

# Handling Pledged Securities In A Changing Market

Asset based lenders love marketable securities. Securities traded on public markets are easy to value and easy to liquidate. Articles 8 and 9 of the Uniform Commercial Code, together with well-drafted control agreements, make securities one of the best possible forms of collateral.

The same factors that make securities so desirable also create special challenges once a loan goes into default and the lender must decide whether to liquidate the collateral. Particularly in situations where the loan is not fully secured, a lender may be faced with difficult choices.

For example, if a \$10,000,000 loan is secured by securities with a value of \$9,500,000 today, a lender might be inclined to wait and see if those securities are worth \$10,000,000 next week, or even next month. On the other hand, those securities may only be worth \$9,000,000 or even less next week or next month. The situation becomes more complicated if the securities are only part of the collateral package, and the fluctuation in their value causes the lender's oversecured or undersecured status to fluctuate as well.

The lender's decision not only impacts the lender's recovery, but also the liability of secondary obligors, typically guarantors. The lender's decision will be closely scrutinized by guarantors, who will be on the hook if the lender makes a decision that, with the benefit of hindsight, appears to have been incorrect.



Consider also that the trading volume for a particular security can affect the amount recovered. If the security is thinly traded and the lender “dumps” a large volume on a single day, the stock price will be adversely affected and a lower recovery will result.

Fundamentally, Article 9 requires lenders to act in a commercially reasonable fashion with regard to all aspects of the disposition of collateral following default. Yet determining what that means in a particular situation is frequently far from clear. Nor have attempts by several courts to address the issue yielded uniform guidelines.

For example, in *Solfanelli v. Corestates Bank, N.A.*, the Third Circuit held that a secured lender acted unreasonably by failing to sell publicly traded stock that had been trading at prices that would have yielded a 100 percent recovery for the lender had it liquidated the stock during the 30-day period following default. The court barred recovery of any deficiency as a result of the lender's failure to sell the stock in a timely fashion.

The Seventh Circuit, however, has held that lenders have no duty to make decisions about selling pledged stock. In *Capos v. Mid-America National Bank*, it wrote: “It is the borrower who makes the investment decision to purchase stock. A lender in these situations merely accepts the stock as collateral, and does not thereby itself invest in the issuing firm. Nor,

[Changing Market](#) - continued on page 3

[Bankruptcy-Proof](#) - continued from page 1

## “BANKRUPTCY-PROOFING” YOUR AGREEMENT

To the surprise of many, the Supreme Court denied the lessee's petition for review of the First Circuit's *Bankvest* decision allowing the debtor to assume certain equipment leases without curing non-monetary defaults. As a result, the split between the First and Ninth Circuits persists, and the opportunity to “bankruptcy-proof” agreements with debtors-to-be remains, at least in the Ninth Circuit and in other courts that follow *Claremont*.

The typical non-monetary default is an historical fact that is impossible to cure after the fact—for example, a failure to maintain leased property in good condition or to meet specified quality or performance thresholds. With this in mind, it is relatively simple to conceive of a contract or lease provision that a counter-party experiencing financial distress might easily breach prior to seeking bankruptcy relief. If the counter-party later files bankruptcy and seeks to assume the contract or lease (or often more ominously for the non-debtor party, to assume and assign the contract or lease to a third party), the non-debtor party may be

able to block the debtor's efforts completely. On a more practical level, the ability to credibly threaten to block assumption on the grounds that the debtor is unable to cure a non-monetary default will provide the non-debtor party with leverage it would not otherwise have to negotiate more favorable terms in connection with the debtor's assumption or assignment of the contract or lease.

The prospect of a bankruptcy filing by a counter-party to a contract or lease is often not a serious consideration during negotiations. As demonstrated by the *Bankvest* and *Claremont* cases, however, recognition during the negotiating process of the leverage to be gained by including stringent quality or performance requirements in a contract or lease may yield unexpected benefits if the counter-party later becomes financially distressed and seeks bankruptcy relief. If the prospect of gaining such an advantage is of interest to you or your company, you are invited to contact the author to discuss strategies to “bankruptcy-proof” your contracts and leases.

[Timothy W. Brink](#) | 312.443.1832 | [tbrink@lordbissell.com](mailto:tbrink@lordbissell.com)

# A Name Is A Name, Or Is It?

One of the primary reasons for the recent revisions to Article 9 of the Uniform Commercial Code (“UCC”) was the simplification of filing rules for financing statements. Revised Article 9 (“RA9”) did simplify many aspects of perfecting a security interest in personal property, but issues related to the identification of the debtor remain unclear. This article focuses on the issues secured parties and courts still face with respect to the identification of individual debtors on UCC financing statements under RA9.

The UCC provides that a financing statement is sufficient to perfect the secured party’s interest in the collateral so long as it contains the name of the debtor, the name of the secured party, and a description of the collateral. Once filed in the appropriate office, a financing statement is indexed using the debtor’s name. Secured parties search the records of the filing office by the debtor’s name. A standard method of identifying debtors is therefore essential to fulfillment of the policy of providing notice by way of a central filing. A financing statement will not be effective if it is “seriously mislead-

ing.” RA9 clarifies when a financing statement is seriously misleading in its identification of the debtor where the debtor is an entity, but does not provide any such clear rule for individual debtors. Instead, the drafters of RA9 left secured parties only with the instruction to provide the “individual . . . name of the debtor” on the financing statement.

...the searching party should not have the burden of determining what “familiar” names should be searched—the burden should be upon the filing party to use the “legal” name.

In most cases, identifying the individual debtor is simple. Under certain circumstances, however, it can be complicated. Consider the impact a marriage or divorce might have on a debtor’s name, or the use of a nickname by a debtor. Some individuals use initials as their name, or abbreviate their name. Some do not use

the formal names appearing on their birth certificates. Some individuals use their middle name, some use an initial, and some ignore middle names entirely. These variations make it difficult for a secured lender to ensure that it is properly perfected when filing a financing statement related to an individual debtor, or that it has accurately determined whether other secured parties have perfected interests in the property of a proposed individual debtor.

Getting the debtor’s name right is essential. RA9 provides a safe haven for secured parties if the filing office’s “standard search logic” reveals the filed financing statement when using the debtor’s “correct name.” Whether the search will find a debtor may be dependent upon the search logic used by the particular filing office. For example, if the debtor’s full name is Charles James Schmidt but Mr. Schmidt has been known as “C.J. Schmidt” since kindergarten and has obtained secured credit using that name, a search of the filing office’s records under “Charles James Schmidt” might or might not return a UCC financing statement

[A Name Is A Name](#) - continued on page 4

## Changing Market - continued from page 2

unless otherwise agreed, does the lender undertake to act as an investment adviser, although imposing a duty on the lender to sell the stock at the ‘reasonable’ time would foist that role upon it.” The court went on to hold that the duty of reasonableness under the UCC applied only to the “physical care” of the certificates themselves.

Finally, in *FDIC v. Caliendo*, the district court for the District of New Hampshire held that a rule that protected only tangible certificates was “nonsensical” and “inequitable.” That court held that the “foremost consideration” should be the protection of the value of collateral—regardless of its physical form. The court disagreed with the Seventh Circuit’s decision in *Capos*, and held that a lender has a duty to exercise reasonable care in protecting the value of securities pledged as collateral. However, the court held that this duty would be “contingent upon specific factual situations and is subject to exception.” The *Caliendo* court also specifically limited the duty to overcollateralized loans, and held that no duty to sell securities would exist unless there had been both a default and a demand by the borrower that the lender sell the securities. If all of these circumstances existed, then, the court held, the lender would have a duty to “take appropriate action in a timely fashion.”

A more troubling situation occurs when the borrower requests that the lender liquidate stock pledged as collateral at a time when the market is declining and the loan is undercollateralized. One court faced with this situation held that the lender had no obligation to sell under these circumstances, but allowed the borrower to attempt to establish that the lender had been unreasonable in its refusal to sell.

Many different factors will determine whether a lender has acted reasonably in the handling of pledged securities, including whether the loan is in default, how quickly the securities decline in value, the “float” and any impact “dumping” the securities on the market might have on their value, whether the borrower has requested the lender sell the securities, and numerous other factors. Nevertheless, if a lender chooses to dispose of stock that is traded on a recognized market and does so in the “usual manner,” section 9-627 of the UCC ensures that the disposition itself will be considered reasonable. The issue of whether the lender is under a duty to dispose of the collateral in the first place—and how quickly—may be resolved in different ways depending upon the jurisdiction, and remains a particularly murky issue for lenders holding securities as collateral.

Thomas J. Cunningham | 312.443.1731 | [tcunningham@lordbissell.com](mailto:tcunningham@lordbissell.com)