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LEGAL UPDATE

JEFFREY WURST, PARTNER
ARMSTRONG TEASDALE

Armstrong Teasdale

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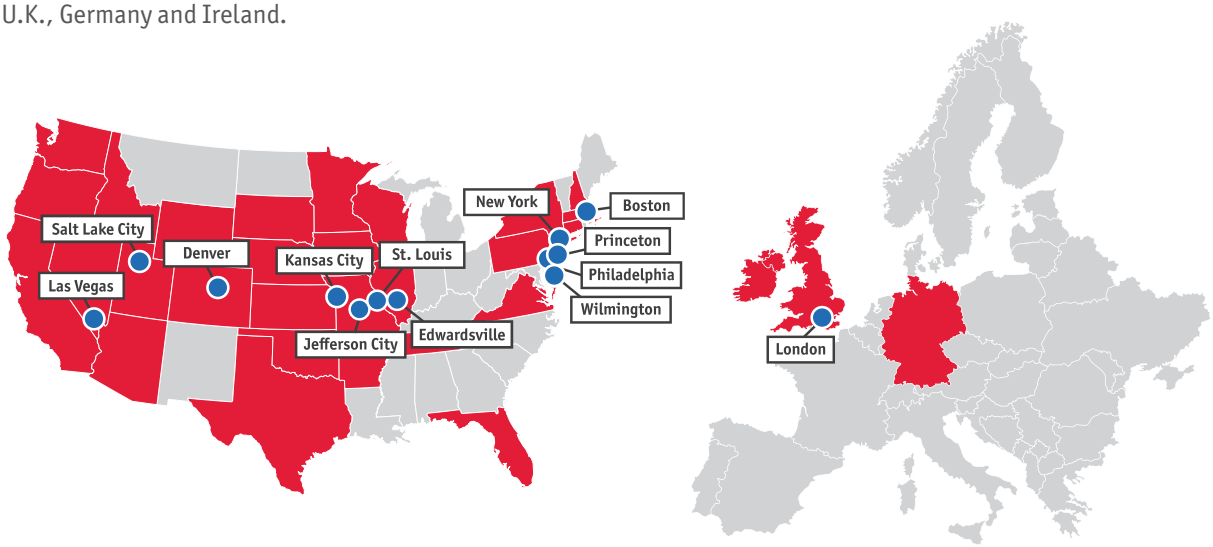

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Armstrong Teasdale

Jeffrey Wurst, a Partner at Armstrong Teasdale, has more than 30 years of experience and is well recognized for handling significant commercial finance and bankruptcy matters. He is an esteemed fellow of the American College of Commercial Finance Lawyers and is a panelist on the American Arbitration Association's National Roster of Arbitrators.

Highly regarded for his knowledge and experience in commercial finance, Jeff is an outside-the-box thinker who is skilled in handling matters involving loan workouts, asset-based lending, factoring, syndications, leasing and C&I, as well as bankruptcy matters, and turnaround situations stemming from transactions. His experience also extends to counseling emerging finance companies and commercial marketplace lenders.

Jeff advises lenders and borrowers when commercial borrowers seek protection, whether in or out of bankruptcy, often under Chapter 11 and state court insolvency proceedings. He has extensive experience in obtaining orders authorizing debtors-in-possession to borrow money on a secured basis, and in litigating contested claims for use of cash collateral. Jeff is also well versed in representing clients who are acquiring the assets or stock of companies in bankruptcy, and regularly represents the interests of commercial landlords in bankruptcy matters.

An established writer and blogger, Jeff's Wurst Case Scenario, the commercial finance law newsletter, has thousands of followers. He is also a frequent lecturer on topics concerning lenders and entrepreneurs.

WURST CASE SCENARIO
COMMERCIAL FINANCE LAW BLOG

August 18, 2021
www.WurstCaseScenario.com

Third-Party Beneficiary Rights to Legal Fees? Not So Fast!

I am confident my readers will understand that one of the things near and dear to my heart is having lawyers get paid for their work. Those of us at the lenders' bar often take solace in knowing that borrowers are obligated to pay our fees; and when they do not, the institutions we represent have both the wherewithal and desire to work with us in getting paid.

But not always.

We understand that at times the scope of the transaction exceeds initial expectations and fees may run up. We lawyers remain sensitive to that and work with our clients and their borrowers to reach a reasonable resolution when this occurs. But when a deal does not result in a closing, things may get difficult.

The United States District Court for the Southern District of New York recently issued a decision concerning a law firm's attempt to recover over $800,000 in legal fees owed in connection with its representation of the agent lender in a deal that resulted in an executed loan agreement that did not fund.

The $167 million loan was intended to fund the development and construction of an 18,000-seat arena on the Virginia Beach waterfront. The City retained the right to approve the financing, and when it declined to grant its approval, the deal fell through.

The developer sued the City, which resulted in a finding that the City had not breached its agreement with the developer. The law firm brought its action against the borrower-developer and not its client, the lender.

The loan agreement provided that the borrower would pay all reasonable fees, charges and disbursements of counsel for the agent. The law firm, however, was not a party to the loan agreement and the law firm argued that it was an intended third-party beneficiary. The developer moved to dismiss the complaint claiming that the law firm did not have standing to sue because it was neither a party to the loan agreement nor an intended beneficiary.

The Court wrote:

> *Under New York law, non-parties can sue for breach only if they are an intended beneficiary of the contract. Those who qualify as mere incidental beneficiaries have no standing to sue on the contract.*

The Court then focused on whether the contract provided that the law firm was intended to be a third-party beneficiary. The contract specifically stated:

> *... Nothing in this Agreement, expressed or implied, shall be construed to confer upon any Person ... any legal or equitable right, remedy or claim under or by reason of this Agreement.*

The Court noted that the contract did not specifically include the law firm or even *counsel to the agent*.

> *So, the question becomes: Is there anything in the contract that "expressly contemplates" that [the law firm] can bring a claim against [the developer] for payment of the fees it incurred in representing [the lender]? The answer is no. There is no such provision. There is no indication anywhere in the Credit Agreement that [the law firm] was either to receive payment directly from [the developer] or that it had any right to sue ... for payment.*

In fact, the Court stated:

> *the contract specifically indicates that [the lender] was to receive payment from the "Borrower" ... for its counsel fees.*

The Court went on:

> *The New York Court of Appeals has "sanctioned a third party's right to enforce a contract in two situations: when the third party is the only one who could recover for the breach of contract or when it is otherwise clear from the language of the contract that there was "an intent to permit enforcement by the third party."*

The contract provided that the lender would receive payment, which excluded the law firm from directly suing to collect.

In dismissing the law firm's complaint, the Court added:

> *This dismissal is of course without prejudice to [lender]'s ability to sue to recover any attorney's fees that it pays to [law firm].*

However, it would appear that if the lender was willing to sue to pursue its legal costs it would have at least authorized the firm to bring the action in the lender's name. It is understandable that the lender might not have wanted to sue in its own name to recover legal fees – especially when a transaction does not close. That left the law firm out of pocket for a significant fee.

So, what is the takeaway?

Lawyers write the agreements. Protect yourself and make yourself a third-party beneficiary.

But consider that this case was very rare in that the loan agreements were executed but the deal still did not fund. Most deals that fail collapse before execution of the loan agreements. That certainly takes away a significant element – the executed loan agreements. Commitment letters – even nonbinding term sheet/proposal letters, provide for the lender recovering its legal costs and fees. Consider this a plea to add the lawyers as third-party beneficiaries to the proposal/commitment letters.

One can only imagine what might have occurred in the relationship between lender and its lawyers to leave the law firm strung out.

Caveat attornatus. (Lawyers beware.)

Winston & Strawn LLP v Mid-Atlantic Arena, LLC, ESG Enterprises, Inc., SDNY July 19, 2021, 2021 WL 3037478

WURST CASE SCENARIO
COMMERCIAL FINANCE LAW BLOG

July 22, 2021
www.WurstCaseScenario.com

The Emerging Use of Arbitration in Bankruptcy Matters

Readers of this blog (as well as my other published articles) should be familiar with my advocacy for use of arbitration in resolving commercial finance disputes. Certainly, in matters involving disputes between secured creditors (e.g., intercreditor disputes), I have long expressed my view that things like these should be resolved privately, not through a public forum. This is a great benefit of arbitration. I am also inclined to privately resolving disputes between lenders and borrowers through arbitration. In those rare instances when a lender may have crossed the line and is subject to liability, isn't it better to keep that dispute under the cover of a confidential arbitration?

Over the past 30 years, the use of mediation has become common in bankruptcy disputes. But the question has long been raised whether arbitration clauses would be enforced in the context of a bankruptcy case. That issue was addressed in a recent decision from the Bankruptcy Court for the District of Maryland. While this decision may not be the first to address this question and enforce a prepetition arbitration private provision, the scholarship of this decision certainly makes it ripe to present.

The Maryland Bankruptcy Court wrote:

> *The filing of a chapter 11 bankruptcy case generally stops all matters affecting the debtor's financial affairs and consolidates the resolution of those matters in one forum, the bankruptcy court. That collective process is intended to, among other things, allow a debtor to catch its financial breath and develop a cohesive reorganization plan; provide consistency and certainty in the resolution of matters potentially affecting the debtor's reorganization; and ensure fair and equal treatment of the debtor's creditors. ...A frequent question.... is how these basic principles apply to an arbitration clause in a prepetition contract between the debtor and just one creditor.*

Prior to the filing of his personal bankruptcy case, the debtor entered into a litigation funding agreement whereby the lender extended financing to fund the cost of the lawsuit in exchange for a percentage of the debtor's interest in a whistleblower litigation. When the lender and borrower found themselves in a dispute, the lender invoked the arbitration clause contained in its agreement and the debtor filed a Chapter 11 case. The lender moved for relief from the automatic stay to allow the arbitration to proceed. The debtor objected.

The lender argued that the Bankruptcy Court was required to enforce the prepetition arbitration agreement, while the debtor argued that enforcement would conflict with the objectives of the Bankruptcy Code.

> *The [Federal Arbitration Act] and the [Bankruptcy] Code both are grounded in important policy considerations concerning efficiency and fairness. The FAA focuses on these notions in the context of, among other things, private contracts affecting commerce, creating a strong presumption in favor of the parties' threshold agreement to arbitrate disputes. ...The Code ... is not party- or contract-specific but seeks to balance the rights of many parties with many different contracts, rights, and interests involving a single debtor.*

The Court turned to whether the dispute was a *core proceeding*:

> *If a claim is a constitutionally core proceeding, the bankruptcy court has the discretion to retain the proceeding and not enforce the terms of the parties' arbitration agreement. ...[T]his discretion arises from the inherent conflict in allowing an arbitrator to resolve proceedings that are grounded in the Code itself or that are integral to the debtor's reorganization efforts.... A bankruptcy court's discretion is far more limited with respect to nonconstitutionally core or non-core proceedings.*

Some circuit courts have ruled that a bankruptcy court has no discretion to refuse arbitration of non-core claims. The Court quoted a New York case for the steps to follow in evaluating requests to compel arbitration:

> *[F]irst, it must determine whether the parties agree to arbitrate; second, it must determine the scope of that agreement; third, if federal statutory claims are asserted, it must consider whether Congress intended those claims to be nonarbitrable; and fourth, if the court concludes that some, but not all, of the claims in the case are arbitrable, it must then decide whether to*

> *stay the balance of the proceedings pending arbitration.*

In doing its analysis, the Court determined that this was a hybrid case involving constitutionally core and non-core proceedings with the state law contract claims being subject to the prepetition arbitration agreement. The Court further noted that those claims could be separated from the bankruptcy and fair debt collection claims – "even if that may not be the most procedurally efficient approach…." In light of legal precedent in the Fourth Circuit Court of Appeals, the Bankruptcy Judge felt compelled to bifurcate the claims and allow the contract and nonbankruptcy claims to proceed to arbitration.

> *The Court acknowledges that, if the arbitrator resolves the Contract Claims or the Non-Bankruptcy Claims prior to this Court addressing the Bankruptcy Claims, the parties could face conflicting results, or one forum may be bound by the other's decision under the doctrine of claim or issue preclusion. The Court is not prepared to rule on such matters at this time, but will by separate order issue a temporary stay of proceedings on the Debtor's Complaint to monitor how these matters progress and to guard against undue delay or gamesmanship. The Court dislikes the element of uncertainty introduced by this approach but, absent clear authority under the Code or case law giving this Court more discretion to refuse arbitration in the context of non-constitutionally core or non-core claims, the Court finds this approach warranted and most appropriate under the circumstances.*

The takeaway in this developing area of the law is, that while bankruptcy claims must be resolved in the Bankruptcy Court, nonbankruptcy claims that are the subject of an arbitration agreement may be compelled to be resolved by an arbitration tribunal. I will continue to keep an eye on this doctrine and continue to advocate the use of arbitration for the resolution of commercial finance disputes.

In re: John McDonnell McPherson v Camac Fund, L.P., Bankr. MD, June 1, 2021, 2021 WL 2232351

WURST CASE SCENARIO
COMMERCIAL FINANCE LAW BLOG

April 7, 2021

(Where) to Sue or Not to Sue? That Is the Question!

Two decisions issued a day apart, one from California and the other from Michigan, highlight the importance of bringing your action in a court where you can obtain jurisdiction over your defendant.

It's My Seat, a ticketing vendor and concert promoter operating and organized in California, brought an action in the California state court system against Hartford Capital, a New York-based merchant cash advance company. Hartford removed the action to the Central District of California under diversity (actions between parties of different jurisdictions) and moved to dismiss the action for lack of personal jurisdiction.

The facts of the case involve It's My Seat having sought a low-rate business loan by filing a loan application online. Hartford's representative contacted It's My Seat and promised that if It's My Seat first took a $250,000, 30-day "bridge loan" with an interest rate of 15%, that it would then provide a $750,000 term loan with interest at 8.99%. The bridge loan provided for daily ACH payments in the amount of $3,600. The Hartford representative *assured* that the term loan would be made but did not document that assurance in any way. It's My Seat signed and notarized the bridge loan documents and Hartford advanced the bridge loan, but for a previously undisclosed $22,000 "funding fee." When It's My Seat protested the funding fee, Hartford's representative promised to credit the amount. It's My Seat made the daily payments for the required 30-day period, but the $750,000 line of credit was not issued. The Hartford representative claimed that he was "doing everything I can to get this pushed through." It's My Seat continued to make the $3,600 daily payments for 70 days (40 more than originally required) having to obtain third-party emergency loans in order to do so. Ultimately, Hartford refused to provide the term loan on the basis that the third-party loans violated the bridge loan agreements, and It's My Seat brought the action against Hartford and its representatives.

The court dismissed the action against Hartford and one representative because the complaint was not timely served. The other representative, Stein, moved to dismiss for lack of personal jurisdiction. The question of personal jurisdiction turned on whether Stein's relevant contacts with It's My Seat subjected Stein to *specific* personal jurisdiction.

> *Where a defendant's contacts are "not so pervasive as to subject him to general jurisdiction," the Ninth Circuit applies a three-part specific jurisdiction test: "(1) The nonresident defendant must do some act or consummate some transaction with the forum or perform some act by which he purposefully avails himself of the privilege of conducting activities in the forum, thereby invoking the benefits and protections of its laws. (2) The claim must be one which arises out of or results from the defendant's forum-related activities. (3) Exercise of jurisdiction must be reasonable." (citations omitted)*

Stein admitted that he called It's My Seat in California to solicit and conduct business in the form of the bridge and term loans. The court determined that Stein's contacts with California are therefore integral and essential parts of the claims made in the case and that It's My Seat made a prima facie showing of the first two prongs. The burden then shifted to Stein to set forth a compelling reason why the exercise of jurisdiction would not be reasonable.

The court then cited the factors in determining reasonableness:

> *(1) the extent of the defendants' purposeful injection into the forum state's affairs; (2) the burden on the defendant of defending in the forum; (3) the extent of conflict with the sovereignty of the defendant's state; (4) the forum state's interest in adjudicating the dispute; (5) the most efficient judicial resolution of the controversy; (6) the importance of the forum to the plaintiff's interest in convenient and effective relief; and (7) the existence of an alternative forum. (citations omitted)*

The California court then weighed each of the factors and concluded that Stein failed to make a compelling case that the exercise of jurisdiction in California would not be reasonable and declined to dismiss the action as against Stein.

The Michigan case concerned a dispute between two lenders and their priority in the collateral of a mutual borrower organized and operating in Ohio. The underlying claim is one of great interest although not decided in the case. Plaintiff and its predecessor provided financing to borrower under a *revenue purchase agreement* and perfected an all-asset Uniform Commercial Code (UCC) filing on Dec. 12, 2019. Defendant provided one or more merchant cash advances and perfected an all-asset UCC filing on Jan. 23, 2020. Defendant also secured ACH payments from the borrower's bank account.

Plaintiff brought an action in Michigan state court against Defendant for (1) declaratory judgment as to priority in collateral, (2) tortious interference with a contractual relationship, (3) tortious interference with future business expectations, (4) conversion, and (5) temporary, preliminary and permanent injunctive and declaratory relief. Defendant removed the case to the Federal District Court in Eastern Michigan under diversity and moved to dismiss the complaint for lack of personal jurisdiction.

Michigan law recognizes two bases for personal jurisdiction over a corporation: (1) general, and (2) specific (called *limited personal jurisdiction*). A court has general jurisdiction over a corporation where the defendant's contacts within the forum are so continuous and systematic as to render it essentially at home in the forum state. As to specific jurisdiction, the inquiry focuses on the relationship among the defendant, the forum and the litigation. For a court to exercise specific jurisdiction, the defendant's suit-related conduct must create a substantial connection with the forum state. The plaintiff has the burden of proof to establish that a defendant's contacts are sufficient to subject it to jurisdiction.

Plaintiff argued that the Michigan Court had general jurisdiction over Defendant because Defendant solicited business from Michigan residents through its website and established "long-term lending relationships with Michigan residents" as evidenced by UCC filings in favor of Defendant, and litigation within Michigan courts. The Court found that evidence to be insufficient to establish general jurisdiction over Defendant as it failed to demonstrate continuous and systematic contacts.

Plaintiff further argued that Defendant had utilized its website to solicit business from Michigan residents and establishes general jurisdiction. The Court found no authority to support that proposition and indicated that case law states the opposite. The Court held:

Plaintiff has offered no evidence to support a finding that this is "an exceptional case," or any authority to support the proposition that Defendant[]'s contacts are sufficient to establish it was "at home" in Michigan. There is no evidence that Defendant [] has physical locations, employees, or officers in Michigan. There is no evidence that Defendant [] has bank accounts or conducts daily corporate activities in Michigan. While Plaintiff offers proof that Defendant has filed multiple UCC debtor financing statements and has brought one case within Michigan courts, this evidence merely confirms that Defendant [] has done some in-state business in Michigan. This is insufficient for purposes of establishing general jurisdiction.

The Court then focused on whether "specific jurisdiction" would apply. Under specific jurisdiction, a plaintiff may sue a defendant "only on claims that arise out of the defendant's activities in the forum state." The Court cited the standard for specific jurisdiction as determined by the Sixth Circuit Court of Appeals:

> *First, the defendant must purposefully avail himself of the privilege of acting in the forum state or causing a consequence in the forum state. Second, the cause of action must arise from the defendant's activities there. Finally, the acts of the defendant or consequences caused by the defendant must have a substantial enough connection with the forum state to make the exercise of jurisdiction over the defendant reasonable.*

Plaintiff alleged that the second prong was met because Defendant's "actions had consequences in Michigan resulting in harm to [Plaintiff], a Michigan resident." However, the Court noted that both the U.S. Supreme Court and Michigan courts have rejected this theory of specific jurisdiction.

> *When assessing specific jurisdiction, "[t]he proper question is not where the plaintiff experienced a particular injury or effect but whether the defendant's conduct connects him to the forum in a meaningful way."*

*****

> *...it is clear that Defendant[]'s conduct—entering into a contract with a company in Ohio to purchase revenue and withdrawing funds from that company's bank account in Ohio—may not form the basis for Defendant to be sued in a Michigan court. .... Plaintiff does not allege that any of Defendant[]'s challenged conduct took place in Michigan.*

The dismissal of the action does not bar Plaintiff from pursuing its claims in a proper jurisdiction; it certainly does not appear that any statute of limitations is at risk. However, the cost and time incurred takes its toll on Plaintiff.

Each of the California and Michigan cases rests on nonphysical presence of the parties—email and websites. The Michigan case concerned a loan made into Ohio, while the contacts in the California case concerned a loan made into California. That is not to say that had the Michigan plaintiff brought its case in Ohio that an Ohio court would have ruled differently.

The takeaway is to make a careful analysis when bringing an action against a party of a different jurisdiction, and assure that jurisdiction is proper in the venue where the action is brought.

One final thought: Commercial lenders and factors have long expressed concerns about egregious conduct engaged in by certain merchant cash advance providers. Each of these cases highlights questionable conduct that commercial lenders and factors will want to monitor.

It's My Seat, Inc. v Hartford Capital LLC, et al. (CD CA, 3/30/21) 2021 WL 1200042

Franklin Capital Funding, LLC v Ace Funding Source, LLC (ED MI, 3/31/21) 2021 WL 1224917

February 18, 2021

Think Before You Click: A $500 million mistake!

A major objective of this blog is to keep lenders apprised of significant judicial decisions that impact their business lives so they can learn from them, correct bad habits and improve their best practices. WurstCaseScenario seeks to help lenders avoid making mistakes. Today, we focus on a critical decision from the Southern District of New York ("SDNY") concerning a costly mistake that could and should have been avoided.

Readers of these pages should remember the debacle that resulted from another bank inadvertently terminating the Uniform Commercial Code (UCC) financing statements perfecting the security interests of the syndicate of lenders in the General Motors case.

As an aside, we may want to keep in mind that the facts underlying this decision all occurred during the COVID-19 pandemic.

In 2016, Revlon took out a seven-year, $1.8 billion syndicated loan with Citibank as agent. Amongst its duties, the bank was to receive payments from Revlon and pass them on to the 2016 term loan lenders.

In the spring of 2020, Revlon, through a series of transactions, obtained over $800 million in "new financing" in part by adding an amendment to the 2016 loan agreement. This included sharing collateral that had previously secured the 2016 term loan as collateral for new loans from other lenders. Some of the 2016 term loan lenders, including most of the defendants in this action, opposed the amendment claiming that it would "siphon away collateral that was providing essential security for payment of the 2016 Term Loans."

On Aug. 11, 2020, the bank intended to wire approximately $7.8 million in interest-only payments to the term loan lenders. Instead, it mistakenly wired some $894 million, which effectively paid off the term loan lenders. When it realized its error, it requested the term loan lenders return the wires, and some actually did, to the extent of $393 million. The bank brought actions against those 2016 term loan lenders that did not return some $501 million in wires made in error, claiming they were unjustly enriched.

You must be wondering, "How could this error have been made?" Those 2016 term loan lenders who joined the syndicate for the 2020 financing had the right to roll up the balances on their 2016 term loans into their 2020 transaction. It appears that the bank, in *rolling up* these loans, intended to effect ledger payments from one loan to the other but, instead, sent those funds to the 2016 term loan lenders along with the $7.8 million of interest payments that they did intend to wire out. (I know, you are still scratching your heads – so am I). As a result, in addition to Revlon's $7.8 million in interest payments, almost *$900 million* of the bank's money was sent as well. The payments equaled — to the penny — the amount of principal and interest that Revlon owed on the 2016 term loan.

The bank has a "six-eye" approval procedure (three people): (a) the "maker" inputs the payment information; (b) the "checker" reviews and verifies the transaction; and (c) the "approver" does a final review of the transaction. However, none picked up the error.

In December 2020, the Court held a six-day remote bench trial to decide whether the bank could recoup the money. The defendants in this case — 10 investment advisory firms' managing entities that collectively received more than $500 million of the mistaken wire transfers — contended that this exception to the general rule, known as the "discharge-for-value defense," applied here and that the bank was not entitled to the return of its money.

In its analysis, the Court noted that as a general matter, the law treats a failure to return money that is wired by mistake as unjust enrichment or conversion and requires that the recipient return such money to its sender.

Federal courts, in ruling on state law issues, look to the rulings from that state. You may remember that in the General Motors case, the Second Circuit Court of Appeals certified the critical issue to the Delaware Supreme Court, who ruled that despite the bank's error in that case, it intended to file the termination statements leaving it unsecured.

In the instant case, the SDNY considered a 1991 decision, where the New York Court of Appeals explained the New York exception to unjust enrichment, stating:

> *When a beneficiary receives money to which it is entitled and has no knowledge that the money was erroneously wired, the beneficiary should not have to wonder whether it may retain the funds; rather, such a beneficiary should be able to consider the transfer of funds as a final and complete transaction, not subject to revocation.*

The SDNY explained the New York exception to the general rule:

> *The recipient is allowed to keep the funds if they discharge a valid debt, the recipient made no misrepresentations to induce the payment, and the recipient did not have notice of the mistake.*

The Court determined that once the bank sent the wire transfer, the mistake was irreversible. The internal checks completely failed. Instead of treating the wire transfers as interest-only payments, the bank's agents failed to check the boxes which resulted in the system defaulting to principal payments. The transaction was supposed to go to an internal account for verification, but instead, it went straight to the 2016 term loan lenders. An entire day passed before the bank realized its mistake and it was too late. Essentially, the court held that since all elements of the "discharge-for-value" defense had been met, the bank could not recover its funds.

Takeaway: Wire transfers are irrevocable and final. Perhaps the six eyes required to verify the transfers were impacted by the pandemic and working at home; perhaps with distractions of young children and pets (as we are now accustomed as we Zoom with our colleagues and clients on a daily basis). However, one must be certain before sending a wire, or run the risk of having a costly lesson; or, another costly lesson.

In re Citibank August 11, 2020 Wire Transfer, 20-cv-6539 (SDNY, February 16, 2021)

WURST CASE SCENARIO
COMMERCIAL FINANCE LAW BLOG

December 22, 2020

Who Do You Trust?

This edition of WurstCaseScenario is dedicated to those readers who remember Johnny Carson's pre-*Tonight Show* era afternoon game show, *Who Do You Trust?* Read on.

Many of you take comfort in a fairly standard provision contained in loan agreements such as this one: "[debtor] shall hold and keep all Property and the proceeds thereof (collectively, the 'Trust Property') in trust for the benefit of [lender]."

The Montana Bankruptcy Court just issued a decision examining how far one might stretch a trust clause. The case involved a Chapter 11 filed by an auto dealer. Trust clauses, such as the one in this case, are very common to help the lenders assert their rights in the proceeds from the sale of their collateral. In fact, when the lender's collateral is sold and the proceeds are not turned over to the lender, the debtor is commonly referred to as being *out of trust*.

One of the auto dealer's floorplan lenders brought a motion for stay relief. The lender did not claim to have a security interest. Instead, it claimed that the debtor was in possession of inventory and sale proceeds belonging to the lender under the terms of an express trust created by a *Wholesale Financing Agreement*. The lender asserted that it "owns the Inventory Property and Sale Proceeds and the debtor merely holds such property in trust for [lender]" and that, based on the existence of the trust, "the property is not property of the bankruptcy estate," entitling the lender to stay relief.

The decision does not address why the lender did not have a perfected security interest or even a consignment agreement. In its papers opposing the lender's stay relief motion, another creditor argued that the lender was a secured creditor with an attached, **but unperfected**, security interest in the inventory and proceeds. The opposing creditor wrote that the debtor granted the lender a security interest in its assets, but the lender did not file a UCC financing statement. Accordingly, the opposing creditor contended that the inventory and proceeds are property of the bankruptcy estate and that stay relief was inappropriate because the lender lien was not perfected.

The court engaged in an analysis of the parties' intent in entering into the *Wholesale Financing Agreement*. It noted that the agreement provided that

> *[a]s a condition to making the Loan to [debtor], [lender] requires that it be granted, and [debtor] has agreed to grant [lender], a security interest in the Property…and the collateral described in Exhibit "A" attached hereto (collectively, the 'Collateral').*

The agreement went on to say that

> *[Debtor] owns the Collateral free and clear of all liens, securing interests, judgments, levies, or other encumbrances, except for those in favor of [lender]. It is the intention of [debtor] to grant to [lender] a security interest in the Collateral.*

The court enumerated similar provisions ultimately concluding that the agreement created a security arrangement governed by Article 9 of the Uniform Commercial Code.

> *When a security interest is created, Article 9 applies regardless of the form of the transaction or the name the parties have given it. Instead of focusing on the form of the transaction or the name ascribed to it by the parties, the Court must look beyond the label of the transaction or the language used by the parties to describe it:*
>
> *A preeminent theme in…Article 9…is that substance governs form. If Article 9 otherwise applies, the parties cannot render it inapplicable merely by casting their arrangement in the language of some particular pre-Code device or in the language of some other transaction.*

Article 9 requires two steps to create an enforceable security interest: attachment and perfection. Generally, attachment requires three things: 1) value must be given; 2) the debtor must have rights in the collateral; and 3) the debtor must authenticate a security agreement that provides a description of the collateral. Once a security interest is attached, it becomes enforceable by the creditor against the debtor, **but not against third parties**.

> *In this case, [lender] gave value in the form of "wholesale line(s) of credit financing," debtor had rights in the "Collateral" in which [lender] took a security interest, and the parties executed the [agreement], which described the Collateral. Accordingly, [lender's] interest in debtor's inventory and sale proceeds, included in the definition of "Collateral," attached for Article 9 purposes.*

The court explained that **perfection** under Article 9, on the other hand, is the mechanism that makes a security interest enforceable against third parties.

> *The essence of perfection is to furnish public notice of the secured party's interest in the collateral, thereby protecting third persons against secret liens. The "trust" arrangement urged by [lender] appears to be precisely the sort of secret lien, or interest, perfection is intended protect against.*

The takeaway is that you cannot trust your trust clause to bail you out for not perfecting your security interest. Filing and maintaining your perfection is basic and should never be overlooked or neglected. File and continue your filing prior to a lapse. Your failure to do so will result in you finding a lump of coal in your stocking hanging over the fireplace.

Best wishes of the season to all of our treasured readers.

In re Hawaii Motorsports, LLC, (Bankr. D Montana) Dec. 7, 2020. 2020 WL 7233187

WURST CASE SCENARIO
COMMERCIAL FINANCE LAW BLOG

November 18, 2020

PACA: If It Looks Like a Duck and Walks Like a Duck, It Still Needs to Be a True Sale to Avoid Liability

The strong arm effect of The Perishable Agricultural Commodities Act (PACA) continues to strike at lenders who refuse to take "no" for an answer.

In March 2018, we dedicated two *Wurst Case Scenario* posts to a significant PACA decision (Tanimura) from the Ninth Circuit Court of Appeals where the Court reversed its prior position and joined the Second, Fourth and Fifth Circuits in protecting true sale factors from exposure when a PACA beneficiary goes unpaid. In that case, the Ninth Circuit said:

> *…. a PACA trustee's true sale of accounts receivable for a commercially reasonable discount from the accounts' face value is not a dissipation of trust assets and, therefore, is not a breach of the PACA trustee's duties. … ("The assets of the trust would thus have been converted into cash and the receivables would no longer have been trust assets.")… "([A] 'bonafide purchaser' of trust assets receives the assets free of claims by trust beneficiaries" and noting that the determinative issue on appeal is whether the "factoring agreement" was a loan secured by accounts receivable or a true sale of accounts receivable); … ("[N]othing in PACA or the regulations prohibits PACA trustees from attempting to turn receivables into cash by factoring. To the contrary a commercially reasonable sale of accounts for fair value is entirely consistent with the trustee's primary duty.")…*

In January 2020, we focused on a case affecting Produce Pay, Inc., a "multi-service finance company," that asserted a PACA claim against a bankrupt distributor, claiming it was a purchaser that was entitled to assert PACA trust claims against a nonpaying/bankrupt purchaser of produce. The bankruptcy court in that case determined that Produce Pay purchased produce from growers but with full recourse. Thus, it was not entitled to the protection of the PACA trust.

On Oct. 13, 2020, the United States District Court for the Central District of California issued a decision – again concerning Produce Pay. This time Produce Pay claimed not to be a factor but instead a consignor and that the risk of nonpayment fell on Produce Pay's *consignment agent* (Izguerra), who assumed the risk of nonpayment. The Court noted:

> *While it is true that the opinion in Tanimura focuses on whether a factoring agreement is a sale in order to determine whether the proceeds remained in the trust, this Court must decide whether a transaction is a sale to determine whether Plaintiff is entitled to PACA protection. Therefore, this Court applies the transfer-of-risk test adopted by the Ninth Circuit in Tanimura.*

The transfer-of-risk test established in *Tanimura* provides:

> *Where the lender has purchased the accounts receivable, the borrower's debt is extinguished and the lender's risk with regard to the performance of the accounts is direct, that is, the lender and not the borrower bears the risk of non-performance by the account debtor. If the lender holds only a security interest, however, the lender's risk is derivative or secondary, that is, the borrower remains liable for the debt and bears the risk of non-payment by the account debtor, while the lender only bears the risk that the account debtor's non-payment will leave the borrower unable to satisfy the loan.*

In considering whether to apply the transfer-of-risk test, the Court, looking to the Second Circuit's seminal decision on the subject, considered: (a) whether Produce Pay has a right to recover any deficiency from Izguerra if the assets assigned do not satisfy the debt; (b) whether Produce Pay's right to the assets assigned is affected should Izguerra pay the debt from independent funds; (c) whether Izguerra has a right to any funds recovered from the sale of assets above that necessary to satisfy the

debt; and (d) whether the debt is reduced by the assignment itself.

The Court noted that according to the agreement, Izguerra bears all the risk should its purchaser fail to pay. Accordingly, the Court held that:

> *the transaction is a secured loan and not a true sale, contradicting the Complaint and making Produce Pay ineligible for protection under PACA.*

Produce Pay loses again. These are expensive lessons. Notwithstanding, there are reasonable opportunities to provide financing to the PACA industry. But be warned not to be cavalier in extending financing, and be sure to make and rely upon sound business and legal practices or run the risk of sustaining losses.

Produce Pay v. Izguerra Produce, CDCA October 13, 2020

WURST CASE SCENARIO
COMMERCIAL FINANCE LAW BLOG

November 17, 2020

Personal Guaranties: The Document of Last Resort

Lenders take guaranties but hope to never need them. Sometimes, lenders take them knowing that the guarantor is judgment-proof, but hope that the guaranty will serve as a deterrent against otherwise improper acts. Guaranty agreements have grown in verbiage over the years and typically include all types of conditions and waivers. Once the lender determines to pursue a guarantor, it is common for the guarantor to look for reasons that the guaranty should not be enforced. Thus, the waivers are important and enable lenders to prevail on motions for summary judgment and avoid an expensive trial. But that is a topic for another day.

But what if the lender does not have a written guaranty? Is it out of luck? The Michigan Court of Appeals issued a decision on Oct. 29, 2020, that sheds some light on this. But first, let us consider some underlying requirements.

Readers of Wurst Case Scenario are familiar with the term ***statute of frauds***. Most, if not all, jurisdictions have enacted statutes of frauds that require certain agreements to be in writing. For example, the California statute of frauds (California Civil Code 1624) provides:

> *(a) The following contracts are invalid, unless they, or some note or memorandum thereof, are in writing and subscribed by the party to be charged or by the party's agent: …*
>
> *(2) A special promise to answer for the debt, default, or miscarriage of another, except in the cases provided for in Section 2794.*

Section 2794 provides:

> *A promise to answer for the obligation of another, in any of the following cases, is deemed an original obligation of the promisor, and need not be in writing: … Where the promise is upon a consideration beneficial to the promisor, whether moving from either party to the antecedent obligation, or from another person;*

Similarly, by way of example, the New York statute of frauds (New York General Obligation Law §5-701) provides:

> *a. Every agreement, promise or undertaking is void, unless it or some note or memorandum thereof be in writing, and subscribed by the party to be charged therewith, or by his lawful agent, if such agreement, promise or undertaking: …*
>
> *2. Is a special promise to answer for the debt, default or miscarriage of another person;*

That statute goes on to say:

3. There is sufficient evidence that a contract has been made if:

> *(a) There is evidence of electronic communication (including, without limitation, the recording of a telephone call … sufficient to indicate that in such communication a contract was made between the parties….*

The Michigan case involves enforcement of an oral guaranty for a business loan made under California law, although the lawsuit was brought in Michigan where the guarantor resides. There is no explanation why the lender did not obtain a written guaranty. There is no explanation why neither the original written business loan agreements, nor the amended documents entered into 10 years later, failed to even reference the guaranty.

Instead, the lender relied on the transcript of a pre-loan closing telephone conversation between the lender's representative and the guarantor. Fortunately for the lender, the guarantor admitted the accuracy of the transcript.

> *Q. You personally guaranty [sic] to pay [lender] upon demand all that you owe on the business line account. As guarantor, you authorize [lender] without notice or prior consent to change any of the terms of the amount of your company's business line account. In addition, you agree to pay attorney's fees and other expenses incurred in enforcing this guaranty.*
>
> *A. Uh-huh.*
>
> *Q. This guaranty benefits the [lender] and its successors and assigns. Finally, you agree this audiotaped application may be used as evidence of your agreement to the terms of this guaranty.*

A. Uh-huh.

Q. Do you understand and agree to these terms?

A. Yes.

During the conversation, the guarantor also agreed that the agreement would be subject to California law.

The Michigan Court of Appeals, applying California law, ruled in favor of the lender saying: "An oral guaranty is ...enforceable if the guarantor gained a business or personal advantage from the transaction," and, "Here it is clear that [guarantor's] leading and main objective was not to become a surety or guarantor but to simply serve his own personal interests connected to keeping his business afloat."

But how would other states address an oral guaranty? Likely, in a similar way. As indicated, New York has a similar statute of frauds, and other similar exceptions. However, my search for even a single case in New York where an oral guaranty was enforced came up empty. However, there are cases that discuss what would be needed to enforce an oral guaranty. One New York case went so far as to say:

An oral guaranty would be enforceable (1) if it were supported by new consideration; (2) if it were beneficial to the promisor; and (3) if the promisor had agreed to be directly liable for the debt.

That court, however, declined to find that an oral guaranty existed.

The facts in the Michigan case may be unique but not out of reach. It is common (and perhaps even standard) to have recorded conversations when interviewing potential borrowers and guarantors during the application process. Having to rely on that recorded conversation may give rise to other problems. That said, the best practice is still to obtain a well-written guaranty executed by the guarantor.

WURST CASE SCENARIO
COMMERCIAL FINANCE LAW BLOG

November 17, 2020

CAN A BANKRUPTCY DEBTOR BE A PPP BORROWER?

As we remain glued to the national and local news about return-to-work procedures and the effects that the pandemic has had on the worldwide economy, we take a look at an interesting decision that just came down from the Bankruptcy Court for the Western District of Tennessee.

The individual debtor filed his voluntary petition in December 2019. An operating trustee was appointed who asserted that as trustee he stepped into the debtor's *shoes* as the shareholder of the debtor's businesses. Alpha Visions Learning Academy, Inc. (Alpha), one of the debtor's businesses, is a childcare center with 20 employees and about 70 children attending. As a result of the COVID-19 pandemic, attendance dropped and the trustee applied to the Small Business Administration (SBA) for a loan under the Paycheck Protection Program (PPP).

The trustee brought a motion and complaint seeking entry of a temporary restraining order, preliminary injunction and permanent injunction directing the SBA to consider Alpha's PPP application without consideration of the debtor-owner's bankruptcy proceedings. In addition, Alpha sought a declaration that SBA violated the Administrative Procedures Act and 11 USC Section 525(a) in excluding applications from entities who are in bankruptcy or who have an owner in bankruptcy.

The trustee alleged that the SBA made approval of any PPP loan expressly contingent on the applicant or any owner of the applicant not being "presently involved in any bankruptcy," even though this condition is not articulated in the CARES Act that enacts the PPP, or in the Small Business Act. The trustee relied upon Section 525(a) of the Bankruptcy Code, which provides in part:

a governmental unit may not deny…a grant to…a person that is or has been a debtor under [the Bankruptcy Code]…solely because such…debtor is or has been a debtor…has been insolvent before the commencement of the case…or during the case but before the debtor is granted or denied a discharge, or has not paid a debt that is dischargeable in the case under this title or that was discharged…

The trustee argued that Section 525 applied because the PPP is by nature a grant rather than a loan because the debt is to be forgiven.

The SBA responded that the Small Business Act precluded the injunctive relief sought by the trustee, which provides that the SBA:

May…sue and be sued in any court…but no attachment, injunction, garnishment, or other similar process…shall be issued against the [SBA].

The SBA relied on a case from the Sixth Circuit Court of Appeals in asserting that the Small Business Act:

…provides basically that parties may proceed against the SBA but only as Congress has provided. [When the SBA brought] an action against a private party, and where that private party brings a counterclaim that implicates the SBA's rights, the SBA's rights are unaffected unless it is made a party to that action pursuant to the consent statute.

The SBA argued that the bankruptcy court's authority to adjudicate Alpha's Section 525(a) claim did not extend to its PPP claim, which did not arise under the Bankruptcy Code. The SBA said that it did not consent to the entry of a final judgment on the PPP claims.

The bankruptcy court, however, found that the SBA violated the Bankruptcy Code's anti-discrimination provision when it directed lenders to refuse to accept PPP applications from entities owned by bankruptcy debtors. The court stated:

Perhaps nothing illustrates the arbitrariness and caprice of the bankruptcy exclusion rule better than SBA's explanation. In order to implement a Congressional program intended to protect American workers from unemployment and loss of health insurance, SBA arbitrarily eliminated all workers employed by debtors in bankruptcy and all workers employed by entities whose owners are debtors in bankruptcy… In attempting to expedite the PPP application process, SBA chose a path that was diametrically opposed to its prior practice and the stated intention of Congress to provide funds for payroll, mortgage interest, rent, and utilities to struggling businesses. As the Administrator herself explained "no creditworthiness assessment is required for PPP Loans," yet the explanation offered by SBA in its

Opposition to Alpha's Motion and Complaint is that it excluded bankruptcy debtors in order "reasonably to assure repayment."…"Given the obvious purpose of the PPP, it was arbitrary and capricious for Defendant to engraft a creditworthiness test where none belonged."

The court joined two other courts that considered similar claims in finding that the PPP "loan" is in the nature of a "license, permit, charter, franchise, or similar grant" without which a debtor's fresh start would be impeded.

As there is no question that the only reason that Alpha's application was turned away by Community Bank was the ruling by SBA that entities owned by debtors in bankruptcy are ineligible for the PPP program, the court finds and concludes that the SBA's bankruptcy exclusion violates section 525(a) of the Bankruptcy Code.

The court ruled that the SBA violated the Administrative Procedures Act, 5 USC § 706(C), when it exceeded its rulemaking authority by excluding entities owned by bankruptcy debtors from the PPP program; 706(B), when it arbitrarily and capriciously excluded entities owned by bankruptcy debtors from the PPP program; and Section 525(a), when it directed lenders to refuse to accept PPP applications from entities owned by bankruptcy debtors.

Various courts that have considered these issues have determined that the PPP is not a loan program:

It is a grant or support program. The target grant recipients are small businesses in financial distress. The PPP could only be offered by the government; private lenders do not give away money. PPP funds "are unobtainable from the private sector." … They also are essential to Plaintiff's fresh start. … Of all the benefits a government can grant, free money might be the best of all. Denying Plaintiff access to PPP funds solely because it is a debtor violates § 525(a).

Free money?

Alpha Visions Learning Academy, Inc., v. Jovita Carranza, in her Capacity as Administrator for the United States Small Business Administration, Defendant (Bankr. WDTN) 2020 WL 2893413

WURST CASE SCENARIO
COMMERCIAL FINANCE LAW BLOG

October 15, 2020

No Fraudulent Conveyance Despite Transfer of Assets After Notice of Default to Guarantor

In a Sept. 29, 2020, decision, the Eleventh Circuit Court of Appeals issued a disturbing decision affirming dismissal of a bank's action to bar a guarantor's bankruptcy discharge despite the guarantor having transferred substantial assets to a limited liability company he set up for his wife and daughter. The transfer occurred after the default by the borrower.

The non-dischargability action was dismissed by the Bankruptcy Court for the Southern District of Alabama, and was later affirmed by the United States District Court. The bank then appealed to the Eleventh Circuit (the appellate court just below the United States Supreme Court), which covers the states of Georgia, Alabama and Florida.

The guarantor guaranteed two business loans made in 2006 to fund a real estate development project. In 2008, he reaffirmed his guaranty when the loans were increased. A year later, the development project was in financial trouble and the bank sent the guarantor a warning of potential default. Less than two weeks after receiving the warning letter, the guarantor conveyed parcels of real property to a newly formed limited liability company whose members were the guarantor, his wife and daughter. He later conveyed his membership interest to his wife and daughter, fully divesting himself of any interest. This transfer was part of a series of conveyances of personal assets including real property, cash and business interests made to family members over the next five years. In 2010, the bank brought an action against the guarantor resulting in a money judgment in the amount of $9.1 million. The guarantor continued to transfer assets through 2014.

The bank (by its successor) ultimately sued the guarantor, his wife and daughter under the Alabama Uniform Fraudulent Transfer Act resulting in the guarantor filing for bankruptcy. The bank then commenced an adversary proceeding to declare the guarantor exempt from discharge due and allege the fraudulent conveyance. The guarantor answered the complaint and then moved for summary judgment dismissing the complaint by arguing that he did not defraud the bank in guarantying the loans, and because his conveyances did not injure the bank or its property.

The Bankruptcy Court found that the bank's claim failed because the bank did "not contend that the underlying debt from the guaranties was obtained by fraud or was anything other than a standard contract debt" and because "[t]he underlying debt is the result of personal guaranties, not any willful and malicious injury by [guarantor]." Finally, the Bankruptcy Court found no basis for the bank to amend its complaint to add a claim under the Fraudulent Transfer Act, noting that the bank had "not provided any Alabama law that [a] debtor/transferor who fraudulently transfers property is liable to a creditor for the value of the transferred property." On appeal, the District Court agreed with the Bankruptcy Court "for all the reasons articulated in [its] order," and the bank appealed to the Eleventh Circuit.

The Eleventh Circuit stated that the bank

> *does not—and cannot—argue that [guarantor] or the entity whose debt he guarantied fraudulently obtained money or property from [the bank]. A state court awarded [the bank] a judgment on its ordinary breach of contract claim, and that judgment makes no findings of fraud. The only fraud that [the bank] alleges—[guarantor's] conveyances of real and personal property—happened years after [guarantor] incurred the debt by signing the guaranties. The money that the bank loaned is obviously not traceable to those later conveyances.*

It went on to distinguish the 2016 decision of the United States Supreme Court in *Husky International Electronics*, which held "[t]he term 'actual fraud' in § 523(a)(2)(A) encompasses forms of fraud, like fraudulent conveyance schemes, that can be effected without a false representation."

However, the Eleventh Circuit claimed that

> *...the Supreme Court [did not] eliminate[] the requirement that for a debt to be exempt from discharge ..., the money or property giving rise to the debt must have been "obtained by" fraud, actual or otherwise. Instead, [it] merely recognized the possibility that fraudulent schemes lacking a misrepresentation—including fraudulent transfers of assets to avoid creditors—*

can satisfy the "obtained by" requirement in some circumstances.

Readers of **WurstCaseScenario** likely understand how difficult it is to prove ***intent*** in order to succeed in proving "actual fraud." But a fraudulent conveyance does not need to be done with intent to defraud. It is the action that matters – not the reason for it.

Section 8-9A-4 of the Uniform Fraudulent Transfer Act, as adopted in Alabama, provides:

> *(a) A transfer made by a debtor is fraudulent as to a creditor, whether the creditor's claim arose before or after the transfer was made, if the debtor made the transfer with actual intent to hinder, delay, or defraud any creditor of the debtor.*

This type of fraudulent transfer does require proof of intent. Although, in its complaint, the bank used some of this language, it did not make any reference to this Alabama state law. Instead, it only referred to Section 523 of the Bankruptcy Code, the section that addresses exemptions to discharge. In addition, Section 8-9A-5 of the Uniform Fraudulent Transfer Act, as adopted in Alabama, provides for certain transfers that do not require proof of intent to defraud:

> *(a) A transfer made by a debtor is fraudulent as to a creditor whose claim arose before the transfer was made if the debtor made the transfer without receiving a reasonably equivalent value in exchange for the transfer and the debtor was insolvent at that time or the debtor became insolvent as a result of the transfer.*
>
> *(b) A transfer made by a debtor is fraudulent as to a creditor whose claim arose before the transfer was made if the transfer was made to an insider for an antecedent debt and the debtor was insolvent at that time and the insider had reasonable cause to believe that the debtor was insolvent.*

These claims were not included in the complaint although it would appear likely that they could have been proven.

Section 523 of the Bankruptcy Code, which the bank did specifically cite in its complaint, does not provide for fraudulent conveyances. Inasmuch as the bank did not ask to set aside the transfer under Alabama law, the Court did not have to address whether the transfer would be exempted from discharge. It merely needed to deny the relief under Section 523.

Had the Eleventh Circuit stopped there, it might not have been so bad. Instead, it went beyond the failure to prove intent under 523:

> *The only misconduct alleged by [the bank] pertains to [guarantor's] fraudulent conveyances of assets. But those conveyances occurred years after [guarantor] became indebted to [the bank] for the [borrower's] guaranties, and the conveyances are not traceable to that debt, which arose from an ordinary breach* of contract.

That is what should concern lenders. This makes it unclear whether Alabama and the Eleventh Circuit will protect lenders against fraudulent transfers by its borrower and guarantors when a well-pled complaint is at issue, instead of the one in this case, which clearly failed to put forth the proper claims.

SE Property Holdings, LLC v. Jerry DeWayne Gaddy, 11th Cir., September 29, 2020 (2020 WL 5793082)
Posted on

WURST CASE SCENARIO
COMMERCIAL FINANCE LAW BLOG

March 3, 2020
www.WurstCaseScenario.com

GREED IS A TERRIBLE THING

I have a distaste for lender against lender litigation. That goes for any financial institution for that matter. Perhaps it comes from the doctrine of not airing one's dirty laundry. I am reminded of this from a decision that came down this Monday (March 2, 2020, for those reading this in reprint) by the US District Court for the S.D. Indiana. No one gains from these types of lawsuits.

If the following story bores you (and it should not) please do read the penultimate statement at the end.

BMO Harris Bank was financing a construction project for its customer, North & Maple LLC, with Midwest Form Constructors, LLC as the general contractor. Throughout most of the project BMO Harris funded advances to Midwest's account at Salin Bank and Trust Company to be used for the completion of the construction project. At some point North & Maple notified BMO Harris to no longer send loan advances to Midwest but instead, to send them to Atlas Funds Control, LLC, the agent for Midwest's bonding company.

However, when BMO Harris received instructions to transfer funds to Atlas, BMO mistakenly wired the funds to Midwest's account at Salin. Salin accepted the wire transfer and credited the funds to Midwest's bank account and then withdrew most of it as a setoff to credit an outstanding loan made by Salin to Midwest.

BMO promptly issued a recall request advising Salin of the mistake and demanding that the wire be returned. Salin did not and instead, completed the setoff transaction. Salin did this even though it had full knowledge that Midwest was having financial problems. BMO claimed that Salin knew, or should have known, that the transfer was mistakenly sent to Salin.

BMO Harris brought an action against Salin for unjust enrichment, conversion and replevin. Salin moved for judgment dismissing the action relying on Article 4A of the Indiana Uniform Commercial Code (yes, the UCC has more than Article 9), arguing that was the exclusive source of rights for financial institutions participating in the federal wire transfer system. The court began with an examination of the Article 4A definition of a *fund transfer*:

> *[T]he series of transactions, beginning with the originator's [North & Maple] payment order, made for the purpose of making payment to the beneficiary [Midwest] of the order. The term includes any payment order issued by the originator's bank [BMO Harris] … intended to carry out the originator's payment order. A funds transfer is completed by acceptance by the beneficiary's bank [Salin] of a payment order for the benefit of the beneficiary of the originator's [North & Maple] payment order.*

Keep in mind that North & Maple's payment order was for the funds to go to Atlas – not Midwest. The Court went on to consider Section 211 of Article 4, which provides:

> *(a) A communication of the sender [also North & Maple] of a payment order canceling or amending the order may be transmitted to the receiving bank [Salin] orally, electronically, or in writing[.]*
>
> *(b) Subject to subsection (a), a communication by the sender [North & Maple or BMO standing in its shoes] canceling or amending a payment order is effective to cancel or amend the order if notice of the communication is received at a time and in a manner affording the receiving bank a reasonable opportunity to act on the communication before the bank accepts the payment order.*
>
> *(c) After a payment order has been accepted, cancellation or amendment of the order is not effective unless the receiving bank [Salin] agrees or a funds-transfer system rule allows cancellation or amendment without agreement of the bank.*

The Court then turned to case law from other districts, focusing on a New York case:

> *"[P]arties whose conflict arises out of a funds transfer should look first and foremost to Article 4A for guidance in bringing and resolving their claims[.]" …. If a situation is unequivocally covered by particular provisions in Article 4A, then it is beyond debate that Article 4A governs exclusively…..However, courts*

> *should not interpret this directive to mean that Article 4A has "completely eclipsed" the applicability of common law in the area of funds transfers.....(Article 4A "does not establish a legislative intent to preclude any and all funds transfer actions not based on Article 4A"); ....(holding that Article 4A did not preempt common law claim when the UCC was "silent" as to the factual scenario alleged);.... Rather, preemption likely does not foreclose common law claims related to funds transfers when the disputed "conduct or factual scenario is not addressed squarely by the provisions of [Article 4A]."*

The Court went on to conclude:

> *Article 4A does not squarely address BMO's allegations and thus does not preempt the common law claims presented.*

However, that did not end the case: it only denied the motion to dismiss. BMO Harris still needs to prove its case – especially that Salin knew of Midwest's financial distress and that BMO would no longer be sending wires to Midwest.

Perhaps reasonable minds will prevail and the banks will recognize their risks and reach a settlement.

BMO erred and Salin took advantage of it. There was a time when financial institutions would not seize upon an opportunity like this. Disputes such as these reflect poorly on the industry and only help to fuel borrowers' claims against lenders.

Here comes the penultimate statement.

How could they have avoided airing their dirty laundry? Arbitration. With arbitration the same result could have come about but without the notoriety of having the decision made public. Yes, one of the major benefits of arbitrating disputes is that the process may remain confidential. Had these parties submitted their dispute to arbitration those of you thinking "H*ow dumb"* or "H*ow greedy"* would never have known of this.

You will be reading more on these pages about using arbitration in commercial finance disputes. Its time has come.

BMO Harris Bank N.A. v Salin Bank and Trust Company, 2020 WL 998657, (SD Indiana, March 2, 2020)

WURST CASE SCENARIO
COMMERCIAL FINANCE LAW BLOG

January 6, 2020

PACA BITES AGAIN

There is always room for another PACA story. Perhaps had Produce Pay, Inc. read this blog it would be in a better position today. Instead...., well read on.

Produce Pay billed itself as a "multi-service finance company" that could provide "access to cash flow...the day after you ship your produce to the U.S.". Spiech Farms, LLC is a grower and processor of blueberries, asparagus, and grapes. Spiech fell on hard times in early 2017 when frost destroyed a significant portion of its blueberry crop. In an attempt to shore up its financial state, Spiech entered into a "Distribution Agreement" with Produce Pay.

The Distribution Agreement provided that Spiech would notify PP that it had a pallet of produce for sale by registering that pallet on Produce Pay's software platform. Produce Pay would then purchase the pallet of produce from Spiech for half the market price. In connection with that purchase, Spiech would assign "all right, title and interest" in the produce to PP, but Spiech would keep the produce in its possession.

Spiech would then sell, or attempt to sell, that produce to a grocery store or other customer. Whether Spiech sold the produce or not, it was obligated to repay the money it received from Produce Pay, plus a commission, within 30 days after receipt. After 30 days, the commission rate increased. After 60 days, Spiech had to "repurchase" the produce from Produce Pay by repaying the purchase price to Produce Pay, plus a commission. Although the agreement claimed the transaction to be a purchase of the produce, In effect, the agreement, provided for short-term loans from Produce Pay as a partial advance on payments that Spiech expected to receive from its existing customers. Also by listing its produce on Produce Pay's software platform, Spiech could potentially reach new customers. If Spiech sold the produce to a customer introduced by Produce Pay, then Produce Pay would receive a higher commission.

As you must have anticipated, Spiech filed for bankruptcy protection.

Produce Pay asserted a $1 million PACA claim against the bankruptcy estate to recover the unpaid cash advances that Produce Pay made to Spiech. The bankruptcy court held an evidentiary hearing and denied Produce Pay's claim. Produce Pay appealed to the United States District Court for the Western District of Michigan.

Readers of WCS will recall our two-part blog published in March of 2018, which addressed a decision of the Ninth Circuit Court of Appeals in which the Ninth Circuit reversed its long standing policy of not exercising a "true sale" analysis in situations concerning factoring of PACA receivables. In doing so the Ninth Circuit joined the Second, Fourth and Fifth
Circuits, holding:

> *.... a PACA trustee's true sale of accounts receivable for a commercially reasonable discount from the accounts' face value is not a dissipation of trust assets and, therefore, is not a breach of the PACA trustee's duties. ... ("The assets of the trust would thus have been converted into cash and the receivables would no longer have been trust assets."... "[A] 'bonafide purchaser' of trust assets receives the assets free of claims by trust beneficiaries" and noting that the determinative issue on appeal is whether the "factoring agreement" was a loan secured by accounts receivable or a true sale of accounts receivable); ... ("[N]othing in PACA or the regulations prohibits PACA trustees from attempting to turn receivables into cash by factoring. To the contrary a commercially reasonable sale of accounts for fair value is entirely consistent with the trustee's primary duty.")...*

Produce Pay apparently believed that by purchasing produce with full recourse it would obtain the benefits of a PACA trustee. Instead, it paid a high tuition for its lesson.

The District Court affirmed the bankruptcy court's denial of Produce Pay's PACA claim, stating:

> *The bankruptcy court properly determined that Spiech did not transfer its receivables, or any other interest protected by a PACA trust, to [Produce Pay]..*

The District Court went on to say:

> *...when making this determination, the bankruptcy court employed a "transfer-of-risk" test that has been used in circumstances that are different from the instant case. In the cases cited by the bankruptcy court, courts applied this test to determine whether the buyer of agricultural commodities breached its duties as a PACA trustee when entering into what was either a lending arrangement or a sale of the buyer's rights in its own receivables. [*citations omitted] *But there is no reason why the same test should not apply to the agreement between Spiech and [Produce Pay]. Indeed, the UCC recognizes that it is not unusual for a commercial agreement to "blur" the distinction between a transaction "in which a receivable secures and an obligation" and one in which "the receivable has been sold outright." [*citation omitted] *This is one of those agreements. Although the circumstances of the aforementioned cases were different, the transfer-of-risk test performs the same basic function in those cases as it does in this one; it helps the court distinguish the true nature of the parties' agreement. It was not improper for the bankruptcy court to employ a widely-used test to ascertain whether the distribution agreement assigned Spiech's rights in its receivables.*

Although not specifically stating it, both courts utilized a "true sale" test. Simply, Spiech sold its produce or its receivables, Produce Pay retained full recourse to Spiech, denying it the protection of a "true sale."

Had Produce Pay followed this blog [*OK, the facts in this case preceded the March 2018, blog*] it would have been $1mm richer.

The takeaway for lenders and factors following this blog is to exercise caution when dealing with collateral that is protected by PACA. When PACA bites, it takes a pound of flesh with it.

In re: Spieth Farms, LLC, Debtor, Produce Pay, Inc v Spiech Farms, LLC. (United States District Court, W.D. Michigan, December 17, 2019)

WURST CASE SCENARIO
COMMERCIAL FINANCE LAW BLOG

November 13, 2019

COLLATERAL DESCRIPTION BY REFERENCE

The UCC has two standards for collateral description. Section 9-108 provides that the security agreement's "description of personal ... property is sufficient, whether or not it is specific, if it reasonably identifies what is described." It goes on to give examples (not requirements) of reasonable identification. However, it specifically prohibits *super*-generic description:

> *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.*

On the other hand, the UCC permits *super generic* descriptions of collateral on the financing statement. Section 9-504 provides:

> *A financing statement sufficiently indicates the collateral that it covers if the financing statement provides: (1) a description of the collateral pursuant to Section 9-108; or (2) an indication that the financing statement cover all assets or all personal property.*

So the standard for a security agreement is specific while the standard for a financing statement is generic. What if the financing statement merely provides that the collateral is what is described in the security agreement without anything further?

No problem when you get a UCC search which shows a prior lien on "all assets". How about if the UCC search only states that the secured party is secured in the collateral described in the security agreement? What do you do? Do you rely on the security agreement your prospective borrower hands over to you? What if it had been amended to add more collateral? And what if your intended borrower does not want you to approach the existing lender.

Now comes a decision from the United States Court of Appeals for the Seventh Circuit (Chicago – a significant commercial center). Yes, the situation in this decision is different from what I described above but the issue is not. The Court indicated that the issue was

> *a matter of first impression for our court: Whether Illinois's version of Article 9 of the Uniform Commercial Code requires a financing statement to contain within its four corners a specific description of secured collateral, or if incorporating a description by reference to an unattached security agreement sufficiently "indicates" the collateral.*

This decision was not about a dispute between lenders as to whom held a valid interest. It was an action by a Chapter 7 trustee against First Midwest Bank (FMB). FMB made a loan to 180 Equipment LLC. The security agreement contained 26 categories of collateral (e.g. accounts, goods, etc). Instead of using the "all asset" description in the financing statement, FMB, instead, described the collateral as

> *[a]ll Collateral described in First Amended and Restated Security Agreement dated March 9, 2015, between Debtor and Secured Party.*

When FMB brought an action against the trustee to recover almost $8 million that it claimed to be the proceeds of collateral in which it held a properly perfected and senior interest, the trustee asserted a counterclaim under §544(a) of the Bankruptcy Code, that, as a *statutory lienholder*, the trustee's lien was superior to the interest of FMB because FMB did not properly perfect its interest due to its failure to provide a sufficient collateral description. The Bankruptcy Court ruled in favor of the Trustee and the appeal was certified directly to the Seventh Circuit.[1]

The appeals court stated:

> *A court must view the statute as a whole, construing words and phrases in light of other relevant statutory provisions and not in isolation. Each word, clause, and sentence of a statute must be given a reasonable meaning, if possible, and should not be rendered superfluous.*

The Court looked at Section 9-502, which requires that a financing statement:

> *(1) provide the name of the debtor; (2) provide the name of the secured party or its representative; and (3)* indicate the collateral covered by the financing statement.

The Court went on:

> *A financing statement that substantially satisfies these requirements is effective, even if it has minor errors or omissions that are not "seriously misleading." ….. But if a financing statement fails these basic requirements, the lender's interests are subject to avoidance under §544(a) of the Bankruptcy Code.*

It recited Official Comment 2 of Section 9-102, as follows:

This section adopts the system of "notice filing". What is required to be filed is not, as under pre-UCC chattel mortgage and conditional sales acts, the security agreement itself, but only a simple record providing a limited amount of information (financing statement)…. The notice itself indicates merely that a person may have a security interest in the collateral indicated. Further inquiry from the parties concerned will be necessary to disclose the complete state of affairs.

The Court held that the financing statement is an abbreviation of the security agreement and concluded:

> *The approach … to financing statements supports the conclusion that* incorporation by reference *is permissible in Illinois as "any other method" under § 9-108, so long as the identity of the collateral is objectively determinable. That requirement is met here by the security agreement's detailed list of the collateral.*
>
> * * *
>
> *The plain and ordinary meaning of Illinois's revised version of the UCC allows a financing statement to indicate collateral by reference to the description in*

Reversed. Success to FMB. But what can we take away from this?

First, of course, FMB could have avoided a ton of aggravation (and legal costs) if it merely described its collateral as "all assets" on the financing statement – or even "all assets other than…" assuming its list of 26 was not intended to be all inclusive.

The more significant issue, referring back to the situation described above, is that lenders must exercise caution when intending to lend against collateral that is represented not to be part of a prior lender's collateral package. In such a case, and when the prior lender's financing statement does not clearly enumerate the collateral description (as the Seventh Circuit stated), "*Further inquiry from the parties concerned will be necessary to disclose the complete state of affairs.*"

In other words, if the proposed borrower does not want you to communicate with the prior lender as to the nature of the collateral – and you cannot enter into a reasonable intercreditor agreement, are you that hungry to do the deal?

All of this said, I have found that financing statements filed by equipment leasing companies to give notice of their interest in their leased equipment may describe collateral by reference to the lease agreement. In examining these leases I have, on occasion, found broad granting clauses securing the lessee's obligations. Without that review lenders would have found themselves subordinate to the prior filed lessor.

You may detect my distaste for descriptions of collateral by reference but, at least in the Seventh Circuit, it is sufficient and we must be guided accordingly.

In re 180 Equipment LLC, 938 F3d 886 (7th Cir, 2019)

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[1] This is a process employed when the parties agree that an appeal to the District Court would be futile.

WURST CASE SCENARIO
COMMERCIAL FINANCE LAW BLOG

September 3, 2019

RECOVERING ON COLLATERAL – AND ITS HIDDEN COSTS

Asset based lenders lend against the value of their collateral – at least they are supposed to. Thus, when making a loan the lender needs to consider what it will cost to recover on its collateral in order to set a reasonable advance rate. Each type of collateral has its own issues in recovering. Account debtors protest in paying someone other than the debtor. Landlords deny access to inventory and equipment until the rent is paid. Even then, equipment has additional issues. For example, we once represented a lender who wanted to take back a huge printing press that required the removal of exterior wall to a building. We succeeded in obtaining a court order authorizing the demolition and replacement of the wall but the cost and time affected the lender's recovery on its collateral.

Rolling stock has its own types of issues. The 1984 film *Repo Man* made the repossession of rolling stock entertaining but it is far from fun – even when you have a set of keys.

UCC 9-609 of the UCC provides:

SECURED PARTY'S RIGHT TO TAKE POSSESSION AFTER DEFAULT.

> *(a) Possession; rendering equipment unusable; disposition on debtor's premises. After default, a secured party: (1) may take possession of the collateral; and (2) without removal, may render equipment unusable and dispose of collateral on a debtor's premises under Section 9-610.*
>
> *(b) Judicial and non-judicial process. A secured party may proceed under subsection (a): (1) pursuant to judicial process; or (2) without judicial process, if it proceeds without breach of the peace. (emphasis added).*
>
> *(c) Assembly of collateral. If so agreed, and in any event after default, a secured party may require the debtor to assemble the collateral and make it available to the secured party at a place to be designated by the secured party which is reasonably convenient to both parties.*

A recent decision from the United States District Court for the District of Maryland highlights how easy it is for a debtor to make out a claim for breach of the peace in a non-judicial repossession of collateral. The plaintiffs (the debtor) purchased a dump truck financed by the lender and a dispute arose concerning payments. When the lender's "repo man" showed up with a tow truck, the debtor protested loudly and called the police who directed the debtor to allow the repossession. The debtor then brought an action against the lender claiming that the repossession was in violation of UCC § 9-609 because it involved a breach of the peace.

The Court held:

> *Plaintiff alleges that he "objected loudly" to the repossession and claimed that Defendant "did not have the right" to repossess the truck.... Plaintiff further alleges that this disagreement "intensified" to the point that the police were called. ..... Therefore, Plaintiff plausibly alleges that Defendant violated § 9-609(b).*

The lender's motion to dismiss the action was denied and even if the lender will ultimately recover its collateral, the cost to do so has gone through the roof.

The Maryland case addressed complications from recovering collateral without judicial process. A few weeks earlier the United States District Court for the District of New Mexico addressed a judicial process to recover collateral – commonly referred to as *replevin*. That case was brought *ex parte* – meaning that the debtor did not appear in the case. Even so, a court will review the facts and determine whether the lender is entitled to repossess its collateral even upon the debtor's default in responding to the claim.

Replevin was an original common-law remedy, however most states have since authorized a suit for replevin by statute. The New Mexico statute provides:

> *Any person having a right to the immediate possession of any goods or chattels, wrongfully taken or wrongfully detained, may bring an action of replevin for the recovery thereof and for damages sustained by reason of the unjust caption or detention thereof... A replevin suit has two possible components: physical recovery of the collateral, and*

> *pursuit of damages for wrongful taking… . In order to obtain a pre-judgment writ of replevin, an affidavit must be filed [according to the statute] "stating: A. that the plaintiff is lawfully entitled to the possession of the property mentioned in the complaint; B. that the same was wrongfully taken or wrongfully detained by the defendant; C. that the plaintiff has reason to believe that the defendant may conceal, dispose of, or waste the property or the revenues therefrom or remove the property from the jurisdiction, during the pendency of the action; D. that the right of action accrued within one year; and E. specific facts, from which it clearly appears that the above allegations are justified"*

The magistrate judge hearing the dispute broke out and applied the facts to each of the required elements that needed to be proven and went on to recommend to the District Court that it:

> *authorize the issuance of a writ of replevin for recovery of the collateral described in the complaint and supporting documents*

But that successful ruling was not the end of the story. Inasmuch as replevin is an equitable remedy, it typically comes with the requirement for the posting of a bond – just in case the debtor ultimately appeals and disproves what the court had granted. In this case, the bond was to be in an amount "double the value of the collateral as described in the complaint and supporting documents."

These costs are often anticipated and even mitigated by obtaining landlord waivers. The loan agreement should include a provision where the borrower grants the lender and its agents a license to enter the debtor's premises (even to break locks) to repossess the collateral, which entry is specifically agreed not to be a breach of the peace.

The lesson is that it costs – and sometimes dearly – to recover on collateral and that cost needs to be factored into the amount a lender is advancing based upon the value of the collateral. As we say time and time again: plan your divorce before you get married -be sure your loan agreements adequately provide for your recovery in the event things do not go as hoped when you made the loan.

Darren Trucking Company v. PACCAR Financial Corp., USDC Maryland, August 20, 2019, 2019 WL 3945103

Commercial Credit Group Inc. v. Protégé Excavation, Inc. USDC New Mexico, August 5, 2019 2019 WL 3973848.

FEATURE STORY

Is Cannabis Lending In Your Future?

BY JEFFREY A. WURST AND PAUL J. CAMBRIDGE

Armstrong Teasdale partners provide lenders with up-to-date information on the complexities of lending to the legalized marijuana industry.

Perhaps the most frequently asked question by growth-oriented lenders is "How and when can we lend into the rapidly growing and already major industry of legalized marijuana?"

The answer is: "It is not so simple."

Takeaways

1. Legalized cannabis is amongst the most rapidly growing U.S. industries, yet it is substantially unserved by lenders.
2. While Federal Law continues to prohibit the manufacture, possession and use of marijuana, a growing number of states have legalized adult (recreational) and medical use.
3. Despite the legal prohibition, Federal agencies have taken a hands-off position in enforcement in jurisdictions where state law has allowed the use and sale of cannabis products.
4. Despite the rumors to the contrary, financial institutions may provide services to direct and indirect marijuana-related businesses provided they comply with certain reporting requirements.
5. Clearly, marijuana-related businesses are ripe to become borrowers – once lenders learn how to make these loans.

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It is estimated that U.S. sales of legal marijuana exceeded $15 billion in 2020 (up from about $10 billion in 2019), $2 billion of which came from Colorado alone. These numbers are projected to double by 2024. The legal marijuana industry is certainly escalating, but roadblocks remain, making it difficult to lend to cannabis-related businesses.

Let's start with a review of the state of the law. There is a cacophony of state and federal laws, many of which are at odds with each other. As of this writing, medical marijuana is legal in 35 states and Washington, D.C., while 15 of these states plus Washington, D.C., have legalized adult-use (recreational) marijuana.

Federal Law

Since 1970, with the enactment of the Controlled Substances Act (CSA), the manufacture, possession or use of marijuana – even the use of marijuana for medical purposes – has been prohibited. The Money Laundering Control Act of 1986 imposed harsh penalties (fines and/or imprisonment) upon those who knowingly conducted financial transactions that involved proceeds of any unlawful activity. But, as early as August 2013, the Department of Justice (DOJ) by then-Deputy Attorney General, James Cole, in what has been referred to as the Cole Memorandum took an official hands-off policy suggesting that the U.S. Attorneys refrain from prosecuting state-authorized marijuana use provided that such use does not interfere with certain federal law enforcement. That policy, however, was rescinded in January 2018 by then-Attorney General Jeff Sessions. Prior to that, Congress adopted the Rohrabacher-Farr Amendment, which prohibited the DOJ from using federal funds to prevent implementation of state laws authorizing the use, distribution, possession or cultivation of medical marijuana.

In February 2014, the Financial Crimes Enforcement Network (FinCEN) issued guidance to clarify the Bank Secrecy Act (BSA) expectations for financial institutions providing services to marijuana-related businesses (MRBs). The FinCEN guidance relies heavily on the Cole Memorandum, despite it being rescinded. The FinCEN guidance is the only official federal guidance available to financial institutions regarding marijuana banking. The FinCEN guidance has two key areas of focus: (1) customer diligence and (2) suspicious activity report (SAR) filing.

As a result, when entering into a relationship with a company engaged in an MRB, financial institutions are obligated to conduct substantial customer due diligence to verify that the MRB is in compliance with state law and that there is no indicia of violations of federal law as described in the Cole Memorandum. This due diligence must continue throughout the relationship – not just at the beginning. As a result, there is a significant cost to the financial institution in accepting MRBs as customers.

In September 2019, the House of Representatives passed the Secure and Fair Enforcement (SAFE) Banking Act, which, if enacted, prohibits regulators from penalizing depository institutions for providing banking services to state-authorized MRBs. However, the Senate has not taken any action on the SAFE Banking Act.

In December 2020, the House approved the Marijuana Opportunity Reinvestment and Expungement (MORE) Act of 2020, which, if enacted, would remove marijuana from the list of controlled substances and eliminate criminal penalties for the manufacturing, distribution or possession of marijuana. Ancillary parts of the MORE Act include a 5% federal tax on cannabis products. The bill was referred to the Senate, but no action has been taken as of the writing of this article.

In light of change in control of the Senate, one may expect significant changes in the area of federal marijuana law which could, in fact, be the game changer for which lenders have been waiting.

State Laws

Fifteen states and Washington, D.C., have enacted laws legalizing adult recreational as well as medical use of marijuana and 21 states

have legalized the use of medical marijuana. Fourteen of the states that have legalized use of medical marijuana plus Washington, D.C., have done away with jail time for possession, of small amounts, and two states that have not legalized recreational or medical use have removed jail time for possessing, small amounts. That leaves 12 states that have not legalized marijuana where jail time may be imposed for possession of even small amounts of marijuana for medicinal purposes.

States have been moved to adopt marijuana laws as a result of public pressure, the medical benefits attributed to cannabis products and especially the economic growth that comes along with it – including the tax revenues.

Banking Services to MRBs

Since 2014, FinCEN has been monitoring depository institutions actively providing banking services to MRBs based on the filing of SARs. While there was a sharp increase in such numbers during 2019, those numbers slightly declined in 2020. This is likely the result of MRBs closing due to pandemic restrictions on business operations, in general, as well as staffing reductions at depository institutions causing delays in the filing of SARs. As of September 2020, there were 677 depository institutions reporting SARs related to MRBs, a drop from 747 less than a year earlier.

We are likely at the cusp of the opportunity to enter into the marijuana lending business, providing lenders are prepared to invest in the infrastructure necessary to comply with FinCEN requirements. That infrastructure needs to be in place to monitor and report on MRB customers and may be shared by both internal and external sources.

It must be understood that MRBs come in different sizes and shapes. Unfortunately, the FinCEN guidance does not provide a comprehensive definition of what is considered an MRB for purposes of the enhanced due diligence and SAR requirements under BSA. Many financial institutions and lenders take a three-tiered approach to providing financial services to direct and indirect MRBs, with the most scrutiny applied to customers in the higher tiers.

- Tier I MRBs include growers, processors, wholesalers and dispensaries – entities that are hands-on with the cannabis products. These are the riskiest customers from a BSA compliance standpoint and the requirements of the FinCEN guidance clearly apply.
- Tier II MRBs are indirect MRBs that receive a significant portion of their revenue from Tier I MRBs, including suppliers, security and licensing consultants focused on the marijuana industry.
- And Tier III includes those that do incidental business with MRBs, such as landlords, professional service firms, banks, etc.

The FinCEN guidance indicates that for indirect MRBs, such as those in Tier II and III, the marijuana-specific SAR requirements of the FinCEN guidance do not apply and it is left to every financial institution or lender to make a risk-based decision whether it will take on those indirect MRBs as customers.

In addition to the BSA compliance costs and risks associated with providing financial services to MRBs, a lender should consider the unique standing of MRBs, given the disconnect between federal and state law when underwriting and structuring loans. For example, when determining appropriate collateral for a loan to an MRB, a lender should consider what would happen if its customer ran into regulatory issues with its state-licensing body or federal law enforcement, including the potential effect of seizure laws if an MRB is ever charged with a crime. Also, a lender should consider how it would take possession of collateral in an event of default given that many states have complex regulatory regimes that only allow licensed business to legally operate as an MRB.

Before lending to an MRB, it is necessary to be familiar with the marijuana laws of the borrower's state. For example, some states prohibit the granting of security interests in Tier I products. Even if granting a security interest is legally permissible under applicable state law, taking possession of collateral may not be feasible for a lender if it is not licensed as an MRB by the state.

We should be in agreement that it is just a matter of time before MRBs will become a major industry serviced by lenders – both banks and commercial finance companies. Those looking to enter this market are advised to start preparing for this influx of business if they are willing to venture into it. It remains uncertain when, if ever, the diligence and reporting requirements will ease and make MRB borrowers more akin to others that are not regulated; however, it is unlikely that will be soon. Thus, lenders anxious to enter the MRB marketplace are advised to be prepared to take on the reporting requirements and to price their loan products accordingly.

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LEGAL LINES

THE NUTS AND BOLTS OF A WORKOUT IN A PANDEMIC ENVIRONMENT

BY **JEFFREY A. WURST**

Workout activity has reached a fever pitch in the wake of the COVID-19 pandemic. Jeffrey A. Wurst provides important tips, recommendations and considerations for secured lenders looking to execute successful workouts with a growing population of distressed borrowers in the current marketplace.

JEFFREY A. WURST
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Christmas has not yet arrived, yet workout attorneys are singing "It's the Most Wonderful Time of the Year." After the longest boom market in history, the economy came to a sudden stop as a result of the COVID-19 pandemic and the falsely inflated economy, and lenders are peeling back the onion to find that what is inside their loans is not what they thought. The purpose of this article is to address a systematic approach to engaging in a productive workout and how to turn a lose-lose into a win-win.

While some observers might debate whether the economy was falsely inflated, we should all agree that with the assistance of the Paycheck Protection Program and other Small Business Administration support, some suffering businesses have kicked the can down the road and deferred falling into default with their lenders. Even so, many companies have shuttered their doors while others continue to limp on with no realistic prospect of turning the corner in the near future.

The dilemma lenders face now is how to provide accommodations to their distressed borrowers without subjecting themselves to undue risk. Thus, it is time to dust off and update the workout playbook.

The first step should be to collect information and look at the loan with a fresh set of eyes, but there's more than that. Here are the most important steps, considerations and recommendations for a successful workout in the current environment.

DOCUMENT REVIEW

Conduct a legal review of the loan documents and perfection filings. Assure that the agreement was properly executed; the collateral you expect is properly identified in the security agreement (or section of a credit agreement); that your rights, upon default, are what you would expect them to be; and that you (or your servicing agent) are in possession of the original loan documents.

UPDATED SEARCHES

Run a Uniform Commercial Code search to confirm that you are in a first position and that your lien has not lapsed. The search also will detect whether any unknown junior liens were filed. Note that it is becoming common to find that a distressed borrower has taken one or more *merchant cash advance* loans and that you may now have a junior lienholder exercising rights against your collateral. Obtain current tax lien and litigation searches. Let's hope you do not find any unpleasant surprises. If you have a trademark or other intellectual property as collateral (even as *boot* collateral), run a search to assure that your filings are in order.

COLLATERAL ASSESSMENT

Take a close look at your borrower's detailed accounts receivable aging. Do you have the contact information you will require should you need to put account debtors on notice? Are there any suspect entries on the aging? Be sure to perform verifications. Are credits and chargebacks properly posted? Obtain a new inventory appraisal and assure that the appraiser is adequately confirming the counts. Equipment appraisals also should be obtained, as values may have changed during the pandemic.

CASH FLOW BUDGET

Have your borrower prepare a rolling cash flow budget. Is it reasonably reliable and not a "pie in the sky" prayer for better times? Watch out for straight line income items and whether they are realistic. Monitor the budget along with your borrower to assure that it is meeting reasonable benchmarks and recast the budget as the benchmarks are missed.

DEFAULTS

What are the defaults? Are they reasonably the result of the pandemic or do you envision any foul play? Was the company in trouble prior to the pandemic? Was that trouble exacerbated by the pandemic? Has the borrower been open and candid with you about the problems, or are they coming to you after they have dug themselves into a ditch? That will affect your willingness to provide accommodations.

APPROACH

You need to decide whether to monitor the problem and see if things improve, work with the borrower in fixing the problem or exit the facility. In each instance you need to revisit your exit strategy and assess whether it is still viable. Is your first loss your best loss? Can the borrower make a turn and improve, and are you willing to support it? What needs to be reported to regulators and can you keep the credit even if it improves?

WORKOUT AGREEMENT

Here comes the game plan. Get into a workout/forbearance agreement. Call it anything you want, but it is what it is. Don't let the title get in the way if the borrower insists that it cannot be called what you want it called. Be prepared to make an accommodation even if you just want to get out and get out fast.

The most important item in the forbearance agreement is the release that the borrower will give you. Even if you believe that you have not done anything that requires a release, you will find the release invaluable should the relationship break down. Should the borrower ultimately bring an action against you (directly or by way of a counterclaim), the release will save you tons of money in defending yourself. If the borrower will not sign a release (inconspicuously included amongst the litany of other items), why make any accommodation? I have often said that if the lender has done nothing wrong, the borrower should have no problem signing a release. If the borrower thinks the lender has done something wrong and refuses to give the lender a release, why should the lender provide the borrower with any accommodation? The release is the main reason to assist a borrower — especially one you want to exit. It will ease the pain when you ultimately do.

Keep the borrower to short benchmarks. Try to keep the first forbearance agreement to a period not longer than a month. Go month by month until you are comfortable with longer periods. Don't expect the problems to be cured too quickly, but if progress is being made (even if the losses are stabilizing or slowing down), feel free to continue.

Watch the credit closely. Don't trust your borrower. Remember that you never get defrauded by someone you distrust. We always hear, "How could he do that to me? He was my friend." Know your customer and don't allow yourself to get too close.

Introduce or recast financial covenants. If you want an exit, build in time for the borrower to exit. Will another lender advance enough to take you out? Are you willing to provide a discount? If so, structure the discount based on a reasonable date for the payoff. Condition the payoff on that date or it is lost. Extensions may be given but only at your discretion after the borrower has demonstrated progress (or at least substantial credible effort) in securing a replacement lender.

Engage the guarantors. If they have assets, they will be very motivated to work with you — even if their only asset is their home and it is fully mortgaged. They still don't want their family living on the street.

Of course, the major consideration is whether to fund or not and whether to forbear or pull the plug. These are difficult decisions but be sure not to make them out of anger or through any irrational considerations. Again, it is best to get to that first forbearance agreement and get a release. That way there is a demarcation line between everything that occurred prior to the forbearance agreement and whatever happens after, which is not subject to the release.

FEES

Don't forget that you are entitled to fees (and they may be significant) for the privilege of deferring. If the borrower has the funds (or collateral), then this is a price for the accommodations you may give. But even if the funds are not available, it is still wise to charge the forbearance fee and have it forgiven if you are paid out (even at a reduction).

TEMPER

The final recommendation is to make sound business decisions and not to act out of spite. If you retaliate for mistreatment by your borrower — even if you are justified — there is a greater chance that you will be defending yourself against a frivolous lawsuit. Better to be rational and stay to the high ground. •

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LEGAL LINES

COLLATERAL DESCRIPTION BY REFERENCE

BY **JEFFREY A. WURST**

Jeffrey Wurst examines two standards of the UCC for collateral description. He explains why lenders must exercise caution when intending to lend against collateral that is represented not to be part of a prior lender's collateral package.

JEFFREY A. WURST

The UCC has two standards for collateral description. Section 9-108 provides that the security agreement's "description of personal … property is sufficient, whether or not it is specific, if it reasonably identifies what is described." It goes on to give examples (not requirements) of reasonable identification. However, it specifically prohibits super-generic description:

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.

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A financing statement sufficiently indicates the collateral that it covers if the financing statement provides: 1) a description of the collateral pursuant to §9-108, or 2) an indication that the financing statement covers all assets or all personal property.

So the standard for a security agreement is specific while the standard for a financing statement is generic. No problem when you get a UCC search, which shows a prior lien on "all assets."

But what if the financing statement merely provides that the collateral is what is described in the security agreement without anything further? What do you do? Do you rely on the security agreement your prospective borrower hands over to you? What if it was amended to add more collateral? And what if your intended borrower does not want you to approach the existing lender?

Now comes a decision from the U.S. Court of Appeals for the 7th Circuit, which is in Chicago, a significant commercial center. Yes, the situation in this decision is different from what I described above but the issue is not. The court indicated that the issue was

a matter of first impression for our court: Whether Illinois's version of Article 9 of the Uniform Commercial Code requires a financing statement to contain within its four corners a specific description of secured collateral, or if incorporating a description by reference to an unattached security agreement sufficiently 'indicates' the collateral.

This decision was not about a dispute between lenders as to whom held a valid interest. It was an action by a Chapter 7 trustee against First Midwest Bank (FMB). FMB made a loan to 180 Equipment. The security agreement contained 26 categories of collateral, such as accounts and goods. Instead of using the "all asset" description in the financing statement, FMB, instead, described the collateral as

[a]ll collateral described in First Amended and Restated Security Agreement dated March 9, 2015, between debtor and secured party.

When FMB brought an action against the trustee to recover almost $8 million it claimed to be the proceeds of collateral in which it held a properly perfected and senior interest, the trustee asserted a counterclaim under §544(a) of the bankruptcy code, that, as a statutory lienholder, the trustee's lien was superior to the interest of FMB because FMB did not properly perfect its interest due to its failure to provide a sufficient collateral description. The bankruptcy court ruled in favor of the trustee, and the appeal was certified directly to the 7th Circuit.

The appeals court stated:

A court must view the statute as a whole, construing words and phrases in light of other relevant statutory provisions and not in isolation. Each word, clause, and sentence of a statute must be given a reasonable meaning, if possible, and should not be rendered superfluous.

The court looked at §9-502, which requires that a financing statement:

1) provide the name of the debtor, 2) provide the name of the secured party or its representative and 3) indicate the collateral covered by the financing statement.

The court went on:

A financing statement that substantially satisfies these requirements is effective, even if it has minor errors or omissions that are not "seriously misleading." … But if a financing statement fails these basic requirements, the lender's interests are subject to avoidance under §544(a) of the bankruptcy code.

It recited official comment 2 of §9-102, as follows:

This section adopts the system of 'notice filing.' What is required to be filed is not, as under pre-UCC chattel mortgage and conditional sales acts, the security agreement itself, but only a simple record providing a limited amount of information (financing statement)… The notice itself indicates merely that a person may have a security interest in the collateral indicated. Further inquiry from the parties concerned will be necessary to disclose the complete state of affairs.

The court held that the financing statement is an abbreviation of the security agreement and concluded:

The approach … to financing statements supports the conclusion that incorporation by reference is permissible in Illinois as "any other method" under § 9-108, so long as the identity of the collateral is objectively determinable. That requirement is met here by the security agreement's detailed list of the collateral.

The plain and ordinary meaning of Illinois's revised version of the UCC allows a financing statement to indicate collateral by reference to the description in the underlying security agreement.

Reversed. Success to FMB. But what can we take away from this?

First, of course, FMB could have avoided a ton of aggravation (and legal costs) if it merely described its collateral as "all assets" on the financing statement, or even "all assets other than…" assuming its list of 26 was not intended to be all inclusive.

The more significant issue, referring back to the situation described above, is that lenders must exercise caution when intending to lend against collateral that is represented not to be part of a prior lender's collateral package. In such a case, and when the prior lender's financing statement does not clearly enumerate the collateral description (as the 7th Circuit stated), "Further inquiry from the parties concerned will be necessary to disclose the complete state of affairs."

In other words, if the proposed borrower does not want you to communicate with the prior lender as to the nature of the collateral — and you cannot enter into a reasonable intercreditor agreement, are you that hungry to do the deal?

All of this said, I have found that financing statements filed by equipment leasing companies to give notice of their interest in their leased equipment may describe collateral by reference to the lease agreement. In examining these leases I have, on occasion, found broad granting clauses securing the lessee's obligations. Without that review, lenders would have found themselves subordinate to the prior filed lessor.

You may detect my distaste for descriptions of collateral by reference but, at least in the 7th Circuit, it is sufficient, and we must be guided accordingly. •

In re 180 Equipment LLC, 938 F3d 886 (7th Cir, 2019)

"If the proposed borrower does not want you to communicate with the prior lender as to the nature of the collateral — and you cannot enter into a reasonable intercreditor agreement, are you that hungry to do the deal?"

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THE SAN ANDREAS ECONOMY:
PROTECTING YOUR BUSINESS FROM THE INEVITABLE EARTHQUAKE

BY **JEFF WURST**

Thousands of Californian's persist in living on both sides of the San Andreas fault line, knowing that a major earthquake can send them tumbling into the sea. Jeff Wurst points out that some lenders live the same way — enjoying the current economic boom and ignoring the inevitable downturn on the horizon. His suggestions can help protect businesses when the boom falls.

JEFFREY A. WURST

We are all aware of the San Andreas Fault that some say threatens the west coast of California. Common knowledge predicts that one good tremor around the fault will drop a slice of California into the sea. Regular tremors shake the area, and every so often there is a major earthquake. This year back to back quakes measured at or about 7.0 and there were hundreds of lesser reactions. Yet, Ob-La-Di life goes on and people continue to live near and west of the fault. They think, "The big one is not going to happen to me." Yet, logic has it that someday — despite all the warnings — people will get caught by surprise.

We have been living with a booming economy for more than 10 years. Still, we all know that what goes up will come down. The stock market continues to grow despite having some tremors of its own. Five hundred points in a day. Seven hundred points in a day. A thousand points in a day. Each time the market has fallen it has bounced back. Ob-La-Di life goes on, and

people continue to remain invested. They think, "The big one is not going to happen to me." Yet, logic has it that someday – despite all the warnings – people will get caught by surprise.

The Great Depression commenced with the stock market crash on October 24, 1929, and continued at least through 1938. Although the Wall Street crash showed an initial drop in the Dow Jones Industrial Average of 12.8%, the market continued to slip to an 89% drop when it bottomed out in July, 1932. It took 25 years before the stock market returned to its September, 1929, level. Subsequent crashes (1987 and 2008) had quicker recoveries.

We may be prone to burying our heads in the sand and ignoring the risk of a major adjustment. Why not? It is so unpleasant to consider such concepts. But history does repeat itself and despite what we have learned from the past, we tend to make the same mistakes. Prudent lenders need to prepare themselves for a downside.

What can lenders (and even borrowers) do to get ready... just in case?

LEGAL REVIEW

Take a fresh look at your legal documents. Periodic legal reviews, although they may appear to be unnecessary, are cost effective even if they only save you from one problem. The fact is that over time your practices change, but they are not always reflected in your documents. Do you (or your servicing agent) have possession of original documents- especially promissory notes? Are the loan documents properly executed? Are there missing pages? Are there any patent errors? We once were asked to handle the workout of a loan that we had not documented and, in our legal review, we noticed that while the borrower was ABC Corp the granting clause read "XYZ grants lender a securing interest in and to…." You'd be surprised what kinds of errors can occur in the cut and paste world in which we live.

UCC FILINGS

Is your UCC filing correct? Did you file as CW Mining Company when the debtor's legal name is actually C.W. Mining Company? Or Silver Dollar LLC instead of Silver Dollar Stores, LLC? Or, did ABC Corp., a New York corporation reorganize and merge with and into ABC, LLC, a Delaware limited liability company and the borrower didn't think to tell you about it? Or was the UCC-1 securing General Motor's $1.5 Billion loan erroneously terminated when another secured facility was paid off? These types of nightmares happened to someone else. Don't let them happen to you. Is there now another secured party you did not know about? How about a pre-existing equipment lien that contained a hidden all asset filing?

TAX LIENS

Of course, you should be doing regular searches for tax liens, but do you? You need to.

VERIFICATIONS

Are you (or your servicing agent) performing regular verifications of accounts? Face it! There is fraud in your portfolio. You just haven't found it. It is not difficult to camouflage fraud during a strong economy such as the one we have been enjoying. But once a down-turn arrives, and you peel back the onion, you may be shocked at what you find. Diligent and regular verifications will help to identify these types of problems before they turn into a serious problem.

ACCOUNT DEBTORS

Are you monitoring your borrower's account debtors? Are they on reasonably sound ground? Are they on any watch list? Are they paying on time and consistent with prior history? If not, at least start with discussing this with your borrower.

APPRAISALS

Are they current? Are you comfortable that they were properly performed? Are you comfortable that in the event of a liquidation you will recover what the appraisal says you will recover? Is the appraised inventory reasonably turning around, or is it aging out? Is there still a market for all those expensive silk ties that no one wears any longer?

EXIT STRATEGY

Is it sound? Once, when we were re-documenting an existing loan to a concession of a major national department store chain, we pressed about the exit strategy. Lenders rarely share appraisals with their lawyers prior to a workout, and we had asked about the exit strategy during the initial loan documentation process only to be told that the very reputable appraiser had properly addressed that. We did get to see the appraiser's exit strategy during the re-documentation only to find that it called for going out-of-business sales. Fortunately, as part of the re-documentation we needed to revise the agreement with the department store chain that hosted the borrower's concession. We were able to negotiate a process whereby what we might consider to be a GOB sale could be affected in a seamless manner so as not to disturb the ordinary course of business at the department store. Fortunately, that process has not been needed. However, without those modifications to the agreement with the department store, a liquidation of the borrower's inventory in place would have not been possible.

REVIEW THE BORROWER'S BANK RECORDS

Since the advent of merchant cash advance providers, we are finding more and more incidents where borrowers have turned to MCAs to satisfy what they perceive to be short term additional cash needs. They do this without advising their lender out of fear that the lender will not permit it. As a result, it is becoming more and more common for lenders to discover that their borrowers' bank records show daily or weekly ACH transfers to MCAs, indicating that the borrowers' liquidity is not as it otherwise appeared.

Of course, this is just a short list of things lenders can do to mitigate potential risks in their portfolios. The point is, there are many key indicators that point to a down turn in the economy and, with that, we need to expect and prepare for softness in our loan portfolios. Now is the best time to take measure to minimize the risks.

Unlike those living within the reach of the San Andreas Fault who refuse to take measures to mitigate their risks, lenders need to prepare for a down turn in the economy and the effect it will have on their portfolios. Early preparation is the best way to ensure the success of you borrowers and your institution. •

UCC INSIGHTS

Looking For A Better Mouse Trap?

Article 9 Sales Spring To Action.

BY JEFFREY A. WURST, ESQ.

The time and cost of liquidating collateral can often be prohibitive and is always a nuisance. Of course, this problem is exacerbated when the asset value is less than the balance owed to the secured creditor(s), leaving no value for unsecured creditors. Lenders often step up and carve out an amount to be distributed to unsecured creditors to enable a Chapter 11 to proceed to effect a sale of the debtor's assets free and clear of liens. Some consider this to be a price to be paid by secured creditors for the privilege of utilizing the bankruptcy court to sell their collateral. Thus, the cost of a bankruptcy can be very expensive not only to the debtor, but also to the secured lender. As a result, small and middle-market companies and their lenders have grown receptive to non-bankruptcy vehicles for the disposition of assets.

State law assignments for the benefit of creditors (ABCs) have grown into a popular alternative to bankruptcy. This is often a non-judicial proceeding existing under a state's debtor-creditor law where a debtor selects an assignee to liquidate the company's assets. Some jurisdictions (including New York) provide for judicial proceedings where the ABC is supervised by the court and the court ultimately issues an order confirming the liquidation.

Article 9 of the Uniform Commercial Code provides for a fast, simple and effective process for liquidating a secured lender's collateral. Of course, the Article 9 sale must be conducted in a commercially reasonable manner. Commercial reasonableness, however, is measured by the process and not by the results. Notice is only required to be given to the debtor and secondary obligors on the secured debt (e.g., guarantors, co-borrowers, etc).

In recent years I have found myself involved in more and more Article 9 sales. For example, when a bankruptcy judge would not permit a bankruptcy §363 sale (claiming that the sale would be a sub rosa plan) we obtained relief from the automatic stay to enable our lender-client to sell the assets in an Article 9 sale – fully disclosed to the Court and the creditors. In other situations where the assets are insufficient to pay the lender in full, instead of funding a borrower's Chapter 11 and carving out amounts for unsecured creditors, we are turning to Article 9 to realize on the debtor's collateral.

We recently represented a client who was interested in acquiring the assets of a distressed company where the liabilities owed to three secured lenders exceeded the value of the collateral. The debtor wanted to sell and the junior-most lender was amenable to a discount. The purchaser, however, was reasonably concerned that unsecured creditors might try to upset the sale made in an arms-length transaction. We worked with our client in purchasing the assets from the junior-most secured party – subject to the senior creditors' liens – in a public sale in accordance with Article 9. Notice of the public sale was published and sent to all known unsecured creditors. The reason for such broad notice – in excess of what is required under the UCC – was to flush out a challenge before the purchaser committed and to allow him to exit should a challenge arise. The sale proceeded without objection. The junior-most secured creditor willingly accepted a payment that was less than the debt owed and the purchaser ultimately paid off the senior debt. Thus, the purchaser was able to acquire the assets free and clear of all liens, except without the benefit of a bankruptcy court order. Of course, there are purchasers and secured creditors who are unwilling to proceed in this manner out of fear of post-Article 9 sale litigation challenging the efficacy of the transaction.

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Shortly after that sale was concluded, a decision was issued by the New York State Appellate Division which was spot-on in addressing the concerns of buyers in Article 9 sale. As a result, the decision sparks thoughts for an expanded role for Article 9 sales.

In this case the collateral was not your typical accounts, equipment, inventory, etc. which ABL lenders typically rely on for collateral. Instead the collateral was membership units in limited liability companies, each of which was a single-asset real estate company. The membership units were given as collateral (or boot collateral) to secure loans. Yes, membership units are Article 9 collateral.

Atlas MF Mezzanine Borrower, LLC (Atlas), the debtor, brought an action asking to unwind a UCC sale of the equity interest in 11 commercial properties which was collateral for Atlas' $71 million mezzanine loan, borrowed from defendant Macquarie Texas Loan Holder LLC, the secured creditor. The properties were valued at $240 million and subject to senior loans aggregating about $140 million.

The history of this action is interesting. When Atlas failed to pay its loan at maturity and after a brief forbearance period, Macquarie served Atlas with a "Notification of Disposition of Collateral" which set forth the proposed terms of a nonjudicial public sale of "[o]ne hundred percent (100%) of the limited liability company interests in Atlas MF Holdco, LLC." The sale was published in *The Wall Street Journal* and a data room was established to enable prospective purchasers to conduct due diligence.

Atlas brought an action in Federal Court to enjoin Macquarie's sale of the membership units. However, the Court denied the injunction,

holding that there was no irreparable injury (a critical prong to be established in order to obtain an injunction) in that Atlas could be satisfied by a money judgment should Macquarie act improperly. Atlas, through an affiliate, then qualified to bid at the auction

Four bidders appeared at the auction including Atlas' affiliate. After bidding closed, Macquarie rejected Atlas' highest bid because it was not satisfied that Atlas had the ability to close and proceeded to accept a lower bid. Following the sale, Macquarie transferred ownership of the LLCs to the purchaser. Atlas then brought an action in state court for a declaratory judgment that Macquarie improperly rejected Atlas' bid, that Macquarie lacked authority to transfer the membership units, that the sale was commercially unreasonable and other claims not relevant to this article. Macquarie brought a motion to dismiss the action, which motion was denied by the trial court and Macquarie appealed.

In its complaint, Atlas alleged that under equitable considerations, the Court had the right under UCC 9-617 to declare the sale void, to order the sale unwound and order the property returned to Atlas. The Court ruled that Atlas erred in its interpretation of UCC 9-617 stating:

> *...a disposition "(1) transfers to a transferee for value all of the debtor's rights in the collateral; (2) discharges the security interest under which the disposition is made; and (3) discharges any subordinate security interest or other subordinate lien" ... The section also addresses "good-faith transferee[s]" and "other transferee[s]" in terms of the transferee's rights after disposition. If the transferee acts in good faith, then it takes the collateral "free of the rights and interests [of the debtor] even if the secured party fails to comply with this article or the requirements of any judicial proceeding"... However, if the transferee is something other than a "good-faith transferee," it takes the collateral subject to "the debtor's rights in the collateral."*

When Atlas failed to pay its loan at maturity and after a brief forbearance period, Macquarie served Atlas with a "Notification of Disposition of Collateral" which set forth the proposed terms of a nonjudicial public sale of "[o]ne hundred percent (100%) of the limited liability company interests in Atlas MF Holdco, LLC." The sale was published in *The Wall Street Journal* and a data room was established to enable prospective purchasers to conduct due diligence.

The Court reversed the trial court and dismissed Atlas' cause of action to unwind the sale, holding that the UCC did not provide this as a remedy available to a debtor and that the debtor retained the remedy of money damages if it prevailed on its claims. However, the Court did not dismiss Atlas' cause of action on commercial reasonableness, stating that involved a determination of fact that could be done on a motion to dismiss. The court also declined to dismiss Atlas' claim that it was entitled to be paid the surplus attained at the sale inasmuch as Macquarie's claim for attorneys' fees (which exceeded the surplus) could not be determined on a motion to dismiss.

What is most significant from the Atlas case is the appellate court's statement:

> *...if UCC sales could be unwound, it would only serve to muddy the waters surrounding non-judicial sales conducted pursuant to article 9 of the UCC, and to deter potential buyers from bidding in non-judicial sales, which would, in turn, harm the debtor and the secured party attempting to collect after a default.*

The issue of commercial reasonableness is one that remains in any situation where a non-judicial disposition of collateral occurs but is easily manageable by the secured creditor assuring that it adheres to sound procedures in effecting its sale. The take-away, however, is that purchasers in secured party sales can take comfort that their acquisition will not be set aside – even if the selling secured party failed to effect the sale in a commercially reasonable manner.

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LEGAL

DON'T WAIVE WAIVERS IN LOAN DOCUMENTS

BY **JEFFREY A. WURST, ESQ.**

Jeffrey Wurst cautions lenders "to plan your divorce before you get married," when preparing loan documents. Incorporating waivers is one way to avoid subsequent litigation. A Texas case illustrates how even unenforceable waivers can strengthen a lender's position.

While documenting new loan transactions, lenders should be laying out their exit strategies and how to accomplish them in the most cost-effective way. In a recent article in this publication, I suggested that lenders utilize arbitration provisions as a means of saving costs on litigation that might arise out of the loan. A properly drafted arbitration clause can keep the dispute on a fast track, limit discovery, require a rapid decision and maintain confidentiality. In other words, when entering into a new loan, plan your divorce before you get married. Pre-nuptial agreements are better included in your loan documents and not worked out after the default arises.

Lenders have historically included waivers in their loan documents and guarantees to avoid certain issues being raised in an ensuing litigation. When Article 9 of the UCC was completely revised in 2001, a number of those waivers were prohibited. Some were barred completely, while others could be effective if given only following a default. §9-602 enumerates certain waivers that, if included in the loan agreement or guaranty, will not be effective at any time.

For example, debtors cannot waive protection that deal with: (a) use and operation of the collateral by the secured party; (b) requests for an accounting and requests concerning a list of collateral and statement of account; (c) collection and enforcement of collateral; (d) application or payment of non cash proceeds of collection, enforcement, or disposition; (e) the requirement for an accounting for or payment of surplus proceeds of collateral; (f) a secured party's obligation not to breach the peace when taking possession of collateral without judicial process; (g) disposition of collateral; (h) calculation of a deficiency or surplus when a disposition is made to the secured party, a person related to the secured party, or a secondary obligor; (i) explanation of the calculation of a surplus or deficiency; (j) acceptance of collateral in satisfaction of obligation; (k) deal with redemption of collateral; and (l) the secured party's liability for failure to comply with Article 9.

§9-624 enumerates certain waivers that can be made only after a default. These include: (a) the right to notification of disposition of collateral; (b) the right to require disposition of collateral; and (c) the right to redeem collateral (which right may not be waived at any time in a consumer transaction).

With these exemptions and limitations, lenders still take advantage of waivers that are not prohibited, such as waivers of right to jury trial, offset, notice of demand, subrogation, reimbursement, indemnity, exoneration, or contribution.

STATUTE OF LIMITATIONS WAIVERS

A recent decision from the Supreme Court of Texas[1] addressed waiver of the statute of limitations. That case involved waivers contained in a guaranty. The waiver provision provided;

> GUARANTOR'S WAIVERS. Guarantor …waives any and all rights or defenses arising by reason of (A) any "one action" or "anti-deficiency" law or any other law

JEFFREY A. WURST

> which may prevent lender from bringing any action, including a claim for deficiency, against guarantor, before or after lender's commencement or completion of any foreclosure action, either judicially or by exercise of a power of sale; (B) any election of remedies by lender which destroys or otherwise adversely affects guarantor's subrogation rights or guarantor's rights to proceed against borrower for reimbursement, including without limitation, any loss of rights guarantor may suffer by reason of any law limiting, qualifying, or discharging the Indebtedness; (C) any disability or other defense of borrower, of any other guarantor, or of any other person, or by reason of the cessation of borrower's liability from any cause whatsoever, other than payment in full in legal tender, of the Indebtedness; (D) any right to claim discharge of the Indebtedness on the basis of unjustified impairment of any collateral for the Indebtedness; (E) any statute of limitations, if at any time any action or suit brought by lender against guarantor is commenced, there is outstanding indebtedness of borrower to lender which is not barred by any applicable statute of limitations; or (F) any defenses given to guarantors at law or in equity other than actual payment and performance of the Indebtedness....

The lender did not bring its action for a deficiency judgment until after a two-year statute of limitations expired, but it argued the protection of the statute of limitations was waived in the guaranty and, even if the waiver was not effective, a parallel four-year statute of limitations should apply.

TRIAL COURT UPHOLDS WAIVER

The guarantor argued that under Texas law "a statute-of-limitations defense can only be waived if the language in the waiver is specific and for a defined period of time." The trial court disagreed and granted judgment in favor of the lender and the guarantor appealed. The court of appeals affirmed the trial court's decision, holding the guarantor's agreement to waive "all rights or defenses arising by reason of ... any ... anti-deficiency law" was sufficient to waive the two-year statute of limitations. The court of appeals did not consider the guarantor's argument that his contractual waiver of the limitations period was void as against public policy under a long-standing Texas decision from its Supreme Court. The court of appeals determined that the guarantor waived this public-policy argument by failing to affirmatively plead it as a "matter constituting an avoidance."

The guarantor appealed to the Texas Supreme Court, which noted, that, although the court of appeals did not consider the guarantor's public-policy arguments against enforcement of the waivers, it did not decide whether the guaranty agreement's waiver provision was sufficient to waive all of its possible statute-of-limitations defenses. Because the lender sued within the four-year limitations period applying generically to suits to collect debts, the court of appeals concluded that its suit was timely even if the guarantor could not contractually waive all limitations defenses. The court of appeals decided only that the guarantor waived the two-year statute of limitations and that the lender's suit — filed three-and-a-half years after the foreclosure sale — was not barred by the four-year limitations period that would apply in the absence of the two-year period.

In its decision, the Texas Supreme Court determined that

> Blanket pre-dispute waivers of all statutes of limitation are unenforceable, but waivers of a particular limitations period for a defined and reasonable amount of time may be enforced.

The supreme court expressed concerns of public policy, noting that a statute of limitations is not solely a right belonging to the party asserting it. It "protect[s] defendants and the courts from having to deal with cases in which the search for truth may be seriously impaired by the loss of evidence whether by death or disappearance of witnesses, fading memories, disappearance of documents or otherwise."

SPECIFIC WAIVER ENFORCEABLE

The Texas Supreme Court noted that there were three provisions in the guaranty that waived the statute of limitations and dispensed with two as being unenforceable. However, a third provision provided:

> Guarantor also waives any and all rights or defenses arising by reason of (A) any "one action" or "anti-deficiency" law or any other law which may prevent lender from bringing any action, including a claim for deficiency, against guarantor, before or after lender's commencement or completion of any foreclosure action, either judicially or by exercise of a power of sale ....

The court ruled that unlike the other two provisions this section is both "specific" and "for a reasonable time."

Finally, the court stated:

> The guaranty agreement's savings clause further supports this conclusion. It states, "[i]f any such waiver is determined to be contrary to any applicable law or public policy, such waiver shall be effective only to the extent permitted by law or public policy." Enforcing the section... waiver "to the extent permitted by law or public policy," as the parties agreed we should, we conclude that the four-year statute of limitations applying to suits to collect debts applies as a backstop

The Texas Supreme Court affirmed the court's holding:

> We hold that the court of appeals erred by declining to reach [the guarantor's] argument, but we nonetheless agree with its ultimate disposition of the case. While portions of [guarantor's] contractual waiver are unenforceable under [prior case law, other portions are sufficiently specific and result only in the substitution of a four-year limitations period for a two-year period rather than the abandonment of all limitations prohibited by [such prior case law]. When the enforceable portions of [guarantor's] contractual waiver are applied, limitations do not bar [lender's] suit against him. We therefore affirm the judgment of the court of appeals.

Whether intended or not, the redundancies contained in the guaranty provided for both enforceable and unenforceable waivers. The lender only needed one to be enforceable. Thus, one of the takeaways from this decision is to resist the insistence by borrower's counsel during negotiations to remove redundancies in the loan documents. Another is that it is okay to include waivers that may otherwise not be enforceable inasmuch as the worst thing that might occur is that a court will rule the waiver ineffective. But then again, as it did in this Texas case, it might uphold the waiver. •

[1] *Godoy v Wells Fargo Bank,* (Texas Supreme Court, May 10, 2019) 2019 WL 2064538

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LEGAL lines

Why Are MCAs Doing So Well in the Courts?

BY JEFFREY A. WURST

Merchant Cash Advances (MCAs) are a divisive issue in the lending community, with good reason. Jeffrey Wurst examines the pitfalls that can undermine an ABL lender and observes that many judges make rulings regarding MCAs without fully understanding the nuances of the issues.

JEFFREY A. WURST

Okay, this title has already alienated a chunk of our reading audience, so let me clarify.

Let's first separate Merchant Cash Advance (MCAs) into two groups:

First are MCAs that advance money and get repaid solely from the collection of future receivables (assuming the risk of collection) and those that advance money and get repaid by taking daily or weekly ACH payments from the *client's* bank account whether or not any receivables actually exist.

Second are MCAs that rely on the performance of receivables found in factoring, which are generally based on true sales of the future receivables and without recourse. Although certain MCAs claim to be without recourse because the *client* is not creditworthy and any claim against the merchant is uncollectable, that does not qualify as a true sale.

Let's focus on the first type of MCA — the recurring ACH repayment method which is not connected to the performance of future receivables. In other words, ACH payments made even when no receivables are created or that do not change based on a percentage of receivables collected.

Whether an MCA is a usurious loan first depends on whether the merchant sold the receivable or borrowed money with the receivable as collateral. Whether the sale of the receivable was a *true sale* under applicable law determines this.

Let's look at these transactions under New York law, which has the harshest usury penalties in the country. Under New York law, the penalty for lenders making a usurious loan is not being deprived of any interest payments, as it is in many jurisdictions, but being deprived of receiving both interest *and principal*. In other words, the borrower gets a windfall by forgiveness of debt when it has borrowed money under usurious terms. Thus, it should not come as a surprise that when confronted with a lawsuit to recover on advances made to a merchant, that merchant attempts to claim the high cost of funds they are paying is usurious.

Whether an MCA is a usurious loan first depends on whether the merchant sold the receivable or borrowed money with the receivable as collateral. Whether the sale of the receivable was a *true sale* under applicable law determines this.

The True Sale Test

So, what is a true sale? This is important because, for a purchase of receivables to avoid being deemed a loan (and often a usurious one at that), the purchase needs to first pass a *true sale* test.

To avoid a claim that the advance was made on usurious terms, a sale of receivables must be a *true sale* (and not a loan). While few courts have engaged in detailed *true sale* analysis, some have abbreviated the standard into three prongs:

1. Whether or not the maker of the MCA is absolutely entitled to repayment under all circumstances. For a true loan, it is essential to provide for repayment absolutely and at all events or to secure the principals in some way as distinguished from being put in a hazard.[1]
2. The MCA agreement must have an indefinite term, evidencing the contingent nature of the repayment plan.
3. Whether the purchaser of receivables has any recourse should the merchant declare bankruptcy.

1 *NY Capital Asset Corp. v. F & B Fuel Oil Co.*

While these indicia provide a reasonable method to determine whether the transaction is a true sale or a disguised loan, courts, while stating this standard, rarely engage in an analysis applying the facts to the standard. As a result, it appears some courts miss the point.

One of the recurring facts many courts have failed to consider is when a "purchaser of receivables" makes MCAs and requires a confession of judgment from the merchant, that the confession of judgment may indicate that the "purchaser" has recourse other than to the purchased receivables.

Of course, there is no assurance the judge hearing the case will be familiar with the UCC or similar law. Instead, many judges blindly rely on the conclusions of parallel judges, even when the facts may not be sufficiently similar. Two cases, coincidently, rely on the conclusions of other courts, using identical conclusory language:

> Many trial courts have examined similar agreements in the last several years, and have largely determined that most are not loans, but purchases of receivables.[2]

One judge ruled:

> New York Courts have held that a contract such as the within agreement are not loans and are not subject to usury laws. In *Merchants Advance*, the court found an agreement for the purchase of future receivables and sales proceeds lacked "the necessary elements of a loan transaction" and was not subject to usury laws.[3]

Judges Miss the Point

The problem is, in many cases the judge never considers the reason why New York courts consider certain agreements not to be loans — perhaps because they are *true sales* — even when the facts of the case at bar is not a true sale. This judge clearly missed the point — probably because the defendant's attorney never adequately explained the issue.

Keep in mind that these cases typically involve small amounts, and the attorneys representing the merchants are inexperienced in commercial finance and UCC matters.

Some courts have considered whether the merchant actually has collections of receivables and whether repayment of the advance is contingent upon the merchant actually generating sales and those sales actually resulting in the collection of revenue.

Sales Disguised as Loans

That said, some courts have peeled back the onion and have seen that certain MCAs are, in fact, disguised loans:

> The court comes to the inevitable conclusion that the real purpose of the agreement was for plaintiff to lend money to defendants at the usurious interest rate set forth therein, and that defendant agreed to borrow the money based on the same usurious terms dictated by plaintiff. Denominating a loan document by another name, as in this case, by calling it a "Merchant Agreement," does not shield it from the judicial determination that it contemplates a criminally usurious transaction. Accordingly, as the party seeking to exact criminally usurious interest, plaintiff is also "not entitled to equitable relief."[4]

MCAs have established themselves as viable methods of financing for small businesses, many of which are not otherwise deemed to be loan worthy, and ABLs must monitor them and take appropriate measures to protect the integrity of their loans.

Another court concluded:

> In the instant case, however, the submitted affidavits and exhibits clearly and unequivocally demonstrate that the agreement is criminally usurious on its face, obviating the need for a superfluous plenary action.[5]

So, what is the take away?

Are MCAs Bona Fide?

ABLs remain skeptical whether MCAs are *bona fide*. They remain concerned that merchants often *stack* (making a series of MCAs one on top of another) MCAs with ACH payments automatically being deducted from the merchant's accounts and leaving the ABL's borrower strapped for cash. They remain concerned that MCAs are made without regard to the ABL's security interests. The problem is, ABLs have no practical way to monitor what ACH commitments its borrowers have made unless the ABLs have access to their borrowers' bank account statements or require account debtors to make payments to a lockbox.

The fact is, where MCAs are effected as true sales, courts will uphold them, and where they are disguised as loans, some will avoid scrutiny and be able to have recourse. Some will be caught as disguised loans and surrender any recovery.

Monitoring ABL borrowers, especially those that may be vulnerable with cash needs, must become a regular practice such as monitoring for tax liens and additional UCC filings.

Of course, that adds to the cost of making and monitoring a loan, something ABLs may be reluctant to do in a competitive marketplace where additional monitoring means less profitability.

What remains, however, is that MCAs have established themselves as viable methods of financing for small businesses, many of which are not otherwise deemed to be loan worthy, and ABLs must monitor them and take appropriate measures to protect the integrity of their loans. abfj

2 This precise quote appears in each of *LG Funding, LLC v. Branson Getaways* and *K9 Bytes v. Arch Capital Funding*.
3 *IBIS Capital Group v. Four Paws Orlando*. 2017 N.Y. Misc.
4 *Pearl Capital Rivis Ventures v. RDN Construction*. 54 Misc.3d 470. 2016.
5 *Merchant Funding Services v. Volunteer Pharmacy*.