UNIFORM COMMERCIAL CODE COMMITTEE

REPORT PREPARED FOR THE MARCH 10, 2011 COUNCIL MEETING

1. **Next Scheduled Meeting of the Committee.**

   Next scheduled meeting of the Committee: None has been scheduled yet.

2. **Council Approval.**

   No matters require Council approval.

3. **Membership.**

   On November 23, 2010 and February 3, 2011, the attached communications were sent to all Committee members.

4. **Accomplishments Toward Committee Objectives.**

   I will continue to monitor current developments in Michigan law relevant to the UCC and report on those developments to Committee members.

5. **Meetings and Programs.**

   Nothing to report at this time.

6. **Publications.**

   An article authored by me addressing the ambiguities in the Michigan tooling lien acts and a request for legislative reform was published in the November 2010 issue of the *Michigan Bar Journal* in a special-themed, UCC issue.

7. **Methods of Monitoring Legislative/Judicial/Administrative Developments and Recommended Action.**

   See response to #4 above.

8. Miscellaneous.

Nothing to report at this time.

Respectfully submitted,

Patrick E. Mears, Chairperson

Ledezma, Martha

From: Ledezma, Martha
Sent: Tuesday, November 23, 2010 4:41 PM
To: Mears, Patrick
Subject: UCC Committee Memo - 11-23-10
Attachments: UCC Committee Memo - 11-23-10.pdf; National City v Syatt Realty.pdf; International-Matex v Chemical Bank.pdf; Commercial Law Newsletter.pdf

Per Mr. Mears, please see the attached Memorandum and attachments.

BARNES & THORNBURG LLP

MEMORANDUM

TO: All Members of the UCC Committee

FROM: Patrick E. Mears

DATE: November 23, 2010

To All: I am transmitting to you copies of the following:

1. *National City Bank v. Syatt Realty Group, Inc.*, 2010 WL 456814 (E.D.Mich. Feb.4, 2010)(Steeh, J.). In this bank fraud action, this decision addresses (almost as an aside) the negotiability of a promissory note executed by one of the defendants and the legal consequences of a determination of negotiability by the court.

2. *International-Matex Tank Terminals-Illinois v. Chemical Bank,* 2010 WL 2219396 (W.D.Mich. April 29, 2010)(Scoville, M.J.). This report and recommendation on damages authored by Magistrate Judge Joseph G. Scoville, involved an action under UCC 5-111 by a beneficiary against an issuing bank to recover for wrongful dishonor of requested draws on a letter of credit. Central to Judge Scoville's findings on damages is a determination, contained in Official Comment 1 to this UCC section, that a beneficiary of a letter of credit has no duty to mitigate its damages. If, however, the mitigation occurs, then the amount of damages avoided by the mitigation must be applied against the amount otherwise recoverable by the beneficiary from the issuer.

3. *The Fall 2010 Issue of the Commercial Law Newsletter published by the ABA Commercial Finance and Uniform Commercial Code Committees.* This issue contains (i) a summary of the 2010 Amendments to UCC Article 9 authored by Ed Smith; (ii) a case update on forbearance agreements and workouts, as well as other articles.

Patrick E. Mears

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Only the Westlaw citation is currently available.

United States District Court,
E.D. Michigan,
Southern Division.
NATIONAL CITY BANK, Plaintiff/
Counter-Defendant,
v.
SYATT REALTY GROUP, INC.; Fairfield & Banks Real Estate Group; LLC, Fairfield & Banks Fund Manager, LLC; Lisa Wright; Glen Wright; and Delbert Saulter, Defendants,
and
Glen Wright, Counter-Plaintiff,
and
Glen Wright, Cross-Plaintiff,
v.
Syatt Realty Group, INC.; Fairfield & Banks Real Estate Group, LLC .; Lisa Wright; and Delbert Saulter, Cross-Defendants.
No. 07-CV-12438.

Feb. 4, 2010.

West KeySummary

Fraud 184 ⟹27

184 Fraud
184I Deception Constituting Fraud, and Liability Therefor
184k27 k. Fraudulent Representations or Concealment as to Particular Facts. Most Cited
A lender sufficiently stated a fraudulent misrepresentation claim under Michigan law against a borrower. The lender alleged that the borrower submitted falsified financial information, including fraudulent tax returns and a forged appraisal to the lender, and that the lender relied on the representations, which were material to its decision to lend money to the borrower.

Jennifer Kate Alward Green, Jordan S. Bolton, William G. Asimakis, Jr., Clark Hill, Detroit, MI, for Plaintiff/Counter-Defendant.

David S. Senawi, Hyman Lippitt, H. Joel Newman, Norman L. Lippitt, Birmingham, MI, for Counter-Plaintiff.

Jennifer Kate Alward Green, Clark Hill, Detroit, MI, for Cross-Defendants.

ORDER DENYING DEFENDANT GLEN WRIGHT'S MOTION FOR SUMMARY JUDGMENT AGAINST PLAINTIFF NATIONAL CITY [DOC. 99], DENYING WRIGHT'S MOTION FOR PARTIAL SUMMARY JUDGMENT ON BREACH OF THE PROMISSORY NOTE [DOC. 108] AND GRANTING NATIONAL CITY'S MOTION FOR PARTIAL SUMMARY JUDGMENT ON BREACH OF THE PROMISSORY NOTE [DOC. 109]

GEORGE CARAM STEEH, District Judge.

*1 This case arises out of a loan transaction involving plaintiff National City Bank on one side and defendants Glen Wright, Lisa Wright, Delbert Saulter, and their corporate entities, Syatt Realty Group, Fairfield & Banks Real Estate Group, and Fairfield & Banks Fund manager LLC on the other side. The matter is presently before the court on defendant Glen Wright's motion for summary judgment against National City Bank and cross motions for summary judgment on breach of the promissory note filed by National City and Wright.

FACTUAL BACKGROUND

Glen Wright is a self-employed financial planner who splits his time between Tennessee and Detroit. In 2004, Mr. Wright reconnected with his cousin Lisa Wright at a family function, and they discussed doing business together. Mr. Wright and his

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business partner owned Winfrey & Wright Financial Services in Tennessee, while Lisa and her business partner Delbert Saulter owned Syatt Realty Group in Southfield, Michigan. Wright opened a Michigan office for Winfrey & Wright, and informally rented space from Syatt. Winfrey & Wright was eventually dissolved. Wright formed a new financial services company in Michigan called Worth Financial in January 2006. Worth Financial continued to share office space with Syatt until December, 2006.

Wright admits that in 2005, he, Lisa and Saulter began discussing various real estate investment options. (Wright dep., 88-89). Saulter testified that the three of them decided to form a real estate investment trust ("REIT") called Fairfield & Banks. Lisa and Saulter both testified that Wright was a partner in Fairfield & Banks. (Lisa Wright dep., 63-64, 68-70; Delbert Saulter dep., 56-59). Lisa explained that Wright, as a Certified Financial Planner, would find investors, and in return they would pay him a commission. (Lisa Wright dep., 107-08). Wright is listed on Fairfield & Banks' offering memorandum as its financial advisor. Wright solicited clients to invest in the real estate trust, including Dr. Jaunita Buford, who invested $50,000 in Fairfield & Banks. (Wright dep., 200-203).

In February 2005, Wright and Lisa bought a house together, known as the Avon Property. Syatt brokered the mortgage deal, and they used Wright's financial information to borrow the money to buy the Avon Property. Wright gave Lisa power of attorney to sign all of the documents on his behalf at the closing. (Wright dep., 62). The Avon property was renovated and sold, and Wright made a profit of $5,000 on the deal.

In June 2005, Saulter learned about a distressed sale opportunity and pitched the idea to Lisa and Wright of buying the Webber Property and selling it quickly for a profit. (Lisa Wright dep., 162-66). The three agreed to use Wright's credit profile and financial information because it was stronger than Lisa and Saulter's (Saulter dep., 58-62), but all three of them were involved in the Webber Property transaction. (Saulter dep., 78; Lisa Wright dep., 168-70). The proceeds from the deal would be used to fund Fairfield & Banks. (Saulter dep., 56, 61-62).

*2 On June 30, 2005, a Personal Financial Statement for Glen Wright, signed by Glen Wright, was submitted to National City Bank. The statement contained false information, including listing Wright's income as $650,000, when it was really $250,000. (Wright dep., 104). Saulter testified that Wright was present when a fraudulent appraisal for the Webber Property was submitted to National City. (Saulter dep., 77).

Mark Clark was the Vice President of the Private Client Group at National City's Birmingham, Michigan location. Clark was a private banker, who worked with high profile bank customers. While employed at National City, Clark allegedly participated in several fraudulent loan transactions, which caused him to be sued directly by National City and several customers. Clark testified that he met with Wright, Lisa and Saulter in person prior to the loan closing on the Webber Property. Clark understood the three to be business partners doing real estate investment deals together. (Clark dep. 9-21-2009, 38-43).

Wright testified that he signed blank loan documents, given to him by Lisa, which he believed were part of the application process. (Wright dep. 119, 123, 128, 143-44). Wright initially testified that he did not fill out the forms, they were not in his handwriting, and the initials and signature did not look like his. After reviewing the documents, he testified that the signature on each of the loan documents was his. Wright then explained that when he signed the documents they were blank and he only had the signature pages in front of him. (Wright dep., 129-39).

The documents which admittedly contained Wright's signature included: the Fixed Rate Consumer Note and Security, the Future Advance Mort-

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gage, the Good Faith Estimate of Closing Costs, the Settlement Statement, the Servicing Disclosure Statement, and the Notice of the Right to Cancel. (Wright dep., 129-39). Wright testified he is familiar with the lending process, from the taking of applications to closing a loan, and he would not expect to see a promissory note, a mortgage, and a good faith estimate as part of the application process. (Wright dep., 33-36, 127-28, 135-36).

Geoff Jakiel, National City's manager of underwriting, testified that there is no way to obtain blank loan documents at a local National City branch, because loan documents are created in Cleveland, Ohio. (Jakiel dep., 53-54). Therefore, the only type of document Wright could have signed "in blank" was an initial loan application.

Clark testified that his role in the application process was to submit the loan package to the underwriting department for approval. Clark submitted Wright's loan application to Geoff Jakiel. Jakiel testified that Wright's loan approval was subject to two conditions: (1) that the bank take a second lien on the Webber Property, and (2) that the first mortgage on the property not be greater than $293,000 .00. (Jakiel dep. 22-23; Officer Approval Memo, NC 084). Jakiel granted this conditional approval and sent the loan package back to Clark to follow up on the conditions. Clark testified that he did nothing further other than to distribute the money as directed by Wright. (Wright dep. 83-84). The Title Commitment on the Webber Property shows a first mortgage in the amount of $655,000.00.

*3 The loan documents are dated August 2, 2005, and were notarized by Clark on August 9, 2009. According to Clark's affidavit:

> [with] regard to Glen E. Wright II, I never personally witnessed Mr. Wright sign any of the documents which are part of the loan at issue in this matter, including but not limited to the page attached to this affidavit as Exhibit A ... I have no personal knowledge of Mr. Wright having been present at the bank for a closing or for the signing of these documents ... The notary signature and information appearing on these documents are mine.

(Clark Aff. ¶ 5, 7, 8). Clark testified in his deposition that he "does not remember the loan" or whether Wright was present at the bank. (Clark dep. 65).

Wright claims he was not in Michigan to attend the closing, but Clark's secretary, National City Bank employee Aderenne Williams-English, saw a person she assumed to be Wright at the closing. She made a copy of Wright's driver's license for identity verification purposes. (Williams-English dep., 68-76).

Williams-English testified that Clark instructed her to prepare three checks on the Settlement Statement as follows: (1) $350,000 to Syatt Realty, (2) $130,000 to Fairfield & Banks, (3) $20,000 to Glen Wright. The checks are dated August 8, 2005. The same day the $130,000 was deposited into Fairfield & Banks' account from the Webber Property loan, $53,000 was withdrawn and used to pay back disgruntled Fairfield & Banks' investor, Dr. Juanita Buford. Wright was responsible for getting Dr. Buford to invest in Fairfield & Banks in the first place.

Wright acknowledges he received a National City check for $20,000 from Lisa, but he was told by Lisa that it was a commission check from the "Avon Property" deal. Wright claims he was told by Saulter that the loan application for the Webber Property had not been approved. (Wright dep. 123-24). Wright also claims that he did not discover that National City had processed the loan until 2006, when he applied for a Southwest Airlines credit card.

Exhibit Q to National City's response to Wright's motion for summary judgment is a Uniform Residential Loan Application. The application is for a loan of $50,000 for property located at 4605 Sundown Lane, in Memphis, Tennessee. The borrower

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is Glen Wright, and the application is dated February 28, 2006, approximately six months after the National City loan closed. In the liabilities section of the application, the National City loan is listed as having an unpaid balance of $505,955, and a monthly payment of $2,957. The schedule of real estate owned includes only one property-53 Webber Place-with a mortgage listed as $506,000, and a mortgage payment of $2,957. The application is signed by Glen Wright, and each page is initialed by Wright.

It is Wright's theory that Clark abused his position at National City by authorizing disbursement of a loan that was never approved by the bank, and distributing the loan proceeds directly to Syatt and Fairfield & Banks, who were not parties to the loan documents. Lisa notarized a Quit Claim Deed to the Webber Property and recorded it on August 16, 2005. Lisa and Saulter paid Clark $55,000 out of their company, Valulist, for what Wright claims was a kick-back to Clark from the loan proceeds relating to the Webber Property.

*4 National City Bank filed this lawsuit against Syatt Realty, Fairfield & Banks Real Estate Group, Fairfield & Banks Fund Manager, Lisa Wright, Glen Wright and Delbert Saulter. Count One alleges bank fraud by intentional or innocent misrepresentation by Glen Wright. National City alleges that Wright made false representations regarding his level of income and his ownership of the "Webber Place Property" in order to induce National City to enter into the loan transaction. Counts Two and Three are based on the allegation that National City mistakenly paid $40,000 to Syatt, which was received by Syatt, Fairfield & Banks, Lisa Wright and Delbert Saulter. This allegation arises from a loan involving non-party Keith McKenzie, and does not involve Glen Wright. Count Four alleges unjust enrichment against all defendants in the amount of $540,000. Count Five alleges civil conspiracy against all defendants. Count Six alleges breach of promissory note against Glen Wright.

Glen Wright filed a counterclaim against National City Bank alleging a violation of the Fair Credit Reporting Act, 15 U.S.C. § 1681 et seq., and negligence in reviewing and approving the loan to him. Wright also filed a cross claim against the other defendants, alleging fraud in falsifying documents to represent that Wright was applying for a loan with National City Bank. Wright seeks additional damages to his reputation and credit report arising out of defendants' actions.

Wright filed a motion for summary judgment against National City Bank, arguing that he should prevail on the claims stated against him, including fraudulent/innocent misrepresentation, unjust enrichment, and civil conspiracy. Wright and National City Bank filed cross-motions for summary judgment on National City's claim of breach of promissory note. This court heard oral argument on the motions on January 13, 2010.

On December 21, 2009, clerks entry of default was entered against Fairfield & Banks, Syatt Realty, Lisa Wright and Delbert Saulter upon the motion of National City Bank.

STANDARD FOR SUMMARY JUDGMENT

Federal Rule of Civil Procedure 56(c) empowers the court to render summary judgment "forthwith if the pleadings, depositions, answers to interrogatories and admissions on file, together with the affidavits, if any, show that there is no genuine issue as to any material fact and that the moving party is entitled to judgment as a matter of law." *See Redding v. St. Eward,* 241 F.3d 530, 532 (6th Cir.2001). The Supreme Court has affirmed the court's use of summary judgment as an integral part of the fair and efficient administration of justice. The procedure is not a disfavored procedural shortcut. *Celotex Corp. v. Catrett,* 477 U.S. 317, 327, 106 S.Ct. 2548, 91 L.Ed.2d 265 (1986); *see also Cox v. Kentucky Dept. of Transp.,* 53 F.3d 146, 149 (6th Cir.1995).

The standard for determining whether summary judgment is appropriate is " 'whether the evidence

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presents a sufficient disagreement to require submission to a jury or whether it is so one-sided that one party must prevail as a matter of law.' " *Amway Distributors Benefits Ass'n v. Northfield Ins. Co.*, 323 F.3d 386, 390 (6th Cir.2003) (quoting *Anderson v. Liberty Lobby, Inc.*, 477 U.S. 242, 251-52, 106 S.Ct. 2505, 91 L.Ed.2d 202 (1986)). The evidence and all reasonable inferences must be construed in the light most favorable to the non-moving party. *Matsushita Elec. Indus. Co., Ltd. v. Zenith Radio Corp.*, 475 U.S. 574, 587, 106 S.Ct. 1348, 89 L.Ed.2d 538 (1986); *Redding*, 241 F.3d at 532 (6th Cir.2001). "[T]he mere existence of *some* alleged factual dispute between the parties will not defeat an otherwise properly supported motion for summary judgment; the requirement is that there be no *genuine* issue of *material* fact." *Anderson v. Liberty Lobby, Inc.*, 477 U.S. 242, 247-48, 106 S.Ct. 2505, 91 L.Ed.2d 202 (1986) (emphasis in original); *see also National Satellite Sports, Inc. v. Eliadis, Inc.*, 253 F.3d 900, 907 (6th Cir.2001).

*5 If the movant establishes by use of the material specified in Rule 56(c) that there is no genuine issue of material fact and that it is entitled to judgment as a matter of law, the opposing party must come forward with "specific facts showing that there is a genuine issue for trial." *First Nat'l Bank v. Cities Serv. Co.*, 391 U.S. 253, 270, 88 S.Ct. 1575, 20 L.Ed.2d 569 (1968); *see also McLean v. 988011 Ontario, Ltd.*, 224 F.3d 797, 800 (6th Cir.2000). Mere allegations or denials in the non-movant's pleadings will not meet this burden, nor will a mere scintilla of evidence supporting the non-moving party. *Anderson*, 477 U.S. at 248, 252. Rather, there must be evidence on which a jury could reasonably find for the nonmovant. *McLean*, 224 F.3d at 800 (citing *Anderson*, 477 U.S. at 252).

ANALYSIS

I. *Fraudulent/Innocent Misrepresentation*

To establish a claim of fraudulent misrepresentation, a plaintiff is required to prove that (1) defendant made a material representation; (2) the representation was false; (3) defendant knew, or should have known, that the representation was false when making it; (4) defendant made the representation with the intent that plaintiff rely on it; (5) plaintiff acted on the representation; and (6) plaintiff incurred damages as a result. *Foreman v. Foreman*, 266 Mich.App. 132, 701 N.W.2d 167 (2005).

To establish a claim for innocent misrepresentation, the following elements must be shown: (1) the misrepresentation was made by one party to another in a transaction between them, i.e., privity of contract; (2) the misrepresentation must have been false in fact, but the misrepresenting party does not have to know that the statement was false when it was made; (3) the misrepresentation must actually deceive the other party and they must rely on it, but the misrepresentation does not need to have been made with the intent to deceive; and (4) the injury suffered by the victim must inure to the benefit of the misrepresenter. *United States Fidelity & Guaranty Co. v. Black*, 412 Mich. 99, 116-19, 313 N.W.2d 77 (1981). Unlike with fraud, with innocent misrepresentation "it is unnecessary to prove separately that the representer intended that the victim rely on the misrepresentation, because the representation must be made 'in a transaction between them,' where the misrepresenter should realize the misrepresentation would be relied upon." *Id.* at 118-19, 313 N.W.2d 77.

It is undisputed that falsified financial information, including fraudulent tax returns and a forged appraisal, was submitted to National City. Wright acknowledged that this sort of information is material to a bank when determining whether to lend money. (Wright dep., 33-35). National City relied on the representations that Wright had the financial wherewithal to make the loan payments each month, and it also relied on the property appraisal in lending $500,000 against the Webber Property. Because the parties are in privity of contract, the reliance and intent elements are unnecessary. National City can

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recover based solely on the giving of misinformation, whether or not it was done fraudulently.

*6 Wright maintains that National City could not have relied on any of his representations because the loan was only conditionally approved, and the conditions were not met. Wright attacks National City's internal protocol, and argues that the breach of protocol somehow breaks the chain which would make him responsible for the misrepresentations. Specifically, Wright would have the court conclude that the loan was not approved by National City. As described by Geoff Jakiel, the loan approval was subject to two conditions, one of which that the first mortgage on the Webber Property not be greater than $293,000. The Title Commitment shows that the Webber Property had a first mortgage in the amount of $655,000, so National City was not supposed to approve the loan.

Wright's argument fails because the documents he submitted to National City as part of a loan transaction, which bear his signature and contain false information, were relied on by National City in approving the loan. The fact that National City's internal conditions were not met is of no import. National City has the sole authority to waive its internal conditions if it so desired. As a party to the transaction, Wright is assumed to have known that National City would rely on his representations. The bottom line is that a fully-executed loan document exists, National City disbursed $500,000 in accordance with the loan documents, and Wright accepted a portion of the loan proceeds directly (and indirectly accepted the remainder of the loan proceeds through business entitles in which he was a part- ner).

The court denies Wright's motion for summary judgment on fraudulent and innocent misrepresentation.

II. *Unjust Enrichment*

National City pled unjust enrichment in the alternative, if there is an infirmity in the loan agreement.

The essential elements of an unjust enrichment claim are: "(1) receipt of a benefit by the defendant from the plaintiff and (2) an inequity resulting to [the] plaintiff because of the retention of the benefit by defendant." *Barber v. SMH, Inc.,* 202 Mich.App. 366, 375, 509 N.W.2d 791 (1993). "In such instances, the law operates to imply a contract in order to prevent unjust enrichment." *Id.* "However, a contract will be implied only if there is no express contract covering the same subject matter." *Id.*

In this case there is an express contract governing the subject matter-the Webber Property loan transaction documents, including the promissory note. Therefore, the court need not address National City's unjust enrichment claim further.

III. *Civil Conspiracy*

The elements of a cause of action for civil conspiracy in Michigan are (1) a concerted action (2) by a combination of two or more persons (3) to accomplish an unlawful purpose or a lawful purpose by criminal or unlawful means (4) causing damage to the plaintiff. *Fenestra, Inc. v. Gulf Am. Land Corp.,* 377 Mich. 565, 593, 141 N.W.2d 36 (1966); *Mays v. Three Rivers Rubber Corp.,* 135 Mich.App. 42, 48, 352 N.W.2d 339 (1984). In a civil conspiracy, the agreement to do the unlawful act is the thing which must be proved, but "[d]irect proof of agreement is not required ... nor is it necessary that a formal agreement be proven." *Temborius v. Slatkin,* 157 Mich.App. 587, 600, 403 N.W.2d 821 (1986). Instead, circumstantial evidence can establish the conspiracy. *Id.*

*7 National City has submitted evidence to support each of the required elements of civil conspiracy. Lisa and Saulter testified that the agreement between themselves and Wright was to use Wright's financial information to obtain a mortgage from National City, and then use the proceeds to fund

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their REIT, Fairfield & Banks. Lisa and Saulter further testified that all three of them were involved in the Webber Property transaction, and all three were responsible to pay National City back for the loan transaction.

Wright has failed to demonstrate that there is no issue of material fact with regard to the elements of a civil conspiracy cause of action against him. The court denies Wright's motion for summary judgment as to civil conspiracy.

IV. *Breach of Promissory Note*

The promissory note at issue in this case is a negotiable instrument governed by Article 3 of the Uniform Commercial Code. A "negotiable instrument" is an unconditional promise or order to pay a fixed amount of money, with or without interest or other charges, if (1) it is payable to bearer or to order at the time it is issued or first comes into possession of a holder; (2) it is payable on demand or at a definite time; and (3) it does not require any other undertaking by the person promising payment in addition to the payment of money, other than with regard to any collateral to secure payment. MCL 440.3104(1).

Article 3 provides an expedited basis for the enforcement of a negotiable instrument. In an action to enforce a promissory note, "the authenticity of, and authority to make, each signature on the instrument is admitted unless specifically denied in the pleadings." MCL 440.3308(1). Once the validity of the signatures is deemed admitted, then "a plaintiff producing the instrument is entitled to payment if the plaintiff proves entitlement to enforce the instrument under section 3-301 unless the defendant proves a defense or recoupment." MCL 440.3308 (2). A plaintiff is entitled to enforce an instrument if he is the "holder" of it. MCL 440.3301. A person is the "holder" if the instrument is "payable to an identified person," and that person is in possession of the instrument. MCL 440.1201(20). Where the "parties agree that the note is a negotiable instrument, and that plaintiffs are holders" and "the signatures on the note are not in dispute," then "plaintiffs are entitled to recover by merely producing the note." *Behrens v. Appessos*, 39 Mich.App. 426, 428-29, 197 N.W.2d 886 (1972).

In this case, National City loaned Wright $500,000 as evidenced by the promissory note. The promissory note constitutes a "negotiable instrument" under Article 3-it is an unconditional promise to pay money, payable on demand to the order of National City, and it does not require any additional undertakings by Wright. Wright acknowledged he signed the promissory note. (Wright dep., 130). National City maintains it is therefore entitled to enforce the note by producing it, and is entitled to summary judgment.

***8** Wright's response is that the note he allegedly signed was materially altered by National City's personnel, such that it is not enforceable against him. Relief is provided for innocent victims who have been defrauded by a material alteration of a negotiable instrument. MCL 440.3407. When Wright signed the loan documents, he was entering into a personal line of credit for $500,000, that only he was authorized to draw upon. After Wright signed the documents, Clark's secretary, Ms. Williams-English, filled in the blanks under "Additional Items" on the settlement statement, indicating that loan proceeds were distributed to Syatt Realty and Fairfield & Banks. Ms. Williams-English testified she was directed to do this by Mr. Clark. Wright argues that he did not know about, or authorize, disbursements to anybody else. Wright argues that this alteration of the terms of the loan documents, adding payee designations, materially changed Wright's obligation. However, the disbursement information was added to the settlement statement, not to the promissory note. (Exhibit 13 to Wright's Motion for Summary Judgment, NC093). The settlement statement is not a negotiable instrument. There is no evidence of any alteration to the note itself. Therefore, Wright's allegation of fraud is without merit.

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It is also compelling that when Wright filled out a credit application six months after the closing on the Webber Property, he listed the National City loan as a liability, and the Webber Property as a holding. If Wright was not aware that National City had approved his loan, he would not have listed it on a future credit application.

National City is the holder of a valid, signed, negotiable instrument in the form of the promissory note which is at issue in this case. Summary judgment on the promissory note is granted in favor of National City and against Wright.

CONCLUSION

Wright's motion for summary judgment is DENIED as to National City's claim of fraud or innocent misrepresentation and civil conspiracy. As to the promissory note, the court GRANTS National City's motion for summary judgment and DENIES Wright's motion for summary judgment.

E.D.Mich.,2010.
National City Bank v. Syatt Realty Group, Inc.
Not Reported in F.Supp.2d, 2010 WL 456814 (E.D.Mich.), 71 UCC Rep.Serv.2d 907

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Only the Westlaw citation is currently available.

United States District Court,
W.D. Michigan,
Southern Division.
INTERNATIONAL-MATEX TANK TERMINALS-ILLINOIS, Plaintiff,
v.
CHEMICAL BANK, Defendant.
No. 1:08-cv-1200.

April 29, 2010.

Brian Patrick O'Meara, David Lawrence Rieser, David L. Hartsell, McGuirewoods LLP, Chicago, IL, for Plaintiff.

Sean P. Fitzgerald, Kreis Enderle Hudgins & Borsos PC, Grand Rapids, MI, for Defendant.

REPORT AND RECOMMENDATION ON DAMAGES

JOSEPH G. SCOVILLE, United States Magistrate Judge.

*1 This is an action for wrongful dishonor of a letter of credit brought pursuant to U.C.C. § 5-111, MICH. COMP. LAWS § 440.5111. Plaintiff is International Matex Tank Terminals-Illinois (IMTT), the beneficiary under an irrevocable, standby letter of credit issued by defendant Chemical Bank on September 13, 2007. The letter of credit, identified as LOC no.2007-19, was procured by General Sales and Service, Inc., d/b/a Torco Racing Fuels (the "Torco Agreement"), to secure Torco's obligations under a fuel storage tank lease between IMTT and Torco dated September 15, 2006. The bank dishonored four draws by IMTT against the letter of credit. By opinion and order issued October 5, 2009, Chief Judge Paul Maloney granted IMTT a summary judgment declaring the bank liable on the letter of credit. The court's order directed the parties to file a joint notice stating the total amount due to plaintiff as a result of the court's opinion, including pre-and post-judgment interest in attorney's fees as allowed by U.C.C. § 5-111, MICH. COMP. LAWS § 440.5111. The order provided that in the absence of agreement by the parties, the matter would be referred to me for determination pursuant to 28 U.S.C. § 636(b)(1)(B). (docket # 59, Op. & Order at 21-22).

Relevant Procedural History

Acting pursuant to the court's summary judgment order, the parties filed a joint notice on the issue of damages on November 23, 2009. (docket # 60). Attached to the joint notice was a statement by IMTT identifying the principal amount owed as $200,000.00, with total accrued prejudgment interest of $8,903.23, and post-judgment interest (through November 23, 2009) of $173.19. At that time, IMTT claimed approximately $125,000.00 in attorney's fees, for a total award of $333,798.16. The joint statement identified two, and only two, areas of disagreement by defendant concerning the issue of damages. First, the statement indicated that the bank believed that fuel was still contained in the tank at the time the Torco Agreement was terminated and that the value of the alleged remaining fuel should offset any recovery. IMTT denied that any fuel was left and asserted legal arguments against the bank's defense. (The parties and the court have referred to this as the "mitigation of damages" issue.) Second, the joint statement noted the bank's objection to the claimed attorney's fees as excessive. The bank sought an opportunity for further discovery and briefing on the issues, while IMTT argued that the record was complete and no further proceedings should be allowed.

On December 8, 2009, I conducted a telephone status conference with counsel and issued a scheduling order (docket # 64) granting the parties

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a short time to conduct discovery, limited to the issue of mitigation. On January 19, 2010, the parties filed a joint motion (docket # 65), seeking clarification on the scope of discovery allowed by the previous order. Essentially, the bank read the order as allowing extensive discovery concerning the underlying contractual relationship between Torco and IMTT, while IMTT believed that the scope of allowable discovery was much more narrow. On January 21, 2010, I conducted a telephone status conference in an unsuccessful effort to resolve the matter informally.

*2 On January 21, 2010, I entered a discovery order (docket # 68) ruling on the joint motion. The discovery order recognized that a beneficiary's failure to mitigate damages is not a defense under U.C.C. § 5-111(1). The U.C.C. provides only that if a claimant, although not obliged to do so, avoids damages, the claimant's recovery from the issuer must be reduced by the amount of damages actually avoided. Therefore, the issue was not whether IMTT should have reduced its loss by selling off fuel remaining in the tank, but whether in fact it had done so. (Discovery Order at 2). In light of the exceedingly limited defense to damages allowed by section 5-111(1), I found that the bank's interrogatories and document requests "wildly exceed the very limited scope of the issue now before the court." (docket # 68 at 2). The order identified four specific factual issues that were the proper subject of discovery. The order provided for discovery as to these four issues, and also allowed the bank access to the Torco Agreement, in certain circumstances. (*Id.*, 3).

After several delays in the proceedings requested by the parties, the court entered a scheduling order for filing of briefs. (docket # 71). The bank filed its motion for a determination of damages on March 19, 2010. (docket # 72). (The bank was directed to file its brief first, because section 5-111(1) of the U.C.C. places the burden on the issuer to establish that the beneficiary has avoided damages.) The bank's brief said nothing about the mitigation issue. Rather, the bank now raises a completely new argument, based upon its review of the Torco Agreement (docket # 72, Ex. A), which the bank had not seen previously. The bank points out that on July 7, 2008, IMTT terminated the lease on account of Torco's default and then purported to accelerate future lease payments. Relying on paragraph 11 of the lease, the bank argues that IMTT had the option to terminate the Agreement *or* accelerate all monies due, *or* sue for storage charges as they accrued. The bank's essential argument is that IMTT elected its remedies under paragraph 11 of the lease and is entitled to collect only the liquidated damage amount provided for by contract in the event of termination. The bank argues that IMTT was not contractually entitled both to terminate the contract and to accelerate all monies due for the unexpired remaining term. On this basis, Torco argues for a damage award of $28,229.65, and not the full $200,000.00 sought by IMTT. IMTT filed its response (docket # 80) on April 16, 2010, raising procedural, factual, and legal objections to the bank's latest round of arguments. No party has requested an evidentiary hearing or has identified any factual issue in dispute.

Upon review of the record and the submissions of the parties, I conclude that the bank's position is not meritorious and recommend that IMTT be awarded the amount of $200,000.00, plus accrued prejudgment interest. The calculation of reasonable attorney's fees will be addressed in a separate report and recommendation after briefing on that issue is completed.

Proposed Findings of Fact

*3 The facts necessary to resolve the issue of damages are not subject to dispute.

1. On or about September 15, 2006, IMTT and Torco entered into the Torco Agreement (referred to as TOR-L1), under which IMTT agreed to store petroleum products owned by Torco in IMTT's tank storage facilities in Lemont, Illinois. (docket # 72,

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Ex. A) The term of the Agreement extended through December 1, 2009. The Agreement (¶ 4) obligated Torco to pay monthly storage charges as established by an attached schedule.

2. The Agreement contained the following provision regarding the remedies of IMTT upon default by Torco:

> 11. Should Bailor [Torco] fail to pay any monies due or to become due hereunder or should Bailor fail to comply with any of its other obligations under this Agreement within fifteen (15) days from the mailing by Bailee [IMTT] of notice of such default, Bailee shall have the right, at its option (a) to terminate and cancel the within Agreement in which event there shall be due to Bailee, as liquidated damages, a sum equal to the amount of the storage charges hereunder for one (1) month; (b) to accelerate all monies due for the unexpired remaining term of the within Agreement and to declare same immediately due and payable; or (c) to sue for the storage charges in intervals or as the same accrue. The foregoing provisions are without prejudice to any remedy which might otherwise be available under the laws of Illinois for non-payment of monies due, or to become due hereunder, or for breach of any of the obligations of the within Agreement, or to establish any lien or privilege.

(Agreement, docket # 72, Ex. A at 3).

3. To secure its obligations under the Torco Agreement, Torco procured from defendant Chemical Bank Letter of Credit (LOC) 2007-19, dated September 13, 2007, with expiration date September 13, 2008. LOC 2007-19 created drawing rights in favor of IMTT, limited to $200,000.00. The LOC was payable at sight upon presentation of the following documents:

> 1.A) i COPY(IES) OF ORIGINAL, OR TELECOPIES OF INVOICE(S) ISSUED BY IMTT-LEMONT REQUESTING PAYMENT FROM GENERAL SALES AND SERVICE, INC. DBA TORCO RACING FUELS
>
> AND
>
> ii. STATEMENT PURPORTEDLY SIGNED BY AN AUTHORIZED REPRESENTATIVE OF IMTT-LEMONT STATING THAT THE DRAWING AMOUNT REPRESENTS FUNDS DUE TO IMTTLEMONT UNDER THE ACCOMPANYING INVOICE(S) WHICH HAVE NOT BEEN PAID BY GENERAL SALES AND SERVICE, INC. DBA TORCO RACING FUELS UNDER THE LEADED RACING FUEL AGREEMENT NO. TOR-L1 AND THAT THE SAID INVOICE(S) REMAIN(S) UNPAID AT THE TIME OF DRAWING,
>
> OR
>
> B) STATEMENT PURPORTEDLY SIGNED BY AN AUTHORIZED REPRESENTATIVE OF IMTT-LEMONT STATING THAT THIS LETTER OF CREDIT NO. 2007-19 IS SCHEDULED TO EXPIRE LESS THAN 30 DAYS FROM THE DATE HEREOF AND IMTT-LEMONT HAS NOT RECEIVED A SUITABLE RENEWAL OF THIS LETTER OF CREDIT OR A SUITABLE REPLACEMENT LETTER OF CREDIT AND THEREBY DEMANDS PAYMENT OF THE FULL AMOUNT AVAILABLE UNDER THIS LETTER OF CREDIT.

(LOC 2007-19, docket # 38, Ex. 1).

*4 4. On or about June 19, 2008, IMTT sent Torco a notice of default under paragraph 11 of the Agreement, listing five unpaid invoices aggregating $28,229.65 and informing Torco of its ability to cure the default within fifteen days. (docket # 38, Ex. 2).

5. On July 7, 2008, IMTT transmitted to the bank a draw on LOC 2007-19 in the amount of $28,229.65 (First Draw), supported by a copy of the LOC, the notice of default to Torco dated June 19, 2008, and the five unpaid invoices. (docket # 41, Ex. D).

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6. On the same day, IMTT sent Torco a "Notice of Termination," notifying Torco that IMTT elected to "immediately terminate Contract # TOR-L1" and of its election to "accelerate all monies due for the unexpired remaining term of the Agreement." (docket # 72, Ex. D). Attached to the Notice of Termination was Invoice No. LE0807-701 in the amount of $198,187.87, representing accelerated monthly rental of $11,658.11 for a seventeen-month period (August 1, 2008 to December 31, 2009).

7. On June 14, 2008, IMTT sent the bank another draw request (Second Draw), in the amount of $171,770.35, representing the balance of IMTT's $200,000 drawing rights under LOC 2007-19. This draw was based on IMTT's acceleration of the remaining payments under the Torco Agreement. On July 17, 2008, the bank's counsel requested a copy of the Agreement upon which the invoice was based. (docket # 72, Ex. E). IMTT apparently did not respond to this request.

8. On July 18, 2008, IMTT sent Torco an "amendment" of its July 7 notice (docket # 72, Ex. G). The amendment stated that IMTT was *not* electing to terminate the Agreement, and it canceled Invoice LE0807-701, which had been issued on July 7, 2008, in the amount of $198,187.87. Attached to the amendment was a revised Invoice LE0807-701, bearing the date July 18, 2008, and totaling $231,996.55. The revised invoice repeated the charges of $198,187.87 for eleven months of tank rent (August 1, 2008 to December 31, 2009) and added certain monthly surcharges.

9. On the same day (July 28, 2008), IMTT delivered to the bank a draw for the entire $200,000.00 allowed under LOC 2007-19 (Third Draw), accompanied by invoices to Torco totaling $274,003.09 and the certification of a representative of IMTT that the invoices "remain unpaid at the time of this drawing." (docket # 41, Ex. G).

10. On September 12, 2008, IMTT sent the bank its last draw (Fourth Draw), again demanding the $200,000.00 limit on the LOC. (docket # 72, Ex. I). This draw was not premised on the existence of unpaid invoices, but on the alternative ground for drawing rights set forth in paragraph 1.B of the LOC-that LOC 2007-19 was scheduled to expire in less than thirty days, and Torco had not provided a suitable replacement LOC.

Chief Judge Maloney has already determined that the bank failed to give proper notice of dishonor and that the bank had not advanced any other valid defense to IMTT's claim for wrongful dishonor. (Op. & Order, docket # 59). The only remaining issue is the amount of recovery.

Discussion

A. Amendment to Add Mitigation Defense

*5 The first question that Judge Maloney referred to me was whether defendant should be allowed to amend its answer to assert the affirmative defense of mitigation of damages. (Order of Reference, docket # 61, at 5). Although defendant never filed a formal motion to amend, this issue suggested itself as a result of the parties' joint notice on the issue of damages (docket # 60) in which the bank asserted the question of mitigation, and IMTT argued waiver as a result of the bank's failure to plead this affirmative defense. There are numerous procedural and substantive reasons why the court should not allow amendment of the answer to include the defense of mitigation of damages. Discussion of two such grounds will suffice.

First, as a matter of substantive law, mitigation of damages is not a defense available to an issuer in an action for wrongful dishonor of a letter of credit. U.C.C. § 5-111 governs the question:

> If an issuer wrongfully dishonors or repudiates its obligation to pay money under a letter of credit before presentation, the beneficiary, successor, or nominated person presenting on its own behalf may recover from the issuer the amount that is the subject of the dishonor or repudiation. If the

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issuer's obligation under the letter of credit is not for the payment of money, the claimant may obtain specific performance or, at the claimant's election, recover an amount equal to the value of performance from the issuer. In either case, the claimant may also recover incidental but not consequential damages. *The claimant is not obligated to take action to avoid damages that might be due from the issuer under this subsection. If, although not obligated to do so, the claimant avoids damages, the claimant's recovery from the issuer must be reduced by the amount of damages avoided.* The issuer has the burden of proving the amount of damages avoided. In the case of repudiation, the claimant need not present any document.

MICH. COMP. LAWS § 440.5111(1) (emphasis added). Official comment 1 sets forth the rationale for this rule. Because the value of a letter of credit depends upon speed and certainty of payment, it is important that the issuer not be given an incentive to dishonor the LOC. Such an incentive would arise if the issuer could rely on a burden of mitigation that falls on the beneficiary. For this reason, the U.C.C. denies the issuer a mitigation defense and places no duty on the beneficiary under a letter of credit to mitigate damages. The only issue is whether the beneficiary has in fact avoided damages, although not under an obligation to do so. U.C.C. § 5-111 cmt. 1. As a result of U.C.C. § 5-111, the mitigation defense is legally unavailable to an issuer of a letter of credit. *See, e.g., San Diego Gas & Elec. Co. v. Bank Leumi,* 42 Cal.App.4th 928, 50 Cal.Rptr.2d 20, 25 (Cal.App.1996) (failure to mitigate damages is an extraneous defense not available to an issuer of a letter of credit). A court properly denies leave to amend a pleading where the proffered claim or defense is meritless. In such circumstances, amendment would be futile. *See Campbell v. BNSF Ry. .,* No. 09-5614, --- F.3d ----, 2010 WL 1404393, at * 9 (6th Cir. Apr.9, 2010); *Konkol v. Diebold, Inc.,* 590 F.3d 590, 404 (6th Cir.2009).

*6 The only damage-related issue available to the bank under section 5-111(1) is that IMTT actually avoided damage and that its recovery should be reduced by the amount of damages avoided. Neither the U.C.C. nor any other authority with which I am familiar requires this issue to be pleaded as an affirmative defense. The discovery order of January 21, 2010 (docket # 68), allowed the bank limited discovery on this issue, directed to the question whether any fuel remained in plaintiff's tank after Torco defaulted and, if so, whether plaintiff received any money, credit, or other thing of value for the remaining fuel. The order also allowed the bank discovery on the question whether plaintiff released the tank for any period covered by the original contract with Torco. (Order at 3). This discovery apparently confirmed that IMTT had not received anything of value, whether by selling leftover fuel or by re-leasing the tanks during the term of the Agreement. The bank has not presented to the court any evidence to support a conclusion that IMTT's damages for wrongful dishonor should be reduced on account of any value received by IMTT.

For the foregoing reasons, I recommend that the answer not be deemed amended to allege the defense of failure to mitigate damages. I further recommend that plaintiff's recovery from the bank not be reduced by any amount on account of the actual avoidance of damage. The bank has simply presented no proof to this court to support a finding in its favor on this issue.

B. Defense Arising From Torco Agreement

Now that the bank has abandoned its mitigation defense, the only asserted defense is based upon the provisions of paragraph 11 of the tank lease between IMTT and Torco. That paragraph governs the rights of IMTT (identified in the contract as "Bailor") and provides in relevant part as follows:

11. Should Bailor [Torco] fail to pay any monies due or to become due hereunder or should

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> Bailor fail to comply with any of its other obligations under this Agreement within fifteen (15) days from the mailing by Bailee [IMTT] of notice of such default, Bailee shall have the right, at its option (a) to terminate and cancel the within Agreement in which event there shall be due to Bailee, as liquidated damages, a sum equal to the amount of the storage charges hereunder for one (1) month; (b) to accelerate all monies due for the unexpired remaining term of the within Agreement and to declare same immediately due and payable; or (c) to sue for the storage charges in intervals or as the same accrue. The foregoing provisions are without prejudice to any remedy which might otherwise be available under the laws of Illinois for non-payment of monies due, or to become due hereunder, or for breach of any of the obligations of the within Agreement, or to establish any lien or privilege.

(Contract No. TOR-L1, docket # 72, at 3). The bank points out that on July 7, 2008, IMTT purported to immediately terminate the contract after fifteen days of an uncured default. On the same day, IMTT sent the bank its First Draw in the amount of $28,229.65. IMTT further purported to accelerate all monies due for the unexpired remaining term of the Agreement, a right that the bank now argues IMTT did not have because it had already elected to terminate the contract. IMTT thereafter sent the Second and Third Draws, representing accelerated rental payments under the Torco Agreement. The Fourth Draw invoked paragraph 1.B of the LOC, which allowed IMTT to draw "the full amount available" in case Torco failed to procure a suitable replacement LOC. The bank argues that the acceleration was contrary to the provisions of paragraph 11 of the Agreement, that the accelerated payments were never due and owing to IMTT, and that IMTT's termination of the Torco Agreement precludes its recovery on the Second, Third and Fourth Draws.[FN1]

> FN1. In response to the bank's latest defense, IMTT raises numerous objections, some of them extravagant. For example, IMTT argues that the bank is procedurally precluded from relying on the Torco Agreement, which IMTT produced in discovery in response to a court order only after the formal discovery period had closed. IMTT relies on a nonexistent rule of law that it says precludes a party's reliance on evidence that has come to light after the close of discovery. By recommending that the court reject the bank's substantive position, I do not endorse all of the objections raised by IMTT.

*7 The bank's reliance on the provisions of the Torco Agreement as a defense to the letter of credit violates the independence principle. As explained by Chief Judge Maloney in his summary judgment opinion, the very purpose of a letter of credit is to assure payment without reference to disputes regarding the underlying contract. (Op. at 17). Under the independence principle, a bank's duty to pay on letters of credit is independent of the question whether the applicant or the beneficiary have properly performed under the underlying contract. *In re Graham Square, Inc.*, 126 F.3d 823, 827 (6th Cir.1997). Put another way, the bank must pay on a proper demand from the beneficiary even though the beneficiary may have breached the underlying contract with the applicant. 3 JAMES J. WHITE & ROBERT S. SUMMERS, UNIFORM COMMERCIAL CODE § 26-2 at 138 (5th ed.2008). Under this principle, the issuing bank may only determine whether the appropriate documents have been presented. It may not contest the truth of the assertions in those documents. *Intraworld Indus., Inc. v. Girard Trust Bank*, 461 Pa. 343, 336 A.2d 316, 323-24 (Pa.1975). "Absent its agreement to the contrary, the issuer is, under the general rule, not required *or even permitted* to go behind the documents to determine if the beneficiary has performed in conformity with the underlying contract." *Id.* at 323 (emphasis added).

In light of Judge Maloney's clear rejection of this

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defense, the bank's dogged reassertion of rights arising from the Torco Agreement can only be deemed obstinate. The present case is a textbook example of the need for the independence principle. As explained by the Michigan Court of Appeals, the issuing bank's duty with respect to a letter of credit is "purely ministerial." *Osten Meat Co. v. First of Am. Bank-Southwest Michigan, N.A.*, 205 Mich.App. 686, 517 N.W.2d 742, 745 (Mich.Ct.App.1994). The bank's representative, who is presumed to know nothing of the parties or the underlying transaction, must merely check the presented documents carefully against the requirements of the letter of credit. "Under a strict compliance standard, if the documents comply, the draft is paid." *Id.* Banks that ignore the independence principle undermine the commercial value of letters of credit and invite litigation, during which the bank attempts, as Chemical Bank does in the present case, to conjure up a defense arising from the underlying contract. "Similarly, such disputes might often end in litigation, further impairing the efficacy of the letter of credit transactions." *Id.* at 476, 517 N.W.2d 742. The only question is whether the beneficiary has complied with the requirements of the letter of credit, not whether the beneficiary has complied with the requirements of the underlying contract.

Judge Maloney has already rejected the precise argument that the bank now attempts to advance. During summary judgment briefing, the bank asserted that the accelerated, future rental payments were not "due and owing" because IMTT had already terminated the contract. Judge Maloney analyzed and rejected this argument as a violation of the independence principle. (Op., 17-18). The bank seeks to avoid this ruling by pointing out that it had not seen the Agreement at the time the summary judgment motions were briefed. Now that it has seen the Torco Agreement, the bank has learned that the right to terminate and the right to accelerate seem to be in the disjunctive. Although this adds ammunition to the bank's contract-based defense, it does not change the essential nature of that defense-one based upon the underlying agreement and not the LOC itself. Thus, even if the bank had been given access to the Torco Agreement earlier in the case, the bank would not have been successful in resisting IMTT's motion for summary judgment.

***8** The force of the independence principle is not undermined in the least by the principal case cited by the bank, *Mellon Bank, N.A. v. General Electric Credit Corp.*, 724 F.Supp. 360 (W.D.Pa.1989), for two reasons. First, and most fundamentally, *Mellon Bank* was not an action by a beneficiary against an issuer for wrongful dishonor. Rather, it was a suit by an issuing bank against the beneficiary for breach of warranty. The *Mellon Bank* court fully acknowledged the independence principle, which prohibits reference to underlying contracts to determine the validity of a draft on a letter of credit. 724 F.Supp. 364-65. The court pointed out, however, that the independence principle applies only to the bank's obligation to honor a draft in the first instance and does not preclude subsequent lawsuit on a theory of breach of warranty. *Id.* at 365. The court went on to find that the beneficiary breached its warranties by asserting that accelerated payments were due when in fact they were not. If anything, the *Mellon Bank* case reinforces IMTT's position in the present litigation. As the present case involves only a beneficiary's claim of wrongful dishonor, the independence principle precludes the bank's reliance on the underlying Agreement.

Second, the *Mellon Bank* case is no longer good law in states, such as Michigan, that have adopted the 1995 Amendments to the U.C.C. *Mellon Bank* was decided under the 1962 version of the U.C.C. Section 5-111(1) of the 1962 U.C.C. provided that a beneficiary presenting a draw on an LOC "warrants to all interested parties that the necessary conditions of the credit have been complied with." U.C.C. § 5-111(1) (1962). *Mellon Bank* construed this language broadly, allowing a breach of warranty claim by the issuing bank against the beneficiary for incorrectly representing that sums were due and owing under the underlying contract. *Mel-*

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lon Bank was a controversial decision, even in the Western District of Pennsylvania. Later courts interpreting the 1962 Code in the breach of warranty context expressly rejected *Mellon Bank*, holding that a beneficiary's warranty covered only the genuineness of the documents presented to the issuing bank and did not extend to the truthfulness of the statements in the documents. *See, e.g., Amwest Sur. Ins. Co. v. Republic Nat'l Bank*, 977 F.2d 122, 128-30 (4th Cir.1992); *PNC Bank, N.A. v. Liberty Mut. Ins. Co.*, 912 F.Supp. 169, 173-74 (W.D.Pa.1996) (rejecting *Mellon Bank); accord* 2 JAMES J. WHITE AND ROBERT S. SUMMERS, UNIFORM COMMERCIAL CODE § 19-12 at 11 (3d ed. supp.1991) (noting "confusion" and "frightening implications" of *Mellon Bank* rule). In the 1995 version of the U.C.C., the warranty language was removed from section 5-111(1) and a far more limited warranty was included in section 5-110. As amended, section 5-110 provides that *if* a presentation is honored, the beneficiary warrants to the issuer that there is "no fraud or forgery of the kind described in section 5-109(1)." MICH. COMP. LAWS § 440.5110(1). Michigan adopted the 1995 Amendments in Act 488 of P.A.1998, effective January 4, 1999. It is universally understood that the 1995 Amendments adopted the position contrary to *Mellon Bank*. 1 JOHN F. DOLAN, THE LAW OF LETTERS OF CREDIT ¶ 6.07[4] at 6-142 (4th ed.2007). Thus, even if this were a breach of warranty case (which it is not), *Mellon Bank* would be of no avail to Chemical Bank, as breach of warranty under the 1995 Code is limited to egregious cases of fraud in the presenting documents, and does not extend to defenses arising from the underlying contract.

*9 The LOC issued by Chemical Bank in 2007 was subject to the 1995 version of the U.C.C., as adopted by Michigan in 1998. That version of the U.C.C. makes it clear, beyond any reasonable doubt, that a bank dishonoring a letter of credit has no claim for breach of warranty. U.C.C. § 5-110 creates a warranty only *if* the presentation is honored. MICH. COMP. LAWS § 440.5110(1). The commentary makes it clear that this provision was specifically designed to prevent issuers (such as Chemical Bank) from relying on an alleged breach of warranty as a reason for dishonoring an LOC: "Since the warranties in subsection (a) are not given unless a letter of credit has been honored, no breach of warranty under this subsection can be a defense to dishonor by the issuer." *Id.* cmt. 1. Again, the rule goes to the very heart and utility of a letter of credit:

> Note first that no warranty is given unless the presentation is honored. This is critical, for it prohibits the warranty from being used as a defense by an issuer who has not honored or by an applicant when the issuer has failed to honor. This makes sense, as the availability of warranties as a defense would undermine the certainty of payment and would degrade the independence of the letter of credit. If the issuer dishonors, no warranties are given under 5-110(a). *Neither the issuer nor the applicant may defend the issuer's dishonor on the ground the beneficiary broke a warranty in its presentation.*

3 WHITE & SUMMERS, UNIFORM COMMERCIAL CODE § 26-7 at 189 (emphasis added). Chemical Bank has raised no non-frivolous argument that would allow the court to deprive IMTT of full recovery in the amount of $200,000.00 under LOC 2007-19.

C. Computation of Damages

IMTT is entitled to recover $200,000.00, plus prejudgment interest under Michigan law pursuant to Mich. Comp. Laws § 600.6013(8). In its interest calculation sheet (docket # 60-2), IMTT improperly terminated the accrual of pre-judgment interest on October 5, 2009 (the date of Judge Maloney's summary judgment opinion and order) and calculated post-judgment interest thereafter. Final judgment, however, has not yet been entered. Post-judgment interest under 28 U.S.C. § 1961 runs only from a final, appealable judgment. *See Scotts Co. v. Central*

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Garden & Pet Co., 403 F.3d 781, 792-93 (6th Cir.2005); *Dishman v. UNUM Life Ins. Co. of Am.,* 269 F.3d 974, 990-91 (9th Cir.2001). It does not being to run at the time of a jury verdict, summary judgment entry, or other interlocutory event that merely establishes liability. *See Kaiser Alum. & Chem. Corp. v. Bonjorno,* 494 U.S. 827, 835, 110 S.Ct. 1570, 108 L.Ed.2d 842 (1990). Plaintiff is therefore entitled to pre-judgment interest until a final, appealable judgment is entered by Judge Maloney. The post-judgment rate will begin to accrue only upon entry of final judgment.

The attached schedule computes pre-judgment interest on the principal amount of $200,000.00, through April 30, 2010. This amount is $12,768.47. Interest accrues thereafter at $19.75 per day until July 1, 2010, at which time the rate will change again.

Recommended Disposition

***10** For the foregoing reasons, I recommend that (1) defendant not be granted leave to assert a mitigation defense and (2) judgment be entered in favor of plaintiff and against defendant in the principal amount of $200,000.00, with pre-judgment interest awarded under Michigan law at the rate prescribed by Mich. Comp. Laws § 600.6013, and post-judgment interest at the federal statutory rate under 28 U.S.C. § 1961 after the entry of judgment.

W.D.Mich.,2010.
International-Matex Tank Terminals-Ill. v. Chemical Bank
Slip Copy, 2010 WL 2219396 (W.D.Mich.), 71 UCC Rep.Serv. 852

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Commercial Law Newsletter

Joint Newsletter of the Commercial Finance and Uniform Commercial Code Committees

ABA Business Law Section

Fall 2010

IN THIS ISSUE

MARK YOUR CALENDARS

FEATURED NOTES

FEATURED ARTICLES

- **A Summary of the 2010 Amendments to the Official Text of Article 9 of the Uniform Commercial Code**
  By Edwin E. Smith
- **Forbearance Agreements and Workouts: Case Updates**
  By Christine Gould Hamm & M. Reed Mercado
- **The Loan Syndications and Trading Association: the 2010 Loan Market Update**
  By Bridget Marsh & Ted Basta
- **The New FATCA Tax Withholding Rules – Practical Considerations for Drafting Credit Agreements**
  By Carol P. Tello

FEATURED REPORT

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

- **Second Report of the ABA Advisor NCCUSL Drafting Committee for a Certificate of Title Act for Vessels, October 13, 2010**

UCC SPOTLIGHT

USEFUL LINKS AND WEBSITES

Reports from the Chairs

COMMERCIAL FINANCE COMMITTEE CHAIR REPORT

Introduction:

As the new Chair of the Commercial Finance Committee, let me first say that it is an honor and a privilege to lead this Committee along with our Vice Chair, Neal Kling, and to continue and expand the work of our outstanding past Chairs and Vice Chairs. We are one of the largest and strongest Committees within the Business Law Section and we will continue to provide an ever-expanding array of high-quality, up-to-the minute content to our members through a variety of media, including this Newsletter.

Let me also take this opportunity to thank and congratulate my predecessor, Lynn Soukup, for her outstanding service as Chair during the past three years, which increased both the output and the reputation of the Committee in significant ways.

We have a terrific group of active Subcommittees and Task Forces -- please go to the Commercial Finance Committee's **website** for reports on their meetings and upcoming activities. We have started two new Task Forces jointly with the UCC Committee. One is the Joint Task Force for the Legislative Enactment of Amendments to Revised Article 9, for which volunteers from all 50 states are sought (an excellent article by Ed Smith summarizing the amendments is contained in this Newsletter). The other is a Joint Task Force on Survey of the Law of Guarantees, which will provide a state-by-state summary of the law of guarantees similar to the Commercial Lending Law state-by-state summary published to great acclaim by our Committee in 2009.

The lifeblood of a Committee is its members generally, and specifically those members who become active. We are seeking persons who would like to give speeches, participate in CLE and non-CLE panels, and generally become active in the work of the Committee. If you are interested, we will find a role for you. You will meet some fun and interesting people, gain exposure for yourself and your practice, and establish a network of contacts throughout the USA and Canada (and it looks good on your firm bio as well!). If you are interested in being active, please contact me at **jschulwolf@goodwin.com**.

Recent and Upcoming Meetings:

Our recent Fall Meeting in Chicago, held jointly with the UCC Committee, was a great success. It featured four outstanding programs:

- Workouts and Forbearance Agreements, presented by Kyle Mathews of Sheppard Mullin and Christine Gould Hamm of Husch Blackwell
- Primer on Financing Goods, presented by Marshall Grodner of McGlinchey Stafford and Elizabeth Davidson of Jenner & Block
- Mezzanine Loans -- the Vagaries of Membership Interest Collateral, presented by Teresa Harmon and Mohammed Shaheen of Sidley Austin, Norm Powell and Andy Kostoulas of Young Conaway, and Jim Prendergast of First American Title

MARK YOUR CALENDARS

November 9-10, 2010 - Forum: Cape Town Convention and Aircraft Protocol, Assessing and Advancing Ratification - Rome, Italy. More information is available in the UNIDROIT press release, or go directly to the forum's website.

November 19-20, 2010 - ABA Business Law Section's Fall Meeting - Washington, D.C. Additional information about the ABA Business Law Section's Fall Meeting is available here.

January 12, 2011 - Financial Contracts in Bankruptcy (Swaps and Derivatives) - New York, NY. This discussion will be moderated by Paul Ricotta. More information is available on the Association of Commercial Finance Attorney's website.

January 25-26, 2011 - CFA Asset-Based Capital Conference - Las Vegas, NV. See the Commercial Finance Association's (CFA) website for further details.

April 14-16, 2011 - ABA Spring Meeting - Boston, MA. Registration details are coming soon! All programs and meetings will be held at the Boston Marriott Copley Place (800-228-9290) and the Westin Copley Place (800-WESTINS or 800-937-8467).

June 5-9, 2011 - International Association of Commercial Administrators (IACA) 34th Annual Conference – Winnipeg, Manitoba. The 34th IACA Annual Conference will be at the Delta Winnipeg in Winnipeg, Manitoba, Canada. More information is available at IACA's **website**.

August 5-8, 2011 - ABA Annual Meeting - Toronto, Ontario. More details will be coming soon to the ABA's website!

- Beyond *TOUSA*, presented by Jonathan Cooper and Dimitri Karcazes of Goldberg Kohn

Program materials are available on the Commercial Finance Committee **website**. Kudos to Tony Callobre of Bingham McCutchen and Marshall Grodner of McGlinchey Stafford for their excellent work in organizing these programs on behalf of the Committee.

We will next meet at the Business Law Section Spring Meeting in Boston from April 14 - 16, 2011. Boston is a great city, and it should be an excellent meeting. One travel note – book early, since it is Patriots' Day weekend (the weekend of the Boston Marathon, which is run on the Monday following the weekend). We will be presenting three excellent CLE programs:

- Commercial Law Developments, our annual and always-popular survey presented by Steve Weise of Proskauer Rose and Teresa Harmon of Sidley Austin
- State of the Syndicated Loan Markets, chaired by Bridget Marsh of LSTA
- A Midnight Ride -- A Call to Arms on the Basics of Swaps and the Challenges of Documenting the Rights of Swap Providers in Collateral Shared with other Lenders, chaired by Perry Hicks of Cadwalader

A preliminary schedule and information on our annual joint dinner with the UCC Committee will soon be posted on the Commercial Finance Committee **website**.

Jeremy Friedberg of Leitess Leitess Friedberg and **Christine Gould Hamm** of Husch Blackwell are coordinating our programs and subcommittee meetings, so if you have an idea for a panel or presentation or would like to participate in one, please contact Jeremy, Christine, or me at **jschulwolf@goodwin.com**.

Best wishes for the fall and holiday seasons, and I look forward to seeing you in Boston in April.

Jim Schulwolf
Commercial Finance Committee Chair

UNIFORM COMMERCIAL CODE COMMITTEE CHAIR REPORT

Fall Meeting in Chicago:

The UCC and Commercial Finance Committees had a terrific turnout at their joint Fall Meeting which was held on October 20, 2010 in Chicago. The excellent program materials on workout and forbearance issues, LLC membership interest collateral, the basics of financing goods and clawback risk post-*TOUSA* can be found on the UCC Committee's **website**.

Subcommittees and Task Forces:

Please visit the UCC Committee's **website** to read reports from our various subcommittees and taskforces on their projects and meetings.

I am pleased to report that we have two new task forces:

The Joint Task Force (with the Commercial Finance Committee) for the Legislative Enactment of Revised Article 9 for which **Thomas Buiteweg** and **John McGarvey** are co-chairs and which will seek to assist the National Conference of Commissioners on Uniform State Laws and other bodies with the enactment in the U.S. of the recent updates to UCC Article 9.

VIEW CURRENT REPORTS AND DEVELOPMENTS OF THE ...

COMFIN SUBCOMMITTEES AND TASK FORCES

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

UCC SUBCOMMITTEES

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

UCC AND COMFIN JOINT TASK FORCES

- **Commercial Finance Terms Joint Task Force**
- **Deposit Account Control Agreements Joint Task Force**
- **Filing Office Operations and Search Logic Joint Task Force**
- **Legislative Enactment of Article 9**
- **Model IP Security Agreement Joint Task Force**
- **Survey of State Guaranty Laws**

A Joint Task Force on Survey of State Guaranty Laws to be co-chaired by **Jeremy Friedberg, Brian Hulse** and **James Prior** to survey the law of guarantees across the U.S. The survey will have a practical bent and will focus on what practitioners reviewing guarantees would want to know about applicable state law.

Please contact the chairs of these task forces at the email addresses linked to their names above or me at **pchristophorou@cgsh.com** if you are interested in joining or if you have topics or projects that you think are worth pursuing.

Please also join one or more of our other subcommittees or task forces. Even if you cannot attend ABA meetings, our subcommittees and task forces are always working on various long-term projects and welcome contributors. For instance, the International Commercial Law Subcommittee is currently studying and crafting a publication on the substantive and choice of law rules applicable to securities, securities accounts and deposit accounts in various key non-U.S. jurisdictions. The Joint Task Force on Commercial Law Terms is currently working on a wiki of important commercial law terms.

Spring Meeting in Boston:

The UCC Committee will be meeting next on April 14 through 16, 2011 at the Business Law Section Spring Meeting at Copley Place in Boston. A preliminary schedule and registration materials will soon be available on the main page of our website. Our program offerings for the Spring Meeting are varied:

- Difficult Debtors: People and Nations and Trusts, Oh My!
- What Every Deal Lawyer Should Know about Consumer Regulation
- Lehman - Over Two Years Later: Lessons for Secured Parties, Derivative Counterparties and Owners of Custodied Financial Assets

Stay tuned for information on the joint committee dinner at the Spring Meeting with the Commercial Finance Committee. Please join us in Boston!

Best wishes for the fall season,

Penny Christophorou
UCC Committee Chair

Featured Notes

Please take the Model Intellectual Property Security Agreement (MIPSA) Task Force Survey. The MIPSA Task Force has created a survey using SurveyMonkey on specific drafting issues relevant to the granting clause of an IP security agreement and is asking everyone to participate. Please take a moment to fill out the **survey**. For more information, please see the Intellectual Property Finance Subcommittee's **webpage** or the PowerPoint presentation from the MIPSA Task Force's joint meeting with the Intellectual Property Finance Subcommittee in San Francisco which has been posted to **YouTube**.

Public Service Project

The following worthwhile public service project has been undertaken by the Business and Corporate Litigation Committee's Pro Bono and Public Service Subcommittee.

The Business Law Section is partnering with the Mississippi Center for Justice ("MCJ") to raise funds to support residents of coastal communities impacted by the Gulf oil spill.

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- Commercial Finance Committee
- Uniform Commercial Code Committee

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- **WRITE FOR AN OFFICIAL ABA PUBLICATION?**
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- **CONNECT WITH OTHER MEMBERS OF THE COMFIN AND UCC COMMITTEES?**

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

MCJ is one of the few organizations standing between low-wealth communities and economic disaster by working with advocacy organizations in Mississippi, Alabama, Louisiana and Florida to identify and address the legal needs of individuals, small businesses and communities bearing the weight of the disaster.

Contributions made by members of the Business Law Section will be used to address the legal needs of the poor arising as a direct result of the oil disaster. MCJ has created a dedicated **contribution page** for the Section's use.

Feel free to contact **Mac McCoy** with any questions you may have regarding this public service project, which is coordinated by the Business and Corporate Litigation Committee's Pro Bono and Public Service Subcommittee, with co-sponsorship by the Young Lawyer Committee and the Section's Committee on Pro Bono.

Equity Interests as Collateral in Commercial Lending: Enforcing Security Interests in Stocks, Partnerships and LLCs Upon Borrower Default. This 90-minute CLE **webinar/teleconference** will be presented by Lynn Soukup and Steve Weise with an interactive Q&A and will be held **Thursday, November 11, 2010, at 1:00-2:30 pm EST**.

This CLE webinar will provide strategies for counsel advising lenders holding equity interests as collateral in commercial loans on how to properly perfect their security interests and to evaluate and pursue enforcement remedies in the event a borrower defaults.

Commercial Loan Workouts: Forbearance Options and Waivers After Default, This 90-minute CLE **webinar/teleconference** will be presented by Matthew T. Gensburg with an interactive Q&A and will be held **Wednesday, December 8, 2010, at 1:00-2:30 pm EST**.

This CLE webinar will provide guidance to lenders' counsel for crafting and negotiating a commercial loan workout to strengthen the lender's claims and minimize risk and liabilities due to a borrower's bankruptcy or foreclosure.

Featured Articles

A SUMMARY OF THE 2010 AMENDMENTS TO THE OFFICIAL TEXT OF ARTICLE 9 OF THE UNIFORM COMMERCIAL CODE

By Edwin E. Smith, Bingham McCutchen LLP[1]

The 2010 amendments to the Official Text of Article 9 of the Uniform Commercial Code were approved in 2010 by the Uniform Commercial Code's sponsoring organizations, the American Law Institute and the Uniform Law Commission. These 2010 amendments (the "Amendments") are expected to be considered by state legislatures as early as 2011 with a view to all states enacting the Amendments by their July 1, 2013, uniform effective date. This article provides a summary of the statutory amendments.

A Joint Task Force for the Legislative Enactment of Revised Article 9 has been created by the Business Law Section's Commercial Finance and UCC Committees to assist in the enactment of the 2010 amendments to Article 9. This task force is seeking members from all states and from the District of Columbia. If you are interested in serving on the task force, please contact Thomas Buiteweg or John McGarvey, the Joint Task Force for the Legislative Enactment of Revised Article 9 co-chairs.

I. CHANGES RELATING TO THE FILING RULES

The Amendments contain a number of changes related to the rules for filing financing statements in Part 5 of Article 9.

A. Name to be Provided on a Financing Statement When the Debtor is an Individual

Some courts have struggled with the question of what name a financing statement must provide for an individual debtor in order for the debtor's name on the financing statement to be sufficient. The problem arises because individuals do not typically have a single name. An individual's name on his or her birth certificate, driver's license, passport, tax return or bankruptcy petition may all be different. Moreover, the debtor may be known in his or her community by a name that is not reflected on any official document. It would appear that most cases decided under the 1998 revisions to Article 9 finding the individual debtor's name provided on the financing statement to be insufficient have involved the secured party making a filing error rather than being uncertain as to the debtor's actual name. Nevertheless, the cases have created a level of uncertainty that has led secured parties to search and file financing statements under multiple names.

To provide greater guidance, the Amendments offer to each state one of two alternatives for the name of an individual debtor provided on a financing statement to be sufficient. If Alternative A is in effect in the state in which the financing statement is filed, and if the debtor holds a driver's license that has not expired and has been issued by the state, then the name of the debtor that must be provided on the financing statement is the name of the debtor as it appears on the driver's license. This is the so-called "only if" rule, i.e., the debtor's name on the financing statement will be sufficient "only if" the name provided is the name on the driver's license.

Of course, the name on the driver's license cannot be entered onto the financing statement without consideration. The financing statement's written form or electronic template will require that the financing statement set forth the surname and first personal name of the debtor. The secured party will need to determine which name on the driver's license is the debtor's surname and which is the debtor's first personal name. This would normally be an easy task. For example, if the name on the driver's license is *Lester Henry Smith*, it would appear obvious that the debtor's surname is *Smith* and that the debtor's first personal name is *Lester*. *Henry* would then be inserted in the financing statement block for "additional names." In other cases, determining from the driver's license which name is the debtor's surname and which name is the debtor's first personal name may not be as easy and may require the secured party to perform additional investigation.

Under Alternative A, if the debtor does not hold a driver's license issued by the state in which the financing statement is filed, then either of the following names for the debtor would be sufficient as the debtor's name on the financing statement: (1) the individual name of the debtor, as under current Article 9, or (2) the debtor's surname and first personal name.

Under Alternative B, any of the following names for the debtor would be sufficient as the debtor's name on the financing statement: (1) the debtor's name as shown on the debtor's driver's license if the debtor holds an unexpired driver's license issued by the state, (2) the individual name of the debtor, as under current Article 9, or (3) the debtor's surname and first personal name. Alternative B has been called the "safe harbor" approach, in contrast to the "only if" approach reflected in Alternative A.

Under either Alternative A or Alternative B, if the debtor holds two driver's licenses issued by the state, the most recently issued driver's license is the one to which reference should be made to determine the debtor's name to be provided on the financing statement.

In some states, the same office of the state that issues a driver's license also issues an identification card for an individual who does not hold a driver's license, and the state or office does not permit an individual to hold both a driver's license and a non-driver's license identification card at the same time. A Legislative Note to amended section 9-503 suggests that, regardless of which alternative is adopted, these states should refer to the non-driver's license identification card as an alternative of equal dignity with the driver's license.

The rationale for choosing the driver's license name as the name of the debtor to be provided in order for the debtor's name on the financing statement to be sufficient is that in most cases an individual debtor holds a driver's license that is offered as a form of identification when the debtor seeks to obtain secured financing. For lenders that extend credit on a volume basis, procedures can easily be established for the lender to search the records of the filing office under the driver's license name and to file in the filing office a financing statement providing that name as the name of the debtor.

To be sure, a rule that contemplates use of the debtor's driver's license name is not without risk. The driver's license may expire, or the debtor may exchange the current driver's license for a new driver's license. Either event could constitute a change in the name that Article 9 requires to be provided for the debtor. This may be the case if the debtor's name on an expired driver's license is different from a name that would be sufficient for the name of the debtor to be provided on a financing statement in the absence of a driver's license name or if the name of the debtor on the new driver's license is different from the name of the debtor as it appeared on the old driver's license.

If a search under the new name required to be provided for the debtor, following the filing office's standard search logic, does not disclose the financing statement filed under the expired or original driver's license name, the financing statement would become seriously misleading. In that case, the normal rules for a name change under section 9-507(c) would apply. The financing statement would remain effective for collateral in existence on the date of the name change and for collateral acquired by the debtor during the four-month period after the date of the name change. For the financing statement to be effective for collateral acquired by the debtor after the end of the four-month period, the secured party would need to amend the financing statement within the four-month period to provide the debtor's new name.

The observers from the lending community reasoned that, under either the "only if" rule of Alternative A or the "safe harbor" rule of Alternative B, the risk that debtor name changes may be more likely to occur than under current law was more than offset by the greater certainty of being able to look to the debtor's driver's license name.

It is important to emphasize that the driver's license name is relevant for a particular state only if Article 9's choice of law rules in the forum state point to the law of that particular state to determine perfection and the effect of perfection and non-perfection of a security interest that must or may be perfected by filing. For example, if an individual debtor's principal residence is in Illinois, the debtor will be considered to be located in Illinois under section 9-307. A financing statement must be filed in Illinois to perfect by filing a security interest in collateral in which a security interest is perfected by filing in the state of the debtor's location. If the debtor holds an Ohio driver's license rather than an Illinois driver's license, the Ohio driver's license will be irrelevant for purposes of perfecting a security interest that must be perfected by a filling in Illinois.

Based on the views expressed by observers from the American Bankers Association working group it is expected that a number of states will be encouraged by them to adopt Alternative A. But a Legislative Note suggests that a state considering adopting Alternative A should verify that its Uniform Commercial Code database is compatible with the state's driver's license database as to characters, field length and the like. Alternative A would not be workable in a state if a significant number of names reflected on driver's licenses issued by the state could not be entered in the Uniform Commercial Code database of the state, resulting in secured parties not being able to comply with the "only if" rule. If there is lack of compatibility, the lack of compatibility could still be rectified by a change in computer systems that established compatibility or a filing office regulation that explains how a driver's license name should be modified to be entered into the Uniform Commercial Code databases of the filing office.

B. Definition of "Registered Organization"

The Amendments modify the definition of "registered organization" to reflect that an organization is a registered organization if it is formed or organized solely under the law of a single state by the filing of a public record with the state rather than, as under current Article 9, by the state merely being required to maintain a public record showing that the organization has been organized. This change will more accurately reflect that a registered organization includes an organization whose "birth certificate" emanates from the act of making a public filing. The change also confirms that, like the typical corporation, limited partnership or limited liability company, a statutory trust formed under the laws of a state by a filing in the secretary of state's office of that state is a registered organization.

Furthermore, the Amendments expand the definition of "registered organization" to include a common law trust that is formed for a business or commercial purpose and is required by a state's business trust statute to file with the state an organic record, such as the trust agreement for a common law trust. This change will mean that a Massachusetts business trust, for example, will be considered to be a registered organization rather than, as would appear to be the case under current Article 9, an organization that is not a registered organization. This type of common law business trust, i.e., a common law business trust that, because of a public filing requirement, will be considered a registered organization under the Amendments, is referred to in this article as a "Massachusetts type business trust."

The change will not affect a common law trust formed for a purpose that is not a business or commercial purpose or a common law trust formed for a business or commercial purpose that is not required to file a public record with the state. As under current Article 9, neither of these types of common law trust would be a registered organization. Only a common law trust that is a Massachusetts type business trust will be considered a registered organization under the Amendments.

C. Name of Registered Organization

Some concern in practice has been expressed that, in determining the name of a debtor that is a registered organization for the purpose of providing the debtor's name on a financing statement, there may be more than one name of a registered organization reflected on a state's public record. This circumstance could arise when the state maintains a searchable database of the names of registered organizations but where the database uses abbreviations or has limited field codes. In that case, for example, the name of a corporation reflected in its charter document in a public file with the state and the name reflected on the state's publicly available database may differ. If the secured party is to file a financing statement providing the corporation's name as debtor or to search for the debtor's name in the state's filing office records, the secured party may be uncertain as to whether the name should be the name on the corporation's charter

document or the name in the searchable database.

The Amendments clarify that, for a financing statement to be sufficient, the name of the registered organization debtor to be provided on the financing statement is the name reflected on the "public organic record" of the registered organization. In most cases, a registered organization's "public organic record" is the publicly available record filed with the state to form or organize the registered organization. If the registered organization is formed by legislation, the legislation is the public organic record in which the registered organization's name is found. If the registered organization is a Massachusetts type business trust, the registered organization's name is that reflected on the required publicly available filing, usually the trust agreement.

Accordingly, in the example above of the corporation with a name on its publicly available charter document that is different from the name on the state's publicly searchable database, the debtor's name to be provided on the financing statement should be the debtor's name as reflected on the charter document.

If the name of the debtor on a public organic record is amended, the name of the debtor to be provided on a financing statement is the name as so amended. If otherwise there is more than one public organic record stating the debtor's name, the debtor's name is that provided on the most recently filed public organic record as the debtor's name.

D. Name of Debtor When Collateral is Held in Trust

The Amendments distinguish a trust that is a registered organization, i.e., a statutory trust or a Massachusetts type business trust, from a common law trust that is not a registered organization. To be sufficient under the Amendments, when the collateral is held in a trust that is a registered organization, a financing statement must provide, as the name of the debtor, the name reflected as the trust's name on the public organic record of the trust.

If collateral is held in a trust that is not a registered organization, the name to be provided on the financing statement, as under current Article 9, must be the name of the trust itself or, if the trust has no name, the name of the settlor. This rule applies even if, as typically is the case with a common law trust, the trustee and not the trust meets the Article 9 definition of "debtor." In the case of collateral held in a testamentary trust without a name, the name of the testator should be provided. The reference to the name of a testator is a change from current Article 9; the corresponding provision in current Article 9 does not refer to a testator, only a settlor.

The amendments also require that, when the collateral is held in a trust that is not a registered organization, the filer must provide in a separate part of the financing statement a statement that the collateral is held in trust. The reference to "collateral held in trust" replaces the reference under current Article 9 to the debtor being the trust or the trustee. The reference to the debtor being a trust or trustee was thought to be confusing in practice especially because typically under a common law trust in most states the debtor would be the trustee.

If the name of the settlor or testator is provided as the debtor's name, the filer must provide in a separate part of the financing statement sufficient information to distinguish the trust from other trusts of the same settlor or testator. That distinguishing information often could be, for example, merely the date of the trust agreement.

The requirement that this information be inserted in a separate part of the financing statement was intended to reduce the risk that a secured party would provide the information in the debtor's name block of the financing statement. Under the search logic of the filing office in some states, additional information provided in the debtor's name block may cause the financing statement to be ineffective if a search of the debtor's name without the additional information would fail to disclose the financing statement.

E. Name of Debtor When Collateral is Administered by a Personal Representative

Current Article 9 refers to the possibility that the debtor may be an estate. The amendments more accurately refer to collateral that is being administered by a personal representative of a deceased debtor. In such a case the name of the deceased debtor on the financing statement will be sufficient as a "safe harbor" if the name provided is the name of the debtor on the court order appointing the personal representative. If the appointment order contains more than one name for the debtor, the first name of the debtor on the appointment order is sufficient.

F. Debtor's Change of Location

Under current Article 9, if a debtor changes its location to a new jurisdiction, a secured party whose security interest was perfected by filing in the original jurisdiction has a period of up to four months to continue the perfection of its security interest by filing a financing statement in, or otherwise perfecting the security interest under the law of, the new jurisdiction. The four-month grace period applies, however, only to collateral in which the secured party's security interest was perfected at time of the change of location. Of course, a security interest in property acquired by the debtor after the time of the change of location will not be perfected at the time of the change because the security interest in the after-acquired property will not attach until the property is acquired by the debtor and the debtor then

has rights in the collateral. There is no grace period under current Article 9 for perfection of any security interest that may attach to post-change of location after-acquired property of the debtor.

The amendments add a grace period for the after-acquired property. They do so by providing that the financing statement filed in the original jurisdiction is effective with respect to collateral acquired within four months after the debtor's location changes. The secured party can continue perfection beyond the four-month period by filing a financing statement or otherwise perfecting under the law of the new jurisdiction.

The amendments will provide greater protection for a secured party with a security interest in after-acquired property of its debtor if the debtor changes its location. However, a post-relocation secured party considering extending credit to the debtor on the basis of a first priority security interest in the after-acquired property, and a buyer or a lessee of the after-acquired property who is not a buyer in ordinary course or a lessee in ordinary course, will need to do sufficient diligence to know to search for financing statements in the debtor's original jurisdiction during the four month period following the debtor's change of location to the new jurisdiction and, if the search discloses a conflicting financing statement, to obtain an appropriate release.

G. New Debtor

The Amendments provide similar protection for a security interest in after-acquired property if a new debtor becomes bound by the original debtor's security agreement and the new debtor is located in a different jurisdiction from the jurisdiction in which the original debtor was located. For example, if Old Debtor located in State A merges into New Debtor located in State B, under current Article 9 there is a grace period of up to one year for the secured party of Old Debtor to file a financing statement against New Debtor in State B to continue the effectiveness of the financing statement that the secured party filed in State A against Old Debtor. But the grace period applies only to a security interest that was perfected by filing in State A at the time of the merger. There is no grace period for perfection of any security interest that may attach to post-merger after-acquired property. Using an approach similar to that taken with respect to property acquired by a debtor after it relocates, the Amendments provide for a grace period of up to four months in the case of such an interstate merger.

As under current Article 9, a security interest in post-merger after-acquired property that is perfected solely by the financing statement filed by the secured party against Old Debtor in State A will be subordinate to a security interest of a competing secured party perfected by the filing of a financing statement against New Debtor in State B. This result for an interstate merger is consistent with the treatment of after-acquired property of a new debtor in the case of an intrastate merger.

H. Other Filing Related Changes

The Amendments provide for other changes to the filing rules in Part 5 of Article 9:

- Only an initial financing statement may indicate that the debtor is a transmitting utility, in which case the financing statement does not lapse. Current Article 9 suggests that an initial financing statement may be amended to indicate that the debtor is a transmitting utility. The statutory change will make the transmitting utility filing provision consistent with the public-finance and manufactured-home transactions filing provision and will respond to the International Association of Commercial Administrators' concerns about the operational difficulty for filing offices to capture such amendments and prevent the amended financing statements from being treated as having lapsed.
- A filing office will no longer be permitted to reject a financing statement that fails to provide the type of organization of the debtor, the jurisdiction of organization of the debtor, or the organizational identification number of the debtor or a statement that the debtor has none. This information was not considered to be sufficiently useful in practice and often added cost and delay to the filing process.
- The term "correction statement" as used in current Article 9 has been changed to the more accurate "information statement." Under the amendments, an information statement may, but need not, be filed by a secured party of record who believes that an amendment or other record relating to the financing statement of the secured party of record was filed by a person not entitled to do so. Under current Article 9 a correction statement may be filed only by the debtor.
- The uniform forms of initial financing statement and amendment have been updated to reflect the Amendments.

II. CHANGES UNRELATED TO FILING

The Amendments contain some changes that are less connected to the filing rules in Part 5 of Article 9:

- Current section 9-406 renders unenforceable an anti-assignment term of a payment intangible or promissory note that secures an obligation. By way of contrast, current section 9-408 permits a sale of a payment intangible or promissory note notwithstanding an anti-assignment term but does not require the account debtor or maker to attorn to or otherwise recognize the buyer. The amendments clarify that effectiveness of an anti-assignment term of a payment intangible or promissory note in the case of a sale or other disposition of collateral under section 9-610 or an acceptance of collateral under section 9-620 is governed by section 9-406 and not by section 9-408.

- The Amendments modify the definition of the term "authenticate" to conform to the definitions of "sign" in Article 1 and Article 7.
- The Amendments modify the definition of "certificate of title" to take into account state certificate of title systems that permit or require electronic records as an alternative to the issuance of certificates of title.
- The Amendments modify the requirements for control of electronic chattel paper to conform them with those in Article 7 for electronic documents of title and in the Uniform Electronic Transactions Act for transferable records. The result is that the new requirements set forth the current requirements as a "safe harbor" but permit other control systems as well.
- The Amendments clarify that a registered organization organized under federal law, such as a national bank, that, by authorization under federal law, designates its main or home office as its location is located in the state of that office for purposes of Article 9. The provision is a confirmation of a clarification currently stated in the Official Comments.
- The Amendments expand the list of collateral for which a licensee or buyer takes free of a security interest if the licensee or buyer gives value without knowledge of the security interests and before it is perfected.
- The Amendments confirm that a secured party's authorization to record an assignment of a mortgage securing a promissory note assigned to the secured party in order for the secured party to conduct a non-judicial foreclosure sale of the mortgaged real property applies when there is a default by the mortgagor. The language in current Article 9 could arguably have been read to refer to a default by the assignor of the promissory note rather than by the mortgagor.

III. TRANSITION RULES

The Amendments contain their own set of transition rules in Part 8 of Article 9. The transition rules for the Amendments are modeled upon the transition rules used in connection with the 1998 revisions to Article 9 set forth in Part 7 of Article 9.

However, the transition rules for the Amendments are somewhat shortened from those in Part 7 of Article 9 since the Amendments, unlike the 1998 revisions, do not contemplate an expansion of the scope of Article 9 or a change in collateral category definitions. Moreover, although the transition rules for the Amendments do contemplate the possibility that the law governing perfection may change under the Amendments because the location of a debtor may change under the Amendments, the category of cases in which the law governing perfection will change is much narrower than under the 1998 revisions and will likely be applicable only to a Massachusetts type business trust.

FORBEARANCE AGREEMENTS AND WORKOUTS: CASE UPDATE

By Christine Gould Hamm, Husch Blackwell LLP
and
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Two years after the financial crisis, the economy is still in "recovery" and many lenders and borrowers are still dealing with its aftereffects. When the recession began, most of the case law that lenders and borrowers relied on in conducting their workout negotiations came out of prior recessions. Now, however, recent cases[2] have been reported in some important areas of law such as: lender liability, commercial reasonableness and guaranty enforcement. Below are summaries of some recent cases in these important areas of law.

LENDER LIABILITY

A few years ago, as we were just accepting the facts of the financial crisis, several practitioners and other market participants predicted a massive increase in the number of lender liability claims asserted against banks and suggested that the Courts may be less accommodating to the financial institutions (compared to the lender liability case law of the late 1990s and early 2000s). Certainly, the number of lender liability cases in 2009 and so far in 2010 appear to exceed the number of lender liability cases working their way through the Courts in 2007 and before. However, it is difficult to identify lender liability cases, because lender liability can be based on so many theories of law. Perhaps, we have seen more workouts, and fewer foreclosures, than expected - foreclosures tend to fuel lender liability claims.

In any event, lender liability principles are important considerations for lenders and borrowers during the forbearance negotiation process. "Lender liability" generally refers to the liability of the lender to a borrower or another third party arising out of or related to the lending transaction. Such liability could be based on (a) contract claims, such as breach of contract or breach of an implied covenant of good faith and fair dealing, (b) tort claims, such as negligence, tortious interference with contract, tortious interference with business relationship, or breach of fiduciary duty, or (c) even statutory claims, such as violation of unfair business practices statutes, RICO, environmental statutes, and lien foreclosure statutes. In addition, many cases assert multiple theories of liability with respect to the same actions of the lender.

The three cases discussed below highlight common lender liability claims addressed in the recent cases.

***Interpharm, Inc. v. Wells Fargo Bank, N.A.*, 2010 WL 1257300 (S.D.N.Y. Mar. 31, 2010)**

Interpharm, Inc. manufactured and sold generic pharmaceutical drugs. Hoping to expand its business, Interpharm obtained a secured credit facility from Wells Fargo Bank, including a revolving line of credit. The credit agreement provided Wells Fargo with substantial discretion to adjust advance rates and determine eligibility of accounts and inventory. A year and a half into the term of the credit facility, as a result of low revenue, high costs, and increased competition, Interpharm breached the financial covenants.

A. The Forbearance and Workout Process

Wells Fargo and Interpharm subsequently negotiated five forbearance agreements over the course of the next nine months, each of which included a release and waiver of any claims Interpharm had against Wells Fargo arising on or before the date of the applicable forbearance agreement. During the negotiation of the first forbearance agreement, Wells Fargo excluded certain receivables from the borrowing base, which reduced availability and, in Interpharm's view, pressured Interpharm to sign the forbearance agreement. The first forbearance agreement (a) added an additional amount (nearly ten percent) to the revolving line of credit, (b) included a forbearance for a period of about two months, (c) required Interpharm to obtain subordinated debt financing within less than thirty days, (d) added financial covenants, and (e) increased interest and fee rates.

Interpharm asserted that Wells Fargo knew the added financial covenants were "unattainable" and "unreasonable" at the time of the first forbearance agreement. Less than three months later, Interpharm breached the financial covenants and Wells Fargo increased rates and fees to the applicable default rates. Later that month, Wells Fargo excluded certain accounts from eligible accounts, based on the account debtors' rights to charge back. Interpharm was unable to pay suppliers and, eventually, concerned that it could not make payroll, which prompted Interpharm to enter into a second forbearance agreement with Wells Fargo.

The second forbearance agreement was a short-term "interim" forbearance agreement to address Interpharm's immediate issues. It included (a) additional security interests in favor of Wells Fargo, (b) Interpharm's agreement to hire a chief restructuring officer acceptable to Wells Fargo who would prepare a budget, request advances from Wells Fargo, make payments to Interpharm's creditors and administer the budget, (c) amended the definition of eligible accounts to exclude all wholesalers, and (d) an agreement to forbear for a period of three days.

The third forbearance agreement, which was entered into four days after the second, included (a) an agreement to forbear for a period of four months, (b) required Interpharm to reduce payroll expenses by twenty percent, and (c) required Interpharm to take action to sell its real estate. About thirty days later, Wells Fargo reduced the advance rate on inventory by about ten percent, based on a third-party liquidation value analysis of inventory, which reduced availability and prompted the fourth forbearance agreement.

The fourth forbearance agreement (a) changed the inventory advance rate to forty-nine percent or a lesser rate determined by Wells Fargo in its sole discretion, and (b) added the account of one of the wholesalers back in as an eligible account. Interpharm then executed two agreements to sell Interpharm's assets. To obtain funding through the closings of the asset sales, Interpharm entered into a fifth forbearance agreement, which provided for forbearance through closing and a forbearance fee due at closing of the asset sales.

Thereafter, Wells Fargo demanded a release and waiver of claims from Interpharm as a condition to releasing Wells Fargo's liens on the property to be sold. Interpharm refused and then asserted that Wells Fargo's refusal to release liens caused Interpharm to structure the sales in a way that resulted in significant tax liabilities to Interpharm. Wells Fargo also deducted attorneys' fees from an amount it returned to Interpharm without explaining the reason for the attorneys' fees.

B. Borrower's Claims Against Lender

Interpharm then repudiated the forbearance agreements and sued Wells Fargo, asserting claims for (1) breach of contract with respect to the credit agreement and the forbearance agreements, (2) breach of the duty of good faith and fair dealing, (3) tortious interference with business expectations, (4) unjust enrichment, and (5) breach of fiduciary duty. Wells Fargo filed a motion to dismiss based on the broad release and waiver contained in the forbearance agreements. The Court dismissed all but two claims against Wells Fargo.

C. Enforceability of the Release and Waiver of Claims

The Court referred to the "well settled" rule under New York law that a clear and unambiguous release that is knowingly and voluntarily entered into is enforceable, unless there is a legal defense such as fraud, duress, or undue influence. Although the Court found that the release and waiver in the fifth forbearance agreement was unambiguous and clear, Interpharm asserted that the release and waiver should be voided because Interpharm was under economic duress at the time.

Noting that a release between two sophisticated parties is "voided for economic duress only in 'extreme and extraordinary cases'", the Court stated the elements necessary for economic duress: the plaintiff must be compelled to agree by means of a wrongful (unlawful) threat and precluded from exercising free will (no other alternative). Here, the Court found that Wells Fargo's actions did not constitute

wrongful threats and that Interpharm was not compelled to agree to the release. Wells Fargo's actions were not "wrongful threats," because Wells Fargo had the legal right to accelerate the debt and foreclose its security interest and, therefore, had the right to threaten remedies it believed it was legally entitled to exercise.

According to the Court, Interpharm's "assertions provide largely that the Bank drove a hard bargain, not that it did anything unlawful." When analyzing whether Interpharm was compelled to agree to the release and the forbearance agreements, the Court identified at least three alternatives for Interpharm: (1) file for bankruptcy, (2) find a new lender, or (3) sue Wells Fargo to enforce the Credit Agreement. Because Wells Fargo did not make wrongful threats and other alternatives existed, the Court found that Interpharm did not agree to the release under economic duress.

After finding that the release was not voidable for economic duress, the Court determined that the release was effective to release claims arising at or before the fifth forbearance agreement, but not to release any claims relating to Wells Fargo's actions after the fifth forbearance agreement. Therefore, the Court dismissed Interpharm's claims other than breach of contract and breach of duty of faith and fair dealing arising out of (1) Wells Fargo's alleged refusal to release liens without an additional waiver and release and (2) Wells Fargo's alleged wrongful withholding of unspecified attorneys' fees.

Dollar Tree Stores Inc. v. Toyama Partners, LLC, 2010 WL 1688583 (N.D. Cal. Apr. 26, 2010)

Dollar Tree Stores Inc. operated a retail store in a shopping center that was in need of renovation. Comerica Bank financed the renovation project with a construction loan to the landlord. Dollar Tree asserted that the renovation interfered with its business and negotiated a settlement with the landlord. Under the terms of the settlement, Dollar Tree agreed, among other things, to vacate the premises for a period of time and then to accept replacement premises in the newly renovated shopping center, which would include Dollar Tree and another retail business as anchor tenants. The settlement also included a $500,000 closing fee to Dollar Tree, financed through the Comerica loan, rent abatement and other monetary compensation.

Before the renovation project was completed, the other anchor tenant terminated its lease, which resulted in a default under the Comerica construction loan. In response to the default, Comerica ceased further funding of the renovation project, which remains incomplete. The landlord failed to provide replacement premises in the newly renovated shopping center to Dollar Tree, which violated the terms of the amended and restated lease agreement.

Dollar Tree sued the landlord and Comerica. Its claims against Comerica included tortious interference with contract, tortious interference with prospective economic advantage, breach of a subordination, non-disturbance and attornment agreement, breach of the implied covenant of good faith and fair dealing, lender liability (based on negligence) and unfair competition. Comerica filed a motion to dismiss, which the Court granted.

In granting the motion to dismiss, the Court applied the facts to the elements of each claim:

- **Tortious Interference with Contract:**

The elements for tortious interference with contract are:

"(1) a valid contract between plaintiff and a third party;
(2) defendant's knowledge of this contract;
(3) defendant's intentional acts designed to induce a breach or disruption of the contractual relationship;
(4) actual breach or disruption of the contractual relationship; and
(5) resulting damage."

Dollar Tree asserted that Comerica's agreement to finance the renovation project was a conspiracy between Comerica and the landlord intended to cause a breach of the original lease and that Comerica's decision to cease funding caused a foreseeable breach of the amended and restated lease entered into in connection with the settlement. Here, the Court focused on element (3) and held that the facts did not support a "plausible theory" that Comerica intended to induce a breach of either lease. The Court also noted that Comerica's decision to cease funding, which was consistent with its rights under the construction loan agreement, was for "a legitimate business purpose and was justified...."

- **Tortious Interference with Prospective Economic Advantage**

The elements for tortious interference with prospective economic advantage are:

"(1) an economic relationship between the plaintiff and some third party, with the probability of future economic benefit to the plaintiff;
(2) the defendant's knowledge of the relationship;
(3) intentional acts on the part of the defendant designed to disrupt the relationship;
(4) actual disruption of the relationship; and
(5) economic harm to the plaintiff proximately caused by the acts of the defendant."

This tort also requires the assertion of an "independent wrongful act" – acts designed to interfere with a contract are not enough. Here, the Court could find no independent wrongful act by Comerica, relying heavily on its analysis of the tortious interference with contract claim.

- **Breach of a Subordination, Non-Disturbance and Attornment Agreement**

The subordination, non-disturbance and attornment agreement provided that Comerica would not disturb, diminish or interfere with Dollar Tree's possession of the leased premises (absent Dollar Tree's default of the lease). Dollar Tree asserted that Comerica knew the construction loan agreement would interfere with the lease and, therefore, breached the subordination, non-disturbance and attornment agreement. Here, the Court summarily held that it could not "infer that the act of lending money alone would result in a breach of this agreement."

- **Breach of Implied Covenant of Good Faith and Fair Dealing**

Dollar Tree asserted that Comerica breached the covenant of good faith and fair dealing implied in the subordination, non-disturbance and attornment agreement by financing a renovation project, which required Dollar Tree to vacate the premises, and by refusing to continue funding after the event of default. The Court dismissed these claims as well, after discussing the scope of the implied covenant of good faith and fair dealing. In the Court's view, Dollar Tree was attempting to use the implied covenant to impose additional substantive duties on Comerica – specifically, a duty to continue financing even during a default or a duty not to finance a project that may affect Dollar Tree's operation of the premises.

- **Lender Liability (based on negligence)**

Dollar Tree asserted that Comerica was liable for negligent lending. According to the Court, the general rule is that Comerica had no duty of care to the landlord/borrower unless Comerica's role exceeded that of a mere lender of money. The Court noted that no facts were asserted to indicate that Comerica had a more expansive role in the transaction. In this case, the Court declined to impose a greater duty on Comerica with respect to a third-party not in privity (i.e., Dollar Tree) than Comerica had with respect to the borrower.

- **Unfair Competition**

Dollar Tree alleged that Comerica's agreement to make the construction loan and subsequent decision to cease funding were unlawful, unfair and fraudulent business acts and practices under California's Unfair Competition Law. The "unlawful" acts and practices referred to in the statute are those acts and practices that violate other laws. Given the Court's dismissal of all other claims, there were no "unlawful" acts and practices of Comerica to support a claim under the Unfair Competition Law.

FAMM Steel Inc. v. Sovereign Bank, 571 F.3d 93 (1st Cir. 2009)

FAMM Steel, a family owned steel fabricator, began expanding its business operations in the late nineties with financing from Sovereign Bank. When FAMM began experiencing financial difficulty, went into covenant default and its comptroller left the business, Sovereign required FAMM to hire a particular outside consultant to oversee FAMM's accounting while a replacement comptroller was found. FAMM objected to Sovereign's requirement, but Sovereign stated that it was its "prerogative" to require FAMM to hire the consultant. FAMM acquiesced. FAMM eventually hired a permanent comptroller, selected by the consultant. Sovereign also required that the consultant remain an employee of FAMM to train the new comptroller and to continue to oversee FAMM's accounting.

The new comptroller and the consultant allegedly engaged in mismanagement, including failing to reconcile bank statements, failing to pay monthly taxes and presenting inaccurate financial data that showed a profit when in fact FAMM was operating at a loss. When FAMM's other officers discovered the mismanagement and reported it to Sovereign, Sovereign required FAMM to hire a particular turnaround officer.

FAMM's business operations continued to deteriorate, and although Sovereign allegedly indicated a forbearance agreement would be entered into, Sovereign eventually sold the loan at a significant loss. The buyer liquidated FAMM's assets to repay the loans.

A. FAMM's Claims Against Sovereign

After the closure of FAMM's business, FAMM sued Sovereign and claimed, among other things, that (a) Sovereign breached the implied covenant of good faith and fair dealing, (b) Sovereign created, and then breached, its fiduciary duties to FAMM, and (c) Sovereign created a situation in which FAMM became Sovereign's instrumentality.

B. The Implied Covenant of Good Faith and Fair Dealing

The Court concluded that Sovereign did not breach the implied covenant of good faith and fair dealing despite allegations that Sovereign (a) refused to answer inquiries from FAMM's subcontractors and suppliers when FAMM's operations were deteriorating, (b) failed to respond to restructuring proposals or offers to purchase, (c) failed to waive covenant defaults, (d) failed to issue a forbearance agreement despite promises to do so, and (e) failed to extend the line even though it promised it would do so if FAMM made principal reductions.

The Court noted that, when all these events took place, FAMM was in default under the loan documents: "when the borrower is in default, that necessarily alters the contours of the covenant of good faith and fair dealing." The Court then found that the majority of the allegations were based on failure to take actions that Sovereign was not required to take under the loan documents and dismissed them. The Court further held that FAMM had not produced sufficient evidence to support the claims that Sovereign promised to issue a forbearance agreement and extend the line, primarily because no specific discussion of the terms of the forbearance occurred, and there was conflicting testimony (from the turnaround officer) that Sovereign had ever promised to extend the line.

FAMM argued for the first time on appeal that Sovereign had also breached the implied covenant because it forced FAMM to hire the consultant that ultimately hired the new comptroller. Even though the argument was waived (because it was raised for the first time on appeal), the Court noted that the argument would have failed anyway because there was no evidence that Sovereign acted dishonestly or that it was purposefully trying to injure FAMM by insisting that the consultant be hired, nor was there any evidence that Sovereign knew the consultant would not perform his job adequately.

C. Breach of Fiduciary Duty

FAMM argued that Sovereign exerted such a level of control that Sovereign had acquired control over FAMM's day-to-day operations and therefore owed, and breached, a fiduciary duty to FAMM. The Court disagreed and held that Sovereign did not have sufficient control to create a fiduciary duty. The Court found that even though Sovereign had required FAMM to hire the consultant and the turnaround officer, there was no evidence that either individual was acting under Sovereign's direction, nor was there any evidence that the comptroller hired by the consultant was acting under Sovereign's direction. The Court noted that although Sovereign had insisted on the hiring of certain officers, FAMM's other officers, with final say over the company's decisions, remained in place.

D. Instrumentality

The "instrumentality" theory is a claim that a lender has taken such control of its borrower that the borrower has ceased to exist except in shell form and is therefore merely a conduit of the lender. The theory requires a *strong* showing that the lender has taken total control of the borrower and that the borrower had no separate, independent existence of its own. The Court held that FAMM made an insufficient showing. The Court acknowledged that Sovereign and the consultant and turnaround officer interacted, but there was no evidence that Sovereign was directing their actions or that Sovereign had assumed the requisite control. The Court noted that FAMM's other officers still had final say over the company's decisions, and that "an inference [of total control] seems implausible in light of the losses the bank suffered as a result of [the consultant]'s actions."

COMMERCIAL REASONABLENESS

Throughout the workout process, state law remedies enforcement, including Article 9 public and private sales, is typically the backdrop that shapes negotiations. In connection with such public and private sales, the question of paramount importance is whether the sale is "commercially reasonable." The three cases below illustrate the difficulties creditors have had in conducting a commercially reasonable sale and some of the arguments borrowers have raised in attempting to establish that a sale was commercially unreasonable.

***Bremer Bank, N.A. v. John Hancock Life Ins. Co.*, 2009 WL 702009 (D. Minn. Mar. 13, 2009)**

The following is a simplified description of the facts of the case. The creditor made a loan to the borrower to acquire an aircraft, and in return, the creditor took a security interest in the aircraft. When the borrower defaulted, the creditor foreclosed on its security interest and sold the aircraft to the winning bidder. The borrower then sued the creditor, alleging, among other things, that the creditor failed to conduct a commercially reasonable sale of the aircraft.

A. Allegations of Commercial Unreasonableness

The borrower claimed that the foreclosure sale was commercially unreasonable under applicable New York law because (a) the price paid by the ultimate buyer was too low, and (b) the means the creditor used to conduct the sale were inadequate. The borrower's first argument for commercial unreasonableness is referred to as the "proceeds" test and essentially inquires into whether the sale price was optimal. The second argument is referred to as the "procedures" test and inquires into whether the procedures used to sell the collateral conform to commercially accepted standards.

B. Proceeds Test

The borrower valued the aircraft at $20 million. The ultimate buyer purchased it for just under $13 million. The Court began its analysis by noting that, even if a better price could have been obtained at a sale conducted under different circumstances, that fact, without more, cannot establish that a sale was commercially unreasonable. The Court also noted that a low sale price, without more, would not render a sale commercially unreasonable unless "the price is so low as to shock the conscience of the Court."

The Court found that the creditor had marketed the sale adequately (discussed in more detail below) and that $13 million was the best price offered under the circumstances. Moreover, the Court noted that, if the borrower truly believed that the aircraft was worth $20 million, it could and should have bid at the foreclosure sale to protect its equity interest therein.

C. Procedures Test

The borrower alleged that the procedures the creditor used were commercially unreasonable because, among other things, the sale took place only a month after the notice of the sale was delivered, the aircraft was not made available for inspection by potential buyers, and the creditor described the aircraft in a way that was "seriously misleading" and "designed to discourage bidding" because the creditor's description of the aircraft revealed all of its faults and described a long time frame for refurbishing it.

Despite the fact that the creditor sold the aircraft a month after it noticed the sale, the Court found that its marketing procedures were sufficient given that the creditor published an advertisement for the sale in four different trade publications for a month, the creditor advertised the sale on a trade website that received 15,000 hits per day, the creditor directly contacted 448 entities and individuals that it thought might be interested, and the creditor engaged in follow-up negotiations with 31 such parties. Further, the Court found that failure to make the aircraft available for inspection did not render the sale commercially unreasonable. As an initial matter, there was no evidence that any potential buyer had requested access, and further, the creditor released detailed descriptions and technical specifications of the aircraft to interested parties. With respect to the creditor's disclosure of the aircraft's faults and timeframe it would take to repair them, the Court found that the comments were accurate, and as such, were not false, misleading or disparaging, which, had they been, may have rendered the sale commercially unreasonable.

***Hicklin v. Onyx Acceptance Corp.*, 970 A.2d 244 (Del. Super. Ct. 2009)**

Onyx Acceptance Corp. financed a car Hicklin bought and took a security interest in it. When Hicklin stopped making payments, Onyx repossessed the car and sold it at a private auction. The car was worth $4,000, needed about $1,300 in repairs and Onyx sold it for $1,500. Onyx then sued Hicklin for a deficiency, and Hicklin defended on the grounds that the sale was commercially unreasonable.

The trial Court held that the sale was commercially reasonable under Delaware law because the sale price, $1,500, was greater than 50% of the car's value less the repair costs. The appellate Court upheld the ruling. The Delaware Supreme Court, however, reversed.

A. Commercial Reasonableness of Every Aspect of Sale or Safe Harbor

The Court held that Onyx could prove the commercial reasonableness of the sale in one of two ways: (a) demonstrate that every aspect of the sale was commercially reasonable, or (b) demonstrate that it sold the car in accordance with the accepted practices of reputable dealers in that type of property. Onyx presented no evidence throughout the trial and its appeals that the car was sold in accordance with accepted practices of reputable dealers. It therefore had to establish that every aspect of its sale was commercially reasonable.

B. A Fair Price, Without More, Is Insufficient

The Court held that although obtaining a satisfactory price is the purpose of requiring a secured party to resell collateral in a commercially reasonable way, it is only one aspect of commercial reasonableness. Moreover, it is improper to reason backwards from price alone to determine commercial reasonableness of the overall sale process. In particular, the Court found that Onyx's evidence was insufficient to establish that *every aspect* of the sale was commercially reasonable.

Onyx presented the testimony of one employee of ten years who stated that private auctions generally resulted in higher sale prices than public ones. The Delaware Supreme Court did not find this sufficient. It reasoned that establishing that private auctions *generally* result in higher sales prices is insufficient to establish that the *specific* auction procedures used in this case were commercially reasonable. Without proof of the specific auction procedures, Onyx had failed to carry its burden of establishing commercial reasonableness.

***Textron Financial Corp. v. Lentine Marine Inc.*, 630 F. Supp. 2d 1352 (S.D. Fla. 2009)**

Textron Financial Corp. financed Lentine Marine, Inc.'s boat-selling operation and took a security interest in Lentine's inventory. When Lentine defaulted, Textron obtained a Court order entitling it to repossess the boats. Textron then sold some of the boats back to their manufacturers and had some of the others sold through competitors of Lentine. Textron then sued for a deficiency. Lentine defended on the grounds that the sales were commercially unreasonable.

A. Applicable Florida Law

The Court held that, under Florida law, Textron could obtain a deficiency by showing that the disposition was commercially reasonable or that the fair market value of the collateral was less than the debt the collateral secures. Textron failed in both attempts in its motion for summary judgment, because the evidence it put forth was not sufficiently specific.

B. Broad Allegations of Commercial Reasonableness Are Insufficient

With respect to the boats Textron sold back to the manufacturers, Textron submitted an affidavit of an officer that attached the sales agreements and asserted that the prices were higher than that currently available on the retail market. The Court did not regard these as sufficient for summary judgment purposes, because Textron failed to put forth any evidence other than a bald assertion that the prices were higher than the retail market or that the contracts were in conformity with reasonable commercial practices among dealers in the

industry. Textron did not submit samples of other similar contracts or explain how the prices in the contracts entered into were set.

With respect to the boats Textron sold through competitors of Lentine, Textron submitted affidavits from officers of the companies that Textron hired to resell the boats. Those affidavits described the officers' experience in the industry and asserted that the boats were sold for fair market value. For purposes of summary judgment, the Court held that the affidavits were insufficient, because they failed to include specific factual information about the sales or about the current retail market. Without that information, the Court could not determine whether the sales were made in conformity with reasonable commercial practices among marine dealers, that every aspect of the sale was commercially reasonable or that the resale prices represented fair market value.

GUARANTY ENFORCEMENT

Guarantors typically sign guaranties in good times because they don't believe that the borrower will default on its loan obligations. When the borrower defaults and the lender seeks to enforce the guarantor's payment obligations, litigation often results. Below are summaries of three recent cases highlighting some common themes in guaranty enforcement.

TW General Contracting Services, Inc. v. First Farmers Bank & Trust, 904 N.E.2d 1285 (Ind. Ct. App. 2009)

First Farmers Bank & Trust made two loans to TW General Contracting Services, Inc., and principals of TW executed guaranties of the loans at the time the loans were made. The loans were evidenced by two separate notes. The notes were subsequently amended and restated several times, and additional loans, evidenced by other promissory notes, were made. Apparently, the guarantors never signed any acknowledgement of, or consent to, the amendment and restatement or the additional loans. As principals of TW, however, they did sign the new notes on TW's behalf. TW defaulted on the notes, and Farmers sued TW and the guarantors.

A. Guarantor Intentions

The guarantors argued that they were not liable on the renewed notes because, as set forth in an affidavit, they did not intend to guarantee the new loans, and they had not consented to the renewed notes.

B. Enforceability of the Plain Language of the Guarantees, Without Regard to Intent

The Court reviewed the guaranties, determined that the language was unambiguous and enforced them in accordance with their terms. It put no weight on the affidavit regarding the intent of the guarantors. The Court held that the guaranties clearly included any and all debt, whenever arising and howsoever evidenced, owing to Farmers by TW. Further, the guaranties contained language authorizing Farmers to renew, extend and modify existing indebtedness without affecting the guarantors' liability. The Court held that it was not material that the promissory notes failed to refer to the existing guaranties.

Moore v. Wells Fargo Construction, 907 N.E.2d 1038 (Ind. Ct. App. 2009)

Wells Fargo financed a construction company's purchase of drilling equipment and took a security interest in the equipment. Moore, one of the principals of the construction company, guarantied the debt. The construction company defaulted and then went into bankruptcy. Wells Fargo (apparently with an order of the bankruptcy Court) repossessed the equipment, sold it and then sought a deficiency judgment against Moore.

A. Defense of Failure to Conduct Commercially Reasonable Sale

Moore argued that Wells Fargo could not collect a deficiency from him because Wells Fargo failed to conduct a commercially reasonable sale of the repossessed equipment. Wells Fargo countered with an argument that Moore's guaranty released Wells Fargo from its obligation to conduct a commercially reasonable sale.

B. Guaranty Cannot Release the Statutory Obligation to Conduct a Commercially Reasonable Sale

The Indiana Court of Appeals initially sided with Wells Fargo and held that the release was unambiguous and would be enforced in accordance with its terms. *Moore v. Wells Fargo Construction*, 903 N.E.2d 525 (Ind. Ct. App. 2009). However, upon re-hearing, the Court held that the obligation of a creditor to conduct a commercially reasonable sale could not be released under the UCC. As such, the Court went on to evaluate whether Wells Fargo in fact conducted a commercially reasonable sale of the equipment.

SNTL Corp. v. Centre Ins. Co. (In re SNTL Corp.), 571 F.3d 826 (9th Cir. 2009)

SNTL Corporation guaranteed hundred of millions of dollars in reinsurance obligations of certain of its affiliates to Centre Insurance. When SNTL and its affiliates began experiencing financial difficulty, SNTL and Centre entered into an agreement pursuant to which SNTL paid Centre approximately $160 million in exchange for which Centre released SNTL from liability under its guaranty. The agreement contained a revival clause, which provided that, if a Court of competent jurisdiction "enters a final order, judgment or other finding that ... a payment under the [agreement] ... constitutes a voidable or preferential transfer ... or is otherwise ... subject to a claim of preference," Centre was entitled to declare the agreement null and void or exercise "any other remedy provided by law, equity, statute

or contract."

SNTL and its affiliates filed for bankruptcy, and while the proceeding was pending, the California Insurance Commissioner commenced a suit in state Court against Centre seeking to recover the $160 million payment as a preference. Centre ultimately settled the suit with the Commissioner, returning $110 million of the $160 million. The state Court approved the settlement. Centre then filed a proof of claim against SNTL, under the theory that the settlement had triggered the revival clause of the agreement between the parties.

SNTL sought to disallow the claim arguing that (a) the settlement did not constitute a "final order, judgment or other finding" that triggered the revival clause, and (b) SNTL's guaranty was released as of the date of the bankruptcy filing and its obligations could not be revived thereafter.

A. Order Approving Settlement Triggered the Revival Clause

Centre argued, and the Court agreed, that when the state Court entered its order approving the settlement between Centre and the Commissioner, the revival clause was triggered. The approval order specifically stated that the payment Centre made was in settlement of preference claims. The Court held that this triggered the revival clause under the express terms of the clause.

The Court then held that, once the revival clause was triggered, under its express terms, Centre could either terminate the agreement between the parties or pursue all available rights and remedies under applicable law. The Court held that the general principle that a guarantor's obligations revived was applicable law, and Centre could thus elect to revive SNTL's obligations. SNTL argued that the general principle was only applicable if the creditor involuntarily returned a payment, and Centre returned it voluntarily pursuant to a settlement with the Commissioner. The Court dismissed this argument, stating that it "misconstrues the nature of voluntariness" and that "a payment made in settlement of contested litigation is not truly voluntary".

B. Contingent Claim for Revived Obligations

SNTL argued that its guaranty was released as of the date it filed for bankruptcy, and as of that date, it had no obligation to Centre. SNTL argued that Centre's settlement with the Commissioner, entered into after the bankruptcy filing, could not alter the amount of Centre's claim that existed on the bankruptcy filing date. The Court disagreed, holding that on the date SNTL filed for bankruptcy, Centre had a contingent claim, and the fact that the contingency came to pass after that date was immaterial.

THE LOAN SYNDICATIONS AND TRADING ASSOCIATION: THE 2010 LOAN MARKET UPDATE

By Bridget Marsh and Ted Basta[3]

Introduction

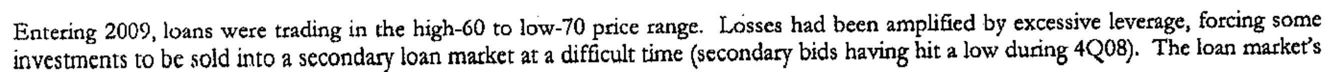
At different times since the credit crisis began in 2008, it seemed that the loan market might be consumed by the financial crisis – either swept aside as an unintended consequence of the regulatory reform laws or irrevocably altered by one of the more recent bankruptcy court decisions. Within the market, its participants continue to grapple with an infrastructure strained by high levels of distressed trading and settlement delays that exceed target. Notwithstanding these challenges, the market continues to function. Indeed, it seems poised to improve – pricing has recovered from the 2009 lows; trading volumes remain impressive; and the looming "re-financing cliff" now appears less dramatic.

In our update published in this newsletter early last year, we noted that the loan market had entered an era of unprecedented volatility (with loan prices more closely correlated to, and no longer shielded from, the daily price fluctuations of other asset classes). We highlighted the steep pattern of price declines, record trading volumes, and rising default rates. More than eighteen months later, volatility has diminished, prices have advanced, and defaults have lessened significantly. The news is not uniformly good, however. The market's investor base has contracted, and both par and distressed trading volumes have fallen, indicating a shrinking market. In this update, we will provide an overview of the leveraged loan market in 2009 and the first half of 2010, focusing on the improvements seen in this market in the six months prior to August 2010. Against this backdrop, we then explore how the LSTA has responded to the recent market challenges and how we view the future.

2009-2010: A Market Recap

Although 2008 will be remembered for the leveraged loan market's first annual negative return, with the S&P/LSTA Leveraged Loan Index (LLI or Index) recording a 29% loss, 2009 notably saw a record gain of 51.6% under the same LLI index. 2010 seems to have witnessed a "leveling-out" compared with those two tumultuous years. As we entered mid-August 2010, the Index had returned 5.15% on the year and default rates were at an 18-month low of about 4%.

Entering 2009, loans were trading in the high-60 to low-70 price range. Losses had been amplified by excessive leverage, forcing some investments to be sold into a secondary loan market at a difficult time (secondary bids having hit a low during 4Q08). The loan market's



default rate then spiked to an unprecedented rate of above 10% during 1Q09, reflecting poor economic fundamentals. But these factors were offset by a series of technical factors that drove the market forward. These included increasing demand as well as shrinking supply – due, in part, to bond-for-loan take outs. In this climate, cross-over lenders stepped in to capture the still-attractive senior secured yields available in the secondary market and, as a result, drove an increase in trading volumes by 23%. During 2Q09, trading volumes reached a total of $133 billion – the first time quarterly volumes were reported north of $108 billion in more than a year. In turn, the LLI registered a 19.2% return during 2Q09 as prices improved by approximately 20% (**Figure 1**), making 2Q09 the strongest quarter on record.

Prices continued to rise in the second half of 2009, surging back up to the mid-80s as bid-ask spreads fell below 150 basis points for the first time since Lehman's collapse. Because bids were well into the 80s and repayments (from bond-for-loan take out deals) were beginning to accumulate, CLOs (which benefit from purchasing loans priced above 80) were finally able to put substantial capital to work. Technical market factors continued to drive loan prices higher, with net new loan supply remaining virtually static. As borrowers continued to make loan repayments, most of 2009's primary issuance was dedicated to refinancings, including amend-to-extend deals that pushed out maturity dates and further reduced the amount of outstanding loans. Of the $56.3B of institutional issuance, only 43% or $24.3 was "net new money" while $74B of bond deals served to replace existing loans (**Figure 2**). These technical conditions were the primary driver of price recovery for much of the year.

After four quarters of "repayment surplus", the dollar value of the outstanding LLI shrunk by 12% to less than $530 billion. Trade prices rallied by a record 21 points, or 31% across all of 2009, while the 2009 LLI returned 51.6%, which more than compensated for the sharp 29% dip in 2008.

Over the same 12 months, the secondary market finally normalized, returning to its pre-Lehman state. Indeed, it underwent the greatest rally in its history. During 2009, the distribution of loans traded at both ends of the price spectrum changed course dramatically. The percentage of loans traded at or above 90 rose to 55% from 7%, while loans traded below 80 fell to 23% from 64% at the beginning of the year (**Figure 3**).

Although returns exceeded expectations in 2009, there were still a number of pending issues facing the leveraged loan market as it entered 2010. First, the default rate remained high. Second, annual trade volumes (as a measure of liquidity) had fallen for the second consecutive year to $474B, from $510B in 2008 and $520B in 2007. Third, distressed trade volume (those loans trading on LSTA distressed trading documentation) averaged $35B per quarter in 2009 versus the previous high of $14B (**Figure 4**). As a consequence of this large distressed trade volume, settlement times were further delayed, increasing by 20 business days and settling on average 68 business days after the trade date (T+68). And, besides the threat of future regulatory changes, a sizable volume of loans were approaching maturity within the next few years and soon would need to be refinanced. This looming threat (dubbed the "refi cliff") raised concerns about who would provide the necessary liquidity to refinance and was exacerbated by a lack of new CLO issuance in 2009 (in the past, 60% of new loans had been acquired by CLOs, thus providing a critical source of liquidity for the primary market).

2010

1Q10 witnessed some improving economic fundamentals. Credit strengthened, and earnings improved. The loan default rate plunged to 5.8%, from 10% at year-end (**Figure 5**). These favorable developments were briefly offset in February 2010, as sovereign debt concerns (largely driven by Portugal, Ireland, Greece and Spain) increased. On the technical side, despite a stronger primary market, net new loans made ($12.2B) were once again outpaced by loan repayments ($26.5B). However, existing demand, as a result of repayments, was buoyed by $3.6B of 1Q10 inflows into loan funds – compared to the $4.9B reported across all of 2009. During this quarter, the LLI returned an impressive 4.64% on a combination of strong technical factors and improving fundamentals. But, for the third consecutive quarter, trade volume fell again, this time by 7% to $110B. Prices in the secondary market, meanwhile, improved by 4%, with the average trade price rising above 90 for the first time in 2 years.

The market continued to perform well in April 2010, but, after 16 consecutive months in which the index yielded a positive return, the LLI turned negative in May, posting a negative 2.23% return. May 2010's loan market correction was attributable to two broad causes – the European contagion and a shift in technical market factors. Europe's sovereign default and related woes weighed heavily not only on loans but across the entire capital structure, as lenders shed risk and sought safe harbors. Within the primary market, as loan fund inflows slowed, supply increased as new demand decreased. While at the same time, high yield bond issuance, a source of cash inflow, was curtailed. Thus, the cash, which lenders had been receiving from bond-for-loan take outs which had driven demand for excess loans, disappeared (**Figure 6**).

In June 2010, notwithstanding the uncertainty surrounding Europe, U.S. economic fundamentals and loan technical market factors remained solid. For the first time in two and a half years, not a single loan defaulted in the LLI, and, as a result, the default rate fell to an 18-month low of 4.02%. U.S. GDP growth had now been solid for three consecutive quarters, and LLI issuers reported nine straight months of year-over-year EBITDA growth. On the technical side, institutional loan issuance slowed for the third consecutive month as did bond take-outs, resulting in a reduction of LLI outstandings of approximately $10B for the quarter (**Figure 7**). At the same time, inflows into bank loan funds were at a four week moving average of $72.6 million. Against this backdrop, although one might reason that loan prices "should" have increased in June, they did not in fact do so and have, unfortunately, followed the volatile direction of the

equity markets. Overall, the market performed poorly, however, with the LLI returning only 0.44%. June's results led to a negative 1.24% for 2Q10 and further reduced this year's 1st half return to 3.34% (**Figure 8**). Even though the secondary prices retreated from their highs during the very light trading sessions of May and June, prices in the secondary still rose 2.9% in 2Q10 to an average of 92.38 – a level not seen since 4Q07.

To summarize, the "good news" in the first half of 2010 was that the default rate fell to an 18-month low of 4.02%, four new CLOs were placed successfully, and, through a series of amend-to-extend deals, the refi-cliff looked much more manageable than it once did – an estimated $40B and $60B of loan maturities, which were due in 2011 and 2012, had been materially extended.

Offsetting this "good news" were some discouraging developments: following 1Q10's 6% decline, secondary loan trading volumes fell by 9% ($10B) in 2Q10 to below $100B. In this respect, 2Q10 represented the 4th consecutive quarter of decline and the first time volumes were reported at or near $100B since the ill-fated fourth quarter of 2008. This decrease in trading, however, was itself a byproduct of improving economic fundamentals: it was driven, in part, by lower distressed volumes, which themselves are a sign of improving credit quality and stronger corporate earnings. Between the end of March 2010 and the middle of August 2010, distressed trading volume plunged by 38% to $21.8B – the lowest level reported in 1½ years (between 1Q08 and 1Q10 distressed trading averaged $35B per quarter).

Despite reduced trading activity, settlement times worsened for the 4th consecutive quarter. The average settlement time of distressed trades during 2Q10 widened even further to T+72, but the median tightened to T+55 (from T+58) signifying that 50% of trades settled within T+55. The lower median was driven by a higher percentage of trades settling within the LSTA guideline of T+20, which increased to 17% – the highest percentage of trades since 2Q09. Moving forward, distressed settlement times appeared to be poised to improve. First, the number of deals trading on distressed documentation fell below 200 for the first time in 18 months and, second, open 2Q10 distressed trade volume was recorded at only $10.6B as compared to the quarterly average of $23.5B that was reported during each of the previous four quarters.

The LSTA's Response

Given the market challenges outlined above, the LSTA has been active in the courts, in the market, and in Washington, D.C. We have expressed our views in critical loan market cases as "amicus curiae"; we have revised our trading documents, intervened to resolve market disruptions, and tackled settlement issues; and we have actively engaged in discussions with politicians, legislators, and regulators, often bringing to their attention potential unintended consequences of legislative drafting.

Amicus Briefs

With the sharp spike in defaults in 2008, there was a commensurate rise in litigation in the loan market. In some instances, the cases resulted in decisions that threatened to erode creditors' rights. The LSTA, therefore, did not hesitate to file amicus briefs in cases that might negatively impact the loan market. Fortunately, our efforts contributed towards several significant victories.

In 2009, we filed an amicus brief in *Trust for the Certificate Holders of the Merrill Lynch Mortgage Investors, Inc. v. Love Funding Corp.*, an important appellate decision involving the law of champerty under New York's Judiciary law. Earlier, a New York federal district court had held that an assignment of litigation rights violated the New York champerty statute. On appeal, the United States Court of Appeals certified a series of questions to the New York Court of Appeals concerning the proper construction of the New York champerty statute. In our brief filed with the New York Court of Appeals, we argued that New York's champerty statute, which prohibits companies from buying or taking assignments "with the intent and for the purpose of bringing an action or proceeding thereon," should be construed narrowly and that assignments of loans with litigation rights are not champertous transfers because the litigation rights are only one means of realizing the value of the underlying asset. Both the New York Court of Appeals and the United States Court of Appeals opinions are broadly in line with the approach we urged, and the federal district court's ruling has thus been reversed. This important decision eliminates any lingering concerns about the application of champerty in the distressed debt trading market.

In another important victory for the syndicated loan market this year, the New York Court of Appeals unanimously found in *DDJ Capital Management v. Rhone Group* that it is not unreasonable for lenders to rely on a borrower's representations in a credit agreement about the accuracy of unaudited financial statements without conducting their own investigation of those statements. In the LSTA's amicus brief filed in support of the lenders, we argued that because most companies release audited financial statements once per year, lenders lend not only on the basis of the latest audited statements but also on the basis of recent unaudited financial statements. We explained that lenders typically require borrowers to represent that those unaudited statements are accurate, rather than engage in their own financial due diligence, and that to require more of the lenders would cause material disruption in the commercial lending market. In accepting these arguments, the Court of Appeals held that a trier of fact could find that the lenders "were justified in relying on the representations" for which they had negotiated. In a possible sign of the impact of our amicus brief, the Court of Appeals justices repeatedly referred to the LSTA's amicus brief during oral argument, questioning the parties' counsel about the impact their decision could have on the corporate loan market.

Although we have been successful in key cases, there have been losses as well. The arguments set forth in our amicus brief filed in *In re*

Philadelphia Newspapers unfortunately did not sway the court. In that case, the United States Court of Appeals for the Third Circuit found that secured creditors could be blocked from "credit bidding" in an auction of the assets of the debtor in a "cram-down" plan of reorganization. We were disappointed with this decision and remain convinced that it threatens one of the fundamental expectations of secured lenders in the loan market – that they can protect their interests by credit bidding for their collateral when a borrower files for bankruptcy. We will continue to monitor developments in this area.

Most recently, the LSTA has filed an amicus brief in support of the lenders in *Citicorp North America v. Official Committee of Unsecured Creditors of TOUSA*. There the bankruptcy court held that loans to the *TOUSA* parent company secured by guarantees from its subsidiaries, the proceeds of which were used to fund a settlement with a joint venture, constituted a fraudulent conveyance. Refusing to look at the company on a consolidated basis, the bankruptcy court concluded that the subsidiaries that pledged their collateral to secure the loan received no value in return and were insolvent when the loan was made, and, consequently, voided those liens. In its brief, the LSTA argues that, amongst other things, in concluding that the loan was a fraudulent transfer, the court improperly ignored the consolidated business organization of the borrower and adopted an unduly narrow (and commercially unworkable) definition of "value." Oral arguments were set for October 29th and the LSTA will continue to follow the case closely.

In another important area for the distressed debt market, the LSTA expressed views on the application of Federal Rule of Bankruptcy Procedure 2019, which requires certain participants in the bankruptcy process to report information about creditors and their claims against the debtor. The latest changes proposed by the Committee on Rules of Practice and Procedure in August 2009 would have required every member of any entity or group representing more than one creditor to disclose the nature and amount of each claim or economic interest the creditor holds in the case, including the price paid and the date the claims or interests were acquired. The LSTA submitted a letter to the Rules Committee opposing the required disclosure of proprietary price and date information. In June 2010, we learned that the Rules Committee had significantly revised the previous version of the proposed rule and the recommendations made by the LSTA were largely adopted.

Primary Market Initiatives

Anticipating the eventual revival of the primary market, the LSTA has launched a project to refresh the LSTA's Model Credit Agreement Provisions which originally had been published in 2005 and to expand them to include language addressing defaulting lenders and the requirements imposed by the Foreign Account Tax Compliance Act ("FATCA") which became law in March as part of the HIRE Act.

Following the collapse of Lehman, parties no longer simply focus on the borrower's creditworthiness, assuming that the other lenders would satisfy their payment obligations. Although the Loan Market Association in the UK published standard defaulting lender language in 2009, we chose to wait until debate in the U.S. market subsided and the language became more settled. After reviewing member comments, we plan to finalize standard language by year's end. The overriding concern with such provisions is whether certain terms will be enforceable upon a defaulting lender's filing for bankruptcy; ultimately, the LSTA's form of defaulting lender language will seek to balance that concern with the market's need for clarity and certainty.

The Model Credit Agreement Provisions will also be expanded to include language addressing FATCA (FATCA will apply generally to loans made after March 18, 2012). FATCA imposes a 30% withholding tax on any "withholdable payments" made to foreign financial institutions (FFI) unless the FFI agrees with Treasury to report information about certain accounts to the IRS. Pursuant to our draft language, if a payment made to a lender would be subject to withholding tax imposed by FATCA if such lender fails to comply with the FATCA reporting requirements, then such lender must deliver to the borrower and agent documentation sufficient for them to comply with their obligations under FATCA. The LSTA also has submitted a comment letter to the IRS/Treasury on FATCA, arguing that the implementation of FATCA could have a significant negative impact on the U.S. corporate loan market. The LSTA suggested that offshore loan securitization vehicles (including CLOs) should be exempted from the FATCA reporting and withholding requirements because their governing documents typically precluded them from obtaining the necessary reporting information. Instead, the LSTA suggested that the regulations adopt a certification mechanism, whereby each payor could rely on a FATCA compliance certification from its payee.

Secondary Market Initiatives

As noted above, although overall secondary trading volume in 2009 had fallen to $474B from a peak of $520B in 2007, distressed trading continued to set record numbers and averaged $35B per quarter in 2009 (**Figure 4**). With such increase in distressed trading volume, the LSTA continued its efforts to improve its distressed trading documents, seeking to eliminate more of the obstacles impeding the market's attainment of faster settlement times. We introduced a data-driven shift date process for selecting the date on which the market convention for transferring debt shifted from par documents to distressed documents[4] and are finalizing a new distressed trade termination mechanism (both of which are discussed below).

The implementation of the LSTA's new Shift Date Rules in January marks another significant step towards streamlining the drafting of distressed documentation. Under the former shift date polling process, the LSTA polled dealers, seeking their opinion on when the market shifted from trading a particular credit on par documents to distressed documents and then posted the results on its website.

Parties to a distressed trade, for which a shift date was required, could then choose to use that information and negotiate a shift date – a process that sometimes contributed to settlement delays. Under the new Shift Date Rules, instead of merely acting as a conduit for information, the LSTA reviews dealer-supplied trade data to determine the shift date for particular debt. The date selected by the LSTA is binding on all loan market participants. By publishing one shift date for the market, thereby eliminating the need for parties individually to negotiate and agree a date, the LSTA has removed one of the obstacles to faster settlement times.

Because the market seemed to have quietly adjusted to the termination mechanism (the "Buy-in/Sell-out Mechanism" or "BISO") introduced in par trading in 2009, with participants judiciously invoking the provision, the timeline for the par BISO was tightened in January 2010 with the hope that this stricter timeline would result in more par trades settling in a timely manner. In addition, the LSTA Board approved the inclusion of a BISO mechanism in the LSTA Distressed Trade Confirmation. Once finalized, the BISO mechanism for distressed trades will largely adopt the BISO mechanism in the Par Confirm but with certain important modifications to reflect the complexities of distressed trading. One of the most notable differences between the two regimes will be the extended timeline for effecting a cover transaction, a necessary modification which accommodates the idiosyncrasies of bankruptcy proceedings, parties' need to negotiate additional trade terms, and the buyers' performance of due diligence. Although we published in early August a revised version of our trading documentation (the turn eliminated some of the optionality of the distressed settlement documents), we expect to publish yet another new version by year's end. At that time, we plan to introduce the new distressed BISO mechanism.

Regulatory Reform Initiatives

The LSTA has been actively responding to the government's regulatory reform initiatives and, during the past year, has tried to ensure that the loan market is not unintentionally caught by some of the proposed changes in the Dodd-Frank Act, including the risk retention rules and the Volcker Rules. Although the LSTA's primary focus has been on the risk retention rules, we believe that the legislation presents possible threats to Loan-only CDS or CDX and total return swaps on loans. During the next six months, the regulators will be drafting the rules required by the new 2,300-page Act. As that process unfolds, the LSTA plans to be completely engaged in the discussions, preparing comment letters and submitting white papers as appropriate.

* * *

Today's market is beginning to resemble more closely the loan market pre-financial crisis. In this environment, the LSTA remains committed to promoting a fair, efficient, and liquid market for loans and maintaining its position as the market's principal advocate. In fact, the LSTA Board has revised our mission statement to provide that we are also committed to growing the corporate loan market.

We know that we will be called upon to address issues raised by our membership as a result of regulatory changes and court decisions and to help effectively and promptly resolve those issues to ensure the market continues to operate smoothly and efficiently. In addition, we will continue to work with market participants to eliminate market inefficiencies. As we commented in our conclusion last year, in all our efforts to resolve those issues, the LSTA will continue to strive to resolve market challenges ever mindful of both its buy-side and sell-side constituents. Although sometimes regarded as having divergent views, we believe that the market's challenges of 2010 and beyond will raise more issues of shared concern to buy- and sell-side alike. We remain confident that these challenges can be faced and surmounted.

THE NEW FATCA TAX WITHHOLDING RULES — PRACTICAL CONSIDERATIONS FOR DRAFTING CREDIT AGREEMENTS

By Carol P. Tello, Sutherland Asbill & Brennan LLP

On March 18, 2010, the Foreign Account Tax Compliance Act ("FATCA") was enacted into law. FATCA is designed to require foreign entities to identify and report to the IRS information about U.S. persons that hold accounts with foreign banks, other financial institutions, and investment funds or who have an ownership interest in a foreign entity. Although the FATCA requirements will not become effective until January 1, 2013, some parties are already modifying the provisions of their lending agreements to address this change in law. This article will provide an overview of FATCA, will consider the question of whether FATCA needs to be addressed currently in lending agreements, and how existing provisions of lending agreements may be amended to account for the new FATCA requirements.

In addition to the new FATCA provisions, another important consideration is the fact that the Internal Revenue Service ("IRS") has identified the existing withholding and reporting requirements as a "Tier 1" issue, meaning that the issue is of high strategic importance to the IRS. The consequence is that IRS examiners are, and will be, reviewing taxpayers' compliance with documentation, withholding, and reporting requirements. Because the IRS is under a Congressional mandate to ensure that U.S. persons may not hide behind foreign accounts and entities to avoid their U.S. tax responsibilities, ensuring FATCA compliance will be an important aspect of IRS audits in the future. Lenders, administrative agents, and borrowers need to ensure that their agreements properly take into account this very important tax issue.

Overview of FATCA[5]

The FATCA tax regime is designed to ensure that offshore income of U.S. persons is reported. To achieve that goal, all foreign entities are subject to U.S. reporting or certification procedures. The FATCA provisions are triggered by the payment of a "withholdable payment," as discussed below, to a foreign entity. If the applicable requirements of FATCA are not satisfied, the U.S. payor must withhold U.S. tax equal to 30 percent of the payment made to the noncompliant foreign entity.

Under the FATCA rules, which are contained in sections 1471-1474 of the Internal Revenue Code, foreign entities are divided into two classes: foreign financial institutions ("FFI") and non-financial foreign entities ("NFFE"). FFIs include depository and investment banks, mutual funds, and likely certain insurance companies. FFIs must enter into an agreement with the IRS in which they are obligated to determine which of their account holders are U.S. persons and provide to the IRS identifying information about the U.S. account holder and about the account. Although an NFFE has similar due diligence requirements, an NFFE is not required to enter into an agreement with the IRS, but, instead, may provide the U.S. payor with a certificate that either the NFFE has no U.S. account holders or identifies its U.S. account holders.

Withholdable Payment

A withholdable payment means (i) U.S. source fixed determinable annual periodic income, commonly referred to as "FDAP," which is currently subject to U.S. withholding tax when paid to a foreign person, and (ii) the gross proceeds from the sale of property that produces FDAP income. The latter category generally is capital gain income that is not subject to U.S. tax when paid to a foreign person.

Not only would FATCA potentially impose withholding tax on such capital gain income, it would impose withholding tax on the gross proceeds with no basis offset, thereby potentially subjecting return of capital to withholding tax. For FFIs that receive such income for their own account which are located in a country with which the United States does not have in effect an income tax treaty, no refunds are permitted. Consequently, in that case, the withholding tax is a final tax.

Recent IRS Guidance – Notice 2010-60

The statutory provisions leave much guidance to regulations. The IRS recently issued its first FATCA guidance, Notice 2010-60, on August 27, 2010, in which it provided rules for identifying which existing accounts are held by U.S. persons, as well as guidance on other priority matters. The guidance is termed as "preliminary" by the IRS and certainly raises as many questions as it answers. Notice 2010-60 requested comments from stakeholders by November 1, 2010 on numerous issues. To provide final detailed guidance in time for FFIs as well as NFEEs to establish their own compliance procedures is a very difficult task, which is why the comment period was short. However, Treasury officials have indicated informally that they will accept comments submitted after November 1, 2010.

Notice 2010-60 provides procedures that U.S. financial institutions ("USFI") must apply to determine the status of a foreign entity to which the USFI makes a payment. Different procedures are provided for pre-existing and new individual accounts and pre-existing and new entity accounts. Nonetheless, the procedures are similar in their application.

The following description is limited to a high level summary of the procedures. Generally, the first step is to review existing searchable electronic databases and identify persons already identified as U.S. persons for existing withholding rules. Following that step, a search of records is made for "indicia" of U.S. status such as a U.S. address. Documentation must be obtained from those account holders to determine whether the account holder is a U.S. or non-U.S. person. For new accounts, documentation must be obtained when the account is opened; otherwise with some exceptions, the account holder is treated as a recalcitrant account holder subject to 30 percent withholding. One important distinction for entity account holders is that the foreign financial institution may rely on third party data to treat the entity as engaged in an active trade or business. In that case, the FATCA provisions do not apply.

Grandfathered Obligations – Exempt From Withholding

Significantly, for commercial finance lawyers who draft credit agreements and similar documents, Notice 2010-60 addresses the statutory grandfather rule for obligations outstanding on March 18, 2012. Under that rule, an obligation in existence on March 18, 2012, will not be subject to withholding under FATCA unless there is a material modification of the obligation under Treas. Reg. §1.1001-3, which is discussed below. Notice 2010-60 provides guidance on the scope of the term "obligation," which will include any legal agreement that (i) produces or could produce certain types of U.S. source FDAP income (such as interest) and (ii) has a definitive expiration or term. An obligation that undergoes a "material modification" will be treated as newly issued as of the date of the modification.

What this means is that obligations that are executed or materially modified on or before March 18, 2012 will not be subject to any requirement to withhold 30 percent U.S. tax. As a practical matter, this is very helpful because the regulatory guidance has not been completed so while agreements currently being negotiated may take account of the FATCA requirements, when final guidance is provided, agreements that are modified now may need to be amended to conform to that final guidance. In the meantime, grandfathered obligations will not be subject to the FATCA withholding requirement.

It should be noted that the language of Notice 2010-60 does not extend an exception from reporting to the IRS for grandfathered obligations, which is consistent with the statute. Therefore, a borrower will need to be able to identify the U.S. or non-U.S. status of the

lender. Further guidance will presumably provide more information about the reporting obligations of a borrower that pays interest under a grandfathered obligation.

One interesting aspect of the interplay of the grandfather date and the FATCA effective date is that payments under obligations that are executed or materially modified after March 18, 2012 will not become subject to withholding under FATCA until the effective date of January 1, 2013. However, for obligations executed in that time period, FATCA provisions should definitely be included in the tax provisions.

"Material Modification"

For obligations that are treated as debt obligations under U.S. tax law, as noted above, the tax regulations apply to determine whether a material modification has occurred. Although the underlying legislative history anticipates that regulatory guidance will be provided as to the application of those tax rules, government officials in public remarks have recently said that they do not intend to change the existing regulations.

Under the "material modification" regulations, certain modifications generally will constitute a material modification, which will cause grandfather status to be terminated as of the effective date of modification. Those modifications are: (i) changes in yield; (ii) changes in the timing of payments; (iii) changes in the obligor or debt collateral; (iv) changes from debt to equity and from recourse to nonrecourse classification; and (iv) changes involving financial and accounting covenants.

Revolvers

Not explicitly addressed by the tax regulations is the treatment of revolvers. Logically, a drawdown on a revolver that does not exceed the agreed commitment amount should not be treated as a material modification and, thus, as not a newly issued obligation. Similarly, it would seem that a repayment of a revolver executed on or prior to March 18, 2012 should not be subject to FATCA. An *increase* in an amount of a term loan or revolver loan commitment, however, may constitute a material modification that would not enjoy grandfather status for purposes of chapter 4 if executed after March 18, 2012.

In recent public comments, a government official seemingly agreed with the foregoing analysis by stating that he did not believe that it would be appropriate to go back and taint a prior tranche that was issued prior to the grandfathering date. However, this statement raises the question of what is an "issuance" and an "issuance date." The government official noted that these questions are currently being considered; concepts in the original issue discount regulations, which provide specific rules about what is considered an issuance, and how to deal with separate tranches, may provide some guidance. Without guidance, however, it is not clear how revolvers will be treated for purposes of "material modification."

Should a drawdown or a repayment of a revolver constitute a "material modification," it is not clear whether only the additional loan amount or the entire loan amount (including the pre-existing loan commitment) would become subject to FATCA. As the IRS intends to issue further guidance, this issue hopefully will be addressed in that future guidance.

The ABA Tax Section plans to submit comments concerning Notice 2010-60, which specifically addressed revolvers.

Coordination With Existing Withholding Regimes- Foreign Person and Back-Up Withholding

Currently, private lending arrangements generally will contain tax provisions that require the lender to provide the borrower either a Form W-9 or, in the case of a foreign lender, a Form W-8BEN or Form W-8ECI (withholding certificates) so that withholding will not be imposed or will be reduced in the case of certain payments to foreign lenders. In addition, the borrower must report on the interest payments made either on a Form 1099 for a U.S. lender or on a Form 1042/1042S for a foreign lender.

The FATCA statutory provisions mandate that duplicative withholding be eliminated to the extent possible. Consequently, only one tax will be collected under all of the various withholding regimes. Guidance to eliminate duplicative withholding and reporting has not been issued to date, but is anticipated.

Amendment of Existing Lending Agreement Tax Provisions To Comply With FATCA

Most credit agreements contain a gross up provision requiring the borrower to make additional payments to make the lender whole when certain taxes are imposed. Withholding taxes (either backup withholding or withholding imposed on a foreign person) commonly are excluded from the scope of the gross up provision on the basis that compliance with those provisions are within the control of the lender and the borrower should not be required to compensate the lender when the lender has the ability to prevent the withholding event. Similarly, a foreign lender generally will have within its control the ability to comply with the FATCA provisions.

However, there may be instances when an FFI cannot obtain the information necessary to identify its account holders, either because the account holder does not provide the necessary information or the account holder does not waive its local law privacy rights so that the FFI is unable to report the necessary information to the IRS. Although the FATCA provisions allow for an election for withholding to be imposed only on that portion of the payment that is attributable to the "recalcitrant" account holder, the IRS is considering remedies

when an FFI has too many recalcitrant account holders. Such a remedy may be outside the scope of the lender-borrower relationship, but it could result in the IRS revoking the foreign lender's agreement with the IRS, in which case, withholding would be required. Consequently, despite the efforts of the foreign lender-FFI to comply, it may not be able to do so.

In such a case, which party should bear the cost? The borrower would argue that it has no ability to require the lender's account holders to waive their privacy rights. The lender would have the ability to request a waiver from its account holders, but likely under local law would not be able to require a waiver. This would be a particularly difficult case because in a private lending deal the lender's account holders would have no ownership interest in the interest payments, but yet potentially could prevent the lender from meeting its FATCA obligations.

Liability of U.S. Administrative Agents

Under current U.S. cross-border withholding rules, each party that has control, custody, or receipt of U.S. source FDAP income is a "withholding agent," meaning that each such party has liability for the U.S. tax that should have been withheld and any accrued interest on that tax. As a result, a U.S. administrative agent is a withholding agent under the current withholding provisions. While the foreign payee has liability as well, generally, the IRS will assert a deficiency against the last U.S. withholding agent in the chain that pays the U.S. FDAP income to a foreign recipient.

The same liability rule applies to "withholdable payments" subject to the FATCA provisions. Assuming that a U.S. administrative agent is a USFI, it will also have the responsibility to determine the status of the foreign lenders for purposes of the FATCA provisions.

SUMMARY

Although not currently in effect, FATCA will impact cross-border lending agreements at least prospectively. Borrowers' and U.S. administrative agents' counsel may wish to ensure that FATCA provisions are included in current agreements so that, should a material modification occur to the agreement after March 18, 2012, the borrower and U.S. administrative agent are protected from having to gross-up for FATCA withholding. U.S. administrative agents and borrowers, as withholding agents, may wish to ensure that they have the right to request the proper certifications from non-U.S. lenders. Until more complete guidance is provided, very general broad provisions will need to be drafted to account for a potentially changing compliance environment and requirements.

UCC Spotlight

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

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

***Merrill Lynch Business Financial Services, Inc. v. Kupperman*, 2010 WL 2179181 (D.N.J. 2010)**

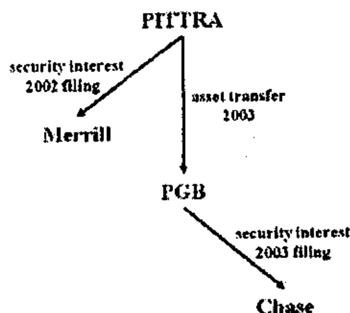
This case concerns the priority of two security interests, one granted by the debtor and one granted by the debtor's predecessor. The court got much of the analysis correct but fumbled badly near the end and reached a grievously wrong result.

The dispute has its origin in 2002, when Arthur Kupperman formed PITTRA G.B. International, Inc. ("PITTRA") to import and export industrial food ingredients. PITTRA obtained a $2¼ million loan from Merrill Lynch Business Financial Services Inc. ("Merrill"). That loan was secured by all or most of PITTRA's assets and Merrill's security interest was perfected by a filed financing statement. Over several years, the loan balance was increased to $4¼ million, primarily as a result of Kupperman's fraud.

Meanwhile, in 2003, PITTRA had in fact sold many of its assets to PGB International, LLC ("PGB") another entity formed and owned by Kupperman to import and export industrial food ingredients. The following year, PGB obtained a secured loan from JP Morgan Chase Bank ("Chase"). Chase's security interest was perfected by a filing against PGB. By 2006, the loan balance was about $3 million.

Eventually, the two borrowers defaulted and Kupperman's fraud was discovered. Merrill and Chase then each claimed priority in the assets of PGB. The following diagram illustrates the relationship of the parties.

Chase claimed that Merrill could not identify the assets transferred years before from PITTRA to PGB, or their proceeds, and therefore Merrill was not entitled to priority. The court disagreed. The court first noted that Merrill's security interest extended to both existing and after-acquired collateral of PITTRA and its successors. It then concluded that PGB was a successor to PITTRA. In reaching this conclusion, the court observed that: (i) the two entities operated out of the same location, (ii) PITTRA transferred its office furniture, equipment, customer lists, supplier lists, telephone numbers, and general goodwill to PGB; and (iii) the entities had the same owners. In addition, it is worth noting that PITTRA apparently stopped conducting business on its own after the asset sale.



So far, so good. Although the court did not cite Article 9's rules on "new debtors," *see* § 9-203(d), (e), those rules contemplate that an entity can become bound by operation of law to a security agreement created by its predecessor.

The court then moved to perfection. It cited to and quoted § 9-507(a), which provides that a filed financing statement remains effective with respect to transferred collateral, and concluded therefrom that Merrill remained perfected in the assets of PGB. What the court did not seem to appreciate is that § 9-507(a) applies only to transferred collateral. That rule has no application to collateral acquired by an entity after it becomes a "new debtor."

The court should have looked to § 9-508.[6] That section makes the filing against a predecessor effective against a differently named successor, but only with respect to the collateral the successor owned at the time it became a new debtor and the collateral acquired within four months thereafter. *See* § 9-508(a), (b). In reality, Merrill's security interest was perfected only in the collateral transferred from PITTRA to PGB, property acquired by PGB within four months thereafter, and possibly the proceeds of all such collateral. If Merrill had been able to identify that property, it would have been entitled to priority under the first-to-file-or-perfect rule of § 9-322(a)(1). As to all the other collateral – everything acquired by PGB more than four months after it became a new debtor – Chase's security interest should have been entitled to priority under § 9-322(a)(2).

Not only did the court err in its analysis of perfection, but it also looked to the wrong priority rule. Instead of looking to § 9-322(a), the court instead relied upon § 9-325. That section deals with the so-called "double-debtor" problem: two security interests in the same collateral granted at different times by different debtors. However, that section gives priority to the first security interest only if:

(i) the second debtor "acquired the collateral subject to a security interest created by another person";
(ii) that security interest was and remains perfected; and
(iii) priority would be different under § 9-322 or § 9-324.

With respect to the transferred collateral, the first two of these requirements were met but not the last because Merrill had filed before Chase. With respect to assets acquired by PGB after it became a new debtor, the first requirement was not met. Those assets were not already subject to Merrill's security interest when PGB acquired them; instead Merrill's security interest could have attached only at the time PGB acquired them. In other words, the security interests of Merrill and Chase attached simultaneously, and that is not a situation to which § 9-325 applies.

The sense one gets from reading the opinion is that the court committed an all too common yet fundamental error. It treated the collateral as a single mass rather than analyzing it item by item. Under Article 9, the analysis of such matters as perfection and priority often varies depending on the type of collateral at issue or the time of attachment. Because this can be different for different items of collateral, the analysis must proceed separately for each.

Roswell Capital Partners LLC v. Alternative Construction Technologies,
2010 WL 3452378 (S.D.N.Y. 2010)

This case concerns what happens to a security interest when the secured obligation is extinguished. The court was on sound footing in the principal part of its analysis, but it strayed far afield in its alternative holding about the efficacy of an unauthorized termination statement.

The case had its beginnings in 2005, when JMB Associates loaned $630,000 to Alternative Construction Technology, Inc. ("ACT"), secured by certain personal property. JMB perfected its security interest by filing a financing statement. The secured obligation was represented by two promissory notes, each of which provided that it could be "converted into equity of [ACT] at the option of the Payee." The notes also provided that if JMB did convert the notes to equity, JMB could "unwind the transaction" and convert the equity back into debt if the price of ACT's stock ever fell below $2.00 per share.

In 2006, in connection with a public offering, JMB elected to convert the notes to equity interests in ACT. Subsequently, Roswell Capital Partners, LLC, as collateral agent for a group of lenders, acquired a perfected security interest in virtually all of ACT's assets. In

connection with those transactions, ACT – the debtor – filed a termination statement for JMB's financing statement.

In 2008, JMB tendered its stock to ACT in an effort to unwind the prior conversion and re-convert the equity to debt. Eventually, litigation ensued as to whether JMB's claimed security interest in ACT's assets had priority over Roswell's. The parties agreed that Roswell's security interest was perfected but Roswell challenged both the attachment and perfection of JMB's security interest.

Attachment
The court began its analysis by noting that the UCC defines a "security interest" as "an interest in personal property or fixtures which secures payment or performance of ***an obligation***." § 1-201(b)(35) (emphasis added by the court). The court then concluded that JMB's security interest was extinguished when the underlying obligation was converted into ACT common stock. It further concluded that JMB's security interest did not re-attach when JMB rescinded the conversion, apparently based in part on the fact that the note did not state that JMB's security interest in ACT's assets would survive conversion of its debt into equity.

The second of the court's conclusions has some appeal. If JMB's security interest was indeed extinguished in 2006, when JMB converted the notes to stock, it is unlikely that the security interest would re-attach absent some clear language to that effect in the security agreement. After all, security agreements are typically interpreted against the drafter, and that is usually the secured party. In other words, the parties certainly could have provided for re-attachment, but there was no evidence that they had.

The court's first conclusion – that the security interest was extinguished in 2006 – is a bit more questionable. While the court was correct in observing that a security interest must secure "an obligation," that obligation need not be a debt. Indeed, the definition expressly refers to "payment *or performance* of an obligation," and one does not normally perform a debt. Accordingly, a security interest can secure contractual duties other than payment of a debt. This point is further supported by the fact that § 9-203(b)(1) requires for attachment that value be given and § 1-204 defines "value" to include "any consideration sufficient to support a simple contract."

Given that JMB's security agreement apparently secured ACT's obligations under the promissory notes, and the notes gave JMB the right to unwind its election to convert the notes to stock, the security interest should have continued to secure this right/obligation after the conversion to stock in 2006. Thus, it is not at all clear that JMB's security interest was indeed extinguished in 2006.

Perfection
The far more troubling aspect of the court's opinion was its analysis of perfection. The court began by noting that, except as provided in § 9-510, upon filing a termination statement, the financing statement to which the termination statement relates ceases to be effective. § 9-513(d). Section 9-510(a) provides that a filed record is effective only to the extent it was filed by someone authorized to do so under § 9-509. Section 9-509 in turn requires the secured party's authorization to file a termination statement, except in certain circumstances not applicable to this case. These are fair propositions and the court was right to begin with them.

Then, quoting *In re S.J. Cox Enterprises, Inc.*, 2009 WL 939573 (Bankr. E.D. Ky. 2009), the court stated that "termination of a financing statement, ***even if mistaken***, releases the secured creditor's lien against the debtor's property" (emphasis added by the court). This statement is partially correct. Filing a termination statement does not release the lien. It merely renders the financing statement ineffective to perfect. It may well be that the security interest was extinguished prior to the filing of the termination statement; as such would indeed be the normal state of affairs. Moreover, if the lien still existed, the filing of a termination statement would not necessarily negate perfection if the security interest were perfected in a manner other than by filing. Putting this small slip aside, the court was correct that a ***mistakenly filed*** termination statement is effective. That is, a mistakenly filed termination statement does make the financing statement to which it relates ineffective. While the Code does provide that the common law of mistake does survive and supplements the Code's rules, *see* § 1-103(b), it is unlikely that a mistakenly filed termination statement would be deemed ineffective against innocent third parties.

Unfortunately, the court's next few sentences went well beyond this. The court stated: "This clear rule accords with the policy of the UCC. Potential creditors must be able to rely on termination statements filed in the public record, even if they were filed in error ***or without authorization***" (emphasis added). Absolutely not! A mistakenly filed ***but authorized*** termination statement is effective. An ***unauthorized*** termination statement is not effective. Indeed, that is what the Code clearly states in the sections quoted by the court at the beginning of its discussion of this issue.

The court offered no explanation of how its statement can be squared with the language of the Code. Nor is the court correct about policy. The filing system provides searchers merely with inquiry notice. A financing statement does not tell searchers that named secured party *has* a security interest, merely that it *may have* one. The searcher must complete its due diligence to ascertain what rights the putative secured party actually has. Indeed, a financing statement could be filed – mistakenly or maliciously – by someone with no claim to any rights in the listed collateral. Similarly, a termination statement might be filed by someone without authorization to do so, and therefore be ineffective to undermine the secured party's perfection. The searcher must complete its due diligence. If the court were correct, then debtors and interlopers could unilaterally un-perfect a creditor's security interest. They cannot. A new comment to § 9-518, still in draft form, will be making this point more clear:

Sometimes a person files a termination statement or other record relating to a filed financing statement without being entitled to do so. . . . If the person that filed the record was not entitled to do so, the filed record is ineffective. . . . Just as searchers bear the burden of determining whether the filing of initial financing statement was authorized, searchers bear the burden of determining whether the filing of every subsequent record was authorized.

Rothrock v. Turner,
2010 WL 2267226 (D. Me. 2010), *recons. denied,*
2010 WL 3199481 (D. Me. 2010)

This case involves perfection of a security interest in a certificated security and the proceeds thereof. The court overlooked the key provisions of Article 9 bearing on the issue, and as such reached the wrong result on some important aspects of the case.

The facts of the case can be simplified without affecting the analysis. In 2004, Parco Merged Media Corp. became indebted to Bruce Rothrock on a $600,000 loan. The loan was secured by a pledge of the debtor's 175,000 shares of stock in MultiSpectral Solution, Inc. To perfect his security interest, Rothrock took possession of the stock certificate.

In March 2008, Scott Cohen, the debtor's treasurer, contacted Rothrock and offered to submit the stock certificate to J.P. Morgan in return for a cash payout as part of a merger and stock redemption taking place at the time. Rothrock, who was chairman of the debtor's board of directors, understood that Cohen would be acting as his agent, rather than as debtor's agent, with respect to this transaction. Rothrock agreed and delivered the stock certificate to Cohen.

On May 12, 2008, Cohen tendered the stock certificate to J.P Morgan, signing the transmittal form as treasurer of the debtor and directing that the funds be remitted to a deposit account in the name of the debtor but over which Rothrock had sole signatory power. The letter included no indication either of Rothrock's interest in the stock or that Cohen was acting as an agent for Rothrock.

One week later, a petition for involuntary bankruptcy was filed against the debtor. A few days after that, the first installment of stock redemption proceeds was deposited into the debtor's deposit account. Rothrock promptly transferred the proceeds to one of his personal deposit accounts. In August, the second installment of stock redemption proceeds was deposited into the debtor's deposit account and Rothrock promptly wired those funds to a personal account. The bankruptcy trustee then sued to recover the funds under a variety of theories, including that the transfer was an unauthorized post-petition transfer of estate assets. The bankruptcy court entered summary judgment for the trustee and Rothrock appealed.

Putting aside issues of breach of fiduciary duty and fraud, much of the case centered on whether Rothrock's security interest in the stock remained perfected after he released possession of the stock certificate to Cohen. Acknowledging that a secured party can perfect through delivery, *see* §§ 9-313(a), (e), 8-301, and that delivery can be to the secured party's agent, the court correctly noted that the debtor cannot for this purpose serve as the secured party's agent. *See* § 9-313 cmt. 3. Thus, according to the court, the issue came down to whether Cohen was acting as the secured party's agent or the debtor's agent.

The court assumed that Cohen acted as each party's agent, but at different times. Specifically, Cohen acted as Rothrock's agent in accepting the stock certificate in March but became the debtor's agent, at the latest, in May when he endorsed the stock certificate as treasurer of the debtor and submitted it to JP Morgan with instruction to remit the proceeds to the debtor's deposit account. This is an intriguing assumption, one to which we will return below. Unfortunately, even accepting this assumption the court's reasoning from this point was flawed.

Citing to § 9-313(e), the court concluded that Rothrock lost perfection on May 12, when Cohen became the debtor's agent. However, § 9-313(e) merely says that perfection "by delivery" expires when the debtor obtains possession. It does not foreclose the possibility that the secured party may remain perfected by some other method. For example, the secured party could have perfected through a filed financing statement. More relevant to this case, the secured party could be perfected automatically for a temporary period. Specifically, § 9-312(g) provides that a secured party who relinquishes possession of a certificate security to the debtor for the purpose of sale, exchange, presentation, collection, enforcement, renewal, or registration of transfer, remains automatically perfected for 20 days. Presentation of the stock certificate to the transfer agent in connection with a merger redemption undoubtedly falls within this rule. Thus, the court should have concluded that Rothrock could remain perfected in the stock as late as 20 days after May 12.

Because identifiable cash proceeds of the stock were received within that 20-day period, Rothrock's security interest in those proceeds was also perfected and it remained perfected as long as the proceeds were identifiable. *See* § 9-315(c), (d)(2).

On a motion for rehearing, Rothrock argued for precisely the analysis presented here. The court refused to consider the argument, particularly the impact of § 9-312(g), because Rothrock had not argued it before the bankruptcy court or initially on appeal. The court then returned to the assumption that Cohen had shifted allegiances, having first served as agent for Rothrock and then for the debtor.

The court stated that while it was willing to entertain this assumption for the purposes of summary judgment, it was not willing to "accept that this artificial transfer triggers the exception under [§ 9-312(g)]." The court expressed concern that this would "enable parties to obfuscate the time of transfer," and thereby potentially convert a rule providing a short period of temporary perfection into a longer one.

That concern may be legitimate, but it does seem that, having been shown the errors in its initial analysis, the court was looking for a way to save face. Moreover, it failed to look at this from the perspective of the creditor. Rothrock's security interest was initially and indisputably perfected by delivery and possession of the stock certificate. Rothrock then delivered the certificate to Cohen, a person Rothrock took to be his own agent, to facilitate redemption. It was Cohen's later actions that made him seem to be the debtor's agent. If the court had concluded that Cohen, as an officer of the debtor, had never truly been Rothrock's agent, then its ultimate conclusion would have been correct. Perfection would have lapsed 20 days after Cohen received the certificate, a time before Cohen submitted the certificate for redemption, and Rothrock's security interest in the redemption proceeds would never have been perfected. More important, secured parties could deal with such a rule. If an officer of the debtor can never serve as the secured party's agent, secured parties can simply avoid delivering possession to such a person.

But that does not appear to be what the court held. Instead, the court seems to have ruled that because Cohen submitted the stock certificate to J.P. Morgan as the debtor's agent, Cohen had always been the debtor's agent. That is a rule to which secured parties cannot adjust. Secured parties cannot be expected to control all the actions of their representatives. If a representative's action – after agreeing to serve as the secured party's agent – may cause the representative to retroactively be deemed never to have been the secured party's agent, secured parties will be vulnerable to a retroactive loss of perfection and will have no way to protect their interests.

Despite the court's errors, it is not clear that the court reached the wrong result. Recall that the bankruptcy court ruled that Rothrock's transfer of the redemption proceeds to his personal account was an unauthorized post-petition transfer, and thus avoidable by the trustee. That should be true even though Rothrock did have a perfected security interest in the proceeds. So, the court was correct in requiring Rothrock to return the funds. However, Rothrock should still be entitled to a perfected security interest in the funds he returns.

Southwest Bank of St. Louis v. Poulokefalos,
2010 WL 2266072 (Ill. App. Ct. 2010)

This case involves a dispute over fixtures between the landlord and a secured creditor of the tenant. The relevant facts begin in 2003, when Converters Extruded Films, Inc. ("Original Tenant") leased building space from two individuals and then installed in the building equipment to be used in the commercial production of plastics. The equipment was brought in piece by piece, reassembled, welded, and then bolted to the floor, ceiling rafters, and joists. The assembly process required removal and replacement of some of the rafters in the ceiling.

Two years later, Original Tenant sold its business and assigned the lease to the debtor. On the same day, Southwest Bank of St. Louis loaned the debtor $1 million, secured by all of the debtor's equipment, including fixtures. The bank filed a financing statement in Missouri, where pursuant to § 9-307 the debtor was located, but did not record its interest in Cook County, Illinois, where the building was located. Thus, the bank did not file a fixture filing under § 9-502(b).

In 2008, after defaulting on its obligations to both the bank and the landlords, the debtor abandoned the leasehold, including the fixtures. The landlords filed a complaint to distrain the fixtures for past-due rent and property taxes. The following day, the bank filed a replevin action seeking attachment of the fixtures. The cases were then consolidated.

The landlords claimed both a landlord's lien for the unpaid rent and ownership of the fixtures. The latter claim was based on a clause of the lease agreement providing that "all . . . fixtures . . . which are permanently affixed to the Premises . . . shall thereupon become the property of Landlord without any payment to tenant." The trial court ruled for the landlords, concluding that although the bank's security interest was perfected, the landlord's lien had priority. The bank appealed.

The appellate court affirmed. In doing so, the court erred both with respect to the facts and the law. Although it noted at the beginning of its opinion that the trial court had ruled that the bank's security interest was perfected, when the appellate court moved to the analysis, it inexplicably characterized the bank's interest as unperfected. There was no explanation for this discrepancy. The court then compounded this error on the facts by expressly ruling that the bank's lack of a fixture filing was fatal to perfection. This is simply not true. A fixture filing is not necessary to perfect, *see* § 9-502 cmt. 4, merely to enhanced priority, *see* § 9-334.

Fortunately, the court's errors do not appear to have led to a wrong result. The default priority rule for fixtures is that a security interest, even if perfected, is subordinate to a conflicting interest of an encumbrancer or owner of the real estate. *See* § 9-334(c) & cmt. 5. The secured party can obtain priority if its security interest is perfected by a fixture filing before the interest of the owner or encumbrancer is of record, *see* § 9-334(e)(1), but here the bank never filed a fixture filing and, even if it had, the filing would have been long after the

landlords' interest in the property was recorded (and the goods had become fixtures). Moreover, the landlords had an alternative argument: pursuant to the lease, they had become the owners of the fixtures two years before the bank's security interest purported to attach. So the court reached the correct result, albeit for the wrong reason.

Useful Links and Websites

Compiled by Commercial Law Newsletter Co-Editors Kelly Kopyt, Carol Nulty Doody, and Christina Rissler

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

1. www.lexology.com– In cooperation with the Association of Corporate Counsel Lexology provides articles and practical tips relating to the practice of law.
2. The UCCLAW-L listserv, is sponsored by West Group, publisher of the "UCC Reporting Service." The listserve is an e-mail discussion group focusing on the Uniform Commercial Code. To subscribe to the UCCLAW-L listserv, go to http://lists.washlaw.edu/mailman/listinfo/ucclaw-l
3. The American Law Institute http://www.ali.org/index.cfm?fuseaction=projects.proj_ip&projectid=21
4. U. Penn's archive of NCCUSL final acts and drafts can be accessed at http://www.law.upenn.edu/bll/archives/ulc/ulc.htm
5. Pace University's database of the United Nations Convention on Contracts for the Initiation Sale of Goods and International Commercial Law Database can be accessed at http://cisgw3.law.pace.edu
6. Gonzaga University's new Commercial Law Center has a variety of links to useful sites and can be accessed at http://www.law.gonzaga.edu/Centers-Programs/commercial_law_center/default.asp
7. The International Association of Commercial Administrators (IACA) maintains links to state model administrative rules (MARS) and contact information for state level UCC administrators. That information can be accessed at http://www.iaca.org
8. The Uniform Law Commissioners maintains information regarding legislative reports and information regarding upcoming meetings, including Joint Review Committee for Uniform Commercial Code Article 9. You can access this information at http://www.nccusl.org/Update/
9. Information on the work of The United Nations Commission on International Trade Law ("UNCITRAL") (including the work of its working groups on Procurement, International Arbitration and Conciliation, Transport Law, Electronic Commerce and Insolvency Law) *available at* http://www.uncitral.org/uncitral/en/index.html
10. The American College of Commercial Finance Lawyers – http://www.accfl.com
11. The Secretariat of Legal Affairs (SLA) develops, promotes, and implements the Inter-American Program for the Development of International Law. For more information go to http://www.oas.org/DIL/
12. The National Law Center for Inter-American Free Trade (NLCIFT) is dedicated to developing the legal infrastructure to build trade capacity and promote economic development in the Americas. For more information go to http://www.natlaw.com.
13. Information on the Hague Conference on Private International Law and its current status *available at* http://www.hcch.net/index_en
14. Information on the (International Institute for the Unification of Private Law "UNIDROIT") project to enhance the internal adequacy and cross-border compatibility of existing national laws, including the Draft Convention on Substantive Rules Regarding Intermediated Securities, *available at http://www.unidroit.org/english/workprogramme/study078/item1/main.htm*
15. In addition, the Commercial Finance Committee's Task Force on Surveys of State Commercial Laws website links to surveys of the law of all 50 states (except Connecticut, DC and Puerto Rico).

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

Figures

Figure 1

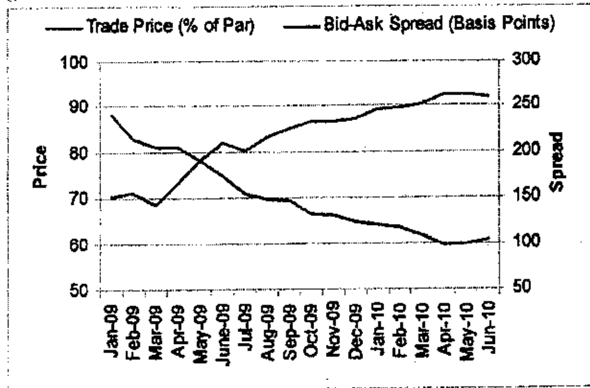
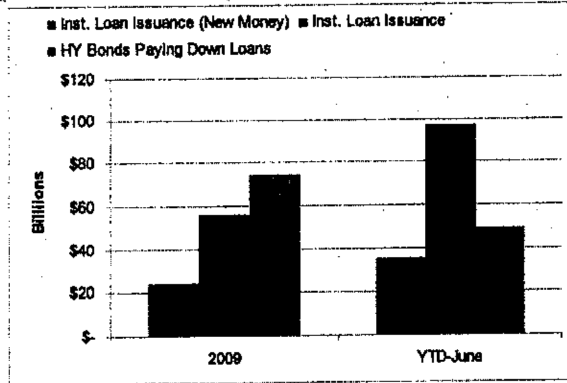


Figure 2



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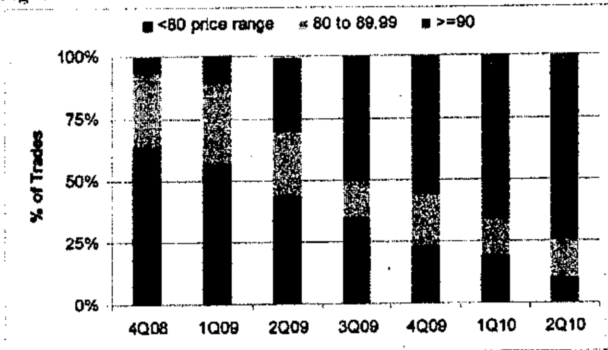

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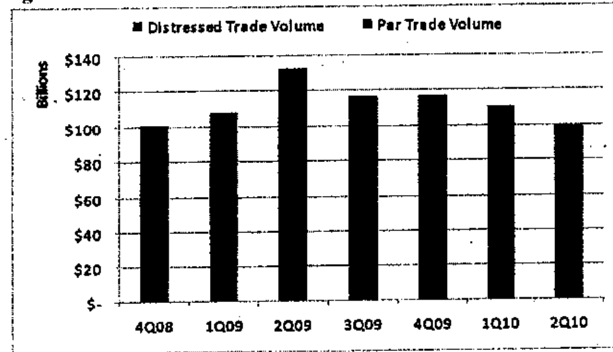

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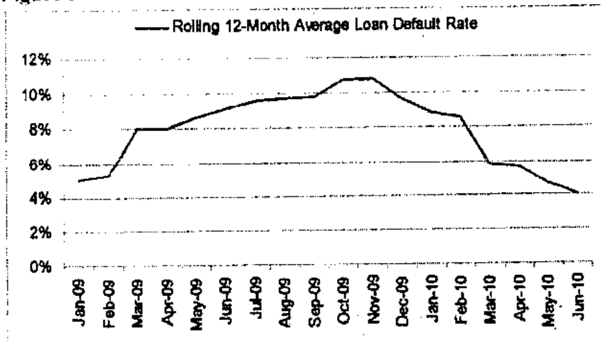

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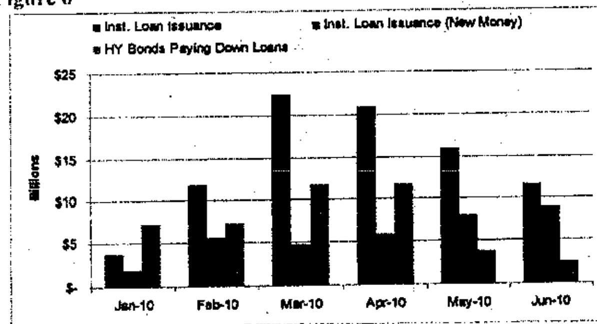

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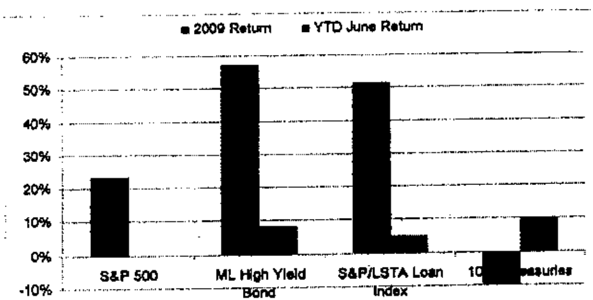

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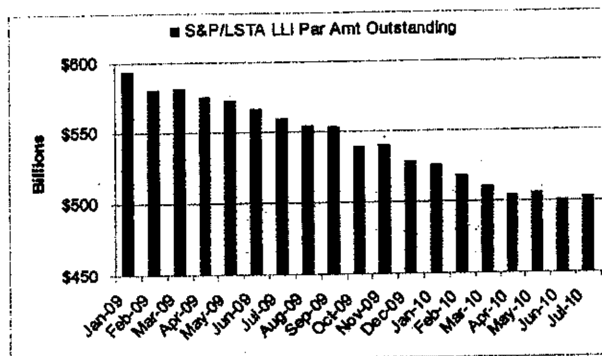

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[1] For a more detailed version of this article, including a discussion of the 2010 changes to the Official Comments, *see* Edwin E. Smith, *A Summary of the 2010 Amendments to Article 9 of the Uniform Commercial Code*, 42 UCC L.J. 4 (2010).

[2] Note that many of the cases described in this article, Forbearance Agreements and Workouts: Case Updates, address the lender's motion to dismiss and, therefore, generally state the alleged facts in a manner that is most favorable to the claimant and least favorable to the lender.

[3] The authors of the Loan Syndications and Trading Association: the 2010 Loan Market Update are employees of the Loan Syndications and Trading Association, a not-for-profit organization. Bridget Marsh is Senior Vice President and Assistant General Counsel, and Ted Basta is Senior Vice President, Market Data & Analysis. For further information, please visit the LSTA's **website**.

[4] Parties entering into a par trade execute an LSTA Par/Near Par Trade Confirm and settle on an assignment agreement. Parties entering into a distressed trade execute an LSTA Distressed Trade Confirmation and settle on an assignment agreement and the LSTA's form of Purchase and Sale Agreement for Distressed Trades.

[5] For a more detailed discussion of FATCA, *see* Carol P. Tello, ***Reporting, Withholding, and More Reporting: HIRE Act Reporting and Withholding Provisions***, 39 TAX MGM'T INT'L J. 243 (2010).

[6] This assumes that PITTRA and PGB were located in the same state. The court noted that PGB was incorporated in New Jersey but did not mention where PITTRA was formed. If the two entities were not located in the same state, then Merrill would not have been perfected in any property acquired by PGB after it became a new debtor and would have been perfected in the assets transferred by PITTRA to PBG only for one year. *See* § 9-316(a)(3).

Ledezma, Martha

From: Ledezma, Martha

Sent: Thursday, February 03, 2011 1:56 PM

To: Mears, Patrick

Subject: UCC Committee Memo - 2/3/2011

Attachments: Memo re Recent Decisions - Lundy - Yatooma.pdf; Lundy Decision.pdf; Yatooma v Barker Decision.pdf

Per Mr. Mears, please see the attached memorandum and attachments.

BARNES & THORNBURG LLP

MEMORANDUM

TO: All Members of the UCC Committee

FROM: Patrick E. Mears

DATE: February 3, 2011

RE: Recent Decisions

I am sending with this memorandum copies of the following two recent decisions of the Michigan Court of Appeals involving Article 9 of the Uniform Commercial Code:

1. *In re Estate of David G. Lundy*, Case No. 292930 (Jan. 20, 2011). This decision, marked "For Publication" by the Court of Appeals, held that an Article 9 security interest in a certificate of deposit had priority over the claim of a homestead allowance filed by the personal representative of a decedent's estate under MCL § 700.2402.

2. *Yatooma v. Barker*, Case No. 294932 (Dec. 28, 2010). In this case, the Michigan Court of Appeals held that a creditor with a perfected security interest in "all of the assets and personal property" of the debtor per the security agreement was not granted a security interest in the debtor's after-acquired, right of first refusal to purchase the collateral. An expanded description of the collateral in the filed financing statement was of no moment because a financing statement may not "expand on the collateral granted by the security agreement."

Patrick E. Mears

STATE OF MICHIGAN

COURT OF APPEALS

In re Estate of DAVID GARY LUNDY, Deceased.

BRIDGET A. LUNDY, as Personal Representative of the Estate of DAVID GARY LUNDY,

Petitioner-Appellee,

v

FIRST FEDERAL BANK OF THE MIDWEST,

Respondent-Appellant.

FOR PUBLICATION
January 20, 2011
9:05 a.m.

No. 292930
Lenawee Probate Court
LC No. 08-046105

Before: DONOFRIO P.J., CAVANAGH, and FITZGERALD, JJ.

PER CURIAM.

Respondent, First Federal Bank of the Midwest ("the bank"),[1] appeals as of right the probate court order granting the petition for return of estate funds filed by petitioner, Bridget A. Lundy, as personal representative of the estate of David Gary Lundy ("the estate"). This case arises from a dispute over the funds in a certificate of deposit ("CD") account that belonged to the decedent. At issue is the interplay between the Estate and Protected Individuals Code ("EPIC"), MCL 700.1101 *et seq.*, Article 9 of the Uniform Commercial Code ("UCC"), MCL 440.9101 *et seq.*, and the terms of an "Assignment of Deposit Account" (the "assignment agreement") between the bank and the decedent, in determining whether a bank, as the holder of a perfected security interest in a CD account that a decedent pledged as collateral to secure a mortgage, is entitled upon default to retain the funds in the account even though there are insufficient funds in the estate to pay the priority claims and allowances set forth in MCL 700.3805 of the EPIC. We reverse and remand.

[1] First Federal Bank of the Midwest was formerly known as the Bank of Lenawee.

Facts and Procedural History

On December 22, 2005, the decedent personally guaranteed a mortgage and promissory note between Lundy's Lane, L.L.C.,[2] and the bank. On that date, the decedent and the bank also entered into the assignment agreement, which granted the bank a security interest in the CD account as collateral for the loan.[3] According to the terms of the assignment agreement, upon occurrence of an "Event of Default," the bank had the right to exercise any one or more of the rights and remedies enumerated in the assignment agreement. Upon default, the rights and remedies provided in the assignment agreement allowed the bank to accelerate the indebtedness to make it immediately due and payable without notice. The assignment agreement also provided the bank the right to take all funds in the CD account and to apply the funds to the indebtedness. Any excess funds remaining after application of the CD account proceeds to the indebtedness would be paid to the decedent.

The decedent died testate on February 20, 2008. On April 24, 2008, Bridget A. Lundy filed an application for informal probate and for appointment of a personal representative. She was appointed personal representative of the estate on that same date.

The decedent defaulted on the loan,[4] and the bank exercised its rights under the assignment agreement. The bank liquidated the CD account and applied the funds to reduce the principal amount of the loan secured by the CD account.[5]

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[2] Lundy's Lane, L.L.C. is apparently a party store owned by the decedent, his son Gary A. Lunday, or both.

[3] The assignment agreement provided as follows:

> ASSIGNMENT: For valuable consideration, Grantor assigns and grants to Lender a security interest in the Collateral, including without limitation the deposit accounts described below, to secure the indebtedness and agrees that Lender shall have the rights stated in this Agreement with respect to the Collateral, in addition to all other rights which Lender may have by law.
>
> COLLATERAL DESCRIPTION: The word "Collateral" means the following described deposit account ("Account"):
>
> CD Account in the name of David G. Lundy
>
> Together with (A) all interest, whether nor accrued or hereafter accruing; (B) all additional deposits hereafter made to the Account; (C) any and all proceeds from the Account; and (D) all renewals, replacements and substitutions for any of the foregoing.

[4] The decedent defaulted on the loan by failing to make payments as they became due. Additionally, the terms of the assignment agreement identified "death" as an event of default.

On May 19, 2008, the estate filed a form selecting the CD account as the "homestead allowance authorized by MCL 700.2402," and as the "exempt property authorized by MCL 700.2404." Fields for a family allowance were also completed on the form, as follows: "A family allowance of $23,000.00 per year has been determined as authorized by MCL 700.2403 and MCL 700.2405." On August 14, 2008, the estate filed an inventory listing only "Claim on Proceeds of CD Held By First Federal Bank" and listing "[$]0.00" as the total value of the property.

Petitioner commenced this action with the filing of a "Petition for Return of Estate Funds" on January 9, 2009. Petitioner asserted that under MCL 700.3805 of the EPIC, the bank's security interest in the CD account was of lower priority than the surviving spouse's claim for reimbursement of reasonable funeral expenses, homestead allowance, family allowance, and exempt property. In response, the bank asserted that, because the bank had properly perfected its security interest in the CD account, the bank had an interest superior to any and all claims to the same collateral. Thus, the bank contended that the bank properly applied the balance of the CD account to the obligation secured by the account pursuant to MCL 440.9607(1)(d) of the UCC.

At a hearing on the petition, the trial court acknowledged that the bank had a perfected security interest in the CD account. The court opined that the bank had the right to apply the balance of the CD account to the obligation secured by the account "prior to the death of the decedent, or, perhaps even prior to the spouse filing an affidavit for information Probate and being appointed personal representative." The court concluded, however, that the EPIC superseded Article 9 of the UCC once a personal representative was appointed. Thus, the court concluded that, under the EPIC, "the surviving spouse has the right to claim homestead and family allowance prior to a creditor's claim, and, that is what the bank had."

I. Standard of Review

This Court reviews issues of statutory interpretation de novo as questions of law. *In re Temple Marital Trust,* 278 Mich App 122, 128; 748 NW2d 265 (2008). An appeal from a decision of the probate court, however, is on the record; it is not tried de novo. *Id.;* MCL 600.866(1); MCR 5.802(B)(1). This Court reviews the probate court's factual findings for clear error, and its dispositional rulings for an abuse of discretion. *Temple,* 278 Mich App at 128.

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[5] By letter dated April 30, 2008, addressed to Gary A. Lundy, the bank, through Vice-president John Selenko, informed Lundy that the mortgage was in default and that the bank had exercised its rights under the assignment agreement and had liquidated the CD account and applied the funds to reduce the principal amount of the loan secured by the CD account. Selenko wrote in the letter that he had had "numerous conversations" with the decedent regarding the loans and that the decedent "had verbally agreed in February to allow the bank to liquidate his certificate of deposit to bring all of the loans current and pay down the principal balance of the real estate loan." Selenko claimed that the bank "held off liquidating" the account pending some negotiations concerning a lease of the store that had apparently ceased with the decedent's death.

II. The purposes of Article 9 of the UCC and the EPIC

Subject to several exceptions, Article 9 of the UCC, as enacted in Michigan governs, among other things, "[a] transaction, regardless of its form, that creates a security interest in personal property or fixtures by contract." MCL 440.9109(a). It governs such things as perfection of security interests, MCL 440.9301 to MCL 440.9306, priority of security interests, MCL 440.9317 to MCL 440.9339, and rights of third parties, MCL 440.9401 to MCL 440.9409.

The purposes of the EPIC include "[t]o discover and make effective a decedent's intent in distribution of the decedent's property," and "[t]o promote a speedy and efficient system for liquidating a decedent's estate and making distribution to the decedent's successors." MCL 700.2101. The provisions relevant to this case are within Article III of the EPIC, MCL 700.3101 *et seq.,* which governs probate of wills and estate administration.

III. Article 9 of the UCC and the Assignment Agreement

The record reveals that the decedent and the bank voluntarily entered into a transaction and intentionally created a security interest in the CD account. Article 9 of the UCC provides the scheme by which security interests in property are regulated. *Shurlow v Bonthuis,* 456 Mich 730, 735; 576 NW2d 159 (1998). Specifically, MCL 449.9607(1) of the UCC provides:

> (1) If so agreed, and in any event after default, a secured party may do 1 or more of the following:
>
> * * *
>
> (d) If it holds a security interest in a deposit account perfected under section 9104(1)(a),[6] apply the balance of the deposit account to the obligation secured by the deposit account.

Under this section, upon default the bank had a right to apply the balance of the CD account to the obligation secured by the CD account. The bank's action was permitted under the terms of the assignment agreement, which provides that the death of the borrower or granter constitutes an event of default. The assignment agreement provides several "Rights and Remedies on Default," including the right of the bank to "surrender the account to the Issuer and obtain payment thereunder subject to any early withdrawal penalty imposed by the Issuer . . ."

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[6] MCL 440.9104(1)(a) provides:

> (1) A secured party has control of a deposit account if 1 or more of the following apply:
>
> (a) The secured party is the bank with which the deposit account is maintained.

and to "obtain all funds in the Account from the Issuer of the Account and apply them to the indebtedness in the same manner as if the Account had been issued by Lender." There is no dispute that the bank, in addition to being the "lender," was also the holder or issuer of the deposit account. Here, the bank was entitled, under Article 9 of the UCC and the assignment agreement, to apply the balance of the CD account to the obligation secured by the account (the mortgage) because the bank held the deposit account.

IV. The EPIC

The EPIC treats secured creditors differently than other potential claimants against an estate. MCL 700.3104 provides:

> (1) Except as otherwise provided in subsection (2), a proceeding to enforce a claim against a decedent's estate or the decedent's successors shall not be revived or commenced before the appointment of a personal representative . . .
>
> (2) This act does not apply to a proceeding by a secured creditor of the decedent to enforce the creditor's security except as provided in part 8 of article III and part 6 of article VII.

This provision precludes all proceedings to enforce a claim against the estate before the appointment of a personal representative, except a proceeding brought by a secured creditor of the decedent to enforce the creditor's right to the creditor's security. The EPIC does not apply to such claims except as provided in two specific sections of the EPIC.[7] The Reporter's comment to MCL 700.3104 explains that:

> This section. . . . subjugates the rights of creditors to the provisions of EPIC, except for secured creditors, who may proceed against the secured property. Even for a secured creditor, the code governs any attempt to recover an amount in excess of the security. [Reporter's Comment to MCL 700.3104, *Estates and Protected Individuals Code with Reporter's Commentary* (2008 ed), p 154.]

While not binding, comments are often used to aid in the interpretation of a statute or rule. See *People v Clement,* 254 Mich App 387, 391-392; 657 NW2d 172 (2002); *Trost v Buckstop Lure Co, Inc,* 249 Mich App 580, 584; 644 NW2d 54 (2002).

Secured creditors are also treated differently than other potential claimants, including other creditors, in part 8 of Article III of the EPIC. MCL 700.3801(1) requires a notice "notifying estate creditors to present their claims within 4 months after the date of the notice's publication or be forever barred." MCL 700.3803 limits the time for presenting claims and bars

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[7] The provisions of part 8 of Article III (MCL 700.3801 through MCL 700.3815) are relevant here and are discussed *infra;* article VII pertain to trust administration and is not relevant here.

claims against the estate unless presented within specified time limits. MCL 700.3803(3)(a), however, expressly exempts "[a] proceeding to enforce a mortgage, pledge, or other lien on estate property" from the time limitations. The "Reporter's Supplemental Coment—2005" to MCL 700.3801 explains, in relevant part:

> While a secured creditor is known, frequently notice is not given to secured creditors because § 3803(3)(a), MCL 700.3803(3)(a), permits a secured creditor to collect its claim without regard to the shortened statute of limitations of § 3803, MCL 700.3803. *The secured creditor, however, has a priority position only as to the asset in which the security is held. If the security is inadequate, the creditor has no preference when trying to collect any deficiency.* Therefore, when there is uncertainty whether the security is sufficient to cover the secured creditor's claim, the personal representative should give actual notice to the secured party. If no notice is given, the secured party may assert that the three-year state of limitations of § 3803(1)(c), MCL 700.3803(1)(c), applies to a recovery of the deficiency. [*EPIC With Reporter's Commentary* at 226 (emphasis added).]

The estate presumably disputes the emphasized portion of the commentary. Although the estate concedes that the bank is a secured creditor, it asserts that the bank has *no* priority position, except as between the bank and a hypothetical second unsecured creditor, where the estate does not have sufficient funds to pay all claims and allowances. The estate relies primarily on MCL 700.3805 in support of this assertion. MCL 700.3805 sets forth the priority of claim payments. Subsection (1) provides:

> If the applicable estate property is insufficient to pay all claims and allowances in full, the personal representative shall make payment in the following order of priority:
>
> (a) Costs and expenses of administration.
>
> (b) Reasonable funeral and burial expenses.
>
> (c) Homestead allowance.
>
> (d) Family allowance.
>
> (e) Exempt property.
>
> (f) Debts and taxes with priority under federal law, including, but not limited to, medical assistance payments that are subject to adjustment or recovery from an estate under section 1917 of the social security act, 42 USC 1396p.
>
> (g) Reasonable and necessary medical and hospital expenses of the decedent's last illness, including a compensation of persons attending the decedent.
>
> (h) Debts and taxes with priority under other laws of this state.

(i) All other claims. [MCL 700.3805(1).]

MCL 700.3809, which governs secured claims, in addition to MCL 700.3801, reveals that the estate's assertion is incorrect in part. That is, the bank has a priority position, without even making a "claim" against the estate, with respect to the secured property. However, the bank is in the same position as other creditors with respect to any claim against the estate for the amount of any deficiency existing after exhausting the security. MCL 700.3809.[8] Like MCL 700.3805, MCL 700.3809 governs the obligations of the *personal representative* in paying *claims*. No provision exists which requires a secured creditor that is otherwise entitled to exhaust a security to first bring a claim against the estate in order to be permitted the exhaust the security. Indeed, MCL 700.3809 contemplates that the secured creditor may exercise that option. Once again, the commentary is helpful:

> *If a secured creditor surrenders the security interest, he or she becomes a general creditor with priority equal to that of other general creditors to be paid for the full amount of the claim. If, instead, the secured creditor realizes against (collects from) the asset that secures the claim but is not fully paid, he or she becomes a general creditor to the extent of the deficiency.* If the secured creditor is given notice as required by §3801(2), MCL 700.3801(2), the secured creditor needs to file a contingent claim within the claims period to preserve his or her rights to collect any deficiency if the security is insufficient to pay the claim. If not given notice, the secured creditor is not barred by the short four-month statute of limitations. [Reporter's Supplemental Comment—2005 to MCL 700.3809, *EPIC With Reporter's Commentary* at 235 (emphasis added).]

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[8] MCL 700.3809 provides:

> A personal representative shall pay a secured claim on the basis of the amount allowed if the creditor surrenders the security. Otherwise, the personal representative shall pay on the basis of 1 of the following:
>
> (a) *If the creditor exhausts the security before receiving payment, upon the amount of the claim allowed less the fair value of the security.*
>
> (b) If the creditor does not have the right to exhaust the security *or has not done so*, upon the amount of the claim allowed less the value of the security determined by converting it to money according to the terms of the agreement under which the security was delivered to the creditor or by the creditor and personal representative by agreement, arbitration, compromise, or litigation. [Emphasis added.]

The secured creditor's special position with respect to the secured property is also reflected in MCL 700.3812, which provides:

> "An execution shall not issue upon nor shall a levy be made against estate property under a judgment against a decedent or personal representative. *This section shall not be construed to prevent the enforcement of a mortgage, pledge, or lien upon property in an appropriate proceeding.*" [MCL 700.3812 (emphasis added).]

Finally, MCL 700.3814 allows the personal representative discretion in dealing with an encumbered estate asset, but in no way suggests that an encumbrance may be disregarded if the asset is needed to satisfy the priorities set forth in MCL 700.3805.[9] In sum, none of these provisions prevent the secured creditor from exhausting the security. On the contrary, they treat a secured creditor differently and contemplate a secured creditor's right to collect from the security without bringing a claim against the estate for estate funds.

Two states that have probate codes modeled after the Uniform Probate Court, like the EPIC, have rendered decisions consisted with the above analysis regarding the appropriate treatment of secured creditors under the EPIC. In *In re Estate of Larson*, 359 NW2d 281 (Minn App, 1984), the Minnesota Court of Appeals addressed the estate's argument that a bank improperly sought payment of its secured claim from the estate's assets, rather than proceeding against the security. The court construed provisions of the Minnesota probate code that are similar to the provisions of the EPIC that are relevant in this case:

> The probate code permits the personal representative authority to pay a secured claim in three ways. The personal representative may pay the claim in whole or in part; renew or extend the secured obligation; or convey or transfer assets to the creditor in satisfaction of the lien, whether or not the holder has filed a claim. Minn Stat § 524.3-814 (1982).
>
> For the secured creditor who seeks payment, the code provides three options. Minn Stat § 524.3-809. First, payment is to be made upon the basis of the amount allowed if the creditor surrenders his security. Second, if the creditor

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[9] MCL 700.3814 provides:

> If property of the estate is encumbered by mortgage, pledge, lien, or other security interest and it appears to be in the estate's best interest, the personal representative may pay the encumbrance or a part of the encumbrance, renew or extend an obligation secured by the encumbrance, or convey or transfer the property to the creditor in satisfaction of the lien, in whole or in part, whether or not the encumbrance holder has presented a claim. Payment of an encumbrance does not increase the share of the distributee entitled to the encumbered property unless the distributee is entitled to exoneration.

exhausts its security before receiving payment upon the amount owing, it may receive its credit less the fair value of the security. Finally, if the creditor does not have the right to exhaust its security, or has not done so, it may receive the amount of the claim allowed less the value of the security. Minn Stat § 524.3-809 provides options for the secured creditor, but does not interfere with the process set out in Minn Stat § 524.3-806. The Minnesota Supreme Court has addressed this question. In *Browning v Eiken*, 189 Minn 375; 249 NW 573 (1933), the court reviewed allowance of an intermediate account, where the probate court approved the act of a bank in applying a part of a deposit account in payment of notes held by it against decedent. The court stated:

> The general rule is that a creditor holding securities has the option, after the debtor's death, to enforce his securities for payment of his claim or to file his claim as a general creditor of the estate. [*Larson*, 359 NW2d at 285-286, quoting *Browning*, 189 Minn at 380.][10]

The *Larson* court concluded that the bank had proceeded lawfully under the probate code. *Id.* at 286. See also *Binder v Fruth*, 150 Ariz 21, 25; 721 P2d 679 (1986) (considering provisions of the Arizona Probate Court modeled after the Uniform Probate Code, and agreeing with the reasoning of the *Larson* court quoted, *supra*); 34 CJS, Executors and Administrators, § 555 ("A secured creditor generally need not present his or her claim for allowance to preserve a right to enforce the security, but presentation is generally required where recovery is sought out of the general assets of the estate.").

In *In re Estate of Stephenson*, 217 Ariz 284; 173 P3d 448 (2007), the Arizona Court of Appeals considered whether a secured creditor must seek permission from the court or from the personal representative before conducting a trustee's sale of property secured by a deed of trust. The court noted several ways in which the Arizona Probate Code treats secured creditors differently than other claimants. *Id.* at 286-287 (discussing the Arizona statute similar to MCL 700.3104, MCL 700.3803, MCL 700.3812, MCL 700.3809). It rejected the argument "that the sale of encumbered estate property is subject to court supervision, and [that] the proceeds of the sale must be distributed pursuant to the priorities specified in" the Arizona analogue of MCL 700.3805. *Id.* at 288. It noted the secured creditor's right under *Binder*, 150 Ariz 21, to choose its remedy. *Id.* at 288. After noting that the appellee (representing the estate) had cited no "authority to support its position that the proceeds of the trustee's sale can be distributed to pay for other expenses of the decedent debtor to the detriment of the secured creditor," it rejected the appellee's argument that ARS 14-3805 (analogous to MCL 700.3805), protects the rights of secured creditors. *Id.* at 288. First, it noted that ARS 14-3805 does not distinguish between

---

[10] The provisions of the Minnesota probate code cited are similar to MCL 700.3814 (Encumbered assets), MCL 700.3809 (Secured claims), MCL 700.3806 (Allowance and disallowance of claims), respectively.

secured claims and other debts and does not even mention secured creditors. Second, it explained that ARS 14-3805 "governs the priority of 'claims'" but that "[a] secured creditor can enforce its security and need not file a claim." *Id.*, citing the Arizona statute comparable to MCL 700.3803. The *Stephenson* court concluded that ARS 14-3805 "has no applicability to a secured creditor that chooses to execute on its security rather than file a claim." *Id.*

Both *Larson, supra*, and *Stephenson, supra*, which interpret the rights and remedies of secured creditors under statutory schemes very similar to the EPIC, lend support to our conclusion that the bank was entitled to exhaust the funds in the CD account.

Finally, there is a dispute between the parties over whether the deposit account ever became estate property.[11] We need not determine whether the CD account was ever technically estate property because the bank was entitled to exhaust the funds in the account without making a claim on the estate.

Reversed and remanded. Jurisdiction is not retained.

/s/ Pat M. Donofrio
/s/ Mark J. Cavanagh
/s/ E. Thomas Fitzgerald

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[11] Under the EPIC, "'Property' means anything that may be the subject of ownership, and includes both real and personal property or an interest in real or personal property." MCL 700.1106(u). "'Estate' includes the property of the decedent, trust, or other person whose affairs are subject to this act as the property is originally constituted and as it exists throughout administration. Estate also includes the rights described in sections 3805, 3922, and 7502 to collect from others the amounts necessary to pay claims, allowances, and taxes." MCL 700.1104(b).

STATE OF MICHIGAN

COURT OF APPEALS

CHRISTOPHER J. YATOOMA,

Plaintiff-Appellee,

v

RUSSELL E. BARKER, a/k/a RUSSELL BARKER, a/k/a RUSS BARKER, METROSWEEP ENVIRONMENTAL SERVICES, INC., METROSWEEP, INC., METRO SWEEP CONTRACTING SERVICES, L.L.C., and CEO CAPITAL GROUP, LLC,

Defendants,

and

INDEPENDENT BANK CORPORATION, INDEPENDENT BANK, and INDEPENDENT BANK EAST MICHIGAN,

Defendants-Appellants.

UNPUBLISHED
December 28, 2010

No. 294932
Oakland Circuit Court
LC No. 2008-096649-CK

Before: BECKERING, P.J., and TALBOT and OWENS, JJ.

PER CURIAM.

Defendants Independent Bank Corporation, Independent Bank, and Independent Bank East Michigan (hereinafter the "Bank") appeal by leave granted the trial court's order denying their motion for summary disposition, which was premised on MCR 2.116(C)(10). We reverse and remand for further proceedings.

I. UNDERLYING FACTS AND PROCEDURAL HISTORY

At issue in this case is whether plaintiff Christopher J. Yatooma had a secured interest in a right of first refusal. On July 17, 2006, Ronald C. Omilian, United Soils, Inc., Earth Products, Inc., Earth Supplies, Inc., and C.A.R.D. Properties, L.L.C., entered into a loan agreement with

Yatooma associated with his lending them $230,000. The loan agreement stated in pertinent part:

> Security: This Loan Agreement and all obligations of Borrower under it are secured by *all of the assets* and personal property of Borrower. This security interest attaches the Creditor's interest to *all collateral*, including, without limitation, all of the issued and outstanding stock and membership interests of the following business entities: C.A.R.D. Properties L.L.C., Earth Products, Inc., Earth Supplies Inc., and United Soils, Inc.
>
> This Security Interest shall be duly recorded with the State of Michigan in Five (5) separate UCC Financing Statements for each individual parties named in the beginning of the agreement who collectively comprise the Borrower. [Emphasis added.]

A Uniform Commercial Code ("UCC") Financing Statement was subsequently filed that purported to cover, among other things, the following collateral:

> All of the assets and personal property of the debtor, including, without limitation, a) all of debtors [sic] Accounts, Equipment, Inventory, Chattel Paper, General Intangibles, Deposit Accounts, Documents, Instruments, Goods, Fixtures, Investment Property, and Letter-of-Credit Rights; b) all property, *tangible or intangible, in which Debtor now has or later acquires any rights* . . . . [Emphasis added.]

The Bank had also made substantial loans to the above entities.

On December 7, 2006, United Soils filed for Chapter 11 bankruptcy. The Bank filed a motion for relief from the bankruptcy stay, which was granted consistent with a stipulation. On February 12, 2007, the Bank and various Omilian entities, including United Soils, entered into a Voluntary Surrender of Assets Agreement ("VSA Agreement"). Pursuant to this agreement, United Soils (and other entities) surrendered their assets to the Bank. The following "Right of First Refusal" clause was in the agreement:

> Upon the Bank agreeing to sell all or any part of the Collateral . . . to any third party in a private sale, the Bank shall give Omilian and United Soils' counsel, Michael I. Zousmer, Esq. written notice of the purchase price and terms of such sale . . . and Omilian or any entity controlled by him shall have seven (7) days from receipt of Bank's Notice to inform the Bank in writing, that he, or an entity controlled by him, agrees to purchase such Sale Assets on the same terms and conditions as set forth in the Bank's Notice . . . .

✓ Ultimately, the Bank provided notice that it had agreed to sell part of the collateral to another entity. Omilian's counsel responded, advising that AKO Enterprises–Waterford, Inc. ("AKO Enterprises") intended to purchase the assets in accordance with the right of first refusal clause of the VSA Agreement.

Following a sale to AKO Enterprises, Yatooma sued the Bank for conversion and tortious interference with a contract. In essence, Yatooma claimed that the Bank failed to honor his secured interest in the right of first refusal, which he claimed was a secured asset covered by the loan agreement. The Bank moved for summary disposition pursuant to MCR 2.116(C)(10), arguing that the right of first refusal was created by the VSA Agreement *after* Yatooma had entered into the loan agreement, and that Yatooma's loan agreement granted him a security interest in Omilian and his entities' assets, but not their after-acquired assets. Accordingly, the Bank asserted that Yatooma had no secured interest in the right of first refusal. Yatooma opposed the motion and argued that a contractual interpretation of the loan agreement dictated that he was entitled to summary disposition under MCR 2.116(I)(2), or in the alternative, the Bank's motion should be denied because genuine issues of material of fact existed regarding whether Omilian and Yatooma intended that the security provisions contained in the loan agreement include future acquired property. The trial court declined to grant either party summary disposition, finding that the loan agreement was silent as to the inclusion of after-acquired property, which created a "sufficient question of material fact as to whether the after-acquired property was to be included in the [financing statement], or if it was an impermissible expansion of the rights granted" in the loan agreement.

II. STANDARD OF REVIEW

We review a trial court's grant or denial of summary disposition de novo to determine whether the moving party is entitled to judgment as a matter of law. *Maiden v Rozwood*, 461 Mich 109, 118; 597 NW2d 817 (1999).

> A motion under MCR 2.116(C)(10) tests the factual sufficiency of the complaint. In evaluating a motion for summary disposition brought under this subsection, a trial court considers affidavits, pleadings, depositions, admissions, and other evidence submitted by the parties, MCR 2.116(G)(5), in the light most favorable to the party opposing the motion. Where the proffered evidence fails to establish a genuine issue regarding any material fact, the moving party is entitled to judgment as a matter of law. MCR 2.116(C)(10), (G)(4). *Quinto v Cross & Peters Co*, 451 Mich 358; 547 NW2d 314 (1996). [*Id.* at 120.]

III. LAW AND ANALYSIS

UCC 9-204, MCL 440.9204(1), provides that "a security agreement may create or provide for a security interest in after-acquired collateral." UCC 9-108, MCL 440.9108, provides in pertinent part:

> (1) Except as otherwise provided in subsections (3), (4), and (5), a description of personal or real property is sufficient, whether or not it is specific, if it reasonably identifies what is described.
>
> * * *
>
> (3) A description of collateral as "all the debtor's assets" or "all the debtor's personal property" or using words of similar import does not reasonably identify the collateral.

Preliminarily, there is no authority in Michigan for the proposition that the UCC Financing Statement can expand on the collateral granted by the security agreement. In fact, the opposite is true. In *Fed Land Bank of St Paul v Bay Park Place, Inc*, 162 Mich App 1, 7; 412 NW2d 222 (1987), this Court held:

> The purpose of a financing statement is to place third parties on notice of the existence of a security agreement. Although a financing statement may be used to assist in the interpretation of the security agreement, the financing statement does not create a security interest and cannot extend a security interest beyond what has been unambiguously described in a security agreement. [Citations omitted.]

Further, authorities from other jurisdictions expressly hold that there can be no such expansion. See *Dowell v D R Kincaid Chair Co*, 125 NC App 557, 561-562; 481 SE2d 670 (1997), citing *Idaho Bank & Trust Co v Cargill, Inc*, 105 Idaho 83; 665 P2d 1093 (1983), citing Ronald A. Anderson, Anderson on The Uniform Commercial Code, § 9-204:9; see also *Allis-Chalmers Corp v Staggs*, 117 Ill App 3d 428, 432; 453 NE2d 145 (1983) ("a broader description of collateral in a financing statement is ineffective to extend a security interest beyond that stated in the security agreement"); *In re Excalibur Machine Co, Inc*, 404 BR 834, 840 (Bankr WD Pa, 2009) ("A financing statement cannot expand the security provided for in the security agreement."). In construing the UCC, this Court "seek[s] guidance from the decisions of other jurisdictions." *Power Press Sales Co v MSI Battle Creek Stamping*, 238 Mich App 173, 180; 604 NW2d 772 (1999). Thus, this case turns on whether the security agreement itself grants plaintiff an interest in the after-acquired right of first refusal.

The parties agree that the loan agreement does not include an explicit after-acquired property clause. They disagree, however, on whether the language provided in the loan agreement is sufficient to imply the inclusion of after-acquired collateral, specifically, the right of first refusal.

In *Mich Tractor & Machinery Co v Jocham Excavating, Inc*, 216 Mich App 94, 96, 98; 549 NW2d 27 (1996), the intervening defendants were assigned "all retainage fees due and owing" in exchange for release from a mortgage and the promise of a loan. This Court concluded that at the time of the assignment, there were no retainage fees due and owing. *Id.* at 99. This Court then looked at whether intervening defendants had a secured interest in after-acquired property. The *Mich Tractor* Court discussed the rule of *In Re Taylored Prod, Inc*, 5 UCC Rep Serv (Callaghan) 286, 290-291 (WD Mich, 1968), which held that "an after-acquired property clause in the security agreement was essential to allow after-acquired property of inventory to become collateral for a present obligation." *Mich Tractor*, 216 Mich App at 99-100. This Court then discussed the conflicting rule of *American Employers Ins Co v American Security Bank*, 241 US App DC 379, 387; 747 F2d 1493 (1984), in which the "court held that it is reasonable to read a security agreement granting an interest in all inventory or receivables to include after-acquired inventory or receivables." *Mich Tractor*, 216 Mich App at 100. Citing *Stoumbos v Kilimnik*, 988 F2d 949, 955 (CA 9, 1993), the *Mich Tractor* Court noted that the reason for this exception was that these assets are in constant flux and "'no creditor could reasonably agree to be secured by an asset that would vanish in a short time in the normal course

of business.'" *Mich Tractor*, 216 Mich App at 101-102. With respect to the retainage arrangements, which were a contingent account receivable, this Court concluded:

> [T]here is no indication that the security agreement would alert an ordinary creditor to the claim that retainage fees not "due and owing" at the time of the assignment were included in the assignment. Therefore, the security agreement cannot objectively be read to inform the ordinary creditor that after-acquired retainage fees . . . were also collateral securing defendant's debt to intervening defendants. Thus, even under *American Employers*, intervening defendants' security agreement would not be construed to include after-acquired property. [*Id.* at 101.]

Here, the security agreement referenced "*all of the assets*" and "*all collateral.*" Under MCL 440.9108, this did not sufficiently identify after-acquired assets as assets that would be covered. As noted, the cases recognizing "all" as sufficient to describe after-acquired assets concerned assets that by their nature are in constant fluctuation. While Yatooma avers that he and Omilian discussed that the assets would be fluctuating, the reference to "all assets" does not indicate *by reference to the security agreement* that an after-acquired right of first refusal would be covered.

Reversed and remanded for further proceedings consistent this opinion. We do not retain jurisdiction.

/s/ Jane M. Beckering
/s/ Michael J. Talbot
/s/ Donald S. Owens