotlight

By Stephen L. Sepinuck and Kristen Adams

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

***GEO Finance, LLC v. Univ. Square 2751, LLC*,**
2015 WL 1637310 (E.D. Mich. 2015)

This case involves the oft-litigated question of whether a lease of goods is a true lease or a disguised sale with a retained security interest. The court's analysis is largely sound and its conclusion might well be correct, but the court overlooked a key point.

The transactions at issue were structured as 10-year leases of geothermal water supply systems designed, constructed, and installed in two buildings. The leased equipment undoubtedly became fixtures; the wells and piping involved in the systems were integrated into the walls, floor, and ground underlying the buildings, and the water supply loops were connected to the buildings' heating and cooling systems. However, neither the original supplier nor its successor ever filed a financing statement. After the real property was sold at a foreclosure sale, the buyer claimed to be the rightful owner of the equipment and refused to make any payments due under the lease.

The parties agreed that if the transactions were true leases, then the supplier's successor remained the owner of the equipment. On the other hand, if the transactions were sales with a retained security interest, the interest of the supplier's successor was extinguished unless the buyer had actual notice of the interest and was not a bona fide purchaser for value.

The court began its analysis by correctly noting that § 1-203 provides a two-step inquiry for distinguishing a lease from a sale. Subsection (b) provides a bright-line test applicable in some situations. Under that test, a nominal lease is in reality a sale if the transaction is not terminable by the lessee and any of four additional facts is true, including whether there is an option to purchase for nominal consideration or a lease term that equals or exceeds the economic life of the goods.

In this case, each lease agreement included an option to purchase at any time for approximately $300,000 and an option to renew for eight consecutive 5-year terms. The equipment had useful life of 50 years. The court concluded that the option price was not nominal and that therefore the bright-line test of subsection (b) was not satisfied. This seems correct.

The court then moved to subsection (a), which looks at all the facts and circumstances. Although not expressly stated, this rule embodies the so-called "economic realities test," which asks whether there is any reasonable chance that the lessor will get the goods back while they still have economic value. If the answer is no, the transaction is a sale with a retained security interest.

Applying this test, the court noted that the most important factors are whether: (1) the lease contains a purchase option price that is nominal; and (2) the lessee develops equity in the property, such that the only economically reasonable option for the lessee is to purchase the goods. The court concluded that these factors did not require a conclusion that the transactions were sales. In doing so, the court placed great weight on two facts. First, that the original lessee did not exercise the purchase option for 12 years, thus apparently believing that doing so was not economically essential. Second, that if the option were exercised, the lessee would have to assume the cost of maintaining, repairing, and replacing the system and its components

While the court might well have been correct, its analysis overlooked a key point, perhaps because no one argued it. As the court noted, if a lessee's only sensible economic option is to exercise an option to either purchase the goods or renew the lease, then even if the price for doing so is not nominal, the transaction is a sale. *See, e.g., Gibraltar Fin. Corp. v. Prestige Equip. Corp.*, 949 N.E.2d 314 (Ind. 2011); *In re Grubbs Constr. Co.,* 319 B.R. 698 (Bankr. M.D. Fla. 2005). This might occur if:

(i) the leased goods are a fungible part of a much larger pool of nearly identical, unmarked equipment, making them difficult or impossible to identify and return, *In re Worldcom, Inc.,* 339 B.R. 56 (Bankr. S.D.N.Y. 2006) (commercial telecommunications equipment);

(ii) the lessee needs the equipment to operate its business, *Park West Fin. Corp. v. Phoenix Equip. Co. (In re Phoenix Equip. Co.)*, No. 2:08-bk-13108- SSC, 2009 WL 3188684 (Bankr. D. Ariz. Sept. 30, 2009) (excavating equipment for company in excavating business); *In re Triplex Marine Maint., Inc.*, 258 B.R. 659 Bankr. E.D. Tex. 2000) (Debtor "sold" to "Lessor" almost every asset it owned, including office furniture and all equipment used in daily business operations, and then "leased" them back); or

(iii) the cost of removing and returning the goods is prohibitively expensive, *Duke Energy Royal, LLC v. Pillowtex Corp.* (*In re Pillowtex, Inc.)*, 349 F.3d 711 (3d Cir. 2003) (lighting fixtures and wastewater system); *In re Kentuckiana Med. Center LLC*, 455 B.R. 694 (Bankr. S.D. Ind. 2011) (medical equipment); *In re Triplex Marine Main., Inc.*, 258 B.R. 659 ;*see also In re Uni Imaging Holdings, LLC,* 423 B.R. 406 (Bankr. N.D.N.Y. 2010) (MRI equipment); *Gibraltar Fin. Corp.* 949 N.E.2d 314 (punch press); *In re Gateway Ethanol, LLC*, 415 B.R. 486 (Bankr. D. Kan. 2009) (thermal oxidizer boiler system) (each concluding that a transaction was a lease but only after considering the cost of removing and returning the goods).

Given the nature of the equipment in this case and how it was installed in the buildings, some discussion of the cost of removal and which party was responsible therefor seems essential. For example, if the lessor was the party responsible for removing the equipment (and repairing any damage to the buildings from such removal), and if that cost would exceed the resale value of the used equipment to the lessor, then there was no realistic possibility that the lessor would ever take the goods back.

In re Ice Mgmt. Systems, Inc., 2014 WL 6892739 (9th Cir. BAP 2014)

This case concerns what constitutes "proceeds" of collateral. The court might have reached the correct result based on bankruptcy law, and it certainly reached an equitable result, but its analysis of Article 9 was simply wrong.

The debtor in the case was in the business of manufacturing and selling devices used to de-ice aircraft. In return for funding, the debtor granted TMC Aerospace, Inc. a first-priority, perfected security interest in all its assets. After the debtor defaulted, TMC accelerated the debt and the debtor filed for Chapter 7 bankruptcy relief. The bankruptcy trustee sought to sell all of the debtor's assets subject to existing liens. TMC objected, claiming that its security interest would attach to the sale proceeds and, therefore, none of the cash received by trustee would be available to pay creditors. The bankruptcy court, relying on *In re Shooting Star Enters.*, 76 B.R. 154 (9th Cir. BAP 1987), a*ff'd*, 843 F.2d 1576 (9th Cir. 1988), ruled for the trustee and TMC appealed.

In *Shooting Star*, the Bankruptcy Appellate Panel noted that when a trustee sells assets of the estate, the trustee is "disposing" of the property and thus the consideration generated from that sale would normally constitute "proceeds," as defined by the UCC. Nevertheless, a different outcome is warranted when the trustee sells assets subject to a security interest. In that case, the amount "received for that interest is more logically associated with the 'equity' in the property, or the value of the property less the amount of the lien." *Id.* at 156.

In analyzing this case, the Panel concluded that *Shooting Star* does not turn on whether the trustee has "equity" in the debtor's assets in the traditional sense. Instead, the price in such a transaction "is only for the trustee's interest in the encumbered assets, 'an ephemeral interest not within the definition of proceeds found in [§ 9-102(a)(64)].' " 2014 WL 6892739. at *7.

The court's decision makes sense from a bankruptcy standpoint. If the trustee is selling collateral subject to an existing lien, the lienholder is unaffected by the sale and the other creditors should be entitled to share in the sale proceeds. But to suggest that this result is mandated by the UCC is simply wrong. Under Article 9, when the debtor sells collateral, the general rule is that the security interest continues in the collateral, § 9-315(a)(1), *and* that the security interest also attaches to the proceeds, § 9-315(a)(2). Moreover, "proceeds" is defined very broadly to include "whatever is acquired upon the sale, lease, license, exchange, or other disposition of the collateral." § 9-102(a)(64)(A). Instead of proffering an incorrect and miserly interpretation of the term "proceeds," the court should have instead relied on Bankruptcy Code § 552(b)(1). That provision expressly provides that a prepetition security interest attaches to postpetition proceeds of collateral unless the court, "based on the equities of the case, orders otherwise." A trustee sale subject to the security interest creates an equity warranting a different rule.

Perhaps the Panel was suggesting that when the trustee sells collateral subject to a security interest, the trustee is selling the estate's interest in the collateral, not the collateral itself. But *Shooting Star* itself expressly rejected this point. 76 B.R. at 156. In any event, one can only hope that the court's decision is not taken out of context and applied outside of bankruptcy. Despite the court's language, a sale of collateral subject to the security interest does generate proceeds under Article 9. That might not make sense in bankruptcy, but it is the law in every other setting.

In re Duckworth, 776 F.3d 453 (7th Cir. 2014)

This decision is very disturbing. The court extended precedent in a way that is unsupported by the law and in the process expanded the powers of the bankruptcy trustee to invalidate minor drafting errors that should be of no concern to anyone.

The case originated with a simple transaction. The debtor borrowed $1.1 million from the State Bank of Toulon. The security agreement was dated December 13, 2008 and indicated that it secured a promissory note of the same date. However, the note, which also referred to the security agreement, was actually dated December 15, 2008. The debtor later sought Chapter 7 bankruptcy protection. Both the bankruptcy court and the district court ruled that the mistaken date in the security agreement did not defeat the bank's security interest. The trustee appealed.

The Seventh Circuit first concluded that the security agreement could not be construed to secure the December 15, 2008 note. It then ruled although parol evidence could have been used to cure the mistake and reform the security agreement as between the original parties, that evidence could not be used against the bankruptcy trustee.

Noting that the bankruptcy trustee has the power and status of a judicial lien creditor, the court relied on one case that refused to admit parol evidence to expand the scope of the collateral described in the security agreement, *In re Martin Grinding & Machine Works, Inc.,* 793 F.2d 592 (7th Cir. 1986) (security agreement covered equipment but mistakenly omitted inventory and accounts), and another that refused to rely on parol evidence suggesting that the agreement was to secure future advances, *Safe Deposit Bank & Trust Co. v. Berman*, 393 F.2d 401 (1st Cir. 1968).

The court emphasized the importance of "third parties' ability to rely on unambiguous documents," 776 F.3d at 459, and noted that a "rigid rule allows later lenders to rely on the face of an unambiguous security agreement, without having to worry that a prior lender might offer parol evidence (which would ordinarily be unknown to the later lender)." *Id.*

This argument suffers from several flaws. First, it improperly assumes that prospective lenders examine the security agreements of prior lenders. Prospective lenders do examine filed financing statements but they are often not shown the security agreements to which the financing statements relate, even if they ask to see them. Second, and more important, such a prospective lender cannot rely on the terms of any security agreement they do see. If the filed financing statement covers some specified property, then the prospective lender cannot rely on that property as collateral even if the filer's existing security agreement does not encumber that property. That is because, if the debtor later grants a security interest in it to the filer, the filer's priority will date from when the financing statement was filed. *See* § 9-322(a)(1). Similarly, even if the existing security agreement does not cover future advances, a new or amended security agreement could, with the result that the prospective lender's interest would be subordinate to the filer's interest even as to that later loan.

Finally, and most important, the court's analysis improperly equates a judicial lien creditor with a subsequent lender. Judicial lien creditors rarely search and never give value in reliance on the apparently unencumbered nature of the collateral. For this reason, the law gives them far fewer rights than it does to a buyer or secured party. This is true not only in Article 9, *compare* § 9-317(a) *with* (b), but also in the law of restitution. While a purchaser for value does take free of a reformation claim, a lien creditor does not. *See* Restatement (Third) of Restitution and Unjust Enrichment §§ 12 comment f, 60(1) and comment b, 66; *see also* Restatement (Second) of Contracts § 155 comment f ("Judgment creditors and trustees in bankruptcy are not included [among the third parties who trump a right to reformation].").

This is not to say that a judicial lien creditor or bankruptcy trustee has or should have no rights. Merely that the court's misunderstanding of how secured financing works and its misunderstanding of the law led it to a result that invalidated a security interest for no good reason.

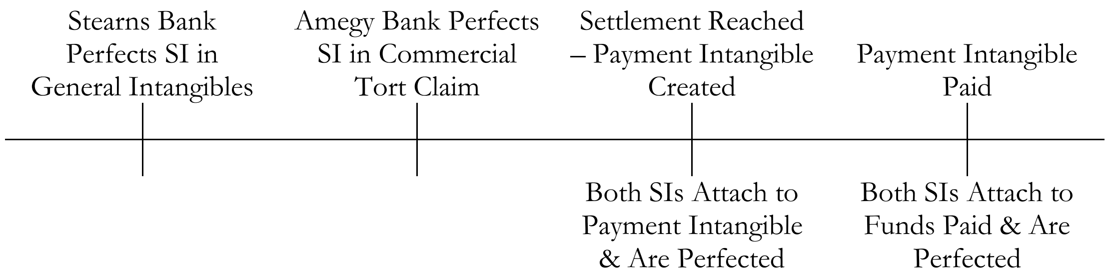
Bayer Cropscience LP v. Texana Rice Mill Ltd, 2015 WL 1474393 (E.D. Mo. 2015)

As in the case above, the court in this case misunderstood and misapplied the principal priority rule of Article 9: § 9-322(a)(1).

Simplifying the facts a bit for the purposes of this discussion, in 2002 Stearns Bank acquired and perfected a security interest in the debtor's existing and after acquired general intangibles. In 2006, Amegy Bank acquired and perfected a security interest in the debtor's commercial tort claim against Bayer Corp. and several related entities. In 2012, Bayer agreed to pay $2.1 million to settle the suit. After a portion of the proceeds were distributed and the remainder deposited with the court, the two banks each claimed priority in the balance on hand: about $1 million.

Much of the court's analysis is sound. In particular, the court properly treated the settlement as creating a payment intangible to which Stearns Bank's security interest attached. *Id.* at *6-7. The court also correctly concluded that Stearns Bank's interest in the payment intangible, being after-acquired collateral, was not perfected until the suit settled. *Id.* at 7. The court then looked to the correct priority rule – § 9-322(a)(1) – to determine the relative priority of the two security interests.

Unfortunately, the court made two mistakes. First, the court stated that "Amegy's interest was the first to perfect." Actually, with respect to both the payment intangible created by the settlement agreement and the funds received in satisfaction of the payment intangible, the security interests of the two banks attached and were perfected simultaneously. Recall, that Amegy Bank had a perfected interest in a commercial tort claim. When that claim was settled, a payment intangible was created. Amegy Bank's security interest attached to the payment intangible as proceeds of the commercial tort claim. *See* § 9-315(a)(2). That security interest was automatically perfected. § 9-315(c), (d). At the same moment, Stearns Bank's security interest attached to the payment intangible as after-acquired property. *See* §§ 9-203(b)(2), 9-204(a). That security interest was also immediately perfected. *See* § 9-502(d). Thus, the attachment and perfection of both security interests in the payment intangible were simultaneous. When the payment intangible was paid, both security interests attached to and were perfected in the cash proceeds, again simultaneously.



Second, the court misread and misstated the priority rule of § 9-322(a)(1). The court paraphrased the rule as follows: "Conflicting perfected security interests on the same collateral are accorded priority based upon whichever interest was first perfected or, if simultaneously perfected, upon whichever secured party first filed a UCC financing statement covering the collateral." *Id.* at *5. That is not the rule. Priority goes to the first to file or perfect. A security interest perfected later in time nevertheless has priority if it is covered by a financing statement that was filed before the competing security interest was filed or perfected. *See* § 9-322 cmt. 4, ex. 1.

Notice that even if the rule were as the court phrased it, Stearns Bank should have won because both security interests were perfected simultaneously in the payment intangible and in the funds paid in satisfaction of that obligation. But even if the court had been correct in concluding that Amegy Bank's security interest was perfected first, the security interest of Stearns Bank was entitled to priority. Stearns Bank's security interest in the payment intangible was immediately perfected by its previously filed financing statement and that financing statement was filed before Amegy Bank filed or perfected. Thus, under a proper reading of § 9-322(a)(1), Stearns Bank's security agreement had priority.

It is hard to understand how a court can navigate through the confusing terrain of Article 9, locate the priority rule that does indeed govern, and yet so thoroughly misunderstand that rule. But this court may have been led astray by the temptation of avoiding a further issue standing between Stearns Bank and a favorable ruling: does § 9-204(b)(2)'s invalidation of after-acquired property clauses as applied to commercial tort claims also apply to payment intangibles that are proceeds of the commercial tort claim? The correct answer is almost certainly no, as decided in a Ninth Circuit BAP case cited by the court, but the court also notes in dictum that a couple of other cases disagree with the BAP case, and seems to have seized on its formulation of § 9-322(a)(1) as a way of avoiding those relatively thorny issues.

In re Davis,
528 B.R. 757 (Bankr. E.D. Tenn. 2015)

This case also concerned a settlement of a tort claim. The court's ruling is probably correct, but the opinion contains some unfortunate language that could be taken out of context and misapplied in subsequent cases.

The debtors owned real property subject to two deeds of trust held by a bank. The property was damaged when a dike maintained by the Tennessee Valley Authority was breached, filling the property with coal ash. The debtors sued the TVA for the damage and the bank intervened. The debtors filed for Chapter 7 relief and the trustee then settled the claim against the TVA for about $81,000, after attorney's fees. The issue was whether the bank or the trustee was entitled to the settlement proceeds.

The court ruled for the bank. Noting that the deeds of trust included language purporting to encumber "all . . . rights . . . now or hereafter existing in connection with the property or derived therefrom," the court concluded that the settlement proceeds were substitute collateral covered by the bank's lien.

This ruling is probably correct. Unfortunately, the court thought it necessary to struggle with whether the debtors' right to the settlement was a general intangible under the UCC. The court seemed to regard the two issues as related and indeed as mutually exclusive alternatives. It concluded that the bank won because "the settlement proceeds are substitute collateral . . . subject to [the bank's lien] rather than general intangibles under the Uniform Commercial Code." *Id.* at 762.

This was incorrect. Regardless of whether – under applicable real property law – the bank's deed of trust encumbered the debtors' rights under the settlement agreement, those rights were a general intangible. This is important because anyone other than the deed of trust holder would certainly need to comply with Article 9 to obtain and perfect a security interest in those rights. Perhaps the court was operating under the assumption that, if the debtors' rights under the settlement agreement were a general intangible, the deed of trust either could not encumber those rights or, if it could, the resulting lien would not be perfected without a filed financing statement. But the classification of collateral is a separate issue from both attachment and perfection. Moreover, it is far from clear whether Article 9 prevents or preempts a lien on real property from attaching to personal property proceeds of real estate or requires that the holder of the lien comply with Article 9 to perfect. For these reasons, the court's conclusion that the debtors' rights under the settlement agreement were not a general intangible is unfortunate and should be disregarded.

Eldesouky v. Aziz,
2015 WL 1573319 (S.D.N.Y. 2015)

The United States signed the United Nations Convention on Contracts for the International Sale of Goods in 1981, and the Convention entered into force in the United States on January 1, 1988. More than twenty-seven years and about one hundred fifty U.S. court opinions later, some courts continue to assume – improperly – that the CISG is merely an international codification of Uniform Commercial Code Article 2. The latest opinion to suffer from this error is *Eldesouky v. Aziz*, a case out of the Southern District of New York.

This case involved a contract for the sale of flaxseed. The buyers brought suit contending that the sellers had breached the parties' contract by failing to meet the contractual quality and quantity requirements. The buyers moved for summary judgment against one defendant and default judgment against two others. After granting summary judgment, the court requested further submissions with respect to damages, and it was at this point that the buyers first alleged that the CISG governs the parties' contract. Although the court acknowledged that the contract was a matter to which the CISG would normally apply pursuant to Article 1(1)(a) because the buyers are Egyptian companies and the sellers are American companies, the court ruled that the parties had waived application of the CISG by failing to raise it. At least one other court has held similarly. *Rienzi & Sons, Inc. v. N. Puglisi & F. Industria Paste Alimentari SPA*, 2014 WL 1276513 (E.D.N.Y. 2014) (failure to cite the CISG prior to summary judgment resulted in waiver).

The court then went on to recite language that is, unfortunately, often used by courts that wish to ignore the fact that the CISG is its own, independent body of law: "In any event, because there is so little case law applying the CISG, courts often look to Article 2 of the Uniform Commercial Code for guidance." *Id.* at *2. The quoted language originated in an early CISG case, *Delchi Carrier v. Rotorex Corp.*, 71 F.3d 1024, 1028 (2d Cir. 1995) ("there is virtually no case law under the Convention"), but unfortunately is still commonly employed even though the premise is no longer accurate.

Even more concerning, however, is the court's next sentence: "Therefore, as a practical matter, whether the UCC or the CISG governs is likely immaterial." 2015 WL 1573319 at *2. Given the significant, substantive differences between the CISG and the UCC, this sentence is irresponsible as a general proposition and inaccurate as applied to the case at bar. The issues remaining to be decided at the time the court issued its opinion included the availability of incidental and consequential damages, lost profits, pre-judgment interest, and attorneys' fees. Each of these issues is governed by one or more articles of the CISG that is interpreted independently of and differently from the UCC, and each has its own body of case law and commentary. Whether attorneys' fees are recoverable as part of CISG Article 74's definition of "loss," and how the relevant rate of interest is to be determined for an award of pre-judgment interest pursuant to CISG Article 78, for example, are unsettled questions under the CISG. Likewise, the CISG's treatment of consequential and incidental damages for buyers is not identical to the UCC's. CISG Article 75, for example, does not include the language the court cited from UCC 2-712(2), requiring that any award of damages subtract "expenses saved in consequence of the seller's breach." *See* Harry M. Flechtner, *Remedies under the New Sales Convention: The Perspective from Article 2 of the UCC*, 8 J. L. & Comm. 53 (1988) (providing an overview of the differences between the CISG and the UCC with respect to damages and other remedies).

In short, then, it is one thing for the court to have determined that the parties waived any potential application of the CISG, but quite another for the court to blithely assert that its ruling made no difference.

Millbrook IV, LLC v. Production Services Associates, LLC
2015 WL 1516531 (Ill. Ct. App. 2015)

When personal property collateral is kept at a real estate location occupied by the debtor as lessee, non-UCC law might give the landlord a lien on that property that conflicts with the rights of the secured lender. Secured parties often bargain with the landlord for the waiver or subordination of the landlord's rights. In this case, the court read such an arrangement much too broadly, such that the landlord wound up unable to collect nearly $900,000 in rent even as a judgment creditor, even after the lenders' security interest had been foreclosed and the collateral sold to a buyer that succeeded to all of the debtor's obligations.

The landlord and the secured lenders entered into a Collateral Access Agreement providing that, "until such time as the obligations" of the debtor to the lenders were "paid in full," the landlord "waives any interest in the Collateral and agrees not to distrain or levy upon the Collateral or any part thereof or to assert any landlord['s] lien, right of distraint or other claim against the Collateral for any reason." Later, the debtor defaulted on the secured debt and a foreclosure sale was held. The buyer at the foreclosure sale was a newly formed entity owned in part by one of the secured lenders, Madison Capital. A substantial portion of the purchase price consisted of assuming some of the debtor's debt. Shortly after the foreclosure, the landlord obtained a judgment against the debtor, and in supplementary enforcement proceedings the court ruled that the buyer was liable for the debtor's unpaid obligations as a "mere continuation" of the debtor.

At this point the landlord's coast should have been clear: it had a judgment for the unpaid rent, on which the buyer was obligated; the buyer owned assets, namely the ones formerly owned by the debtor; and the security interest was out of the way. But Madison Capital intervened and successfully asserted that the landlord was barred from enforcing the judgment against the new entity's assets by reason of the Collateral Access Agreement. The court reached this result by construing the agreement in an overly mechanistic manner. In the court's view, because Madison Capital had not been "paid in full," the agreement barred the landlord from asserting "any . . . other claim against the Collateral."

The court's most fundamental error was in thinking that the Collateral Access Agreement subordinated the landlord's *debt*, rather than just the landlord's *lien rights*. In fact, the opinion incorrectly states twice that the landlord had agreed to "subordinate its claim." Yet "lien" and "debt" are not synonymous and it is generally more drastic to subordinate one's debt than to subordinate one's lien rights. Consequently, an agreement for the latter should not be misconstrued as doing the former. To highlight the difference, suppose that one of the owners of the buyer had contributed new machinery to the entity: a subordination of the landlord's debt would prevent the landlord from executing its judgment against the new machinery, but surely the agreement in this case—being limited by its terms to "the Collateral"—could not be construed as having this effect.

Moreover, while paying lip service to the parties' intent, the court ignored several important indicia of that intent. First, the agreement—right down to its title—was overwhelmingly and perhaps even exclusively focused on the lenders' rights as secured parties, yet the security interest was discharged upon foreclosure under UCC § 9-617(a)(2). Next, some or all of the buyer's unpaid obligations to the lender seem to be distinct from the debt secured, so that they would not likely have been within the intended scope of agreement's reference to "the obligations" being "paid in full." Also, the court was concerned about letting the landlord "step to the front of the line of creditors," but this was misplaced because post-foreclosure, both the landlord and the lender seem to be unsecured creditors of the new entity (the court notes that there was no assertion about the lender having a security interest in the new entity's assets). Still less, of course, is the landlord qua equity owner entitled to any priority.

Last, but not least, in evaluating the intent behind the waiver, the court should have considered the sensible maxim *ejusdem generis* (meaning "of the same kind"). Just as a reference to "cars, trucks, tractors and other vehicles" should not be lightly assumed to include air- or waterborne means of transport, *see, e.g., McBoyle v. United States*, 283 U.S. 25 (1931), so should the waiver of "any landlord['s] lien, right of distraint or other claim against the Collateral" not be lightly assumed to include rights like those of a judgment creditor. The rights specifically waived were asset-based, landlord-specific and involved self help, while the rights at issue in the case were debt-based, almost universal among creditors, and involved judicial process. In any factual context and especially this one, the court should not have found the intent to relinquish such basic rights based only on an airy catch-all phrase.

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11. The National Law Center for Inter-American Free Trade (NLCIFT) is dedicated to developing the legal infrastructure to build trade capacity and promote economic development in the Americas. For more information, go to **http://www.natlaw.com**
12. Information on the Hague Conference on Private International Law and its current status is available at **http://www.hcch.net/index_en.php**

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 Glen Strong, Christina Goebelsmann or Hilary Sledge-Sarnor, the Uniform Commercial Code Committee Editors or Harold Lee, Suhuyini Abudulai or Sidney Simms, the Commercial Finance Committee Editors.

[1] References to UCC Article 9 (hereinafter, "UCC RA9") are to the official text promulgated in 1998 by the Uniform Law Commission (also known as the National Conference of Commissioners on Uniform State Laws) and the American Law Institute, as amended through the 2010 Amendments thereto, which generally took effect on July 1, 2013.
[2] Generally, an organization is located at its place or business or, if it has more than one, at its chief executive office (UCC RA9 § 307(b)(2), (3)); a registered organization organized under the law of a state is located in that state (UCC RA9 § 307(e)); and an individual is located at his or her principal residence (UCC RA9 § 307(b)(1)). *See generally* UCC RA9 § 307.
[3] *See supra* section II.C ("Series Might Not Be Entities").
[4] *See* PERMANENT EDITORIAL BD. FOR THE UNIF. COMMERCIAL CODE, PEB COMMENTARY NO. 17: LIMITED LIABILITY PARTNERSHIPS UNDER THE CHOICE OF LAW RULES OF ARTICLE 9 (June 29, 2012), *available at* http://www.ali.org/doc/PEB%20Commentary%20on%20LLPs-final.pdf.
[5] 805 ILL. COMP. STAT. ANN. 180/37-40 (LexisNexis 2014).
[6] 805 ILL. COMP. STAT. ANN. 180/37-40(a) (LexisNexis 2014).
[7] *Id.* § 180-37-40(b).
[8] *Id.* § 180-37-40(d).
[9] Similarly, consider the Delaware statutory trust, which is "created" by a governing instrument (DEL. CODE ANN. tit. 12, § 3801(g)(1) (2014)), by definition must have a certificate of trust (*Id.* § 3801(g)(2)), and is "formed at the time of the filing of the initial certificate of trust" (*Id.* § 3810(a)(2)).
[10] The 2010 Amendments to UCC RA9 provide improved guidance for determining a registered organization debtor's name for filing purposes, utilizing the new defined term "public organic record." *See* UCC RA9 § 102(a)(68).
[11] *In re RML Dev., Inc.*, 528 B.R. 150, 153–54 (Bankr. W.D. Tenn. 2014).
[12] *See* 11 U.S.C. §§ 101–1532 (the "Code").
[13] *See* PAUL R. HAGE ET AL., CREDIT BIDDING IN BANKRUPTCY SALES: A GUIDE FOR LENDERS, CREDITORS, AND DISTRESSED-DEBT INVESTORS (2015).
[14] 11 U.S.C. § 363(k).
[15] 11 U.S.C. § 1129(b)(2)(A)(ii). The "fair and equitable" test for cramdown confirmation of a chapter 11 plan also may be met with respect to an objecting secured creditor whose claim is impaired in two other ways—if the secured creditor retains its liens on the property securing its claim and receives payments over time having a present value equal to the value of the property or if the secured creditor receives the "indubitable equivalent" of its secured claim. 11 U.S.C. § 1129(b)(2)(A)(i), (iii).
[16] *In re Pac. Lumber Co.*, 584 F.3d 229, 237 (5th Cir. 2009).
[17] *Id.* at 239.
[18] *Id.* at 249.
[19] *In re Phila. Newspapers, LLC*, 599 F.3d 298, 301–02 (3d Cir. 2010).
[20] *Id.* at 302, 319.
[21] *Compare Pac. Lumber*, 584 F.3d at 247–49, *with Phila. Newspapers*, 599 F.3d at 317–18.
[22] *River Rd. Hotel Partners, LLC v. Amalgamated Bank*, 651 F.3d 642, 653 (7th Cir. 2011).
[23] *Id.* at 644–45.
[24] *Id.* at 645, 653.
[25] *RadLAX Gateway Hotel, LLC v. Amalgamated Bank*, 132 S. Ct. 2065, 2070 & 2073 (2012).
[26] *Id.* at 2070–72.
[27] *Id.* at 2073.
[28] *In re Phila. Newspapers, LLC*, 599 F.3d 298, 316 n.14 (3d Cir. 2010).
[29] *See, e.g., In re Olde Prairie Block Owner, LLC,* 464 B.R. 337, 348 (Bankr. N.D. Ill. 2011) (stating that "cause" exists "under § 363(k) to bar a secured creditor from credit bidding when the creditor's lien is questioned or otherwise in dispute"). However, the mere existence of a dispute will not necessarily result in the complete elimination of the secured creditor's right to credit bid. *See., e.g., In re RML Dev., Inc.*, 528 B.R. 150, 156 (Bankr. W.D. Tenn. 2014) (allowing the secured creditor to credit bid the uncontested portion of its claim when the debtor objected only to the secured creditor's claim amount calculation); *In re Charles St. African Methodist Episcopal Church of Boston*, 510 B.R. 453, 458–59 (Bankr. D. Mass. 2014) (refusing to limit the secured creditor's right to credit bid, other than to require it to submit a cash deposit to pay a $50,000 breakup fee due to the debtor's chosen stalking horse bidder, when the debtor did not dispute the validity or extent of the secured creditor's claims but merely asserted counterclaims against the secured creditor).
[30] *See, e.g., In re Aloha Airlines, Inc.*, No. 08-00337, 2009 WL 1371950, at *8–9 (Bankr. D. Haw. May 14, 2009) (finding "cause" to deny a secured creditor's right to credit bid for the debtor's assets where the secured creditor had agreed to license the debtor's intellectual property to a competitor of the debtor who allegedly had contributed to the failure of the debtor's business).
[31] *In re Fisker Auto. Holdings, Inc.*, 510 B.R. 55, 56–57 (Bankr. D. Del. 2014).
[32] *Id*. at 57.

[33] For purposes of the hearing on their motions, the debtor and the committee stipulated that (i) if Hybrid's credit bid was capped or denied, there was a strong likelihood of an auction that would create material value for the estate; (ii) if Hybrid's credit bid was not capped, it was unlikely that an auction would occur; (iii) limiting Hybrid's ability to credit bid would likely foster a competitive bidding environment; and (iv) a material portion of the debtor's assets were not subject to properly perfected liens in favor of Hybrid or were subject to liens in favor of Hybrid that were in bona fide dispute. *Id.* at 57–58.

[34] *Id.* at 60.

[35] *Id.* at 61.

[36] *In re The Free Lance-Star Publ'g Co. of Fredericksburg, VA*, 512 B.R. 798, 802–03 (Bankr. E.D. Va. 2014).

[37] *Id.* at 803–04.

[38] *Id.* at 800.

[39] *Id*. at 807–08.

[40] *Id*. at 806–07.

[41] *Id*. at 807.

[42] *Id.* at 808. After an evidentiary hearing, the court concluded that DSP's credit bid should be capped at a total of $13.9 million. While it is unclear from the court's ruling exactly how it arrived at this amount, the court indicated that it relied on the methodology of the debtor's financial advisor, which "eliminated the unencumbered assets . . . and applied a market analysis to develop an appropriate cap for a credit bid that would foster a competitive auction process." *Id*. at 807.

[43] *In re RML Dev., Inc.*, 528 B.R. 150, 155 n.11 (Bankr. W.D. Tenn. 2014).

[44] *Id*. at 152–53.

[45] *Id*. at 156. Specifically, the court limited the mortgagee's right to credit bid its $2,543,579 claim to the undisputed amount of $2,354,759. To address an ill-defined dispute as to the priority of the mortgagee's and certain other creditors' respective liens, the court also ordered that unless the dispute was resolved prior to the sale the mortgagee must post security in the amount of its proposed credit bid. *Id*. at 156–57.

[46] *See In re Charles St. African Methodist Episcopal Church of Boston*, 510 B.R. 453 (Bankr. D. Mass. 2014).

[47] *Id*. at 457.