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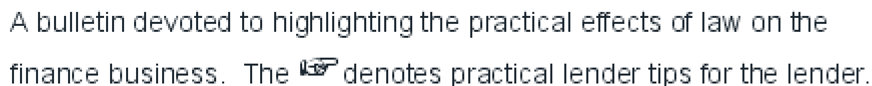
The Practical Lender



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EXECUTIVE SUMMARY OF 1999 KEY JUDICIAL DECISIONS AFFECTING THE SECURED LENDER

Each year, a number of judicial decisions impact the business of secured lending. An executive summary of certain 1999 cases of practical significance is set forth below.

I. Perfection /Article 8 and 9 Issues

A. First Nat'l Bank v. Donaldson, Lufkin & Jenrette Sec. Corp., 1999 WL 163606 (E.D. Pa. 1999)

Legal Principle: A securities intermediary has no duty to a secured party regarding securities entitlements where no "control agreement" exists.

Secured lenders should make it a standard practice to execute control agreements with securities intermediaries who hold collateral representing a security interest of the bank. This is done in addition to perfecting the lien on the securities through filing.

Executive Summary of Case: The borrowers in *First National Bank* received a loan from the bank and granted it a security interest in marketable securities held in an account at Donaldson, Lufkin & Jenrette ("DLJ"). Over a period of years, the bank gave several sets of instructions to DLJ regarding the securities, which DLJ executed. There was, however, no written agreement between the bank and DLJ. When the borrowers defaulted on their

loans, they withdrew their securities from DLJ without the consent of the bank. The bank subsequently sued DLJ, claiming breach of fiduciary duty and fraud. The court held that the only method of imposing a duty on a securities intermediary such as DLJ in a similar case is to execute a control agreement which delineates the duties of the securities intermediary and the rights of the secured party. Pursuant to Article 8 of the UCC, a securities intermediary must *agree* that it will comply with orders from the secured party regarding security entitlements. Such agreement need not be in writing, but the mere act of complying with the secured party's requests does not constitute an agreement. The *First National Bank* case stresses the need for control agreements with security intermediaries, even in instances where the secured party has perfected its interest in the securities by filing.

B. Paulman v. Gateway Venture Partners, III, L.P. (In re Filtercorp, Inc.), 163 F.3d 570 (9th Cir. 1999)

Legal Principle: A grant of a security interest in accounts receivable and inventory presumptively includes after-acquired inventory and accounts.

The practical secured lender will specifically reference the grant of a security interest in after-acquired receivables and inventory in their loan documentation and financing statements if the intent is to have a future lien on such collateral.

Executive Summary of Case: This case involved a lender who had a security interest in the accounts receivable and inventory of the borrower. This collateral was referred to both on the note and the UCC-1 statement, however, neither contained a specific reference to after-acquired property. The court held that security interests in inventory and accounts receivable presumptively include after-acquired inventory and receivables, subject to any clear evidence that the parties intended to limit the collateral (*i.e.*, the specific facts of each case will dictate the result). In *Filtercorp*, the lender retained its security interest in the after-acquired receivables, but lost the interest in the after-acquired inventory because it was described in the loan documentation by reference to a list, thereby showing an

intent to expressly limit the collateral. Secured lenders should note that when describing collateral in documents such as a financing agreement or note, after-acquired receivables and inventory should be specifically included if the lender intends to have a lien on such collateral. However, there is no need to refer to after-acquired property or future advances in a UCC-1 financing statement. (*See* Official Comment 5 to UCC Section 9-204).

C. ITT Commercial Fin. Corp. v. Bank of the West, 166 F.3d 295 (5th Cir. 1999)

Legal Principle: A slight error in the spelling of a debtor's name on a UCC-1 Financing Statement can render such financing statement ineffective.

Prior to filing any UCC financing statements, check and re-check the final version for any errors, especially the correct spelling of the name of the borrower with the official corporate documents on file with the Secretary of State or official corporate records.

Executive Summary of Case: The ruling in this case sends a very important message to secured creditors: *Do not make mistakes in the spelling of the debtor's name on UCC-1 financing statements.* The bank in *ITT* omitted a hyphen in the name of the borrower when filing its UCC-1 statement on the inventory and other assets. (The statement showed the borrower's name as "Compucentro" instead of the correct "Compu-Centro"). A subsequent creditor of the borrower performed a UCC search under the borrower's correct name, did not find the bank's security interest on record, and filed its own UCC-1. When the borrower filed for bankruptcy, there was a dispute between the bank and the other creditor, and the Fifth Circuit decided that the missing hyphen rendered the financing statement "seriously misleading" and held in favor of the subsequent secured creditor. Unfortunately, the computerized searching programs in many states are not capable of finding "close matches" of borrower names when performing a UCC search. Therefore, it is imperative that a secured lender thoroughly inspect all UCC statements prior to filing. The name of the borrower should be cross-

checked against the document that states the borrower's legal name, such as a partnership agreement or articles of incorporation.

I. Bankruptcy-Related Cases

A. In re Catapult Entertainment, Inc., 165 F.3d 747 (9th Cir. 1999), *cert. dismissed*, 67 USLW 3749 (October 12, 1999)

Legal Principle: Debtor-in-possession cannot assume an executory contract (including, for example, patent licenses) without non-debtor's consent where applicable law bars assignment of the contract, even if debtor does not intend to assign the contract.

Lenders should arrange for collateral assignments, licenses or related rights to valuable executory contracts at the closing of the original finance transaction, with consents of the non-borrower contracting party, in order to allow lender to perform if necessary.

Executive Summary of Case: Catapult involved a debtor-in-possession which wanted to assume executory contracts, including certain non-exclusive patent licenses. Although there are different interpretations among the Circuits, the Ninth Circuit's interpretation of the United States Bankruptcy Code is that a debtor-in-possession may not assume an executory contract over the non-debtor's objection if applicable law would prohibit assignment of the contract to a hypothetical third party (as is the case for non-exclusive patent licenses), even where the debtor-in-possession has no intention of assigning the contract in question to any such third party. The effect of this case on secured lenders is best illustrated by example: if a lender advances funds to a borrower to manufacture goods, and the production requires the use of a patent or patented process subject to a non-exclusive license in favor of the borrower, the debtor-in-possession may not assume the license unless the licensor consents to assumption of the license during a bankruptcy proceeding. Accordingly, a secured lender may be affected if its borrower's collateral involves critical executory contracts that may be nonassumable under the applicable non-bankruptcy law,

and therefore, should consider obtaining the non-borrower's consent at the time of the financing to perform the contract in the event of the borrower's default.

B. In re Williams, 234 B.R. 801 (Bankr. D. Or. 1999)

Legal Principle: Notwithstanding the popular view that the *Deprizio* doctrine has been entirely eliminated, liens granted to a non-insider creditor (as opposed to payments) more than ninety days but less than one year before bankruptcy which benefit an insider creditor, can be attacked under the Bankruptcy Code as a potential preference.

Lenders beware – Security interests which are perfected after ninety days but less than one year before the bankruptcy of a debtor, and which benefit an insider creditor of the debtor, are still susceptible to being attacked as preferential transfers. Lenders should always attempt to provide contemporaneous consideration for the lien in order to avoid any preference claims.

Executive Summary of Case: Ten years ago, the Seventh Circuit held that payments made by a borrower to lenders after ninety days but before one year prior to a bankruptcy of the borrower, on debts that had been guaranteed by controlling shareholders of the borrower were recoverable by the bankruptcy trustee as preferential payments. (*Levit v. Ingersoll Rand Financial Corp. (In re Deprizio Construction Co.)*, 874 F.2d 1186 (7th Cir. 1989)). The court in *Deprizio* reasoned that despite the fact such payments were not made directly to the insiders, they were for the *benefit* of insider creditors (by reducing their liability to the lenders under their guarantees), and therefore, expanded the preference period from 90 days to one year – the preference period for insiders. After the *Deprizio* decision, Congress amended Section 550 of the Bankruptcy Code to preclude the bankruptcy trustee from pursuing any recovery against the non-insider transferee for any transfer made more than 90 days prior to the bankruptcy filing pursuant to Section 547 of the Code.

The defendant in the *Williams* case was a non-insider

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creditor who maintained that the amendment to Section 550 of the Bankruptcy Code which eliminated the *Deprizio* doctrine serves to bar any preference *recovery* by the trustee. However, the *Williams* decision held that the Bankruptcy Code continues, under Section 547, to permit a trustee to *avoid* a lien granted in favor of a non-insider creditor more than 90 days but less than one year prior to filing. Congress did amend Section 550, the preference "recovery" section, but not Section 547, the preference "avoidance" section. The result is that bankruptcy trustees may still have an effective remedy against non-insider creditors whose security interests are perfected during the insider preference period. To the extent that perfection of the non-insider creditor's interest benefits an insider, a trustee can attempt to avoid a non-insider transferee's security interest for the benefit of the bankruptcy estate without having to invoke the "recovery" provisions of Section 550 of the Bankruptcy Code. Therefore, lenders need to be aware that part of the statutory interpretation set forth in *Deprizio* is still arguably effective until Congress decides to amend Section 547, which may not happen in the near term.

C. In re El Paso Refinery, L.P., 171 F.3d 249 (5th Cir. 1999)

Legal Principle: A secured lender that receives proceeds of its collateral does not receive a preference under the Bankruptcy Code, even if it received more than it should have received under an intercreditor agreement with another secured party.

When negotiating an intercreditor agreement with other lenders or creditors, make sure the document clearly states that the borrower has no rights under the agreement and is not a beneficiary of the agreement. Additionally, the intercreditor agreement should specify that it is intended merely to modify the creditors' respective priorities among themselves, and is not intended as an assignment of any liens or any underlying debt.

Executive Summary of Case: In *El Paso*, the borrower was an oil refinery that purchased its crude oil from a supplier,

whose debt was secured by a first lien on collateral such as accounts receivable, inventory, contract rights and proceeds. The borrower was also financed on a secured basis by a bank. The bank and supplier entered into an intercreditor agreement which provided that, in the event of default, the bank and the supplier would share the supplier's first lien on an equivalent basis subject to a pro rata allocation based on the respective amounts of debt. During ensuing bankruptcy proceedings, the borrower's Chapter 7 bankruptcy trustee attempted to recover payments made to the supplier from proceeds of the shared collateral during the 90-day "preference" period preceding the bankruptcy filing. The court eventually held in favor of the supplier, because the supplier had simply received payments from its collateral and, therefore, the supplier did not receive more than it would have received in a Chapter 7 liquidation (one of the elements of a preference). The court emphasized that the intercreditor agreement provided that the bank and supplier entered into the agreement "for their mutual convenience" and "not for the benefit of the borrower." Therefore, the bank's proper recourse was against the supplier pursuant to the intercreditor agreement. The key point to remember from this case is for secured lenders to ensure that a borrower has no rights under, and is not a beneficiary to, an intercreditor agreement. This will assist in preventing a borrower or its trustee in a bankruptcy proceeding from asserting rights under such an agreement in an attempt to recover a preference.

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