Commercial Law Newsletter
Joint Newsletter of the Commercial Finance and Uniform Commercial Code Committees

AMERICAN BAR ASSOCIATION
Business Law Section

March 26, 2018 Spring 2018

IN THIS ISSUE

MARK YOUR CALENDARS

**April 12-14, 2018 – ABA Business Law Section Spring Meeting – Rosen Shingle Creek
Orlando, FL**

**September 13-15, 2018 – ABA Business Law Section Annual Meeting – Fairmont Austin and the Austin Convention Center
Austin, TX**

November 16-17, 2018 – ABA Business Law Section Fall Meeting – Ritz-Carlton, Washington, DC

SUBMISSIONS FOR UCC LAW JOURNAL

Dear Readers:

As the Editor in Chief of the Uniform Commercial Code Law Journal (UCC Law Journal), I am delighted to invite you to submit articles for consideration. The Journal, which is published quarterly by Thomson Reuters, has a proud and distinguished tradition. Professor Louis Del Duca, who was

Joint Report from the Chairs

Dear Members:

From April 12-14, Section members will gather in Orlando for the Business Law Section's Spring Meeting at the Rosen Shingle Creek. Registration is still available for this meeting and may be completed on-line at the Section's website.

We are pleased that our committees are again offering a robust number of meetings and programs. Together, the ComFin and UCC Committees are the prime sponsors of seven (7) CLE programs: (1) Current State of the Syndicated Loan Market (Thursday, April 12th, 10:30am - 12:30pm); (2) Multi-Member LLC Interests as Collateral and the New Model Form Security Agreement for Security Interests in LLC Membership Interests (Thursday, April 12th, 2:30 pm – 4:00 pm); (3) How Analytics, Artificial Intelligence, and Other Technologies are Changing Business Practice (Friday, April 13th, 8:00 am – 9:00 am); (4) Protecting Human Rights in Supply Chains; Moving from Policy to Action (Friday, April 13th, 10:30am- 12:30 pm); (5) Consumers, Smart Devices, and Contracts for Goods and Services under the UCC: "Alexa, Are You Really My Agent?" (Friday, April 13th, 2:30pm - 4:30pm); (6) Third Party Financing of Litigation – Structures, Documental and Practical Issues (Saturday, April 14, 9:00 am – 10:30 am); and (7) Electronic Residential Mortgage Notes Under the Proposed Federal Repository Act and the Uniform Commercial Code (Saturday April 14th, 8:30am - 10:00am).

In addition, the Committees will hold the usual Joint Meeting on Thursday, April 6th, from 8:00am-9:30am, during which Joseph Sommer of the Federal Reserve Bank of New York will be discussing special deposits. We will also be having our joint committee dinner at Dragonfly Robata Grill. Tickets are currently available, but you may want to act quickly, as our dinners have been selling out fairly quickly of late. A special thank you to Fasken Martineau, Friedberg PC, and McGlinchey Stafford for sponsoring the dinner (including an open bar) and making it possible for us to lower the ticket price to $90! To purchase tickets, visit the Section Spring Meeting website and click "Register online." Follow the prompts to Add Events to an Existing Registration.

As always, our Committees and the vast majority of our subcommittees and task forces will be meeting. The entire schedule for the meeting is available on the Section's website. If you are unable to attend the meeting in person, prior to the meeting we will provide dial-in information for the various committee, subcommittee, and task force meetings.

In closing, thank you so much to the entire CLN Editorial Board for putting this wonderful newsletter together. Jeremy and I thought it fitting to devote this edition of the Chairs' Report to honor Ray Nimmer, Dean Emeritus of the University of Houston Law Center and a long-time active member of our committees who passed away on January 24, 2018. Ray was an outstanding scholar in commercial law, information law, and intellectual property law, was honored by countless organizations, and was a friend and mentor to so many.

Please email either of us if you have any ideas for either of the Committees or wish to participate in any project, subcommittee or leadership role. The Committees have a number of projects underway. Our subcommittees and task forces are very active and always welcome input. Please do not hesitate to volunteer!

without a doubt one of the great minds in the field of commercial law and a mentor to so many, served as the Journal's first Editor in Chief, and it is truly a privilege to follow him.

Over its history, thus far, the Journal has published articles written by many of the leading academicians and practitioners in the field of commercial law, and Principal Attorney Editor Lisa Ovsiovitch and I are very interested in hearing from prospective authors in both groups. The Journal welcomes articles relating to various aspects of the Uniform Commercial Code that may include, but are in no way limited to, such topics as each of the UCC articles, contract law, commercial arbitration, damages, the Sarbanes Oxley Act, the Truth in Lending Act, alternative payment systems in the modern era, commercial issues in gaming systems, issues related to prepaid accounts, issues related to the 2010 Article 9 Amendments, issues related to the UCC and bankruptcy, litigation, secured lending, issues related to trusts and trustees, searching and filing issues under Article 9, the CISC, etc.

The next deadline for submitting articles to be considered for publication is June 1, 2018. I would be glad to provide additional information, including Thomson Reuters' Submission Instructions and Specifications, to anyone who is interested in having an article published in the Journal. Articles should be submitted by e-mail if possible, and the preferred format is Microsoft Word.

Very truly yours,

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

COMFIN SUBCOMMITTEES AND TASK FORCES

- Subcommittee on Agricultural and

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

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Featured Articles

By Maria Barclay and Ikhlas Rashid of Practical Law,
Janet Vance of Gibson, Dunn & Crutcher LLP,
Peter J. Antoszyk of Proskauer Rose LLP
and Jeong M. Lee of Davis Polk & Wardwell LLP

In 2017, the large cap and middle market segments of the US loan market experienced a record-breaking year with consistent growth. Refinancing levels started strong and continued to dominate the loan market throughout the year. M&A loan volume started off slowly, due partly to uncertainty about US tax reform, but finished the year solidly as M&A activity picked up in the last months of the year. The loan market's strength was supported by healthy volumes of collateralized loan obligation (CLO) issuances and the appetite of other investors for the loan asset class. This fostered a borrower-friendly environment for both large cap and middle market borrowers, enabling many borrowers to negotiate loan structures and covenant packages that allowed them to maximize flexibility in managing their businesses.

Overview

Across the board, loan volume surged, with large cap totals standing at $2.33 trillion, a 21% increase from 2016. Similarly, middle market issuances increased by 23% from 2016, standing at $170 billion for 2017. Also, institutional issuance rose to $924 billion.

Total loan issuance reached over $2.5 trillion in 2017, breaking the record set in 2013. This volume was driven in part by refinancing and repricing activity. Refinancings grew to $1.7 trillion, a 35% increase compared to 2016. Leveraged lending increased to $1.4 trillion, which is up 60% from 2016.

While not performing as strongly as refinancing activity, new money lending stepped up to $790 billion in 2017, an increase of 9% from 2016. At $537 billion, 2017 M&A loan financings rose 12% compared to 2016. Leveraged buyout activity climbed to $126 billion, a 44% increase compared to 2016.

Dividend recapitalizations (dividend recaps) soared to $45 billion, a sharp increase of 83% compared to 2016.

Unlike in the last few years, the second lien market was active, reaching $37 billion, a 74% increase from 2016.

Against this backdrop, this article examines trends in the loan market in 2017, including:

- Regulatory developments with respect to the Leveraged Lending Guidance (LLG), which left market participants questioning its enforceability.
- Expansion of direct lending as an alternate financing source for middle market borrowers.
- Uncertainty arising from the eventual replacement of LIBOR.
- More detailed commitment letters, increasingly negotiated through the use of "grids."
- Greater flexibility in loan terms and conditions.
- Continued migration of large cap terms and conditions to the middle market.

Leveraged Lending Guidance

One key regulatory development in 2017 was the examination by the Government Accountability Office (GAO) of whether the LLG is guidance or a rule for purposes of the Congressional Review Act (CRA). The GAO considers the LLG to be a statement of policy promulgated by regulators to assist financial institutions by providing a minimum standard of creditworthiness for borrowers and adequate risk management for banks. In October 2017, the GAO concluded the LLG did not meet any of the exceptions under the CRA and was therefore a rule subject to the CRA's requirements.

As a rule, rather than guidance, the LLG should have been subject to a 60-day congressional review period and this omission undermines the LLG. To address the resulting concerns about the LLG's unenforceability, US banking regulators (the Federal Reserve, Office of the Comptroller of the Currency, and Federal Deposit Insurance Corporation) are considering revising and reissuing the LLG for public comment.

In this environment, some banks are already pursuing transactions with more aggressive leverage levels in the belief that some aspects of the LLG may be relaxed, while other banks are taking a wait-and-see approach. However, even if some banks decide to loan money to borrowers with leverage above the LLG's stated figure of six times, there is doubt they will adopt more relaxed standards across the board, or that average leverage levels will increase dramatically in the short term.

Direct Lending

Direct lending continues to grow and mature as a source of corporate finance. Direct lenders have become important market players underwriting loans for smaller corporate entities and mid-tier sponsors, but direct lenders are also gaining the attention of top-tier sponsors and public companies. A recent development in the loan terms offered by direct lenders is the inclusion of limited conditionality transaction testing. Direct lenders started including limited conditionality to align with terms offered in syndicated deals.

It remains to be seen whether the concerns about the status of the LLG will enable regulated banks to compete with direct lenders on more transactions, taking away the competitive advantage enjoyed by direct lenders that are not subject to the LLG. However, direct lenders may have sufficiently embedded themselves as a source of capital in the loan market and look set to remain significant market players by providing anchor orders by offering commitments significantly above the average syndicate participant, and by continuing to offer favorable loan terms.

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

DO YOU WANT TO…

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, Jennifer Wasylyk, Peter Marchetti, Shadi Enos or Alex Brown.

LIBOR

In July 2017, the UK's Financial Conduct Authority (FCA) announced that after 2021 banks will no longer be required to submit quotes to LIBOR (London Interbank Offered Rate), a reference rate used for loans and financial instruments. This announcement prompted some borrowers and lenders to include mechanisms to select a successor rate to LIBOR in new and existing loan transactions.

Banks have agreed to support LIBOR through 2021 and the FCA will work towards developing an alternative benchmark. This may alleviate concerns about the medium-term viability of LIBOR. However, market participants are still reviewing their existing LIBOR fallback provisions and amendment provisions to ensure the selection of a successor rate can be made if LIBOR ceases to exist.

There is currently no market consensus on LIBOR successor provisions, which raises a number of issues, including:

- Creating a trigger for implementing the successor rate.
- Identifying the entity that selects the rate, and whether required lenders get a negative consent right.
- Adjusting the spread so the lenders receive the same return.

Commitment Letter Negotiations

Continuing a trend from recent years, term sheets are becoming more detailed as loan terms are negotiated in greater detail at the commitment letter stage.

In addition to increasing in length, the negotiation of commitment letters continues to evolve, particularly in sponsored transactions. The use of grids (charts summarizing competing financing proposals point by point) in larger transactions has started to appear in transactions involving middle market borrowers and sponsors.

Loan Terms and Conditions

The current market dynamics allow borrowers and sponsors to push for highly favorable loan terms, which enable borrowers and sponsors to retain considerable operational flexibility and the ability to pursue opportunistic transactions without the consent of their lenders. In many instances borrowers and sponsors initially pursue terms consistent with these goals on a best efforts commitment basis, but many are successful in obtaining these terms in syndication. Descriptions of some current trends in loan terms and conditions are set out below.

EBITDA Calculations

Borrowers and sponsors continue to negotiate expansive EBITDA definitions to allow borrowers to take credit for cost savings synergies and restructurings. Pro forma cost savings synergies were typically capped at 15% of EBITDA in recent years. However, the current trend is for pro forma cost savings add-backs to be either unlimited or capped at between 25% to 30% of consolidated EBITDA after giving effect to the add-back.

Usually, EBITDA calculations provide credit for actions taken within a certain period of time following the date of the credit agreement (for example, 12 months). However, recently look forwards have increased to between 18 to 24 months.

Pro forma add-backs in EBITDA definitions originally covered projected cost savings arising from acquisitions, but now add-backs are increasingly seen for projected cost savings outside of the acquisition context, which can include any specific action or operational change taken or expected to be taken that can lead to ongoing expense savings for a borrower.

Change of Control

A recent trend in change of control provisions is the removal of so-called "dead hand" proxy puts, which provide that any director elected as a result of an actual or threatened proxy contest is considered a non-continuing director for purposes of the proxy put. The Delaware Court of Chancery's decision in *Pontiac General Employees Retirement System v. Ballantine (Healthways)* has made lenders more sensitive to potential liability. In *Healthways*, the court found that dead hand proxy put provisions may conflict with a director's fiduciary duties to the borrower. The court also found that a lender may be liable for aiding and abetting a breach of fiduciary duties by directors who approve a credit agreement with a dead hand proxy put.

While dead hand proxy puts have been removed from change of control provisions, proxy puts remain. Practical Law What's Market analyzed 107 credit agreements from 2017 with change of control provisions, and 81% of those agreements contained proxy puts.

Another development in change of control provisions is the re-emergence of an exception that allows the sale by a sponsor to another sponsor or to a corporate strategic buyer. This exception was first seen in the market several years ago but did not gain traction. For sponsor-to-sponsor sales, the exception typically requires consummation of the sale within a certain time period after the date of the loan agreement (usually, 24 months), an equity check from the new sponsor (typically around 30%), a certain enterprise value (usually, above $1 billion), and that leverage after the acquisition should be no worse than the original closing date leverage. For sales to corporate strategic buyers, the exception has similar requirements, but instead of the leverage test, the corporate strategic buyer must have a rating no worse than the rating of the original borrower.

Mandatory Prepayments

Asset Sale Sweeps

Exclusions to mandatory prepayment provisions are more widespread. Borrowers continue to request leverage-based step-downs from the requirement to prepay loans with 100% of asset sale proceeds. Other developments include:

- Allowing the borrower to use retained asset sale proceeds to make restricted payments.
- Increasing reinvestment periods from 12 months plus a three-month extension to 18 months plus a six-month extension.
- Allowing the borrower to sell all or substantially all of its business if the proceeds flow through the asset sale prepayment requirement.

Excess Cash Flow Sweeps

In some transactions, the excess cash flow sweep includes a deduction for capital expenditures. Instead of deducting capital expenditures in the calculation of excess cash flow, in these transactions capital expenditures are deducted from the percentage sweep of the excess cash flow, meaning that the borrower can deduct capital expenditures dollar-for-dollar from the prepayment requirement.

Future Debt Capacity: Incremental Loan Facilities

Reflective of a borrower-friendly market, many borrowers continued to push for an expansion of permitted future debt capacity by negotiating favorable incremental loan provisions.

Some incremental facilities have a most favored nations (MFN) provision, under which if the interest rate margin on an incremental loan is higher than the margin on the initial loan, the margin on the initial loan will be increased to be not more than a number of specified basis points less than the rate on the incremental loan. In past years, the MFN threshold has consistently been 50 basis points. However, in 2017 several transactions included an MFN threshold of 75 basis points.

Borrowers routinely try to negotiate MFN sunsets. While sunset provisions may appear in commitment letters, they are routinely flexed out. When borrowers do not obtain sunsets, they often ask for aggressive MFN carve-outs. Commonly requested carve-outs from MFN provisions are:

- Incremental debt maturing two years after the maturity of the term loans.
- Incremental term loans incurred under the free-and-clear tranche.
- Non-syndicated incremental loan facilities.
- Incremental term loans used to finance permitted acquisitions.
- A basket for certain incremental term loans above a specified amount.

In addition to discussions regarding MFN provisions, borrowers and sponsors are also requesting the ability to incur larger amounts of incremental debt, including leverage ratio-based permissions and, in some cases, limitations to incur unsecured debt based only on compliance with a fixed charge coverage ratio.

Traditionally, deleveraging from closing date leverage was a prerequisite for incurring incremental loans. Recently, however, borrowers have been allowed to go beyond closing date leverage for unsecured debt. In some transactions, if the incremental loan is incurred in connection with a limited condition acquisition, the borrower may incur incremental loans in an amount that does not cause the borrower's leverage ratio to be worse than on the closing date.

Also, in connection with permitted acquisitions, some borrowers are permitted to incur an unlimited amount of incremental debt so long as their leverage ratio after the acquisition is no worse than it was prior to the acquisition. Some transactions include "accretive prongs," which permit the borrower to incur incremental debt so long as, on a pro forma basis, the borrower's leverage level does not exceed the level as of the most recently ended fiscal quarter.

A new trend is the permission to incur unsecured incremental debt based on a fixed charge coverage test, which permits the borrower to incur the incremental debt even if the borrower's leverage exceeds closing date leverage. In the large cap market, pursuant to this exception, borrowers are permitted to incur unsecured or junior debt subject to a 2.0 to 1.0 fixed charge coverage ratio. In this scenario, lenders are not as concerned with the principal amount of additional unsecured debt, so long as interest coverage requirements are met.

Covenants

Discussions about covenants and covenant quality in many transactions have centered on:

- **Debt covenant exceptions.** A permission allows borrowers to incur debt up to either the amount of received equity contributions or a multiple thereof.
- **Restricted payments and investments exceptions.** A permission allows borrowers to make restricted payments and investments subject only to a ratio test with limited deleveraging, if any.
- **Unrestricted subsidiaries.** Over the last few years, a trend of applying more scrutiny to restricted and unrestricted subsidiaries has developed. After J. Crew Group, Inc. transferred its intellectual property to an unrestricted subsidiary, effectively relocating a significant asset that secured its original loan outside of the collateral package, lenders became more wary of unrestricted subsidiaries and the related permissions given to borrowers. Lenders are exploring dollar limits on asset transfers to unrestricted subsidiaries or conditioning these transfers on a leverage test. Also, lenders continue to require that unrestricted subsidiaries be single-purpose entities, regulated subsidiaries, or joint ventures that do not adversely affect the borrower's credit profile.
- **Financial covenants in cash flow revolvers.** Cash flow revolvers typically have springing financial covenants triggered by threshold revolver usage. There has been a continued relaxation of the threshold levels set in these covenants. While threshold levels are usually between 25% and 35% of the total revolving commitments, levels reportedly are now being set at between 35% and 40% of utilization (excluding letters of credit) before springing.

Retroactive Default Cures

In a limited number of large cap deals, borrowers and sponsors have negotiated the inclusion of retroactive default cures. A retroactive default cure allows the existence of a default to be rectified by a later action of a borrower. Therefore, the event of default no longer exists if the conditions that gave rise to the default are no longer continuing. Lenders and arrangers resist including these provisions. However, some lenders permit retroactive default cures subject to whether the borrower's officers had knowledge of the events surrounding the default. The consensus is that the cure cannot be exercised if the borrower intentionally breaches a covenant or if the default results in the loss of collateral. In addition, lenders prefer to have these cure provisions apply to specified defaults.

Required Consent for Amendments

Recently, consent requirements for certain amendments have narrowed. Typically, if an amendment requires the consent of lenders adversely affected by the amendment, then each adversely affected lender must consent to the proposed amendment, in addition to the required lenders. However, in some cases only the consent of the adversely affected lenders is required (removing required lender consent).

Large Cap Terms in the Middle Market

As in previous years, large cap terms and conditions are migrating to the middle market. Similar to large cap transactions, some middle market loan agreements permit certain investments and restricted payments so long as the borrower has accomplished a minimum amount of deleveraging. In other transactions, borrowers are allowed to use the "available amount" basket for investments, debt prepayments, and restricted payments. Some middle market credit agreements include unlimited baskets so long as leverage is within one or 1.5 turns of closing date leverage. Also, some middle market borrowers have successfully negotiated the inclusion of reclassification rights for their negative covenants baskets, allowing them to reclassify transactions or events permitted under a particular basket to another permission, thereby "reloading" the original basket.

A Look Ahead

Many market participants expect that in 2018 the loan market may continue to benefit from the momentum seen in 2017. CLO issuances and total syndicated lending were at record levels in 2017, which sets the stage for a successful start to the year.

The impact of US tax reform on corporations may be a significant driver of activity in 2018. Some market participants speculate that 2017 M&A loan volume was weighed down by uncertainty surrounding the proposed tax reform. With tax reform now settled, the certainty concerning tax implications may encourage greater M&A activity. Equally, however, certain financings could appear unattractive due to the limits on the deductibility of interest established by the newly enacted tax legislation. The law caps interest deductions at 30% of EBITDA and Moody's Investors Service predicts this limitation could harm some highly levered companies.

In 2018 it should become clear whether Congress and bank regulators can resolve the uncertainty surrounding the LLG and the impact of any replacement guidelines (or lack thereof) on the loan market. Some market participants believe that the GAO's determination will not affect the average leverage of loans in the market, and that the guidelines have already anchored banks as to acceptable leverage and creditworthiness of borrowers. Others predict that leverage levels may begin to rise again.

The market statistics cited in this article (unless otherwise stated) were provided by Thomson Reuters LPC.

An Expert's View: Janet Vance, Gibson, Dunn & Crutcher LLP

Janet examines current developments in commitment letter negotiations in her Expert's View, including this question:

What are currently the main areas of concern for borrowers and sponsors in commitment letter negotiations?

Borrowers and sponsors are intensely focused on preserving flexibility and positioning themselves to execute business plans and be opportunistic regarding future transactions. As a result, provisions that directly or indirectly restrict the ability to make acquisitions and other investments, execute IPOs, return money to shareholders through dividend recapitalizations, refinance debt to reduce the cost of capital, and engage in similar activities are hotly negotiated. Some specific examples include:

- **Call protection and repricing provisions.** Call protection and repricing provisions are frequently the focus of carve-out requests and demands, such as for an IPO or other change of control, transformative acquisitions, and amendments that lenders decline to approve.
- **Grower baskets.** Grower baskets are very popular. Borrowers and sponsors are now insisting on more aggressive metrics for basket growth, such as increases proportional to EBITDA or total asset growth. These baskets are frequently used for investments, distributions, or debt incurrence in connection with acquisitions.
- **Basket switches.** Multiplying the practical effect of the bloated baskets is the current concept of basket switches, which borrowers and sponsors are pursuing. This is the ability to reallocate covenant basket capacity among investment, junior debt payment, and restricted payment covenants as desired, allowing capacity to be aggregated and diverted to the area of need.
- **Future debt capacity expansion.** Future debt capacity, which is important to facilitate acquisitions, is an area of intense interest. Borrowers and sponsors are demanding expansions of permitted incremental debt facilities and ratio debt incurrences. Previously, deleveraging from closing date leverage was required. Now borrowers and sponsors are going beyond closing date leverage for unsecured debt and there is the addition of a leverage neutral prong, which permits unsecured or secured incurrences even when leverage is above the agreed level. The market is also testing the addition of a new prong for incurring unsecured debt based on a fixed charge test rather than leverage metrics. Borrowers and sponsors also seek to increase free-and-clear (that is, not subject to ratio tests) baskets of permitted incremental facilities.

An Expert's View: Jeong M. Lee, Davis Polk & Wardwell LLP

Jeong discusses developments in the large cap loan market in her Expert's View, including this question:

What were some of the areas of focus for borrowers in credit agreement negotiations in 2017?

Borrowers are intent on preserving as much flexibility within the capital structure as possible, which, outside of the sizing of baskets or incurrence ratios, can manifest itself in subtle ways. One example concerns limitations on the types of debt that are captured in the leverage ratios. First lien or total secured leverage ratios are often limited to debt secured by liens on collateral, so other secured debt (such as capital leases, purchase-money debt, or debt secured by assets of non-guarantors) is not captured when testing, and any such excluded debt outstanding at the time of the test would not impact capacity under the incurrence ratios.

Another example is the ability to disregard simultaneous transactions for purposes of testing incurrence ratios. Originally, this appeared in the incremental provisions to preserve the ability to incur the "freebie" simultaneously with (and in addition to) the incurrence ratio amount. Now we often see it applied to incurrence ratios more generally. The types of simultaneous incurrences that are disregarded can include, in addition to dollar-based baskets, debt under the revolving facility or other non-ratio based baskets generally. The borrower's rationale to support its position is that these other non-incurrence ratio based transactions could be incurred one day after the incurrence ratio based transactions, and any requirement to include them in the incurrence test is an artificial constraint.

An Expert's View: Peter J. Antoszyk, Proskauer Rose LLP

Peter reviews middle market loan trends in his Expert's View, including these questions:

What were the key developments in loan documentation that occurred in 2017?

During 2017, the competitiveness of the market continued, if not accelerated, the market inclusion of upper market terms in the traditional middle market. We have seen a general shift towards capital market or broadly syndicated market terms in private credit transactions in areas such as debt incurrence, permitted investments, available amount baskets, and restricted payments, and extension of refinancing, amend-and-extend, and Dutch auction provisions. Overall, these provisions (and others) provide sponsors with ever greater flexibility to relever the business, engage in a broad range of investment activities without lender involvement, realize a return on their equity investment while maintaining control, and manage their lender group during both good and bad times.

However, the firewall preventing the expansion of these concepts traditionally was a requirement that companies have annual EBITDA in excess of $50 million. Transactions for companies with EBITDA of less than $50 million did not incorporate these more "aggressive" terms. In 2017 we saw these terms move down market to deals with sub-$30 million EBITDA, particularly with upper-market sponsors and their deal counsel who have come to expect these terms in their deals.

Are there particular issues in loan agreement negotiations that you believe will garner increased attention in 2018?

There will be continued friction on the points mentioned above. In addition, we expect to see increased attention paid to credit party exclusions (for example, unrestricted subsidiaries and immaterial subsidiaries) and permitted transactions between and among restricted subsidiaries and unrestricted subsidiaries, particularly as a result of the J. Crew Group, Inc. case. We also expect to see increased attention to excess cash flow deductions, which have started to include not only reinvested cash, but also cash used for any acquisitions, investments, or virtually any other use. We have also seen on occasion traveling change of control provisions coming down market.

Finally, regulatory and tax code changes may generate new discussions. Regulatory changes pertaining to the availability of the new US participation exemption for controlled foreign corporations (CFCs) raise questions about the absolute prohibition on 100% equity pledges of CFCs under Section 956 of the Internal Revenue Code. These regulatory changes call into question whether there is a material tax impact of granting 100% equity pledges in foreign entities and may put these stock pledges in play. Additionally, limitations on the deductibility of interest on corporate debt may push alternative lenders to other structures, such as preferred equity structures.

For a complete copy of this article published on the Practical Law website on February 1, 2018 which also includes links to recent examples of loan agreements and full versions of the Expert Views, see Practice Note, What's Market: 2017 Year-End Trends in Large Cap and Middle Market Loan Terms, Practical Law, at http://us.practicallaw.tr.com/w-012-7520.

UCC Spotlight

By Carl S. Bjerre and Stephen L. Sepinuck

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

Queens Ballpark Co. v. Vysk Communications, 226 F. Supp. 3d 254 (S.D.N.Y. 2016)

This is a case from 2016 about baseball. Well, about baseball parks. Well, about advertising signs at baseball parks. In any event, it will soon be baseball season, and it therefore seems like an appropriate time to discuss this case.

Queens Ballpark Company operates Citi Field, the home of the New York Mets. It sold advertising space on the outfield fence and behind home plate to Vysk Communications for the period from April 2015 through December 2017, with payments to be made at various times during the term of the agreement. Almost immediately, Vysk failed to make payment when due. Queens Ballpark exercised its rights under the agreement to accelerate the payment obligations and terminate the agreement, and it sued Vysk for all unpaid amounts under the agreement. The court awarded summary judgment to Queens Ballpark on the issue of liability because there was no dispute about the validity of the agreement or the fact that Vysk had breached.

The court also awarded Queens Ballpark the entire amount of Vysk's accelerated payment obligations. This ruling may have been correct, but it was based on muddled reasoning. The court wrote:

> [T]hough generally the non-breaching party is "required to make a reasonable effort to mitigate its damages," if the contract includes an enforceable liquidated damages provision or acceleration clause, the non-breaching party has no duty to mitigate damages resulting from the breach. *See Int'l Fid. Ins. Co. v. Aulson Co.*, 2012 WL 6021130, at *7 (S.D.N.Y. 2012); *see also The Edward Andrews Grp., Inc. v. Addressing Servs. Co.*, 2005 WL 3215190, at *5 (S.D.N.Y. 2005) ("An acceleration clause is one type of liquidated damages provision, which ... requires a party who defaults on installment payments to pay the balance of the debt in one lump sum. Parties frequently agree to acceleration clauses, and New York courts typically enforce such provisions according to their terms.").

Packed into this passage are two correct statements but also two incorrect ones. First, of course it is generally correct that a non-breaching party is required to mitigate its damages. Stated more carefully, the non-breacher is never under an *obligation* to mitigate. Mitigation is, instead, a principle that limits damages: damages will not be awarded to the extent that they could reasonably have been mitigated. Second, it is correct that an enforceable liquidated damages clause obviates the need to mitigate. Several contract-law doctrines can impair a non-breacher's ability to recover its full damages, with mitigation, foreseeability, and reasonable certainty chief among them. A liquidated damages clause is the parties' way of dealing with these doctrines; it provides clarity and advance notice of the consequences of breach. To be enforceable, a liquidated damages clause must be a reasonable estimate that takes those limiting principles into account. It would therefore be inappropriate to use any of those principles to reduce the amount of damages called for by the clause.

Turning to the court's first incorrect statement, an acceleration clause is not "one type of liquidated damages clause." The point of an acceleration clause is to override a condition: the passage of time. Monetary obligations originally conditioned on the passage of time are, upon acceleration, no longer subject to that condition. But such monetary obligations – including the ones in this case – are also already readily calculable, and thus need not be "liquidated." Put another way, an acceleration clause is not designed to deal with contract doctrines that limit damages, such as mitigation, forseeability, and reasonable certainty; it is instead designed to accelerate the breach with respect to future payment obligations and thereby obviate the need for multiple lawsuits.

Second, it is incorrect that the non-breacher is freed from its usual duty to mitigate damages, merely because the amounts due under the contract have been accelerated. Suppose (as seems likely, though Vysk failed to establish it) that Vysk's breach freed up an opportunity for Queens Ballpark to profitably resell its advertising space to a third party; if so, then to avoid vastly overcompensating Queens Ballpark, its profits available from that resale transaction should be applied to reduce of the accelerated sum owing by Vysk. By contrast, nothing in the *Edward Andrews* decision cited by the *Queens Ballpark* court involved mitigation. Indeed, there was nothing to mitigate. The plaintiff in that case – a consultant suing to collect agreed-upon compensation for bringing the defendant into a joint venture with a third party – had already provided all the consultation services that the contract required. *Cf. Arbitron, Inc. v. 3 Cities, Inc.*, 438 F. Supp. 2d 216 (S.D.N.Y. 2006) (refusing to follow *Edward Andrews* because there was a dispute about whether the plaintiff had performed all of its obligations to the defendant).

The court's error is easily illustrated by analogizing to a lease of goods. Under Article 2A, a lessor that, after the lessee's default, is able to recover the leased goods, is normally entitled to recover accrued unpaid rent plus the present value of the unpaid future rent *minus the present value of market rent for the remainder of the lease term*. *See* U.C.C. §§ 2A-528(1). *See also* U.C.C. § 2A-527(2) (reducing damages by the amount due under a substitute lease). Thus, Article 2A incorporates a mitigation principle into the measure of damages for breach of a lease even though it also accelerates the obligation to pay rent. Simply put, acceleration does not free the non-breacher from mitigation. The same is and should be true with respect to a lease of advertising space.

This case might have been one of the few wins for the Mets in 2016, but the court's analysis is poorly reasoned and the decision should not be followed.

In re Delano Retail Partners, LLC,
2017 WL 3500391 (Bankr. E.D. Cal. 2017)

The issue in this case was whether a security interest attached to four different "buckets" of money totaling slightly more than $1 million. The court ruled against the secured party with respect to each bucket but its analysis was seriously flawed with respect to two of them.

The facts, somewhat simplified, were as follows. C & S Wholesale Grocers, Inc. loaned the debtor $2 million, and to secure the debt received a perfected security interest in the debtor's inventory, equipment, leases, chattel paper, deposit accounts, and other assets. Of interest here, after the debtor sought bankruptcy protection, C & S and the trustee disputed whether the security interest had attached to the following two "buckets" of funds: (a) proceeds of inventory that the debtor had transferred to its lawyer, which were held in the lawyer's client trust account and then turned over to the trustee; and (b) funds collected postpetition on a prepetition lease of equipment to related entities.

With respect to the inventory proceeds that went into and then out of the lawyer's client trust account, the court relied on two different theories to conclude that C&S did not have an interest in them. First (although discussed second in the court's decision), the lawyer's client trust account contained funds from other sources and held for the benefit of other clients – that is, the inventory proceeds were commingled with funds that were clearly not collateral – and from this the court concluded that any security interest C & S had in the funds was unperfected because the funds were not "identifiable" cash proceeds of the inventory within the meaning of U.C.C. § 9-315(d)(2). Because there was no control agreement, any the security interest in the funds as original collateral was also not perfected. Accordingly, the trustee's strong-arm powers would enable the trustee to avoid C & S's security interest. *In re Delano Retail Partners, LLC*, 2017 WL 3500391 (Bankr. E.D. Cal. 2017) at *9-10. This analysis relies on a rather miserly view of what it takes to identify proceeds, and indeed the sparse facts related by the court would seem to support a tracing claim by C & S under the lowest intermediate balance rule and § 9-315(b)(2). Still, the analysis is not fundamentally unsound.

Second and indefensibly, the court concluded that the trustee took free of C & S's security interest under § 9-332. In other words, even if the funds were encumbered while credited to the lawyer's client trust account, when the lawyer turned the funds over to the trustee postpetition, the trustee took the funds free of the security interest. *Id.* at *8. In reaching this conclusion, the court relied on what is undoubtedly the worst UCC decision from 2016: *Stierwalt v. Associated Third Party Administrators*, 2016 WL 2996936 (N.D. Cal. 2016), a decision heavily criticized both in this column and in the annual survey of commercial law published in *The Business Lawyer*. If this conclusion were correct, then any secured creditor with a perfected security interest in accounts, chattel paper, instruments, payment intangibles, or any other receivable would stand to lose its collateral if and to the extent payment is made postpetition to the trustee or debtor in possession. That is absurd. Such a rule would force secured parties in almost every bankruptcy to immediately seek adequate protection to prevent such a result.

But the court's analysis was even worse with respect to the post-petition payments on the prepetition lease of equipment. The court began by noting that the trustee is a separate legal entity from the prepetition debtor. From this undeniable but irrelevant observation the court wrote:

> stripping the lease payments from the Asset Lease and paying them directly to the estate . . . made the payment stream a new and distinct postpetition intangible that did not exist prepetition when the payment stream remained with the Asset Lease, i.e., was paid to DRP. Second, as a newly-created postpetition payment intangible that did not exist prepetition, the Asset Lease payment stream was not (and could not have been) encumbered by C & S's prepetition security interest. *See* U.C.C. § 552(a).

In re Delano Retail Partners, LLC, 2017 WL 3500391 (Bankr. E.D. Cal. 2017) at *11. The court cited to *In re Commercial Money Center, Inc.*, 2007 WL 7144803 (Bankr. S.D. Cal. 2007), for support.

It is hard not to become apoplectic in trying to decipher the court's thinking. First of all, in 2010 the comments to Article 9 were amended to expressly disapprove of the ruling in *Commercial Money Center* that payment rights stripped from chattel paper are payment intangibles rather than chattel paper. *See* U.C.C. § 9-102 cmt. 5d. Thus, the court was relying on bad law. Second, there was no "stripping" of the payment rights. The debtor had not assigned the right to payment to anyone. All that had happened was that the account debtor had paid. Thus, the facts are distinguishable from those in *Commercial Money Center*. Third, and most important, even if after the petition was filed the right to payment did change classification from chattel paper to a payment intangible, it was not a "newly-created" right, merely a reclassified right. Thus, the right to payment was not acquired post-petition, and thus the security interest in it was not cut off by § 552(a). Instead, the right to payment existed prepetition, the payment was proceeds of the right, *see* U.C.C. § 9-102(a)(64)(B), and the security interest attached to it. *See* U.C.C. § 552(b).

The court's analysis, if followed, would suggest that any post-petition payment on a prepetition receivable subject to a perfected security interest would in fact be after-acquired collateral, to which the security interest is cut off by § 552(a). There is no support for such a conclusion in the case law, in the Bankruptcy Code, or in the UCC.

Focarino v. Travelers Personal Insurance Co.
2017 WL 1456967 (N.J. Super. 2016)

The facts of this case exemplify a form of misbehavior by used car dealers that prospective buyers are often warned about. Focarino bought a car from Emporio Motor Group, LLC, which in turn had bought the car from Martin. Martin had owned the car subject to a security interest in favor of Toyota Motor Credit Corporation (TMCC), and the deal between Martin and Emporio had included a promise by Emporio to pay off TMCC. But Emporio never paid TMCC after all. The result is an unfortunate but simple secured party versus buyer issue – with one small twist: when Martin found out that Emporio hadn't paid TMCC, Martin filed a theft claim with his insurer, and the insurer paid TMCC. Hence the case deals with rights of the Martin's insurer versus the buyer, Focarino.

A buyer in the ordinary course of business, as Focarino seems to have been, would have taken free of a security interest created by Emporio, because Emporio is "the buyer's seller" under U.C.C. § 9-320(a). But the security interest at issue here had been created by Martin – "the buyer's seller's seller," we might say. Upstream property rights such as these are a hazard that buyers like Focarino must simply risk taking subject to, under § 9-201(a). *See* § 9-320 cmt. 3, ex. 1. (If Focarino had insisted on getting the certificate of title at the time of purchase, he might have avoided this problem, but in this case he did not.)

Nonetheless the court here held for Focarino over the insurer, invoking U.C.C. § 2-403(1) and misapplying it. The court thought that Emporio had voidable title, and that Emporio could thereby transfer good title to someone like Focarino, who was a good faith purchaser for value. One error here, though ultimately a harmless one, was in assuming that Emporio's title was voidable in the first place. All we really know from the opinion is that Emporio breached its promise to Martin. But this alone would not have justified Martin in avoiding or rescinding the sale to Emporio; rather it would simply give Martin an action in personam against Emporio. The story would change if we knew that Emporio had made its promise to Martin without any intention of carrying out the promise. In that light Emporio's title could be voidable on the grounds of promissory fraud.

The court's second and more substantial error was in thinking that § 2-403(1)'s reference to "good title" meant that Focarino took free of TMCC's (and, later, the insurer's) security interest. In fact, in this context good title does not mean freedom from encumbrances; it simply means freedom from vulnerability to avoidance (e.g., based on fraud between the buyer's seller (here Emporio) and the upstream seller (here Martin)). Section 2-403(1) does not change the fact that Martin had conveyed property rights in the car to TMCC, and without intervention from § 9-320(a) or some other take-free rule, § 9-201(a) and the idea of derivative title subject Focarino to those property rights (though they are now the insurer's rather than the secured party's, due to the principle of subrogation). To be sure, Focarino has a cause of action against Emporio under § 2-312(1)(b) for breach of the implied warranty of title; but a mere cause of action is slight comfort compared to the unencumbered ownership for which Focarino bargained. Used car buyers, beware.

In re National Truck Funding LLC,
2018 WL 543005 (Bankr. S.D. Miss. 2018)

This is a relatively simple case about perfection of a security interest in proceeds of the original collateral. Unfortunately, the court treated second-generation proceeds as first-generation proceeds, with the result that it did not consider all the relevant facts and might have reached an incorrect result.

The debtor owned a fleet of commercial trucks that it leased on a weekly basis to independent truck drivers. Several lenders had security interests in the trucks (presumably, each lender had a security interest in different trucks, but that is not important to the analysis). None of the lenders had filed a financing statement but the court assumed, given the posture of the case, that they had perfected their security interests through compliance with the applicable certificate of title statute.

The issue was whether the lenders' security interests in the payments that the debtor received pursuant to the truck leases were perfected. The rules applicable to that issue are fairly simple. A security interest that attaches to identifiable proceeds is automatically perfected if the security interest in the original collateral is perfected. U.C.C. § 9-315(c). However, the security interest in the proceeds becomes unperfected 21 days after it attaches unless one of the following exceptions applies:

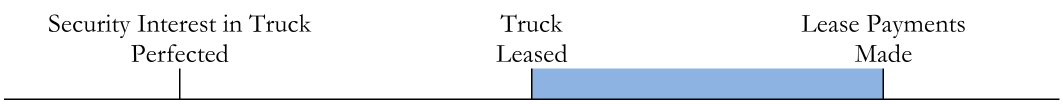
> (1) a filed financing statement covers the original collateral, the proceeds are collateral in which a security interest may be perfected by filing in the office in which the financing statement has been filed, and the proceeds are not acquired with cash proceeds;
> (2) the proceeds are identifiable cash proceeds; or
> (3) before or within the 20 days after the security interest attached, the secured party has done whatever is necessary to perfect the security interest in the property irrespective of the fact that the property is proceeds.

U.C.C. § 9-315(d).

The court correctly concluded that the payments the debtor received are cash proceeds, albeit indirectly, of the trucks. However, the court incorrectly jumped from that premise to the conclusion that the security interest in the payments was perfected under § 9--315(d)(2).

In fairness to the court, its failure to recognize the timing issue might have resulted partly from the close attention that it paid to PEB Commentary No. 9. That Commentary, issued under old Article 9, added an Official Comment explaining that, "[w]here a debtor has granted to a secured party a security interest in goods and the debtor later leases those goods as lessor, the lease rentals constitute proceeds of the secured party's collateral consisting of the goods." However, the Commentary focused solely on the definition of "proceeds" and to what property a security interest attaches, without discussing at all the difference between first- and second-generation proceeds and how the distinction between them can affect perfection. *See* U.C.C. § 9-315(d)(1). This might have caused the court to lose sight of the perfection issue.

In fact, whether the security interest in the payments is perfected depends on how long after the creation of the leases the payments were made (*i.e.*, the length of the shaded area in the time line below).



When each truck was leased, the lease itself was chattel paper proceeds of the truck. The security interest attached to the lease under § 9-315(a)(2) and was initially perfected under § 9-315(c). When payments were made under the lease, the security interest attached to the payments under § 9-315(a)(2), assuming the payments were identifiable to the lease. If payment under the lease was made while the security interest in the lease was still perfected, then the security interest in the payment would be perfected under § 9-315(c) and remain perfected under § 9-315(d)(2) because the payment was cash proceeds of the lease (chattel paper). If, however, payment under the lease was made after the security interest in the lease had become unperfected, the security interest in the payment would never be perfected under § 9-315(c), and the fact that the payment is cash proceeds would be irrelevant.

If the lenders had filed proper financing statements covering chattel paper, then their security interests in the leases would have remained perfected under § 9-315(d)(3), and their security interests in the payments under the leases would have been perfected. However, because they did not file financing statements, the leases themselves are not cash proceeds, and the lenders evidently did not take possession of the leases, their security interests in each lease became unperfected 21 days after they attached. *See* U.C.C. § 9-315(d). The court did not discuss whether the payments under each lease were made within 20 days after the creation of the lease, because the court did not recognize the issue – a potentially crucial error.

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