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Want To Make Your Agreements Bankruptcy-Proof? Thanks To The Supreme Court, You Still Can

On June 21, 2004, the Supreme Court refused to hear an appeal from the First Circuit's decision in *In re Bankvest Capital Corp.* holding that a debtor did not need to cure "non-monetary" defaults before assuming an equipment lease. In so doing, the Court left unresolved a split between the First and Ninth Circuits, and left the door open to the possibility of "bankruptcy-proofing" agreements with debtors-to-be.

THE STATUTORY FRAMEWORK

Section 365 of the Bankruptcy Code governs assumption and rejection of executory contracts and unexpired leases. In general, a debtor must cure all defaults, whether monetary or non-monetary, as a condition to assuming an executory contract or unexpired lease. 11 U.S.C. § 365(b)(1). There are several exceptions to this rule, however, including that found in section 365(b)(2)(D) of the Bankruptcy Code, which provides that the debtor need *not* cure a default that is a breach of a provision relating to "the satisfaction of any penalty rate or provision relating to a default arising from any failure by the debtor to perform non-monetary obligations under the executory contract or unexpired lease." 11 U.S.C. § 365(b)(2)(D).

THE COMPETING INTERPRETATIONS OF SECTION 365(b)(2)(D)

With the First Circuit's *Bankvest* decision, two competing interpretations of the exception to the requirement that the debtor cure all defaults as a condition to assuming an executory contract or unexpired lease have developed. One view—displayed most prominently in the *In re Claremont Acquisition Corp.* case from the Ninth Circuit—is

that section 365(b)(2)(D) only excuses the cure of penalty provisions. Under this view, the debtor would be required to cure any other, "non-penalty" default, and if the default could not be cured, the debtor would be prohibited from assuming the contract or lease.

The First Circuit in *Bankvest* rejected this narrow interpretation of the cure exception, holding instead that section 365(b)(2)(D) excuses debtors from curing non-monetary defaults as a condition to assuming a contract or lease. The debtor in *Bankvest* leased computer equipment. During its bankruptcy case, the debtor moved to assume leases with two lessees who owed the debtor over \$1 million in rent. The lessees objected, arguing that the debtor could not assume the leases because it had defaulted by failing to replace certain loaner equipment prior to the bankruptcy, and that this non-monetary default was an historical fact not susceptible to cure.

In siding with the debtor and rejecting the narrow interpretation of the cure exception urged by the lessees, the First Circuit found that the language of section 365(b)(2)(D) was ambiguous and that the legislative history of the statute was not instructive. Seizing instead on the policy underlying section 365 of the Bankruptcy Code—the promotion of the successful rehabilitation of the debtor's business for the benefit of both the debtor and all its creditors—the court concluded that Congress meant to excuse debtors from the obligation to cure non-monetary defaults as a condition to assumption.



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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,

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“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.

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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

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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.

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identifying Mr. Schmidt as “C.J. Schmidt.” If it does, the financing statement is not “seriously misleading” and will be effective. On the other hand, if Mr. Schmidt has been known as “Chuck” for his entire life, a search of Charles James Schmidt will probably not return a financing statement identifying him as “Chuck Schmidt.” In this case, the financing statement would be seriously misleading and would not be effective. Thus, while use of initials or a nickname might be effective in some cases, it might not be in others.

Might it also be proper to use a debtor’s nickname or initials on a financing statement? Should the searching party have an obligation to search using the nickname or initials? Two bankruptcy judges in Kansas recently held that it was proper for a secured party to use the debtors’ proper surnames with the familiar versions of their first names (“Terry” instead of “Terrance” in one case and “Mike” instead of “Michael” in the other). In those cases, had a later secured party not searched “Terry” or “Mike,” it might not have discovered earlier-filed financing statements. Despite RA9’s desire to foster uniformity, these cases adopted a more liberal “substantial compliance” standard. These decisions impose additional transaction costs on the extension of secured credit because a prudent lender will perform searches under all reasonable alternative debtor names.

However, one of these two cases was subsequently reversed by the Tenth Circuit Bankruptcy Appellate Panel. The appellate court held that the secured party must use the individual debtor’s “legal name,” just as the rules applicable to entities require the use of the “legal name,” rather than a trade name. This approach is consistent with RA9’s overall objectives of promoting simplicity and clarity and flows logically with the other provisions dealing with financing statements and corporate entities. The appellate court held that 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. Practical considerations guided this reversal. According to the

appellate court, using the legal name standard would simplify drafting financing statements and searching filing records, avoid litigation, and not be too burdensome on the filing secured creditor.

Taken together, these three recent decisions provide some guidance for lenders, but still leave several questions unanswered. We believe that the best practice is for secured parties to use the debtor’s legal name on financing statements. An individual’s legal name is presumed to be the name appearing on a birth certificate, unless modified by

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court order or marriage. Thus, a lender should require the debtor to provide a copy of a birth certificate and obtain a representation and warranty that his or her name has not been changed. A driver’s license is insufficient—at least in Illinois—because an individual can obtain a driver’s license without producing a birth certificate. Lenders should

also consider searching familiar names when conducting UCC searches related to individual debtors. Following these practices should help ensure that security interests are properly perfected and prior liens are discovered.

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