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## Joint Report from the Chairs

Dear Members:

The 2013 ABA Annual Meeting in San Francisco represented the last ABA Annual Meeting where the Business Law Section (BLS) fully participated. At this meeting, both the ComFin and UCC Committees put on high quality CLE programming and provided many opportunities to connect with old friends and make new ones. Our joint dinner at McCormick & Kuleto's was well attended.

The BLS has launched the new BLS Annual Meeting. The initial BLS Annual Meeting will be held on Thursday, September 11 to Saturday, September 13, 2014, at the Hyatt Regency Chicago. This first BLS Annual Meeting is expected to include over 40 high-quality CLE programs and more than 150 committee and subcommittee meetings. Our committees intend to fully participate in the new BLS Annual Meeting. We hope that you plan on attending the inaugural BLS Annual Meeting in Chicago.

The 2013 Annual Meeting marked the end of Jim Schulwolf's tenure as Chair of the ComFin Committee. We thank Jim for his leadership, his numerous contributions to the ComFin Committee, and his collaborative efforts with the UCC Committee. Jim's leadership efforts certainly enhanced the reputation of the ComFin Committee.

The 2013 Annual Meeting also marked a transition of leaders within both of our committees. Several of our subcommittees and task forces have recently welcomed new leaders. We thank those whose terms have ended. We welcome and look forward to working with those whose terms have just begun. We encourage all readers to look over the offering of subcommittees and task forces offered by ComFin and UCC, and join those that may be applicable to your practice areas and interests.

Please email either of us if you have any ideas for either of the Committees or wish to participate in any project, subcommittee or leadership role. The Committees have a number of projects underway. Our subcommittees and task forces are very active and always welcome input. Please do not hesitate to volunteer!

Finally, we look forward to seeing you at our next in-person meeting, the BLS 2014 Spring Meeting. The BLS 2014 Spring Meeting will be held on April 10-12, 2014, in Los Angeles, California, at the JW Marriott Los Angeles at L.A. Live and the Ritz-Carlton Los Angeles. Additional information will be forthcoming from the BLS.

We hope you enjoy this issue, and invite you to get involved in your committee(s).

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### Featured Note

For those of you looking for good pro bono/volunteer opportunities, the ABA Business Law Section and Junior Achievement are partnering to promote youth financial literacy. Business lawyers often witness firsthand the high cost of ignorance about personal finances. Volunteer yourself and your firm to provide personal finance

instruction to high school students within the Junior Achievement program. Check [here](#) for more information about the Section's efforts.

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November 13-15, 2013 – Commercial Finance Association 69th Annual Convention – JW Marriott Los Angeles at L.A. Live in Los Angeles, California. Click [here](#) for more information.

November 19, 2013 – 1:00 p.m. to 2:30 p.m. EST – Article 9 Security Interests: Complexities in Drafting Legal Opinions (CLE Webinar). Click [here](#) for more information.

November 20, 2013 – 1:00 p.m. to 2:30 p.m. EST – Pledge Agreements for Equity Interests in Partnerships and LLCs (CLE Webinar). Click [here](#) for more information.

November 22, 2013 – 7:00 p.m. EST – Annual Meeting and Dinner of Association of Commercial Finance Attorneys – Paola's, 1295 Madison Avenue, New York City, N.Y. Click [here](#) for more information.

November 26, 2013 – 1:00 p.m. to 2:30 p.m. EST – Crowdfunding and the Jobs Act: Alternative Source of Capital Raising (CLE Webinar). Click [here](#) for more information.

January 10, 2014 – PLI's Drafting and Negotiating Corporate Agreements 2014 – New York City and Live Webcast. Click [here](#) for more information.

April 10-12, 2014 – ABA Business Law Section Spring Meeting – JW Marriott Los Angeles at L.A. Live and the Ritz-Carlton Los Angeles Los Angeles, California. Click [here](#) for more information.

September 11-13, 2014 – ABA Business Law Section Annual Meeting – Hyatt Regency Chicago, Chicago, Illinois. Click [here](#) for more information.

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## **Featured Articles**

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### **UCC ARTICLE 9 FORECLOSURE SALES: AN ALTERNATIVE TO BANKRUPTCY CODE SECTION 363 TO BUY AND SELL DISTRESSED ASSETS**

By [Theodore A. Cohen](#)<sup>1</sup>

#### **Introduction**

A buyer of distressed assets from an insolvent company often can acquire the assets at a bargain price, as compared to an acquisition of assets from a solvent company. However, unlike an acquisition from a solvent company, in which the claims of the company's unsecured creditors are likely to be paid in full, assumed, or back-stopped by meaningful representations, warranties, and indemnities from the seller, when the seller is insolvent, any representations, warranties, and indemnities that the buyer might obtain from the seller will be worthless.

In a distressed asset sale, the claims of unsecured creditors of the insolvent company will not be assumed by the buyer and typically will receive no payment out of the sales proceeds because the seller's liabilities exceed the value of the assets. Even the secured creditor may not be paid in full. Therefore, unsecured creditors have little to lose by pursuing their unpaid claims against the only solvent source – the buyer – through fraudulent transfer or successor liability litigation. The benefit to the buyer of acquiring the assets at a bargain price can quickly evaporate if the sale is unwound as a fraudulent transfer or if the seller's creditors can collect their claims after the sale from the buyer as a successor to the seller.

Based on these circumstances, a buyer from an insolvent seller must consider the risks of successor and fraudulent transfer liability accompanying the transfer of the distressed assets. Traditionally, to minimize these risks, buyers have acquired distressed assets through a sale under § 363 of the Bankruptcy Code. However, the bankruptcy process can be time consuming and expensive for all constituents, including the buyer, the seller and the secured lender. Moreover, because the parties must obtain court approval to effectuate a bankruptcy sale, the bankruptcy process contains a level of uncertainty. To obtain court approval, after the seller and buyer have reached agreement between themselves, the parties may have to "negotiate" with the bankruptcy court, a committee of unsecured creditors, or even junior secured creditors who are out of the money,<sup>2</sup> and provide consideration to those third parties as a cost of obtaining an order approving the sale.

A typically less expensive and quicker alternative to a bankruptcy sale is a foreclosure of the secured lender's security interest in the assets to be sold through a private or public sale under Article 9 of the Uniform Commercial Code ("UCC") ("UCC foreclosure sale").<sup>3</sup> This article discusses the strategy, benefits and drawbacks of effectuating a sale of distressed assets through a UCC foreclosure sale.

#### **Setting the Table for a UCC Foreclosure Sale**

UCC §§ 9-601 through 9-629 govern UCC foreclosure sales.<sup>4</sup> To transfer assets in a UCC foreclosure sale, there must be a secured creditor, typically a lender, with a perfected lien under Article 9 of the UCC on the assets to be sold. The secured creditor is defined under the UCC as the "secured party." Moreover, the secured obligation of the borrower, defined under the UCC as the "debtor," must be in default.<sup>5</sup> In a UCC foreclosure sale, the secured party forecloses its lien on the assets and sells the assets to a buyer, through a Bill of Sale and/or a more formal Foreclosure Purchase and Sale Agreement.<sup>6</sup>

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A UCC foreclosure sale does not involve or require judicial proceedings or a third party fiduciary such as a trustee, receiver, or assignee. It requires only the consent, participation, and cooperation of the secured lender, a buyer, and, at least partially, the debtor. The secured party can transfer *title* to the assets to a buyer in a UCC foreclosure sale without the consent, participation and cooperation of the debtor. However, from a practical standpoint, the secured party cannot transfer *possession* of the assets to the buyer without the cooperation of the debtor. Thus, unless the secured party and buyer are willing to incur the expense and delay of judicial intervention to transfer possession, the consent and cooperation of the debtor are required in a UCC foreclosure sale.

A properly noticed, conducted and commercially reasonable UCC foreclosure sale results in the buyer acquiring all right, title and interest of the debtor in the foreclosed assets free and clear of the liens of the foreclosing secured party and all liens junior to the lien of the foreclosing secured party.<sup>7</sup> Liens, if any, senior to the lien of the foreclosing secured party are not extinguished. Even if the secured party does not comply with all the default and foreclosure provisions of Article 9 of the UCC, the buyer will acquire the assets free and clear of the lien of the foreclosing secured party and all liens junior thereto if the buyer acted in good faith.<sup>8</sup>

UCC foreclosure sales are either “private sales” or “public sales,” as further described below. UCC foreclosure sales usually have lower transaction costs than alternatives that involve judicial proceedings or a third party fiduciary, such as bankruptcies, receiverships, and assignments for the benefit of creditors. Even though a UCC foreclosure sale does not result in a court order approving the sale (such as a sale under § 363 of the Bankruptcy Code), UCC foreclosure sales can still mitigate fraudulent transfer and successor liability risk, especially if (i) the assets are marketed, (ii) independent evidence of valuation is obtained, (iii) the secured party is undersecured, and (iv) the buyer is unrelated to, and not an insider of, the debtor. Finally, a UCC foreclosure sale can happen much faster than, and without the publicity of, a bankruptcy sale, which means that there is greater value to transfer because (i) there is no stigma of bankruptcy, and (ii) going concern value more likely can be preserved during the sale process.

**Private UCC Foreclosure Sales**

A private UCC foreclosure sale is a sale in which the secured party agrees to sell to a specific buyer. While there may be a marketing process prior to the sale, in a private sale the public is not invited to an auction or other overbid process. In almost all cases, the secured party may not credit bid at a private sale, but must sell to a third party.<sup>9</sup>

The secured party must provide prior written notice of the private sale to the debtor, any secondary obligors (guarantors), junior lienholders, and certain other parties.<sup>10</sup> The notice should state that on or after a specific date, the secured party will sell the assets, in whole or in part, in one or more private sales.<sup>11</sup> In a private sale, while the foregoing parties receive notice that a sale will occur, those parties do not receive notice of the terms of sale or even the identity of the buyer. In fact, there is no public disclosure of the terms of sale or the buyer, either before or after the sale. The secured party must provide the foregoing notice at least 10 days prior to the sale<sup>12</sup> unless the secured party and the debtor have agreed to more notice, in which case the secured party should provide the greater amount of notice.

As there is no competitive bidding in a private sale, a buyer does not have a risk of being outbid. The secured party and the buyer reach an agreement on terms and the sale is consummated under those terms. Specifically, after the requisite notice period runs, the secured party forecloses on and sells the assets to the buyer free and clear of the foreclosing secured party's liens and all liens junior thereto under the terms of the Bill of Sale and/or Foreclosure Purchase and Sale Agreement.

**Public UCC Foreclosure Sales**

A public UCC foreclosure sale is a sale in which the secured party sells the assets through an auction or other competitive bidding process conducted by a third party licensed

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auctioneer or investment banker. There typically will be a marketing process prior to the sale and the public will be invited to the auction or other competitive bidding process. The secured party may credit bid and acquire the assets at a public sale.<sup>13</sup>

Since § 9-611(c) applies to all UCC foreclosure sales, in a public sale the only parties that have to receive notice of the sale are the same parties as in a private sale. However, to ensure that the sale is “commercially reasonable” (discussed below) and to create a record to rebut an argument by a creditor unhappy with the auction results, in addition to providing the requisite notice the secured party should also publish notice of the public sale in a newspaper of general circulation in the geographic area where the sale will take place and a trade or industry publication in the field or industry of the assets being sold. Notice should also be provided to any potential purchasers of the assets of which the secured party, auctioneer or investment banker are aware. An inspection of the assets prior to the sale should be made available to potential purchasers.

Both the notice to the requisite parties and the published notices should provide that the sale will take place on a specific date and time, at a specific location.<sup>14</sup> All notices should also provide the date, time and location of the asset inspection. In a public sale, while the identity of the buyer and the terms of the sale will become known to those who attend the auction, there will be no further public disclosure of the terms of sale or the buyer.

While the amount of notice of the public sale the secured party must provide is the same as required in a private sale,<sup>15</sup> 10 days usually is not sufficient time to allow potential bidders the opportunity to conduct due diligence, including inspecting the assets. Therefore, the secured party should provide the amount of notice that is “commercially reasonable,” which will vary depending upon the facts and the type of assets that are being foreclosed and sold.<sup>16</sup>

Because there is competitive bidding in a public sale, a buyer has a risk of being outbid – even if the secured party and a potential buyer reach tentative agreement on terms, the sale is subject to overbid at the auction. Specifically, the high bidder at the auction will acquire the assets free and clear of the foreclosing secured party’s liens and all liens junior thereto under the terms of the Bill of Sale and/or Foreclosure Purchase and Sale Agreement.

## **Hallmarks of Private and Public UCC Foreclosure Sales**

### **Commercial Reasonableness**

All UCC foreclosure sales, whether private or public, must be “commercially reasonable.”<sup>17</sup> The definition of commercial reasonableness set forth in § 9-627(b)(3) is not particularly helpful.<sup>18</sup> The fact that a greater sales price could have been obtained in a different sale or under different terms does not preclude the secured party from establishing that the actual sale was commercially reasonable.<sup>19</sup>

While commercial reasonableness is important to allowing the secured party to pursue a deficiency against the debtor or guarantors,<sup>20</sup> it is also important to a buyer in minimizing fraudulent transfer and successor liability risk. To establish commercial reasonableness, the secured party should comply with the technical notice requirements of the UCC as well as the additional suggestions for noticing public sales, as both are discussed above.

Moreover, even though the UCC does not impose upon a secured party the explicit obligation to maximize value and sales price, the secured party should take steps to do so. This includes obtaining independent evidence of valuation of the assets, such as appraisals. Further, if the debtor did not already go through a marketing and sales process that can be documented, the secured party should also consider asking a cooperative debtor to go through such a process before the secured party provides notice of the UCC foreclosure sale.

**An Undersecured Secured Party and Third Party Buyer Can Further Mitigate Risk**

## **TOO MUCH OF A TIME COMMITMENT?**

### **CONNECT WITH OTHER MEMBERS OF THE UCC OR COMFIN COMMITTEES?**

If so, submit an article for possible publication in a future issue of the Commercial Law Newsletter. Publishing an article with the Commercial Law Newsletter is a great way to get involved with the UCC Committee and the ComFin Committee. Articles can survey the law nationally or locally, discuss particular UCC or Commercial Finance issues, or examine a specific case or statute. If you are interested in submitting an article, please contact one of the following Commercial Law Newsletter Editors [Glen Strong](#), [Celeste B. Pozo](#), [Hilary Sledge](#), [Christina B. Rissler](#), [Suhuyini Abudulai](#) or [Harold J. Lee](#).

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In addition to taking the steps noted above, the circumstances facing the parties can mitigate fraudulent transfer and successor liability risk. For example, having an undersecured (preferably significantly undersecured) secured party can rebut an assertion that the price obtained at the UCC foreclosure sale (private or public) was too low. To illustrate the point, assume that the secured party, with a blanket lien on the debtor's assets, is owed \$1 million, and proposes to sell the assets to a buyer in a private sale for \$500,000. A creditor of the debtor seeking to avoid the sale as a fraudulent transfer could not show any damages unless the value of the assets exceeded \$1 million. Even if the assets were worth \$250,000 more than the sales price (and any additional value up to \$1 million), that extra value would go to the secured party since the secured party's lien was for \$1 million. The fact that the secured party is willing to take a discount, and preferably a significant discount, is good evidence to rebut an unhappy creditor's assertion that the sales price was too low.

Another relevant circumstance is whether the buyer is an insider of the debtor or a third party. Since one of the typical primary factors under state law in determining whether a buyer of assets will have successor liability for the claims of creditors against the debtor is whether there is common ownership between the buyer and the debtor, a sale to an insider of the debtor is more risky than a sale to an unrelated third party.

While a sale to an insider should not automatically preclude the parties from consummating a sale of assets through a UCC foreclosure sale, especially if, for example, the secured party is significantly undersecured and the sale is accomplished through a public sale, the parties should also consider alternatives that involve a third party fiduciary, such as an assignee in an assignment for the benefit of creditors, analyzing and approving the transaction.

### **No "Clear Channel" Risk in a UCC Foreclosure Sale**

As discussed below in note 94, if there are liens junior to the lien of the foreclosing secured party and the junior creditors do not consent to the sale of assets free and clear of their liens, at least in the Ninth Circuit there is a risk that the buyer cannot acquire the assets free and clear of junior liens in a bankruptcy sale. This risk does not exist in a UCC foreclosure sale because a UCC foreclosure sale extinguishes not only the lien of the foreclosing secured party,<sup>21</sup> but also all liens junior thereto.<sup>22</sup>

### **Timing of the Risk – Before or After the UCC Foreclosure Sale**

In a sale under § 363 of the Bankruptcy Code, objections and challenges to the sale are made prior to the approval and closing of the sale. If the buyer does not like the form of order that the bankruptcy court is willing to give, the buyer need not close the sale, assuming that one of the buyer's conditions to close is a court order in form and substance acceptable to the buyer.

UCC foreclosure sales typically are different. Except for the bankruptcy and injunction risks discussed below, challenges to the sale come after the parties already have consummated the sale. While unwinding a sale or obtaining damages may be more difficult to accomplish than preventing the sale in the first place, a buyer stands to lose more to a successful challenge after the sale has closed. If the successful challenge is made before the sale closes, the buyer loses only its due diligence investment. If the successful challenge is made after the sale closes, the sale could be unwound or the buyer could be liable for claims against the debtor. Moreover, since a UCC foreclosure sale is not a judicial proceeding, the buyer does not obtain a court order approving the sale. This does not mean that a buyer should never acquire assets through a UCC foreclosure sale. Each set of facts should be evaluated carefully to determine the best mechanism for effectuating the sale.

### **The Involuntary Bankruptcy Risk**

Since prior notice is required for both private and public foreclosure sales, creditors of the debtor who obtain notice of a UCC foreclosure sale will have the opportunity to place the debtor into involuntary bankruptcy. While placing the debtor into bankruptcy would prevent the UCC foreclosure sale from proceeding, the parties could still attempt to consummate their sale in bankruptcy or after the bankruptcy is dismissed, if they are able to obtain a dismissal of the bankruptcy.<sup>23</sup>

### **The Voluntary Bankruptcy or Injunctive Relief Risk**

As noted above, a UCC foreclosure sale is often difficult, if not impossible, with an uncooperative debtor since the debtor's cooperation is required to transfer possession of the assets to the buyer. However, in a sale of intangible property, such as patents or

other intellectual property, the cooperation of the debtor may not be necessary. An uncooperative debtor, however, will still receive notice of a UCC foreclosure sale. Based thereon, a risk exists that the debtor will file voluntary bankruptcy, which will prevent the UCC foreclosure sale from proceeding. The debtor could also seek injunctive relief to prevent the sale from proceeding.

### **Inability to Assume and Assign Contracts and Leases**

In a sale under § 363 of the Bankruptcy Code, with certain exceptions, a debtor can assume and assign contracts and leases even over the objections of the counterparties to the contracts and leases. In a UCC foreclosure sale, contracts and leases cannot be assigned without the consent of the counterparties thereto.

### **Conclusion**

A UCC foreclosure sale can be a viable option to effectuate the sale of distressed assets when there is a secured party with a lien on the assets to be sold. As discussed herein, there are benefits and drawbacks to UCC foreclosure sales when compared with other alternatives, such as bankruptcy sales. While a UCC foreclosure sale will not always be the best option, it can be under the right circumstances. The constituents, including the debtor, secured party and buyer, should evaluate each contemplated sale on the facts. Under the right circumstances, a UCC foreclosure sale can be a comparatively inexpensive, efficient and quick means of transferring distressed assets.

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## **SOLAR SAVVY: THE COMMERCIAL LAWYER'S PRIMER TO SOLAR FINANCE<sup>24</sup>**

By Shadi J. Enos

### **I. Introduction**

While solar power has long been a centerpiece of environmental law discussions, it has only recently emerged as a prominent topic in commercial finance law discussions. This is due in large part to the considerable increase in solar power commercial transactions over the past several years. In 2012 alone, the clean energy sector leveraged over \$44 billion in commercial investments in the United States.<sup>25</sup> By the end of 2013, experts project that a new solar power project will have been installed every four minutes.<sup>26</sup> Much of this growth has been driven by government tax and cash incentives that have made the installation of photovoltaic systems ("PV Systems") more affordable in both residential and commercial settings. In fact, one study shows that in 2006, when the government increased a tax credit offered to PV System owners, known as the Investment Tax Credit, from 10% to 30%, annual PV System installations grew by over 3,000%.<sup>27</sup> As the industry continues to gain momentum, commercial lawyers practicing in the areas of tax, corporate, commercial finance, project finance and bankruptcy will benefit from gaining a working knowledge of solar financing transactions. To that end, this article is intended to acquaint unfamiliar practitioners with solar power transactions by providing a systemic overview and highlighting the key concepts and terminology used in such transactions. This article is not intended to analyze all of the legal intricacies or limitless variations of deal structures; rather it is intended to provide readers a high-level explanation of how solar tax equity transactions work.

The article begins with a summary of the principal government tax incentives and explains how the private sector has created a secondary market to monetize these incentives by entering into complex tax equity transactions.

### **II. Government Incentives**

There are three main government incentives applicable to financing PV Systems – (1) the Investment Tax Credit, (2) the 1603 Cash Grant, and (3) the Modified Accelerated Cost Recovery System.

#### **A. Investment Tax Credit**

The Investment Tax Credit (the "ITC") is a tax credit allowance for PV System owners that reduces dollar-for-dollar the federal income taxes such PV System owner would otherwise have to pay.<sup>28</sup> The ITC was originally enacted in 1978 under the Energy Tax Act,<sup>29</sup> but was expanded in 2005 under the Energy Policy Act<sup>30</sup> and again in 2009 under the American Recovery and Reinvestment Act.<sup>31</sup> At present, the ITC provides qualifying taxpayers a tax credit that is equal to 30% of the capital costs of a commercial or residential PV System placed into service before January 1, 2017 and a tax credit equal to 10% of the capital costs for systems placed into service on or after January 1, 2017.<sup>32</sup> Title 26 of the United States Code (the "Tax Code") under Section 25D (for residential property) and Section 48 (for commercial property) more fully sets forth the conditions to the allowance of the ITC. Minimally, a PV system must be owned by the entity claiming the tax credit and must be placed into service in the United States to qualify. The success of the ITC is evidenced by the statistic that "[a]pproximately 90 percent of the nearly 5,000 megawatts of solar capacity in the U.S. today has been installed since the ITC was increased at the beginning of 2006."<sup>33</sup>

## **B. 1603 Cash Grants**

While the ITC is the primary solar tax incentive, the government has employed a variety of alternative incentive programs as well. One of the more successful programs was the cash grant that Congress enacted in 2009 under section 1603 of the Tax Code (the “1603 Cash Grant”),<sup>34</sup> which infused approximately \$3.9 billion into the solar industry<sup>35</sup> and allowed the market to leverage approximately \$7.2 billion in private investments.<sup>36</sup> The 1603 Cash Grant allowed a PV System owner to opt for a cash payment from the Department of Treasury in place of the tax credit under the ITC. With some limited exceptions, PV System owners could qualify for the 1603 Cash Grant only if they commenced construction on or prior to December 31, 2011 and complete construction by December 31, 2016.<sup>37</sup> While the 1603 Cash Grant has now expired, there is a push to bring back the grant to help smaller installation projects that have neither the scale nor the expertise to fully monetize the ITC credits. The incentive amount under the 1603 Cash Grant was comparable to the ITC but because the 1603 Cash Grant was issued in the form of a payment from the government rather than a tax credit, the PV System owner did not need to have taxable liability to monetize the incentive. Even if a PV System owner had no taxable income for a particular year, the owner would still be able to receive the cash payment from the Department of Treasury. In contrast, if the same PV System owner was attempting to use the ITC, the owner would have no taxable income against which the ITC could be applied. For that reason, the 1603 Cash Grant was primarily used for smaller development projects.

## **C. MACRS**

The government has provided a third incentive to PV System owners in the form of an income tax deduction which taxpayers may claim by depreciating the value of the PV System in accordance with the Tax Code. The IRS classifies PV Systems as five-year properties and allows for depreciation over a 6-year period under the Modified Accelerated Cost Recovery System (“MACRS”).<sup>38</sup> As an added incentive, Congress enacted the Economic Stimulus Act in 2008 which provided an additional 50% “bonus depreciation” for the first year a PV System was placed into service.<sup>39</sup> Collectively, these incentives allow taxpayers to accelerate the depreciation of a PV System when calculating their annual income taxes. To qualify for the bonus depreciation, (i) the PV System must have a recovery period of 20 years or less under normal federal tax depreciation rules; (ii) the original use of the PV System must commence with the taxpayer claiming the deduction; and (iii) the PV System must have been acquired and placed into service during the period from 2008 to 2013.

## **III. Tax Equity Structures**

The rapid expansion of the solar industry in the United States since 2005 is due in large part to the implementation of the government incentives discussed above. However, with the high capital costs of PV Systems and the industry still being in its infancy, many developers have been unable to fully utilize tax credits due to having insufficient taxable income. This has created an opportunity for tax equity investors. In recent years, a secondary market has burgeoned, allowing investors with steady annual profits to use the tax credits generated by PV Systems in exchange for providing working capital to the developers.

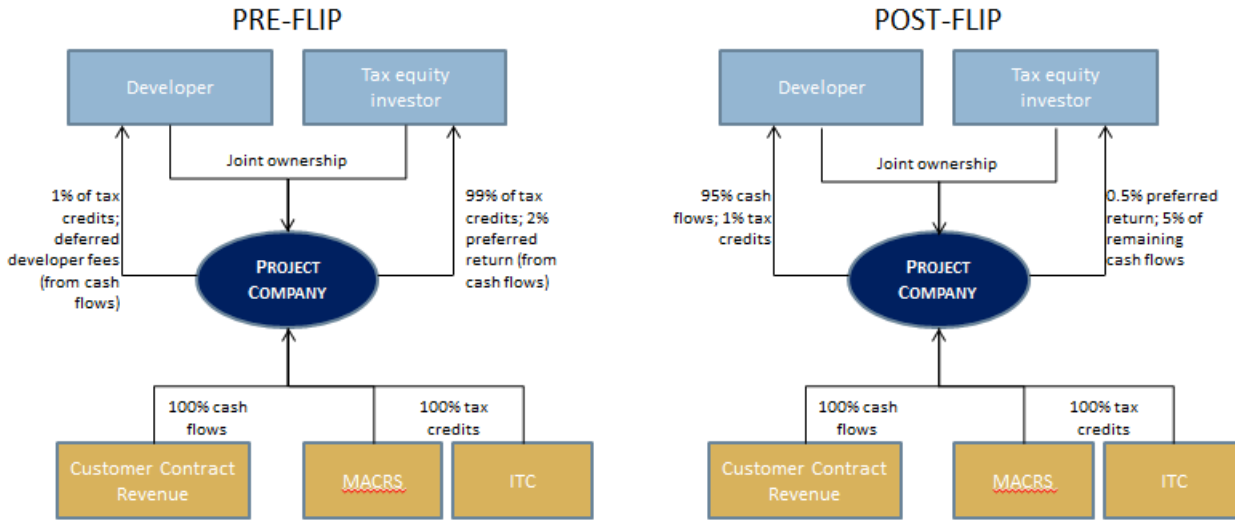
There are three main structures in use among today’s tax equity investors – the Partnership Flip, the Sale Leaseback and the Inverted Lease. While the methods may vary, the goals remains the same – get the tax incentive into the hands of a taxpayer who can benefit from the incentive and get upfront working capital to the developers.

### **A. Partnership Flip**

In a partnership flip, the tax equity investor and the developer co-invest in a special purpose vehicle (the “SPV”), which is typically a limited liability company, that will own the PV System. Both the tax incentives and proceeds from customer payments are issued to the SPV and upstreamed to the developer and tax equity investor in pre-negotiated allocations. Then, at a pre-determined point, the allocations change, or “flip.” Because of the dual nature of these allocations, partnership flip transactions have two stages: the pre-flip stage and the post-flip stage.

During the pre-flip stage, the tax equity investor is entitled to the majority of the tax credits (typically 90% or higher). During the post-flip stage, the tax credits are typically allocated in accordance with the ownership interests of the SPV (commonly 5% to the tax equity investor and 95% to the developer). The timing of the flip varies depending on the deal terms, with some deals aligning the flip date with a fixed number of years (typically 5 years) and others utilizing a “yield-contingent” approach.<sup>40</sup> In a yield contingent approach, the flip happens after the tax equity investor has attained an agreed-upon internal rate of return. Below is a schematic summary of the pre-flip and post-flip stages of a partnership flip transaction. On or after the flip-date, the developer is usually permitted to purchase the tax equity investor’s interest in the SPV at fair market value.

Figure 1: The Partnership Flip (using a 5-year flip model)



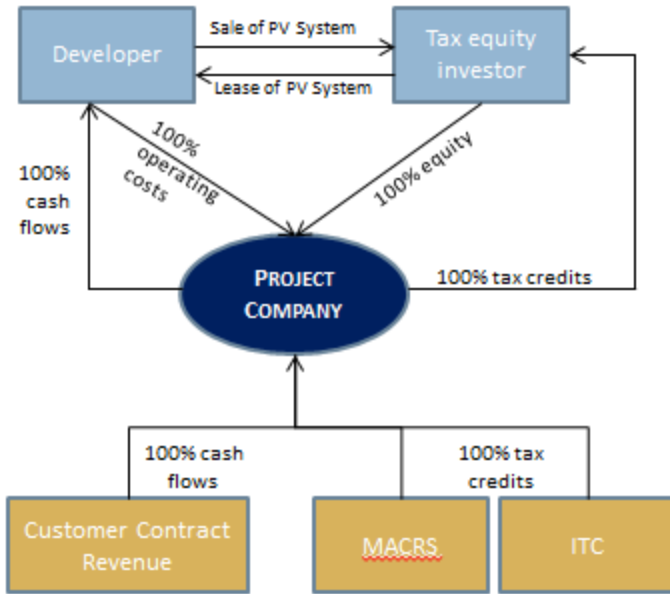
### B. Sale Leaseback

Under a sale leaseback transaction, the developer first sells the PV System to the tax equity investor and then simultaneously will lease back the same system pursuant to a lease agreement. Unlike partnership flip transactions, in these transactions there is no jointly owned SPV that retains the PV System. Instead, the tax equity investor will own 100% of the entity that retains the PV System (in the schematic below, such entity is referred to as the project company). Since this project company (a wholly owned subsidiary of the tax equity investor) is the owner of the PV System, it is entitled to the ITC and other tax incentives. On the other hand, 100% of the customer cash flows will be directed to the developer (as the lessee), who will then pay the tax equity investor lease payments in an amount equal to the customer cash flow receipts minus the operating costs. Because of their historical involvement in New Markets Tax Credits, commercial banks and institutional lenders tend to be more familiar with the sale leaseback structure than the partnership flip structure and often express a preference for the former structure. A new tax equity investor should be careful, however, to ensure the structure satisfies the Tax Code's firm rules on whether a transaction amounts to a "true lease."

In most sale leaseback transactions, the developer will have the option to purchase the PV System in connection with an "early buyout." While the price and timing of an early buyout is negotiated, it is not uncommon to see the option arise between years 7-12 of the lease.



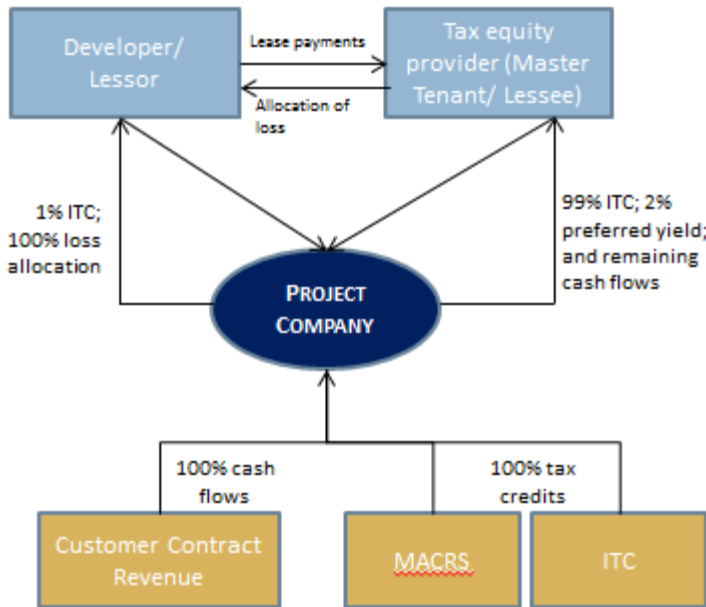
Figure 2: Sale Leaseback Structure



**C. Inverted Lease**

In the inverted lease structure (also known as the “lease pass-through” structure) the developer maintains ownership of the PV System and leases it to the tax equity investor. In this regard, the lease is “inverted” or the reverse of the sale leaseback structure where the tax equity investor was the lessor. Similar to the sale leaseback structure, however, the lease payments are calculated based on the receipt of the customer cash flows. According to Bloomberg New Energy Finance, a “typical structure has the lessee (investor) retaining a 2% preferred yield and 5% of the project’s cash flows.”<sup>41</sup> The benefits of the tax credits are then assigned (or passed through) to the tax equity investor. Typically, in an inverted lease structure, the lessee (a subsidiary of the tax equity investor) will have an ownership interest in the lessor (a subsidiary of the developer). One of the benefits of being partial owner is that a tax equity investor may be allocated a portion of a project’s losses which can be used to offset profits that a tax equity investor may have acquired from other business ventures, thus lowering the tax equity investor’s overall tax liability.<sup>42</sup>

Figure 3: Inverted Lease Structure



#### IV. Conclusion

The three primary tax equity transaction structures discussed above demonstrate how the private commercial sector, with the aid of clever commercial law practitioners, has been able to cultivate a secondary market to monetize government tax and cash incentives afforded to PV System owners. While the transaction structures utilized by the investors and developers to capture solar power tax incentives can be complex, commercial law practitioners should endeavor to become familiar with the general concepts and terminology as the industry continues to grow and as new players such as national commercial banks, Fortune 500 companies and hedge funds line up to become tax equity investors.

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## A LOOK BACK AT THE IMPACT OF THE 2010 AMENDMENTS ON THE UCC FILING PROCESS

By [Paul Hodnefeld](#)

The uniform effective date of the 2010 Amendments to UCC Article 9 (the “Amendments”) has come and gone. The transition went smoothly for most filing offices and for those who file UCC records. There were, however, a few surprises. Some filing issues arose, not because of any defect in the Amendments, but for other reasons. This article will recap those issues, focusing on the enactment status nationwide, misunderstandings of form requirements, and the compatibility of filing office computer systems.

### The Amendments are not in effect everywhere

The Amendments took effect in most states on the uniform effective date of July 1, 2013. A few states, however, failed to put the Amendments in effect by that date. Missouri, for example, enacted the Amendments with a delayed effective date of August 28, 2013.

Other states never got that far. The legislatures of Alabama, Arizona, Oklahoma and Vermont all adjourned for 2013 before enacting the Amendments. Those states will need to start the enactment process over again during the 2014 legislative session. The New York Legislature introduced a bill to enact the Amendments just days before the uniform effective date and then promptly went into recess and left the bill pending in committee. The original bill text provided for a July 1, 2013 effective date. The legislature will likely amend that provision to an effective date sometime in 2014 when it returns from recess. California enacted the Amendments when the governor signed the legislation on October 4, 2013. However, the bill does not take effect until July 1, 2014. The current text may change before that time as wrangling continues over the issue of individual debtor name sufficiency.

The official text of the Amendments offers two legislative alternatives governing the sufficiency of individual debtor names in § 9-503. Alternative A requires a financing statement to provide the name indicated on the debtor’s driver’s license. Alternative B provides that the name indicated on the driver’s license is sufficient as a safe harbor, but other names may also be sufficient. Alternative A became the majority rule for states that enacted the Amendments. Only a handful of states, Alaska, Colorado, Connecticut, New Hampshire, Oregon and Wyoming, enacted Alternative B.

The bill enacted by California adopts neither Alternative A nor B. Instead, the bill provides that the financing statement is sufficient only if it provides either the individual name of the debtor, which is the current law, or a safe harbor consisting of the surname and first personal name of the debtor. It omits any mention of the debtor’s driver’s license. Consequently, advocates on both sides of the Alternative A versus Alternative B debate may try to amend the new law to add a driver’s license alternative before it takes effect.

The U.S. Virgin Islands still has not introduced legislation to enact the Amendments. A bill is expected sometime during this legislative session. The current session runs through the end of 2014, so it could be a while before the legislature passes the Amendments.

Those who file UCC records must recognize that a few states will not have the Amendments in effect for at least the next several months. Filers need to comply with the pre-Amendments law when filing in those jurisdictions. That will require the filer to provide the organization information required by § 9-516(b)(5)(C), if applicable, and to use the older form versions when filing written records.

### Other form issues

The forms designed to implement the Amendments are those set forth as either text or images in the official text of § 9-521. Those forms carry a revision date of April 20, 2011 (the “new forms”).

The filing officers’ professional organization, the International Association of Commercial Administrators (“IACA”), participated in the form design process and also approved the new forms for nationwide use. After approval, IACA added one small indication to the bottom of each form, “International Association of Commercial Administrators (IACA),” to confirm that these were the official

versions of the forms. IACA then made fillable PDF versions available to the state-level filing offices and posted the forms to its website.

To help filers transition to the new forms, most filing offices allowed a 30-day or longer grace period after the Amendments took effect during which they would accept prior versions of the forms. As a result, there were a number of different form versions in use during July, including the new forms, the original 1998 revision § 9-521 forms, other forms approved by IACA, and various forms designed for use in specific states. The number of different form options sometimes confused those who file UCC records.

Any uncertainty filers had about the forms largely disappeared once the grace periods started to expire. After that time, a filer's only option was to use the new forms when filing in states where the Amendments were in effect. Some filing offices, however, especially at the county level, began to question which form versions they could accept after the grace periods ended. The result was that a few county filing offices decided they had to reject records submitted using the new forms. County filing offices tend to follow the lead of their state-level counterparts, usually the secretary of state or equivalent office, when it comes to form approval. Most state filing offices provided announcements regarding the new forms and either posted fillable PDF versions of the new forms or linked directly to the new forms posted on the IACA website.

Not all the state filing offices, however, mentioned the new forms on their websites. Several states approved their own alternative form designs. A few of those state-level filing offices posted only the alternative forms for use by the public. While the state filing offices intended to accept their own alternative forms *in addition to* the § 9-521 new forms, they did not always make that clear in the instructions posted on their websites. When county filing offices looked to the state filing office website for guidance and found only the alternative forms, some assumed those were the only forms they could accept. As a result, a few county filing offices began to reject written records submitted using any other versions, including the new forms. Fortunately, most county recorders quickly learned the correct rules and adjusted their practices accordingly. By mid-September, the problem had mostly disappeared.

To a lesser degree, state-level filing offices also struggled with acceptable form versions. Sporadic state-level rejections occurred because the new rules were not always fully communicated to filing office personnel. Moreover, several states had adopted non-uniform versions of § 9-521 that left form approval to the filing office or other state authority.

Keeping track of the form versions and non-uniform provisions led to isolated rejections by state UCC filing offices. For example, more than one filing office rejected the new forms because the revision date was prior to 2013 and these were actually old pre-effective date versions.

The use of unofficial forms further complicated the issue. Many UCC filers prefer to integrate form preparation into their word processing and document management software. The new forms, however, were designed and created as PDFs using Adobe products. They never officially existed in any other format. To integrate the new forms into document management systems, they had to be converted into a word processing format. Therefore, some enterprising UCC filers attempted to recreate or "clone" the PDF forms in Word or WordPerfect format. Many had successfully done this before with earlier versions of the forms. Some of the new cloned forms were nearly indistinguishable from the approved forms. However, many had differences in font styles, text sizes or field layouts. Any departure from the exact field and text layout can create processing issues for some state computer systems.

Shortly after the Amendments took effect, the Texas Secretary of State's office began to receive cloned forms that deviated from the approved form and format. Initially, most of these non-compliant forms lacked the IACA text at the bottom. The state filing office did not want to scrutinize every written record to determine whether it was a clone. Because most of the cloned forms lacked the IACA text, the filing office decided to reject *all* new forms submitted without that indication. The filing office relied on the non-uniform Texas version of § 9-521 that allowed the Secretary of State to designate what industry standard forms filing offices in the state must accept. That policy is still in force, but is currently under review and could change later this year.

In contrast, one state-level filing office was, for a brief time, rejecting new forms *with* the IACA text at the bottom. The filing office rationale was that the new forms set forth in the official text of the Amendments lacked that indication. However, the filing office quickly determined that new forms with the IACA indication were otherwise identical to those without the indication and changed its rejection practices.

Filing offices will continue to have authority to reject cloned forms that deviate, even slightly, from the official form layouts. However, filers generally don't have to worry about subtle non-substantive differences between the new forms set forth in the official text of the Amendments and those available from IACA or the state filing offices. Nearly all filing offices nationwide will accept the new forms, with and without the IACA text. The Texas Secretary of State's office remains the possible exception. To be safe, filers should only submit the IACA-approved forms when filing in Texas until the state filing office announces a change in its policy.

## Filing office electronic filing systems

The Amendments' impact was not limited to written forms. Many state electronic filing and UCC management systems were also affected. State filing office UCC computer systems had been programmed to comply with Article 9 as enacted prior to the Amendments. These systems required some small upgrades to be fully compatible with changes to the statute and forms.

Many state filing offices, however, failed to complete upgrades by July 1, 2013. In fact, the UCC systems in more than 20 states were not fully compatible with the Amendments on the effective date. While many states were able to upgrade their systems within a month or two after the Amendments took effect, a small number may take much longer.

Initially, a few state systems continued to reject records that lacked the debtor organization information required by former § 9-516(b)(5)(C). In most cases, filing offices were able to make minor programming fixes that quickly resolved the issue. Otherwise, the only records potentially affected were those required to indicate that the collateral is being administered by a personal representative or that the collateral is held in a trust. Filers who must make those indications may not be able to file electronically with state filing offices that have not upgraded their systems.

Fortunately, continued use of the old systems had very limited impact and poses no risk with most transactions. In other cases, the solution is simple. If the jurisdiction has not yet upgraded its UCC electronic filing system, the filer should comply with the new indication requirements by submitting a written record using the new forms.

## Conclusion

The transition to the new rules was trouble-free for most filing offices and those who file UCC records. Some unanticipated issues arose over effective dates, form versions and computer capabilities, but these were of a relatively minor nature and did not affect most filing activity. Most of the issues have been resolved. A few state computer systems still await programming upgrades, but only a small number of records are potentially affected and the risks can be avoided simply by filing written records in those situations.

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## KNOW YOUR VARIETIES OF GOOD FAITH: LESSONS FROM RECENT RULINGS BY THE DELAWARE SUPREME COURT

By [Tammy L. Mercer](#) and [John J. Paschetto](#)

The duty of good faith plays an uncharacteristically prominent role in the world of Delaware limited partnerships (“LPs”) and limited liability companies (“LLCs”). While the fiduciary duties of care and loyalty generally take center stage in the governance of Delaware corporations, those and other fiduciary duties can be—and frequently are—restricted, redefined, or entirely removed by the terms of LP and LLC operating agreements. Only the implied contractual covenant of good faith and fair dealing may not be eliminated, with the result that the implied covenant’s reach, and the meaning of “good faith” more generally, have drawn increasingly close attention from plaintiffs and the courts in cases involving Delaware alternative entities.

So far, 2013 has been an active year for judicial guidance regarding good faith. In five opinions, the Delaware Supreme Court (the “Court”) has addressed the interplay of provisions in LP agreements that purported to limit or eliminate the liability of a partner (and in some cases of the partner’s affiliates) for breach of an express contractual duty of good faith or breach of the implied covenant of good faith. Those cases, listed here in the order they were decided, are *Norton v. K-Sea Transportation Partners L.P.*, 67 A.3d 354 (Del. 2013); *Brinckerhoff v. Enbridge Energy Co.*, 67 A.3d 369 (Del. 2013); *Gerber v. Enterprise Products Holdings, LLC*, 67 A.3d 400 (Del. 2013); *Allen v. Encore Energy Partners, L.P.*, 72 A.3d 93 (Del. 2013); and *DV Realty Advisors LLC v. Policemen’s Annuity & Benefit Fund*, No. 547, 2012, 2013 Del. LEXIS 430 (Del. Aug. 26, 2013) (to be published in A.3d).<sup>43</sup>

Taken together, these opinions analyze contractual duties of good faith in terms of two classifications that will be helpful to practitioners drafting or interpreting operating agreements of Delaware LPs or LLCs. First is the distinction among an express contractual duty of good faith, the common-law fiduciary duty of good faith, and the implied covenant of good faith. Second is the distinction between a subjective standard of good faith and an objective standard.

Regarding the subjective/objective distinction, the Court has clarified what language will invoke one standard or the other, and has indicated the paths available for establishing a breach under the subjective standard. Direct evidence of a defendant’s bad intent is not

always required. Instead, a breach under the subjective standard can also be inferred from actions so far beyond the bounds of reasonableness that nothing other than a failure of good faith could explain them. Finally, the express duty/implied covenant distinction has bite when an operating agreement provides that a partner's good faith will be "conclusively presumed" under specified circumstances. While (as one would expect) such a provision may protect a partner against a claim of having breached an express contractual duty of good faith, it will not preclude a claim based on the implied covenant that LP and LLC agreements may not avoid.

### Five Similar Cases

All of the aforementioned cases involved Delaware limited partnerships. Four of them (*Gerber*, *K-Sea*, *Enbridge*, and *Encore*) involved publicly traded master limited partnerships. In each of those four cases, the plaintiff asserted that the general partner and certain of its affiliates had breached an express contractual duty of good faith and the implied covenant of good faith and fair dealing. In the sole case not involving a master limited partnership (*DV Realty*), the plaintiff limited partners sought a declaratory judgment that their removal of the general partner complied with an express contractual duty of good faith.

In *Gerber*, *K-Sea*, *Enbridge*, and *Encore*, the Delaware Court of Chancery dismissed all claims against all defendants.<sup>44</sup> In *DV Realty*, the court found after a trial that the limited partners did not breach the LP agreement's express good faith requirement. Each case was appealed, setting the stage for the present quintet of good faith opinions by the Delaware Supreme Court.

### Four and a Half Affirmances

In *Gerber* and *K-Sea*, the Court affirmed the dismissal of the express-duty claims against all defendants. The plaintiffs' claims of breach of express contractual duties of good faith could not be sustained because the governing agreement in each case afforded the defendant partner a conclusive presumption of good faith if the partner relied on an expert opinion, which the partner had done. Importantly, however, the Court refused to affirm the dismissal of the implied covenant claim asserted in *Gerber*. A presumption of good faith rooted in an express contractual provision (the Court held) could not preclude such a claim.

In *Enbridge* and *Encore*, the Court did not address the contract terms providing for a conclusive presumption of good faith.<sup>45</sup> Instead, in both cases, the Court affirmed the trial court's dismissal because the plaintiffs had failed to adequately plead that the defendant partners did not act in good faith. Likewise, in *DV Realty*, the Court affirmed the trial court's declaratory judgment for the limited partners, based on the limited partners' showing that they had determined in good faith that removal of the general partner was necessary.

In each of the cases, the Court's decision turned on the specific language of the relevant LP agreement. The centrality of contract interpretation in these cases "is not surprising," the Court explained in *DV Realty*, "because the Delaware Revised Uniform Limited Partnership Act [DRULPA] is intended to give 'maximum effect to the principle of freedom of contract.'"<sup>46</sup>

### The "Good Faith" Provisions in the Underlying LP Agreements

The relevant provisions in the LP agreements at issue in *Gerber* and *Encore* were substantially similar. Each agreement required that when the general partner "makes a determination or takes or declines to take any other action, or any of its Affiliates causes it to do so . . . [the general partner], or such Affiliates causing it to do so, shall make such determination or take or decline to take such other action in good faith."<sup>47</sup> Each LP agreement defined good faith as "a belief that the determination or other action is in the best interests of the Partnership."<sup>48</sup> Further, each LP agreement gave the general partner the benefit of a conclusive presumption of good faith if the general partner acted "in reliance upon the opinion . . . of such Persons as to matters that [the general partner] reasonably believes to be within such Person's professional or expert competence."<sup>49</sup> Each agreement also contained a provision that exculpated the general partner and its affiliates from monetary liability unless they acted in bad faith or engaged in fraud, willful misconduct, or a criminal act with knowledge that the act was criminal.<sup>50</sup>

The relevant contractual provisions in *K-Sea* were similar to those in *Gerber* and *Encore*, except for two critical differences. First, the *K-Sea* agreement's express good faith provision contained a reasonableness requirement. It provided that in taking any action (including approval of a merger), the general partner must "reasonably believe that its action is in the best interest of, or not inconsistent with, the best interests of the Partnership."<sup>51</sup> Further, the *K-Sea* agreement exculpated the general partner and its affiliates from liability for action taken in good faith.

Second, unlike the LP agreements in *Gerber* and *Encore*, the *K-Sea* LP agreement did not define "good faith." The Court therefore determined its meaning. Looking at the entire agreement and its "overall scheme," the Court found that "good faith" as used in the agreement should be defined in a manner consistent with the agreement's approval provision. In other words, "good faith" meant a *reasonable* belief that the general partner's actions were in the best interests of the LP or not inconsistent with the best interests of the LP.<sup>52</sup> But the *K-Sea* agreement resembled those in *Gerber* and *Encore* in providing for a conclusive presumption that the general partner acted in good faith if it relied upon "the opinion . . . of such Persons as to matters that [the general partner] reasonably believes to be

within such Person's professional or expert competence."<sup>53</sup>

The LP agreement in *Enbridge* differed slightly from those in *Gerber*, *K-Sea*, and *Encore* in that it did not contain a provision expressly requiring the general partner to act in good faith. Rather, it provided that the general partner and its affiliates could engage in a self-interested transaction so long as the transaction was "fair and reasonable" to the partnership.<sup>54</sup> Similar to the agreements in *Gerber*, *K-Sea*, and *Encore*, however, it did exculpate the general partner and its affiliates from liability for any acts taken in good faith.<sup>55</sup> And it, too, contained a provision that gave the general partner the benefit of a conclusive presumption of good faith when the general partner acted in reliance on the opinion of a professional or expert.<sup>56</sup>

Finally, in *DV Realty*, the LP agreement gave the limited partners a right to remove the general partners, provided that they had made a good faith determination that removal was in the best interest of the partnership.<sup>57</sup> Like the agreement in *K-Sea*, the *DV Realty* agreement did not define "good faith." Here, based on the context in which "good faith" was used, the Court found the parties intended it to mean conduct that would not be outside the protection of the business judgment rule. Thus, a failure to act in good faith would involve "an action 'so far beyond the bounds of reasonable judgment that it seems essentially inexplicable on any ground other than bad faith.'"<sup>58</sup>

### The Implied Covenant vs. Express Duties of Good Faith

In *Gerber* the Court explained important differences between the good faith of the implied covenant and the good faith required by an express contractual term. These differences stem from the temporal scope of a court's inquiry. An express contractual duty to act in good faith (like the common-law fiduciary duty of good faith) "looks to the parties as situated at the time of the wrong."<sup>59</sup> A court examines whether, at that point, the defendant owed the plaintiff a duty, what the defendant's obligations were under that duty, and whether the defendant breached those obligations. The temporal focus in such an analysis is thus on the parties' relationship at the time of the purported breach. In an implied covenant case, on the other hand, a court looks at the underlying contract and what the parties considered at the time they entered into it. The court asks what the parties would have agreed to when they entered into the contract if they had considered the now-disputed issue. Likewise, in an implied covenant case, a court's threshold question is not whether the defendant acted "fairly" in carrying out the challenged act or transaction. It asks instead what the parties "would have agreed upon had the issue arisen when they were bargaining originally."<sup>60</sup>

Significantly, the Court in *Gerber* then answered a question that had, until this case, not been definitively resolved under Delaware law—whether an implied covenant claim is barred when, under the express terms of the contract, the defendant is entitled to a conclusive presumption of good faith. The Court answered the question in the negative. It held that while an agreement may provide a procedure by which a party may conclusively establish that it satisfied the contract's express duty of good faith, such a procedure could not "operate retroactively to alter the parties' reasonable expectations at the time of contracting, and it [could not] be used to fill every gap in the [agreement]."<sup>61</sup> Parties can agree that they will be conclusively presumed to have acted in good faith if they take certain actions. But such a presumption may not be used as a means of circumventing the prohibition in the DRULPA (and in the Delaware Limited Liability Company Act) against eliminating the implied covenant of good faith and fair dealing.

### Subjective Good Faith vs. Objective Good Faith

In addressing the merits of the good faith claims in *Encore* and *DV Realty*, the Court provided further guidance on interpreting contract terms that expressly impose duties of good faith. The Court held that when an LP agreement imposes a duty of good faith accompanied by no reasonableness modifier, the "subjective" standard of good faith governs. Conversely, if an agreement requires a party to act in reasonable good faith, the "objective" standard will apply.

The *Encore* LP agreement required that when the general partner "makes a determination or takes or declines to take any other action, or any of its Affiliates causes it to do so," the general partner shall "make such determination or take or decline to take such other action in good faith."<sup>62</sup> The agreement defined "good faith" as a "*belie[f]* that the determination or other action is in the *best interests of the Partnership*."<sup>63</sup> Similarly, the *DV Realty* LP agreement required the limited partners to act in "*good faith* [to] determine that [removal of the general partners was] necessary for *the best interest of the [Limited] Partnership*."<sup>64</sup>

In both *Encore* and *DV Realty*, the Court interpreted the above language as invoking a subjective standard of good faith.<sup>65</sup> As the Court explained, the ultimate inquiry under this standard focuses on "the subjective belief of the specific [persons] accused of wrongful conduct."<sup>66</sup> The Court recognized that "it may be virtually impossible" for a plaintiff to adequately plead a defendant's state of mind.<sup>67</sup> For this reason, the Court refused to rule out judicial inferences of subjective bad faith from evidence tending to show the objective unreasonableness of an act.<sup>68</sup> Evidence of "objective factors" may be relevant under the subjective standard "to the extent they bear on the defendant's credibility when asserting [a subjective belief]."<sup>69</sup> Further, "[s]ome actions may objectively be so egregiously unreasonable . . . that they 'seem[] essentially inexplicable on any ground other than [subjective] bad faith.'"<sup>70</sup>

The Court juxtaposed the *Encore* agreement's unmodified good faith requirement to the requirement in *K-Sea*. In *K-Sea*, the LP

agreement gave the general partner broad discretion to act “so long as such action is reasonably believed by [the general partner] to be in, or not inconsistent with, the best interests of the Partnership.”<sup>71</sup> The *Encore* Court interpreted this language—with the decisive inclusion of “reasonably”—as imposing an objective standard of conduct.<sup>72</sup> Thus, to survive a motion to dismiss, the complaint’s well-pleaded allegations did not need to establish a subjective state of mind, but only that the general partner had “reason to believe that it acted inconsistently with the Partnership’s best interests.”<sup>73</sup> The Court held that the “unqualified” use of “believes” in the *Encore* agreement, as opposed to “reasonably believes” in the *K-Sea* agreement, rules out the objective standard that the *K-Sea* formulation requires.<sup>74</sup>

### The Reach of a Conclusive Presumption of Good Faith

As mentioned above, in both *Gerber* and *K-Sea*, the LP agreements contained provisions that entitled the general partner to a conclusive presumption of good faith when it acted in reliance on an opinion of an expert. The provisions creating the conclusive presumption did not expressly extend to the general partners’ directors, officers, or affiliates.<sup>75</sup> In each case, the general partner sought to obtain the benefit of the conclusive presumption by relying on an investment banker’s fairness opinion.<sup>76</sup> Moreover, in each case it was a committee that approved the transaction in reliance on the fairness opinion.<sup>77</sup>

The *K-Sea* plaintiffs argued that because the committee (and not the general partner as an entity) relied upon the fairness opinion, the conclusive presumption could not shield the general partner from liability.<sup>78</sup> The Court rejected this notion. It was “unreasonable to infer” that the general partner (itself an LP) did not rely on the opinion, since a committee of the board that ultimately controlled the general partner had relied on the opinion.<sup>79</sup>

The Court also suggested that when a general partner obtains the benefit of a conclusive presumption of good faith, contract claims against affiliates of the general partner may be foreclosed as well. The reliance by the general partner in *K-Sea* on the investment banker’s opinion shielded not only the general partner but also its affiliates, because the plaintiffs’ “only claim against the other defendants is that they caused [the general partner] to enter into the Merger. [The plaintiffs] cannot state a cognizable claim for relief against the other defendants for causing [the general partner] to take an action that did not breach [the general partner’s] duties under the LPA.”<sup>80</sup>

### Lessons for Commercial Lawyers

The five cases discussed here offer several guidelines for attorneys who are drafting or negotiating operating agreements for Delaware LPs or LLCs. **First**, agreement terms imposing an objective standard of good faith will be easier for a plaintiff to enforce than terms imposing a subjective standard. **Second**, the inclusion or absence of “reasonably” (or a comparable modifier) may determine whether an express good faith requirement is objective or subjective. **Third**, a party subject to an express contractual duty of good faith can obtain a substantial measure of protection with a provision entitling the party to a conclusive presumption of good faith if a specified procedure has been followed. **Fourth**, however, such a provision will not afford protection against a claim that the implied contractual covenant of good faith and fair dealing has been breached.

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## SECURITY INTERESTS IN LIFE INSURANCE POLICIES: DISCOVERING THE NORTH AMERICAN LANDSCAPE

By Amir Tajkarimi<sup>81</sup>

It is common practice amongst financial institutions to use insurance policies as collateral to secure loans. The process, commonly referred to as “leveraging,” is a means by which a borrower can access the cash value of the policy by offering the latter as security.

This article aims to offer the reader a comparative analysis of the legal framework in Canada and in the United States with respect to security interests in life insurance policies.

### 1. Quick Canadian Background

Canada is a bi-juridical country. The province of Quebec is governed by a civil code (“CCQ”) which has adopted the notion of a “hypothec” as the principal security device.<sup>82</sup> In contrast, the other nine provinces and three territories, which follow a common law and statutory framework, rely on their respective *Personal Property Security Act* (“PPSA”) which has replaced the numerous security interests that have come to be recognized under common law.<sup>83</sup>

Essentially, in Canada, financial institutions charge insurance policies through (i) a hypothec for Quebec and (ii) a collateral assignment in the other provinces and territories.

## 2. Common law governed jurisdictions

The PPSA was modeled on Article 9 of the *Uniform Commercial Code* (“UCC”) and contains a similar conceptual framework dealing with the attachment and perfection of security interest and the priority rules involving competing secured parties.<sup>84</sup> The first version of the PPSA was enacted and implemented by the legislature of the province of Ontario in 1976 (“OPPSA”) and will be the main version referred to in this article.

Section 4(1)(c) of the OPPSA states that it does not apply “to a transfer of an interest or claim in or under any policy of insurance or contract of annuity, other than a contract of annuity held by a securities intermediary for another person in a securities account.”<sup>85</sup> In other words, security interests in any insurance policy are excluded from the scope of the PPSA but only with respect to registration (perfection by filing).<sup>86</sup> Therefore, s.4(1)(c) exempts the secured party “from the need to register its interest under the [OPPSA].”<sup>87</sup> Consequently, the result of this exclusion from the OPPSA is that the ranking of a security interest “in or under any policy of insurance,” is no longer based on the OPPSA but rather “determined in accordance with non-Act law, which depends upon the order of giving notice to the insurer.”<sup>88</sup>

On the other side of the border, under Article 9 of the UCC, security interests in insurance policies are excluded and consequently issues related to the validity of interests and priority of payments are governed by applicable state law other than Article 9.<sup>89</sup> Essentially, “with the sole exception of health-care-insurance receivables, the revision [of Article 9] retains the effect of the existing rule under §9-104(g), which allows security interests in insurance claims only as ‘proceeds’.”<sup>90</sup> In other words, the collateralization of rights under a life insurance policy in order to secure a debt owed to a financial institution is not subject to Article 9.<sup>91</sup>

The exclusion of security interests in insurance policies is based “on the ground that the insurer maintains records of title and claims to policies and contracts issued by it and that there was no need for a separate registry.”<sup>92</sup> Therefore, it is not necessary to perfect such security interest under the OPPSA.<sup>93</sup>

Similarly, under the UCC, the rationale behind this exclusion is that “[such] transactions are often quite special, do not fit easily under a general commercial statute and are adequately covered by existing law.”<sup>94</sup>

### 2.1 Exception of Proceeds

Article 9 applies to proceeds of collateral. In fact, “the proceeds exception of section 9-109(d)(8) (and the meaning of exception is that Article 9 governs the transaction)”<sup>95</sup> has significant consequences on a secured party. “Suppose the debtor grants the secured party a security interest in her automobile. The automobile is damaged in an accident. Article 9 makes the insurance payable under the debtor’s insurance policy a proceed of the automobile collateral and the secured party has a security interest in it.”<sup>96</sup>

In the Canadian provinces and territories (except Quebec), despite the fact that a transfer of an insurance policy is not governed by the PPSA, “the payment of money in the form of a claim under the policy will be.”<sup>97</sup> Therefore, the exclusion of s.4(1)(c) does not encompass payment rights under a policy of insurance for loss of or damage to collateral.<sup>98</sup> Simply put, “an insurance policy other than one covering loss or damage to collateral, that provides for insurance payments to third party is not within the scope of the [PPSA].”<sup>99</sup> The difference between Ontario and the other common law provinces in Canada is that insurance proceeds are directly brought back within the scope of the PPSA. For example, s.4(c) of the Alberta PPSA provides the following:

4 Except as otherwise provided under this Act, this Act does not apply to the following:

(...)

(c) the creation or transfer of an interest or claim in or under any policy of insurance, except the transfer of a right to money or other value payable under a policy of insurance as indemnity or compensation for loss of or damage to collateral;

The OPPSA does not contain such language. Nevertheless, “section 25 and the s. 1(1) definition of “proceeds” in the Act support the inclusion of proceeds from an insurance policy within its scope.”<sup>100</sup>

To sum up, in Canada the transfer of an interest in an insurance policy is excluded from the PPSA in all common law provinces and territories; however, due to the fact that “proceeds” include the right to an insurance payment as indemnity, such proceeds fall within the scope of the respective provincial PPSAs and perfection in accordance with the PPSA rules is required.



## 2.2 Standard Practice

In Canadian provinces and territories except Quebec, a borrower (policy owner) can provide security for a loan by executing a collateral assignment. It is also encouraged to name the lender as additional loss payee with respect to the insurance policy. As assignee, the ownership rights of the policy do not vest upon the secured party. However, the latter can take measures in order to protect the value of its collateral and avert situations under the policy that would weaken its security interest. If the borrower defaults, the secured party can exercise its remedies and realize its security by recovering the cash value of the policy.

The landscape is very similar in the United States. Lenders will seek security in a life insurance policy by obtaining from the debtor a written collateral assignment of the policy. Moreover, the secured party does not become owner of the policy, that is, the latter “has no rights in the policy until the borrower defaults, at which time, the creditor’s interest in the pledged collateral may be used to satisfy the debt.”<sup>101</sup>

With respect to priority, standard industry practice in Canada and the United States dictates that the assignee that first provides notice to the insurance company will have priority. Nevertheless, it is important to mention that in *Rose v. AmSouth Bank of Florida*<sup>102</sup> the US Court of Appeals for the Second Circuit rendered a decision that followed a different tangent than the general race-notice practice. In fact, the Circuit Judges decided that despite the fact the plaintiffs (Mark S. Rose and Frederic G. Rose) failed to provide notice of their assignment to the insurer, under New York law, the plaintiffs’ valid first-in-time assignment was entitled to priority over defendant’s subsequent assignment. Therefore, “notice to the [insurer] is not required to preserve the priority of an earlier assignment.”<sup>103</sup>

## 3. Quebec

Under the CCQ, a hypothec is a real right on movable (personal) or immovable (real) property made liable for the performance of an obligation.<sup>104</sup> A hypothec can charge intangibles such as life insurance policies.<sup>105</sup> To that end, a debtor (whether a corporation or an individual<sup>106</sup>) can grant a *movable hypothec without delivery* (i.e.: without dispossession) on an insurance policy in order to secure a loan.

Like the common law governed collateral assignment, the movable hypothec does not involve the transfer of policy ownership. In fact, it establishes a security by providing the lender rights in the policy to the extent of the loan balance.

The possibility to create a hypothec “without delivery” on an insurance policy emanates from a reform that took place in 2009 in order to standardize and modernize secured transactions under the CCQ. Essentially, prior to January 2009, only “natural persons” (i.e.: individuals) operating a business and corporations were able to grant a movable hypothec “without delivery” on their “claims” (i.e.: accounts). Debtors (natural persons not operating a business) were not permitted to grant security on movable property in a non-possessory fashion, hence without delivery. Such debtors had to grant a “pledge,” which involved physical delivery of the encumbered asset to the secured party. However, the pledge was too restrictive and, to that end, articles 15.01 and 15.02 of the *Regulation Respecting the Register of Personal and Movable Real Rights* (“RPMRR Regulation”) were introduced. The latter were exceptions which allowed debtors (natural persons not operating a business) to grant a movable hypothec without delivery on, *inter alia*, incorporeal (intangible) property, claims and rights arising from an insurance contract.<sup>107</sup>

Unlike the PPSA regime, in order to create a valid movable hypothec without delivery, there is a mandatory formality that must be respected in Quebec: the existence of a written agreement. In other words, in common law provinces oral security agreements between a secured party and a debtor are recognized and enforced. It is only for third-party effectiveness that a written formality is imposed.<sup>108</sup> In Quebec, however, a written security agreement is required at all times, on pain of absolute nullity.<sup>109</sup> In addition, article 2697 CCQ states that the act constituting a movable hypothec (i.e.: the security agreement) must contain a sufficient description of the hypothecated property (i.e.: the insurance policy).

### 3.1 Enforceability

In general, a movable hypothec without delivery charging an insurance policy becomes effective against third-parties when it is published (i.e.: perfected by filing) at the *Register of Personal and Movable Real Rights* (“RPMRR”).<sup>110</sup>

However, in reality, the special rule of article 2461 CCQ overrides the general rule:

Art. 2461. The assignment or hypothecation of a right resulting from a contract of insurance may not be set up against the insurer, the beneficiary or third persons until the insurer receives notice thereof.

Where a right under a contract of insurance is subject to several assignments or hypothecations priority is determined by the date on which the insurer is notified.

Pursuant to the foregoing article, between two hypothecs on life insurance policy, the first not published and the second published, the first having notified the insurer and the second not, the special rule of article 2461 CCQ gives precedence to that for which the insurer was notified first. Consequently, it would seem that this article has the effect of displacing the general rule of publication with the notice to the insurer (as a form of perfection).<sup>111</sup>

To illustrate the context of the adoption of article 2461 CCQ, the comments of the Minister of Justice are relevant: (our translation)

- The assignment or hypothec of an insurance policy is enforceable from the moment when the insurer is notified.
- In case of multiple assignments or hypothecs, priority is given according to the date on which the insurer is notified.
- The prior concept of pledge is replaced by the more generic concept of hypothec.

In summary, to create a movable hypothec on a life insurance policy it is necessary to have a written agreement with an accurate description of the policy. Subsequently, to render the hypothec enforceable, according to article 2461, it is sufficient to notify the insurer. Does this mean that the general rule of perfection by filing is to be discarded? Not necessarily. Given that there is some uncertainty as to the need to publish a hypothec on an insurance policy, it has become standard industry practice that, in addition to the notification by the creditor to the insurer,<sup>112</sup> the formalities of publishing a hypothec without delivery also be accomplished.<sup>113</sup>

Furthermore, as a precautionary measure, prior to taking a hypothec on an insurance contract, a financial institution should contact the insurance company which issued the policy to inquire as to the existence of a prior notice from a third-party. If in fact a prior creditor notified the insurer of its security interest, for sake of being ranked in priority, the lender should obtain a cession of rank from such creditor who has previously notified the insurer. This cession would be published in the RPMRR and a copy should be given to the insurer.

#### 4. Conclusion

Despite the variations in the legal framework, the treatment of security interests in life insurance policies is similar in Canada (especially in common law provinces and territories) and in the United States. All jurisdictions impose notification by the lender to the insurer and priority issues are governed by a race-notice practice. However, in Quebec, life insurance policies are collateralized through a movable hypothec, and, in common law jurisdictions, a collateral assignment.

Considering that insurers are not obligated to notify actual or potential creditors, subsequent assignees do not have “the information they need to determine whether their interest is subordinated.”<sup>114</sup> Therefore, as mentioned previously, as a precautionary measure, potential assignees (often financial institutions) have the burden to inquire with insurers as to the existence of a prior notice from a third-party.<sup>115</sup>

In light of the foregoing, the insurance exclusion seems to bifurcate from the fundamental purpose of Article 9 and the PPSA, which was to avoid secret liens. As many authors and practitioners have pointed it out, the race-notice (to the insurer) mechanism currently in place, does not provide the transparency of a central registry. But that’s a tale for another day.

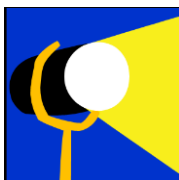
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### UCC Spotlight

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By **Stephen L. Sepinuck**



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

*Newsom v. Rabo Agrifinance, Inc.,*  
[2013 WL 1682379](#) (Ark. Ct. App. 2013)

This case deals with the perfection of a security interest in crops. The court may have reached the correct result, but it failed to mention or consider an important fact, and it relied on a rationale that has no place in a proper analysis.

The facts begin when Newsom, a Mississippi farmer, and Roberts, a farmer with operations in Indiana, Louisiana, and Tennessee, decided to work together to farm 5,100 acres in Arkansas. Under their agreement, Newsom was to provide the labor, equipment, and expertise while Roberts was to provide the financing. Roberts already had an existing line of credit with Rabo Agrifinance and applied for a new loan to finance the Arkansas venture. Rabo initially rejected the loan request, causing Newsom to advance funds needed to begin the farming operation. Later, Rabo made a smaller loan and received in exchange a security interest in the crops from Roberts and a partnership Roberts had formed. Rabo filed a financing statement in Arkansas against both Roberts and the partnership to perfect its security interest.

Newsom brought an action against Roberts and the partnership for failing to provide their promised joint-venture capital. Newsome also sued Rabo seeking a declaration that Rabo did not have a perfected security interest in the Arkansas crops or, if it did, that Newsom had a superior equitable lien to secure his crop-related expenses. Rabo and Roberts filed cross-claims against each other but this column deals only with Newsom's claims.

Newsom made three arguments for why Rabo's financing statement was ineffective to perfect its security interest. First, Newsom claimed that the financing statement's description of the collateral as "all crops grown, growing, or to be grown" was insufficient because it did not mention the site of the crops in Arkansas. The court quite properly rejected this argument. In doing so, the court noted that § 9-108(b)(2) provides that a description of collateral by category is sufficient. 2013 WL 1682379, at \*8. The court also reasoned that a description of collateral need not enable a searcher to identify the encumbered property; rather, it need only enable a searcher, aided by further inquiry, to identify the property. *Id.* at \*9.

If the court had stopped there it would have been on very solid ground. Unfortunately, the court also observed that, because the financing statement was filed in Arkansas, the statement implicitly suggested that the crops were located on Arkansas land. *Id.* This is patently wrong. The law governing perfection of a security interest in crops is the law where the debtor is located, not where the crops are located. *See* § 9-301(1). The place to file against crops, then, is the state of the debtor's location, not the crop's location. *See* § 9-501(a). The rules are different for as-extracted collateral and fixtures covered by a fixture filing, *see* §§ 9-301(4), 9-501(a), but crops are not either of those, *see* § 9-102(a)(6). The law is also different for an agricultural lien, *see* § 9-302, but an agricultural lien is an interest that arises by statute, not by contract, *see* § 9-102(a)(5), and thus a security interest in crops is not an agricultural lien. As a result, Rabo's filing in Arkansas in no way implied that the crops were located in Arkansas.

Newsom's second argument was that the financing statement was ineffective because it incorrectly listed (prior to an amendment) the partnership's address as Barretville, Indiana, rather than Barretville, Tennessee. The court properly rejected this argument too. After all, the only essential information in a financing statement is the debtor's name, the secured party's name, and the description of the collateral. *See* § 9-502(a). The filing office can reject a financing statement that lacks an address for the debtor, *see* § 9-516(b)(5), and a security interest perfected by a filed financing statement that incorrectly lists the debtor's address may be subordinated to a conflicting security interest, *see* § 9-338(1), but a filed financing statement that lists an incorrect address for the debtor is effective to perfect.

Unfortunately, the court did not cite to any of these provisions in its discussion of this issue. Instead, the court focused on Newsom's ability to conduct a proper inquiry had Newsom searched for and found the filed financing statement. Specifically, the court stated that "under the circumstances of this case, Newsom's ability to inquire was not affected, given his association with Roberts and his partnership in the Arkansas operation." The statement is true but irrelevant at best and more likely misguided. The effectiveness of a financing statement must be judged objectively, not subjectively by the knowledge of the person attacking it. Otherwise, circular priorities may result. *Cf.* Stephen L. Sepinuck, *Searchers Beware: Court Validates Notice of Tax Lien Filed Against Debtor's Former Name*, CLARKS' SECURED TRANSACTIONS MONTHLY, Aug. 2010, at 2 (making a similar point with respect to a notice of federal tax lien); Stephen L. Sepinuck, *Misguided California Court Changes "Consignment" Standard*, CLARKS' SECURED TRANSACTIONS MONTHLY, Sept. 2009, at 1 (making a similar point with respect to whether, under the definition of "consignment," a person is generally known by its creditors to be substantially engaged in selling the goods of others).

Newsom's final argument was that the partnership did not own the collateral and thus a filing against the partnership could not have perfected the security interest. The court rejected this argument by noting that the financing statement also listed Roberts as a debtor and he did have ownership rights in the crops. 2013 WL 1682379, at \*9. That may have been true but what the court neglected to consider was where Roberts was located. In fact, the court never indicated where either Roberts or the partnership was located. If Roberts was not located in Arkansas – and it is worth remembering that he was a farmer with experience in three other states but who had not before operated a farm in Arkansas – then a filing against him in Arkansas would be irrelevant. The place to file a financing

statement to perfect a security interest in crops is where the debtor is located, not where the crops are located. It appears that someone – either the court or Newsom’s counsel – dropped the ball on this one.

***T. Gluck & Co. v. Craig Drake Manufacturing, Inc.,***  
**[2013 N.Y. Misc. LEXIS 2384](#) (N.Y. Sup. Ct. 2013)**

This case involved a priority dispute in consigned inventory and its proceeds. The court reached the correct result but its analysis overlooked a potentially important issue. The case also serves as a cautionary lesson for inventory financiers.

In 1997, T. Gluck & Co. began providing diamonds to a manufacturer of jewelry pursuant to a consignment and security agreement. At that time, Gluck filed a financing statement to perfect its interest and notified the debtor’s inventory lender of Gluck’s plans to retain a purchase-money security interest in the diamonds it provided. Twelve years later, after the original inventory lender had assigned its security interest to Sovereign Bank, the debtor conducted a going-out-of-business sale and remitted most of the proceeds to Sovereign Bank. Gluck sued Sovereign Bank for conversion and claimed priority in the diamonds it had provided to the debtor and in the proceeds of the diamonds.

The court ruled for Sovereign Bank and did so for correct reasons. The court noted that even if Gluck were entitled to PMSI priority in the diamonds, that priority would not extend to noncash proceeds, such as accounts. *See* § 9-324(b). Instead, priority would be determined under the basic first-to-file-or-perfect rule of § 9-322(a)(1), and because Sovereign Bank and its predecessor had filed timely continuation statements, that meant Sovereign Bank had priority in such proceeds.

As to the diamonds themselves, the court looked to § 9-324(b), which provides that PMSI priority in inventory applies only if the inventory financier receives the PMSI-lender’s notification of PMSI financing “within five years before the debtor receives possession of the inventory.” Because Gluck had sent only one PMSI notification, and had done so back in 1997, Gluck was no longer entitled to PMSI priority in the inventory. As a result, Sovereign Bank could not be liable for conversion.

The court was mostly correct and its ruling underscores the need for PMSI inventory lenders to renew their PMSI notifications every five years, just as they must file a continuation statement every five years to remain perfected. What the court failed to consider, though, perhaps because no one argued it, was whether any of the diamonds sold in the 2009 going-out-of-business sale had been provided to the debtor on or before 2002 and thus were received within the five-year period. In other words, the effect of a failure to renew a PMSI notification is different from the effect of a failure to timely file a continuation statement. If a secured party fails to file a continuation statement, its entire security interest becomes unperfected (or at least that portion for which filing is necessary to perfect), and thus priority can be lost as to all of the collateral, whether acquired by the debtor before or after the financing statement lapses. In contrast, if a PMSI inventory lender fails to renew its PMSI notification, the PMSI inventory lender will lose priority only in the inventory received by the debtor more than five years after the original notification; the lender will retain priority in inventory acquired within that five-year period.

Perhaps all of the diamonds that the debtor in this case acquired between 1997 and 2002 had been sold long before the 2009 sale. If that were true, then the court was correct in awarding priority to Sovereign Bank. If, however, Gluck could have identified some of the diamonds sold in 2009 as inventory acquired by the debtor during that five-year period, then Gluck should have been entitled to priority in those diamonds and in any cash proceeds thereof received by the debtor on or before delivery of the diamonds to the buyer.

***American Bank v. Cornerstone Community Bank,***  
**[2013 WL 4309622](#) (6th Cir. 2013)**

This case involves insurance premium financing that went south when the bank in which the insurance broker deposited the advanced funds swept the deposit account to satisfy a debt owed to it by the broker. The premium financier sued for conversion and won. The Sixth Circuit affirmed with a decision filled with confused and sloppy analysis. Nevertheless, the court may have inadvertently reached the correct result.

The facts are more fully described as follows. American Bank agreed to loan \$430,000 to Saberline Transportation to acquire an insurance policy. The loan was to be secured by the unearned premiums. American wired the funds to the insurance broker’s deposit account at Cornerstone Community Bank. Cornerstone swept the deposit account to recover on a debt owed to it by the broker. Consequently, no insurance policy was ever acquired. The broker later repaid American with other funds, but that payment was avoided as a preference in the broker’s subsequent bankruptcy. American repaid the funds to the bankruptcy trustee, preserving its rights to pursue Cornerstone for conversion. The lower court ruled for American, and on appeal the Sixth Circuit affirmed.

The court began by looking at the Tennessee Premium Finance Company Act, TENN. CODE ANN. §§ 56-37-101 *et seq.*, which gives a premium financier a perfected security interest “in any premiums financed” if the borrower signs a written security agreement. *Id.*

§ 56-37-112 (subsequently re-designated as subsection (a)). From this, the court reasoned, American Bank had a perfected security interest in the broker's deposit account and that, also pursuant to the Tennessee Act, this security interest was superior to the rights of Cornerstone.

There are at least two problems with the circuit court's analysis. First, the court improperly conflated a security interest in the unearned premiums with a security interest in the loan proceeds that had been deposited at Cornerstone. Because the broker never acquired the policy, there never were any unearned premiums. Thus, it is far from clear that Tennessee Premium Finance Company Act applied at all.

The court's second error flowed from its first. In ruling that American Bank had priority, the court had two alternative rulings. First, that the Tennessee Premium Finance Company Act was more specific and thus controlled over the more general rules of Article 9. Second, that Article 9 was inapplicable under § 9-109(d)(8) because the issue involved an interest in a policy of insurance. 2013 WL 4309622, at \*2-3. The first ruling is questionable but defensible. The second ruling is not. The property at issue was a deposit account, not unearned premiums or insurance. Article 9 undoubtedly applies to a security interest in a deposit account. Perhaps recognizing the same analytical error by the trial court, the Tennessee legislature has since amended the Tennessee Premium Finance Company Act to expressly provide that Tennessee's Article 9 "shall govern the relative priorities of security interests in, and any right of set-off against, funds advanced pursuant to a premium finance agreement." TENN. CODE ANN. § 56-37-112(b) (effective April 12, 2013).

Nevertheless, the circuit court may have reached the correct result. Recall that the funds were transferred to the broker's deposit account to facilitate the broker's purchase of an insurance policy for Saberline. Under such circumstances, the broker arguably held the funds in trust for Saberline (and possibly also for American). As a result, the broker may not have had any right to the deposited funds and thus could not have granted a security interest in the deposited funds to Cornerstone. *See* Stephen L. Sepinuck, *Deconstructing the Constructive Trust*, TRANSACTIONAL LAW., Aug. 2013, at 2. For much the same reason, Cornerstone would not have had a right to exercise setoff against the deposited funds to satisfy a debt owned by the broker, as there would have been no mutuality of obligation.

In its very first paragraph the circuit court stated that the broker "held the money . . . in trust." Thus, the court itself seemed to embrace this idea. Unfortunately, its analysis was not based on principles of trust, but on a misunderstanding of the law and the facts.

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*Compiled by Commercial Law Newsletter Co-Editors Glen Strong, Celeste B. Pozo, Hilary Sledge, Christina B. Rissler, Subnyini Abudulai and Harold J. Lee.*

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#### ENDNOTES:

<sup>1</sup> The views and content of this article are solely those of Mr. Cohen and not Sheppard Mullin.

<sup>2</sup> *Clear Channel v. Knupfer (In re PW, LLC)*, 391 B.R. 25 (B.A.P. 9th Cir. 2008) (in a 363 sale, assets cannot be sold free and clear of the lien of a non-consenting junior creditor under Bankruptcy Code § 363(f) when the creditor is not paid in full; mootness under 363(m) applies only to the transfer of assets, and not to the transfer free and clear of the lien of the non-consenting creditor). While *Clear Channel* has not been overruled and remains good law, it has been criticized and distinguished. See, e.g., *In re Boston Generating*, 440 B.R. 302, 333 (Bankr. S.D.N.Y. 2010) (foreclosure actions under state law satisfy 363(f)(5)); *In re Jolan*, 403 B.R. 866 (Bankr. W.D. Wash. 2009) (under 363(f)(5), state legal and equitable proceedings exist where junior lienholder can be compelled to accept money satisfaction); *In re Nashville Senior Living, LLC*, 407 B.R. 222 (B.A.P. 9th Cir. 2009) (court rejected *Clear Channel*, concluding that 363(m) applies to “free and clear” aspect of 363(f)).

<sup>3</sup> Bankruptcy sales and UCC foreclosure sales are not the only options. Other alternatives include assignments for the benefit of creditors and receivership sales. This article does not discuss such alternatives. For a discussion and comparison of distressed asset sales through bankruptcies, UCC foreclosure sales, assignments for the benefit of creditors, and receivership sales from the secured lender’s perspective, see Theodore A. Cohen, *Lenders’ Alternative Liquidation Strategies for Defaulted Loans Secured By Personal Property*, *J. Tax’n & Reg. Fin. Institutions*, Jan./Feb. 2012, at 29-41. Some of the material in this article is also covered in the foregoing article, both of which are authored by Mr. Cohen.

<sup>4</sup> References in this article to the UCC are to the California version of the UCC. Citations may vary in other states.

<sup>5</sup> UCC § 9-601(a).

<sup>6</sup> Under either document, the secured party, not the debtor, is the seller.

<sup>7</sup> UCC § 9-617(a).

<sup>8</sup> UCC § 9-617(b).

<sup>9</sup> UCC § 9-610(c)(2) sets forth an exception for collateral “customarily sold on a recognized market or the subject of widely distributed standard price quotations.” This exception essentially applies to publicly traded securities.

<sup>10</sup> UCC § 9-611(c).

<sup>11</sup> UCC § 9-613 sets forth a “safe harbor” form of notice for private UCC foreclosure sales. The notice should contain at least what is set forth in the safe harbor provision.

<sup>12</sup> UCC § 9-612(b). Moreover, the United States (through the Internal Revenue Service) and state or local taxing agencies may be statutorily entitled to more notice for tax liens. A UCC search will disclose all the liens of record against a particular debtor, and both the secured party and the buyer should be familiar with the UCC search and ensure that sufficient notice is provided to the proper parties under applicable law. The UCC search will also reveal if there are any liens senior to the lien of the foreclosing secured party, which liens are not extinguished.

<sup>13</sup> UCC § 9-610(c)(1).

<sup>14</sup> UCC § 9-613 also contains a “safe harbor” form of notice for public UCC foreclosure sales.

<sup>15</sup> UCC § 9-612(b) applies to any UCC foreclosure sale. Moreover, even in public sales, the secured party and buyer must ensure that the holders of tax liens receive whatever additional notice to which they are statutorily entitled.

<sup>16</sup> UCC § 9-627(b)(3) states that a UCC foreclosure sale is commercially reasonable if it is made “in conformity with reasonable commercial practices among dealers in the type of property that was the subject of the disposition.”

<sup>17</sup> UCC § 9-610(b).

<sup>18</sup> See *supra* note 108.

<sup>19</sup> UCC § 9-627(a).

<sup>20</sup> UCC § 9-626(b)(2)(C).

<sup>21</sup> UCC § 9-617(a)(2).

<sup>22</sup> UCC § 9-617(a)(3).

<sup>23</sup> While creditors could place the debtor into involuntary bankruptcy after the UCC foreclosure sale is consummated, the bankruptcy court would not necessarily unwind the sale. The standards for obtaining a dismissal of an involuntary bankruptcy are beyond the scope of this article.

<sup>24</sup> IRS Circular 230 Disclosure: In order to comply with requirements imposed by the Internal Revenue Service, we inform you that any U.S. tax advice contained in this article is not intended to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing, or recommending to another party any transaction or matter addressed therein.

<sup>25</sup> U.S. P'SHIP FOR RENEWABLE ENERGY FIN., RENEWABLE ENERGY FINANCE AND MARKET OVERVIEW (2013).

<sup>26</sup> *Solar Energy Facts: Q2 2013: U.S. PV Market Installs 832 MW, Grows 15% Over Last Quarter*, SOLAR ENERGY INDUS. ASS'N (Sept. 12, 2013), <http://www.seia.org/research-resources/solar-industry-data> (follow "Download the Q2 2013 Fact Sheet" hyperlink).

<sup>27</sup> SOLAR ENERGY INDUS. ASS'N, THE CASE FOR THE SOLAR INVESTMENT TAX CREDIT (2013).

<sup>28</sup> I.R.C. §§ 25D, 48.

<sup>29</sup> Pub. L. No. 95-618, 92 Stat. 3174 (1978).

<sup>30</sup> Pub. L. No. 109-158, 119 Stat. 594 (2005).

<sup>31</sup> Pub. L. No. 111-5, 123 Stat. 115 (2009).

<sup>32</sup> I.R.C. §§ 25D, 48.

<sup>33</sup> U.S. P'SHIP FOR RENEWABLE ENERGY FIN., PAID IN FULL: AN ANALYSIS OF THE RETURN TO THE FEDERAL TAXPAYER FOR INTERNAL REVENUE CODE SECTION 48 SOLAR ENERGY INVESTMENT TAX CREDIT (ITC) 1 (2012) (citing data from the Solar Energy Industries Association and GTM Research).

<sup>34</sup> Pub. L. No. 111-5.

<sup>35</sup> U.S. P'SHIP FOR RENEWABLE ENERGY FIN., TAX CREDITS, TAX EQUITY AND ALTERNATIVES TO SPUR CLEAN ENERGY FINANCING (2012).

<sup>36</sup> *1603 Treasury Program*, SOLAR ENERGY INDUS. ASS'N, <http://www.seia.org/policy/finance-tax/1603-treasury-program> (last visited Oct. 18, 2013).

<sup>37</sup> *Id.*

<sup>38</sup> I.R.C. §§ 168(e)(3)(B)(vi), 48(a)(3)(A).

<sup>39</sup> H.R. 4853, 110<sup>TH</sup> Cong. I.R.C. (2008).

<sup>40</sup> DIPHA SHARIF, AMY GRACE & MICHEL DI CAPUA, BLOOMBERG NEW ENERGY FIN., US CLEAN ENERGY – WHITE PAPER: THE RETURN – AND RETURNS – OF TAX EQUITY FOR US RENEWABLE PROJECTS 14 (2011).

<sup>41</sup> *Id.*

<sup>42</sup> *Id.*

<sup>43</sup> Certain appellees in *Encore* and *Gerber* were represented by the authors' firm, Young Conaway Stargatt & Taylor, LLP. The views expressed herein are those of the authors alone and should not be taken as representing the views of Young Conaway or its professionals or clients.

<sup>44</sup> In each case except *Gerber*, the plaintiff did not appeal the dismissal of the implied covenant claim. See *K-Sea*, 67 A.3d at 356 ("Importantly, the plaintiffs do not allege that the general partner breached the implied covenant of good faith and fair dealing."); *Encore*, 72 A.3d at 101 n.17 ("Allen does not appeal from the Vice Chancellor's dismissal of his implied covenant of good faith and fair dealing claim."); *Enbridge*, 67 A.3d at 372 n.11 (noting that the trial court dismissed the implied covenant claim and that "Brinckerhoff does not really challenge this holding").

<sup>45</sup> *Encore*, 72 A.3d at 110 n.58 (noting that "we do not address whether a general partner may rely upon a *conclusive* presumption of good faith"); *Enbridge*, 67 A.3d at 373 (noting that "this is not the case in which to address any questions as to the effectiveness of a *conclusive* presumption").

<sup>46</sup> *DV Realty*, 2013 Del. LEXIS 430, at \*13 (quoting 6 *Del. C.* § 17-1101(c)). A parallel provision is contained in the Delaware Limited Liability Company Act. 6 *Del. C.* § 18-1101(b).

<sup>47</sup> *Gerber*, 67 A.3d at 409; *Encore*, 72 A.3d at 101.

<sup>48</sup> *Gerber*, 67 A.3d at 410; *Encore*, 72 A.3d at 101.

<sup>49</sup> *Gerber*, 67 A.3d at 410-11; *Encore*, 72 A.3d at 103.

<sup>50</sup> *Gerber v. EPE Holdings, LLC*, C.A. No. 3542-VCN, 2013 Del. Ch. LEXIS 8, at \*43 (Del. Ch. Jan. 18, 2013); *Encore*, 72 A.3d at 102.

<sup>51</sup> *K-Sea*, 67 A.3d at 362 (emphasis added).

<sup>52</sup> *Id.*

<sup>53</sup> *Id.* at 366.

<sup>54</sup> *Enbridge*, 67 A.3d at 371.

<sup>55</sup> *Id.* at 372.

<sup>56</sup> *Id.*

<sup>57</sup> *DV Realty*, 2013 Del. LEXIS 430, at \*13-14.

<sup>58</sup> *Id.* at \*24 (quoting *Enbridge*, 67 A.3d at 373).

<sup>59</sup> *Gerber*, 67 A.3d at 419 (citing *ASB Allegiance Real Estate Fund v. Scion Breckenridge Managing Member, LLC*, 50 A.3d 434, 440-42 (Del. Ch. 2012), *aff'd in part, rev'd in part on other grounds*, 68 A.3d 665 (Del. 2013)).

<sup>60</sup> *Id.* (quoting *ASB Allegiance*, 50 A.3d at 441).

<sup>61</sup> *Id.* at 420.

<sup>62</sup> *Encore*, 72 A.3d at 101.

<sup>63</sup> *Id.* (alteration in original) (emphasis added).

<sup>64</sup> *DV Realty*, 2013 Del. LEXIS 430, at \*22 (emphasis added).

<sup>65</sup> *Encore*, 72 A.3d at 104 (concluding that "an act is in good faith if the actor *subjectively* believes it is in the best interests of [Encore]"); *DV Realty*, 2013 Del. LEXIS 430, at \*26 (concluding that the good faith standard was "purely subjective").

<sup>66</sup> *Encore*, 72 A.3d at 107.

<sup>67</sup> *Id.* at 106 (quoting *Desert Equities, Inc. v. Morgan Stanley Leveraged Equity Fund, II, L.P.*, 624 A.2d 1199, 1208 (Del. 1993)).

<sup>68</sup> *Id.* at 106-07.

<sup>69</sup> *Id.* at 107.

<sup>70</sup> *Id.* (alterations in original) (quoting *Parnes v. Bally Entm't Corp.*, 722 A.2d 1243, 1246 (Del. 1999)).

<sup>71</sup> *K-Sea*, 67 A.3d at 361.

<sup>72</sup> *Encore*, 72 A.3d at 104.

<sup>73</sup> *K-Sea*, 67 A.3d at 362.

<sup>74</sup> *Encore*, 72 A.3d at 104.

<sup>75</sup> For example, the relevant provision in the *K-Sea* agreement provided:

[K-Sea GP] may consult with . . . investment bankers . . . and any act taken or omitted to be taken in reliance upon the opinion . . . of such Persons as to matters that [K-Sea GP] reasonably believes to be within such Person's professional or expert competence *shall be conclusively presumed to have been done or omitted in good faith* and in accordance with such opinion.

*K-Sea*, 67 A.3d at 366 (alterations in original).

<sup>76</sup> *Gerber*, 67 A.3d at 415; *K-Sea*, 67 A.3d at 366-67.

<sup>77</sup> *Gerber*, 67 A.3d at 406-08; *K-Sea*, 67 A.3d at 366.

<sup>78</sup> *K-Sea*, 67 A.3d at 367.

<sup>79</sup> *Id.* at 367-68.

<sup>80</sup> *Id.* at 368.

<sup>81</sup> The opinions expressed in this article are solely those of the author and do not necessarily represent the viewpoint of the National Bank of Canada. I would like to thank my colleague Kiriakoula Hatzikiriakos for her precious feedback and comments.

<sup>82</sup> Quebec is the only province in Canada under which secured transaction law is regulated by the *Civil Code of Quebec* ("CCQ").

<sup>83</sup> CUMING, WALSH & WOOD, *PERSONAL PROPERTY SECURITY LAW*, 5 (2d ed. 2012).

<sup>84</sup> "The PPSA is provincial chattel security legislation designed to protect the rights of creditors and debtors by regularizing secured transactions in personal property. To achieve this objective, the PPSA establishes a province-wide, notice-based registration system. Under this system, the first creditor to register notice of a security interest in a debtor's personal property generally has a first priority secured interest in that property that is effective against third parties, including other secured creditors": *GE Can. Equip. Fina. G.P. v. ING Ins. Co. of Can.*, 2009 ONCA 171 (CanLII), para. 24.

<sup>85</sup> *Personal Property Security Act*, RSO 1990, c P.10, para. 4(1)(c). Similar provisions were adopted by the other common law provinces.

<sup>86</sup> In other common law provinces (and territories) the exclusion of life insurance policies is substantially the same. *See* s. 4(c), (c.1) of the Alberta PPSA; s. 4(c), (c.1) of the British-Columbia PPSA; s. 4(b), (b.1) of the Manitoba PPSA; s. 4(b) of the New-Brunswick PPSA; s. 5(b), (b.1) of the Newfoundland PPSA; s. 5(b) of the Nova-Scotia PPSA; s. 3(b) of the N.W.T. PPSA; s. 3(b) of the Nunavut PPSA; s. 4(b) of the P.E.I. PPSA; s. 4(b), (b.1) of the Saskatchewan PPSA; and s. 3(c) of the Yukon PPSA.

<sup>87</sup> *Stelco Inc. (Bankruptcy)*, Re, 2005 CanLII 13192 (Ont. Ct. App.), para.7

<sup>88</sup> RICHARD H. MCLAREN, *SECURED TRANSACTIONS IN PERSONAL PROPERTY IN CANADA*, §3.02 (3d ed. 2012).

<sup>89</sup> RICHARD H. NOWKA, *MASTERING SECURED TRANSACTIONS – UCC ARTICLE 9*, 23 (2009) ("Under section 9-109(d)(8), Article 9 is inapplicable to a transfer of an interest in or an assignment of claim under a policy of insurance, except when the interest in insurance represents proceeds of collateral or is an assignment of health-care-insurance receivable.").

<sup>90</sup> Cassandra K. Ward Brown, *Revised UCC Article 9: Insurance Policies As Collateral*, BENCH & BAR OF MINN., Mar. 2000, available at [http://www.mnbar.org/benchandbar/2000/mar00/ucc-9\\_lal.htm](http://www.mnbar.org/benchandbar/2000/mar00/ucc-9_lal.htm)

<sup>91</sup> NOWKA, *supra*, note 8.

<sup>92</sup> *GE Can. Equip. Fina.*, 2009 ONCA 171 (Justice E.A. Cronk)(citing JACOB S. ZIEGEL & DAVID L. DENOMME, *THE ONTARIO PERSONAL PROPERTY SECURITY ACT: COMMENTARY AND ANALYSIS*, 82 (2d ed. 2000)).

<sup>93</sup> "Thus, the purpose of s. 4(1)(c) is to avoid the unnecessary duplication of notice systems concerning transfers that create interests or claims in or under insurance policies. This is achieved by excluding such interests or claims from the PPSA notice and registration scheme." *Id.* para. 29.

<sup>94</sup> Andrew Verstein, *Bad Policy for Good Policies: Article 9's Insurance Exclusion*, 17(2) CONN. INS. L.J. 5 (citing Article 9's Official Comments in Uniform Commercial Code: 1962 OFFICIAL TEXT WITH COMMENTS (Article 3 to End) 621 (1963), reprinted in XXIII UNIFORM COMMERCIAL CODE DRAFTS 401 (Elizabeth Slusser Kelly Comp. 1984)).

<sup>95</sup> *Id.*

<sup>96</sup> NOWKA, *supra* note 8, at 24.

<sup>97</sup> MCLAREN, *supra* note 7, § 6.01.

<sup>98</sup> CUMING, WALSH & WOOD, *supra* note 2, at 165.

<sup>99</sup> *Id.* at 100.

<sup>100</sup> MCLAREN, *supra* note 7, § 3.02.

<sup>101</sup> Verstein, *supra* note 13, at 14.

<sup>102</sup> 391 F. 3d 63, 66 (2d Cir. 2004).

<sup>103</sup> *Id.*

<sup>104</sup> Article 2660 CCQ.

<sup>105</sup> Article 2462 CCQ.

<sup>106</sup> That is, a human being. Also referred to as a "natural person."

<sup>107</sup> *Regulation Respecting the Register of Personal and Movable Real Rights*, RRQ, c CCQ, r.8, article 15.02. Therefore the new legislation excludes the pledge of life insurance contracts, which is now governed by the movable hypothec without delivery. Also, the transitional provisions of the *Act Respecting the Transfer of Securities and the Establishment of Security Entitlements*, RSQ, c T-11.002 (articles 173 and 174) require that pledges created prior to 2009 be registered at the RPMRR in order to maintain their enforceability.

<sup>108</sup> CUMING, WALSH & WOOD, *supra* note 2, at 177-78; *see also* HALSBURY'S LAWS OF CANADA, *PERSONAL PROPERTY AND SECURED TRANSACTIONS*, 394 (2008).

<sup>109</sup> Article 2696 CCQ.



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<sup>110</sup> Under this system, generally the first creditor to file the document entitled “application for registration” at the *Register of Personal and Movable Real Rights* (“RPMRR”) has a first priority hypothec in that collateral.

<sup>111</sup> LOUIS PAYETTE, *LES SÛRETÉS RÉELLES DANS LE CODE CIVIL DU QUÉBEC*, para. 1169 (Éditions Yvon Blais, 4e éd. 2010).

<sup>112</sup> To be enforceable, a *Notice of Hypothecation with Respect to a Life Insurance Policy* must be transmitted to the insurer. Essentially, this notice states that a hypothec with respect to the policy (described therein) has been granted to the financial institution and the latter asks that the hypothec be recorded in the insurer’s books.

<sup>113</sup> Aurore Benadiba, *La Loi sur le transfert des valeurs mobilières et l’obtention des titres intermédiaires ou les excès d’un régime d’exception en matière de sûretés mobilières*, 53(2) *LES CAHIERS DE DROIT*, 303-48(juin 2012) (Faculté de droit de l’Université Laval).

<sup>114</sup> Verstein, *supra* note 13, at 28.

<sup>115</sup> *Id.* at 29 (“There is no reliable mechanism for creditors to determine whether their claims are likely to be subordinated. A creditor who wishes to learn about the encumbrances on a policy has no central filing system to consult. Indeed, an investigation with the Secretary of State of the debtor may deceive some creditors into overestimating their security vis-à-vis a borrower.”).