Commercial Law Newsletter

Joint Newsletter of the Commercial Finance and Uniform Commercial Code Committees

AMERICAN BAR ASSOCIATION Business Law Section

November 2, 2012 Fall 2012

IN THIS ISSUE

MARK YOUR CALENDARS

November 13, 2012 – Perfecting Security Interests in Deposit Accounts, Securities Accounts and Other Investment Property – Webinar hosted by Strafford

Joint Report from the Chairs

Dear Members:

At this year's annual meeting, our committees offered a full schedule of meetings and CLE programs, as well as our usual lively and well-attended joint dinner. That said, both in our committees and across the Business Law Section (BLS), members generally don't attend the annual meeting in nearly the same numbers that they attend the spring meeting. For a variety of reasons, 2013 (Friday, August 9 to Sunday, August 11, in San Francisco) will be the last year in which the BLS fully participates in an ABA-wide annual meeting. In 2014, BLS participation at the ABA Annual Meeting (overall meeting dates: August 7 to 12, in Boston), will be limited to a governance presence and will focus on BLS Council matters and certain administrative committee meetings. At this time we anticipate that BLS will launch a separate Section-focused meeting, complete with subcommittee and task force meetings and CLE. The first such meeting is tentatively scheduled Thursday, September 11 to Saturday, September 13, 2014 in Chicago. We'll keep you posted on that as the time draws nearer, but wanted to pass this along as we know many of you plan your business travel in advance.

Within both the Com Fin and UCC Committees, various subcommittees and task forces have welcomed new officers. We thank those whose terms have ended, and welcome those whose terms have just begun. Without the topical expertise and energy of the many who offer their service, the committees would fall short of their goals. As we look ahead, your Chairmen are particularly interested not only in continuing to reach our usual constituencies with the high-level content to which they've become accustomed, but also to reach broader audiences drawn from within our committees and beyond. For example, we're planning a two hour CLE at next spring's meeting (April 4-6, in Washington, DC) focused on the amendment to UCC Article 9 scheduled to take effect on July 1.

In this issue we feature debut CLN articles from several writers. Tarik Haskins, a newly appointed officer of both Committees, writes on alternative entity collateral. Sal Scanio contributes a piece on cybertheft. Haywood Barnes shares his insights on factoring and true sale issues. And Andrew Connor returns with the second installment of his work on loan participations.

Finally, we hope you can join us for the annual fall CLE program presented by our two committees. This year's program runs from 11 am until 4 pm on Wednesday, November 14 at the JW Marriott Desert Ridge in Phoenix, Arizona (the location of Commercial Finance Association's 68th Annual Convention, from November 14 through 16). Visit americanbar.org/groups/business_law.html and click through for more information and to register.

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

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Publications

November 14, 2012 – ABA Commercial Finance Committee and Uniform Commercial Code Committee Joint Meeting – JW Marriott Desert Ridge in Phoenix, Arizona. Save the date!

November 16-17, 2012 – ABA Business Law Section Fall Meeting – The Ritz-Carlton in Washington, DC.

April 4-6, 2013 – ABA Business Law Section Spring Meeting – Hilton Washington in Washington, DC. Save the date!

August 9-11, 2013 – ABA Annual Meeting - The Fairmont San Francisco in San Francisco, California.

VIEW CURRENT REPORTS AND DEVELOPMENTS OF THE FOLLOWING COMMITTEES AND TASK FORCES:

COMFIN SUBCOMMITTEES AND TASK FORCES

- Subcommittee on Agricultural and Agri-Business Financing
- Subcommittee on Aircraft Financing
- Subcommittee on Creditors' Rights
- Subcommittee on Cross-Border and Trade Financing
- Subcommittee on Intellectual Property Financing
- Subcommittee on Lender Liability
- Subcommittee on Loan Documentation
- Subcommittee on Loan Workouts
- Subcommittee on Maritime Financing
- Subcommittee on Real Estate Financing
- Subcommittee on Secured Lending
- Subcommittee on Syndications and Lender Relations
- ADR Task Force
- Model Intercreditor Agreement Task Force
- Surveys of State Commercial Laws

UCC SUBCOMMITTEES

- Subcommittee on Annual Survey
- Subcommittee on Article 7

Featured Notes

RECENT DEVELOPMENTS: Using the EDGAR Database to Find Contracts

The Securities and Exchange Commission requires companies to file their "Material Contracts" as Exhibit 10 to their SEC filings. These contracts, found in the SEC's online EDGAR database, contain a treasure trove for scholars and practitioners to explore. See http://www.sec.gov/edgar/quickedgar.htm.

These contracts can be put to many uses. For example, the article "Connecting the Circuits" in the Columbia Law School Magazine for Summer 2011 describes the scholars' discovery in the EDGAR database of cutting-edge contracts they refer to as "contracting for innovation." See http://www.law.columbia.edu/magazine/5993/connecting-the-circuits. At the 2012 ABA Business Law Section Spring Meeting, the UCC General Provisions Subcommittee sponsored a session on *Variation by Agreement and Standards of Performance under UCC § 1-302*. The speakers used EDGAR to find language that drafters have used in an attempt to contract around various UCC default rules. The materials can be found by clicking on the 2012 Spring Meeting Program Materials at http://www.americanbar.org/groups/business_law.html. The ABA Model Intellectual Property Security Agreement Task Force is partnering with KIIAC LLC, a document automation company that has a powerful search engine, to find the best terms to incorporate into its model form.
See http://apps.americanbar.org/dch/committee.cfm?com=CL190051.

One fly in this ointment is that the EDGAR database can be difficult to explore, especially when the searcher wishes to examine only documents in Exhibit 10. A power point presentation on how to search EDGAR using Lexis is posted at the website of the Commercial Law Center at Gonzaga School of Law. See "How to Find Documents in EDGAR" under the Information heading at http://www.law.gonzaga.edu/Centers-Programs/commercial_law_center/links_resources.asp.

The Recent Developments column is edited by:

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Also, 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.

Featured Articles

USING LIMITED LIABILITY COMPANY INTERESTS AND LIMITED PARTNERSHIP INTERESTS AS COLLATERAL

By Tarik J. Haskins

I. Introduction

In recent years, there has been an explosion in the use of alternative entities such as limited liability companies, limited partnerships and general partnerships (collectively

- Subcommittee on Commercial Law Newsletter
- Subcommittee on General Provisions and Relations to Other Law
- Subcommittee on International Commercial Law
- Subcommittee on Investment Securities
- Subcommittee on Leasing
- Subcommittee on Letters of Credit
- Subcommittee on Membership
- Subcommittee on Payments
- Subcommittee on Sale of Goods
- Subcommittee on Secured Transactions

COMFIN AND UCC JOINT TASK FORCES

- Commercial Finance Terms Joint Task Force
- Deposit Account Control Agreements Joint Task Force
- Filing Office Operations and Search Logic Joint Task Force
- Legislative Enactment of Article 9
- Model IP Security Agreement Joint Task Force
- Survey of State Guaranty Laws
- Security Interests in LLC and other Unincorporated Entity Interests Joint Task Force

COMMITTEE LEADERSHIP ROSTERS

- Uniform Commercial Code Committee
- Commercial Finance Committee

referred to herein as "alternative entities"). In addition, limited liability companies have become the preferred vehicle for creating bankruptcy remote entities in many financing transactions, which may also feature mezzanine financing arrangements in which the equity interests in the limited liability company is the mezzanine secured party's primary collateral. Therefore, it is imperative that commercial finance attorneys understand the consequences of using equity interests in alternative entities as collateral. Although practitioners may be inclined to treat equity interests in alternative entities the same as corporate stock, the provisions of the Uniform Commercial Code (the "UCC") relating to the use of equity interests in alternative entities as collateral are different from those relating to the use of corporate stock as collateral. Therefore, practitioners cannot approach the issue of perfecting a security interest in equity interests in alternative entities the same as he or she would approach perfection in corporate stock. This article will describe (i) the methods of perfecting a security interest in equity interests in alternative entities, (ii) mistakes practitioners often make when using equity interests in alternative entities as collateral, and (iii) a few helpful tips for practitioners to keep in mind when using equity interests in alternative entities as collateral. This article will primarily focus on the relevant UCC provisions related to using equity interests in alternative entities as collateral but to the extent references are made to statutes governing alternative entities, it will refer to the Delaware Limited Liability Company Act and the Delaware Revised Uniform Limited Partnership Act, however, the concepts discussed will also have applicability in other jurisdictions, which might have similar statutes.

II. Basic Perfection Methods

In connection with any secured financing, the secured party's counsel should first determine what type of collateral he or she is dealing with in order to determine how to perfect its security interest in such collateral. Unlike corporate stock, equity interests in an alternative entity may not always be the same type of collateral for purposes of the UCC. Equity interests in limited liability companies and partnerships can be a "general intangible" or "investment property".[1] Unless the alternative entity has taken affirmative steps to have its equity interests treated as "securities" for purposes of Article 8 of the UCC, such equity interests will probably be general intangibles.[2] Thus, a secured party must review the alternative entity's governing document and certificate of interest, if any, to determine whether the subject alternative entity has opted in to Article 8 to have its equity interests treated as securities, in which case, such interests will be investment property, not general intangibles.

Once the secured party's counsel has determined what type of collateral the equity interests are for UCC purposes, then he or she can determine how to perfect the secured party's security interest in the collateral. If the equity interests are general intangibles, the sole method of perfection is by filing.[3] Therefore, if the equity interests are general intangibles, for priority purposes, the familiar rules of first to file will govern multiple interests in the equity interests.[4] To the extent the equity interests are "securities", and therefore "investment property", then the secured party's counsel must determine whether such interests are "certificated securities" or "uncertificated securities." If the equity interests are "certificated securities," the secured party can perfect its interest by filing, control or possession.[5] If the equity interests are uncertificated securities, a secured party can perfect by control or filing.[6] For purposes of priority, a security interest perfected by control has priority over a security interest held by a secured party that does not have control of the investment property.[7]

III. Common Mistakes

To recap briefly, equity interests in alternative entities can be "investment property" or "general intangibles" and the nature of the collateral will determine the permissible methods of perfection. This all seems relatively simple, but now let's briefly describe some of the mistakes that practitioners make in dealing with this type of collateral. As an overarching premise, it is imperative that the practitioner appreciate that he or she is not dealing with corporate stock and therefore what might apply to corporate stock will not apply in the world of alternative entities. Thus, it will not be sufficient to simply follow the same procedures that such practitioner has followed to perfect an interest in corporate

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stock. For example, under Delaware law, in contrast to corporate stock, an equity interest in a limited partnership or a limited liability company is made up of distinct economic rights and governance rights, and the two sets of rights are not bound together by statute.[8] Ultimately, a secured party will want to have the right, upon default, to take control of the equity interests, and have the ability to receive, or transfer, the economic benefits of the equity interest as well as the governance rights. Thus, it is critical for the secured party to adequately describe the collateral to ensure that the collateral description is broad enough to create a security interest in the economic and governance rights.

A practitioner should be careful about simply using terms like "membership interests," "limited liability company interests" or "partnership interests," which may not be sufficient to encompass economic and governance rights. For example, under the Delaware Limited Liability Company Act and the Delaware Revised Uniform Limited Partnership Act, the terms "limited liability company interest" and "partnership interest" under the relevant act simply refers to a person's right to share in the entity's profits and losses and the right to receive distributions not governance rights.[9] Thus, a collateral description using the terms "limited liability company interest," "partnership interest" or "membership interest" to describe an equity interest in a Delaware entity would not be sufficient to include the governance rights in the secured party's collateral. Therefore, a secured party that used such a collateral description might find itself with a security interest in the economic rights of such entity only and no ability to cause a distribution of the entity's assets or to exercise any governance rights.

The second mistake we often see is a failure to perfect the security interest in a manner that provides the secured party with priority over other secured parties with a competing security interest in the collateral. The method of perfection depends on the type of collateral being perfected. Are the equity interests in the alternative entity "general intangibles" or "investment property"? If the equity interests are investment property, the secured party may perfect by filing, control or possession, but a security interest perfected by control will have priority over a security interest held by a secured party that does not have control of the investment property.[10] Again, the mistake we often see here is a failure to realize that the collateral is "investment property" and the secured party's failure to perfect its security interest by control or possession.

Some of the great benefits of Revised Article 9, are the self-help remedies that enable a secured party to take a number of actions without judicial assistance to realize the value of its collateral in order to satisfy the obligations secured by the security interest. Those self-help remedies include, but are not limited to, strict foreclosure,[11] and selling or otherwise disposing of the collateral to a third party.[12] Thus, one of the other mistakes we see is a failure by secured parties to take advantage of the contractual flexibility inherent in most alternative entity statutes to protect its security interest and facilitate such self-help remedies. Furthermore, such a mistake is often compounded by practitioners using corporate stock pledge agreements as precedent and substituting member for shareholder and membership interests for shares, which without more will probably be insufficient to protect fully the interests of the secured party. Also, if practitioners simply follow corporate precedent, he or she may fail to use the entity's governing document to enhance the secured party's protection and facilitate many of the self-help remedies available under the UCC.

Thus, as will be described below, the secured party will want to make sure that the security agreement and the entity's governing documents contain the necessary protections to allow the secured party to effectively, and efficiently, exercise the self-help remedies available to a secured party under the UCC.

IV. Practical Tips

As a general matter, due to the contractual flexibility inherent in most alternative entity statutes, a secured party should take advantage of its ability to build additional protections into the subject entity's governing documents, and not simply rely upon the representations, warranties and covenants set forth in the security documents. For example, under each of the Delaware Limited Liability Company Act and the Delaware Revised Uniform Limited Partnership Act, the acts contain features to enable creditors to obtain additional rights and protections. Each Act specifically permits the governing document to provide rights to a person that is not a party to the governing document.[13] Thus, counsel for the secured party should take steps to marry the contractual flexibility afforded by the alternative entity statutes to the favorable self-help remedies available under the UCC to ensure that the secured party will be able to realize the value of it equity interest collateral upon a default.

First, provide an adequate description of the collateral in connection with the creation of the security interest. Many alternative entity statutes, including Delaware, disaggregate economic rights from the governance rights provided to a holder of equity interests in the alternative entity. Therefore, the description of the collateral set forth in the security agreement that creates the interest must be broad enough to give the secured party a security interest not only in the economic rights but also the governance rights; otherwise if the description is not broad enough a secured party may find itself holding an interest solely in the economic rights that a debtor has in the alternative entities, similar to a charging order. Thus, the collateral description should make clear that it refers to the debtor's governance rights under the governing document as well as the debtor's economic rights.

Second, it cannot be emphasized enough, know your collateral. As mentioned above, a secured party should have a good understanding of what type of collateral the equity interests in the alternative entity are for purposes of the UCC. Thus, is the collateral a general intangible or investment property, and if investment property, is it certificated or uncertificated. Each of the foregoing conclusions will influence how a secured party perfects its security interest. In the event that the collateral is a general intangible, a secured party may want to request that the subject alternative entity actually opt-in to Article 8 of the UCC and perfect its security interest therein by control. Not only does opting in have the benefit of providing the secured party with a superior method of perfecting its interest, by control, but because the equity interests will be governed by Article 8, the secured party may in certain cases receive the benefits of being a "protected purchaser" and therefore actually receive an interest in the subject collateral that is superior to the interest of the debtor in such collateral because the secured party may take free of any adverse claims.[14] Opting in to Article 8 can be accomplished by executing a short amendment to the subject governing document, which expressly provides that the alternative entity's equity interests will be governed by Article 8.

Related to knowing your collateral, it is also important that the secured party make sure that the subject collateral stays the same type of collateral after the security interest is perfected. Thus, in order to protect itself, the secured party should certainly build covenants into the security document, but also to the extent permitted by the applicable alternative entity statute, the secured party should hardwire protections into the alternative entity's governing documents. Hence, a provision should be added to the governing document to prohibit the entity from amending the governing document to opt-in or opt-out of Article 8, as the case may be. Furthermore, for an entity governed by Delaware law, such entity can expressly provide in its governing document that the secured party must consent to any amendment that would change an equity interest's status as a security or non-security.

Third, provide a mechanism in the documentation to permit the transfer of the equity interests and the admission by a transferee to the alternative entity. In order to fully take advantage of the self-help remedies available to a secured party under the UCC, a secured party should build a mechanism into the security agreement and the subject alternative entity's governing document to permit the secured party or a third party transferee of such equity interest to acquire the equity interests and to be admitted to the entity upon an event of default. This is a common pitfall for secured parties seeking to exercise self-help remedies. Unless the secured party takes steps to facilitate a transfer and automatic admission following a default by the debtor, a secured party may find that it is only able to acquire the economic rights under the equity interest. For example, under Delaware law unless otherwise provided in the governing documents, the secured party's admission to the alternative entity will require the cooperation of the debtor, and possibly the other equity holders, [15] and following a default, the debtor, and the other equity holders, may not be thrilled to assist the secured party with transferring the interest and admitting the transferee to the entity. Thus, in dealing with an alternative entity where admission is required to exercise governance rights, the parties may want to add a mechanic directly into the governing document whereby upon an event of default the secured party will be automatically admitted to the entity, or alternatively, in some cases, a power of attorney can be granted to the secured party in order to facilitate such admission.

In addition, the secured party may require that the governing document contain language that structures the entity's interests more like corporate stock, whereby a transferee succeeds to the transferor's rights automatically upon transfer without further action on the part of the issuer or its equity holders. Under the Delaware statutes governing alternative entities, it is crucial to make sure that the admission issue is addressed if the entity only has one member or one limited partner because the transfer of the equity interest by the debtor to the secured party will cause the entity to dissolve because it has no members or limited partners.[16] That is the case because under the Delaware laws governing alternative entities, the debtor will cease to be a member or partner, as applicable, following the transfer of the interests and unless the governing document provides for an admission mechanic, the secured party or third party transferee will not be admitted to the entity, which will cause the entity to lack the requisite partner or member needed to avoid dissolution.

Finally, due to the contractual nature of alternative entities, and particularly in Delaware which expressly states that the policy of its alternative entity statutes is to give maximum effect to the principle of freedom of contract, the secured party should not merely rely upon the covenants and representations in the loan documents. Thus, instead of relying upon covenant defaults, protections may be added to the governing document that remove from the power and authority of the entity the ability to take certain actions that reduce, or might reduce, the secured party's protection. As previously mentioned, the governing document should limit the entity's ability to change the status of the collateral from a security to a non-security or vice versa, and it should prohibit amendments to the governing document that remove other secured party protections. In addition, the secured party may consider adding limitations on the power to issue additional equity interests or limit the authority to make distributions while obligations are outstanding. Thus, the secured parties should take advantage of the ability to enhance their protections in the alternative entity's governing documents.

V. Conclusion

As the use of alternative entities increases, it is incumbent upon commercial finance attorneys to understand the characteristics of such interests and to ensure that they understand how to perfect such collateral, and otherwise deal with such collateral. Due to the flexibility of many of the alternative entity statutes and the contractual freedom available to the parties thereunder, care should be taken to ensure that a secured party sufficiently protects its security interest by taking some of, or at least considering, the actions described above. As stated at the beginning, the most important step in this process is to recognize that equity interests in alternative entities are not exactly like corporate stock and the approach by a secured party to protect its security interest in such collateral should be markedly different.

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CYBERCRIME AND ONLINE BANKING FRAUD: AN OVERVIEW OF THE RULES FOR ALLOCATING COMMERCIAL ACCOUNT LOSSES

By Salvatore Scanio and Robert W. Ludwig, Jr.

Introduction

In the late 2000's criminals engaged in electronic bank fraud began to target business accounts. In August 2009, the Federal Deposit Insurance Corporation ("FDIC") issued an alert on the incidence of fraudulent electronic funds transfers ("EFTs")--wire transfers and automated clearing house transfers ("ACH")--resulting from compromised login credentials on business accounts, describing the problem as follows:

> Web-based commercial EFT origination applications are being targeted by malicious software, including Trojan horse programs, key loggers and other spoofing techniques, designed to circumvent online authentication methods. Illicitly obtained credentials can be used to initiate fraudulent ACH transactions and wire transfers, and take over commercial accounts. These types of malicious code, or 'crimeware,' can infect business customers' computers when the customer is visiting a Web site or opening an e-mail attachment. Some types of crimeware are difficult to detect because of how they are installed and because they can lie dormant until the target online banking session login is initiated. These attacks could result in monetary losses to financial institutions and their business customers if not detected quickly.[17]

This followed the October 2005 guidance issued by the federal banking agencies to banks for adopting security measures to avoid fraudulent EFTs, published as *Authentication in an Internet Banking Environment*.[18] The agencies emphasized "financial institutions should implement multifactor authentication, layered security, or other controls . . . in light of new or changing risks, such as phishing, pharming, malware, and the evolving sophistication of compromise techniques."[19] More recently, in June 2011, the agencies issued a *Supplement to Authentication in an Internet Banking Environment,* recommending that banks use a layered security framework, covering five core areas: (1) fraud detection and monitoring; (2) multifactor authentication; (3) Internet protocol and device analysis; (4) transaction limits and controls; and (5) customer education.[20]

The Legal Framework for Allocating Commercial Account EFT Fraud

Commercial bank customers utilize two primary types of EFTs: traditional wire transfers and ACH transactions. Wire transfers and nonconsumer ACH transactions are governed primarily by Article 4A of the Uniform Commercial Code ("UCC"), as adopted by the states.[21] UCC Article 4A was developed to provide a comprehensive body of law addressing the rights and obligations in EFTs between businesses and their financial institutions.[22] In contrast, consumer EFTs are governed by the Electronic Funds Transfer Act ("EFTA"),[23] generally providing a limit of $50 on the loss that can be allocated to an account holder for any "unauthorized electronic fund transfer."[24]

UCC § 4A-204 imposes liability on a receiving bank[25] for unauthorized transfers by requiring the bank to refund any funds (plus interest) from a payment order[26] that was neither: (1) authorized by the customer under UCC § 4A-202, nor (2) enforceable against the customer under UCC § 4A-203 as not caused by (a) an authorized employee or (b) a person who obtained access to its transmitting facilities, or otherwise obtained transmittal information from the customer. Thus, whether the risk of loss for an unauthorized EFT falls upon the bank or the customer is governed by UCC §§ 4A-202 and 203.

Under subsection 4A-202(a), a payment order is authorized if the person identified as the sender authorized the order or is otherwise bound under the law of agency. Subsection 4A-202(b) further permits the receiving bank to escape liability, even though the customer did not authorize the payment order, if the bank proves: (1) the bank and customer agreed the authenticity of a payment order would be verified through a "security procedure;" (2) the security procedure agreed upon by the bank and customer is "commercially reasonable;" (3) the bank processed the payment order in "compliance" with the security procedure; (4) the bank processed the order in compliance with any written agreement or instruction of the customer; and (5) the bank accepted the payment order in "good faith."[27]

If these five elements are not met, however, the bank will be strictly liable for any unauthorized EFT.[28] Moreover, even if these conditions are met, the risk of loss will still shift to the bank if "the person committing the fraud did not obtain the confidential information [facilitating breach of the security procedure] from an agent or former agent of the customer or from a source controlled by the customer. . . ."[29]

A. Section 4A-202(b): "Security Procedure" Defense

1. An Agreed Verification "Security Procedure"

A "security procedure" is a "procedure established by agreement of a customer and a receiving bank for the purpose of (i) verifying that a payment order . . . is that of the customer, or (ii) detecting error in the transmission or the content of the payment order or communication."[30] A "security procedure may require the use of algorithms or other codes, identifying words or numbers, encryption, callback procedures, or similar security devices."[31] A "security procedure" does not cover "procedures that the receiving bank may follow unilaterally in processing payment orders,"[32] such as its internal policies and procedures.

In *Experi-Metal, Inc. v. Comerica Bank*,[33] the agreed security procedure required the customer to input its user identification, four-digit PIN, and a six-digit code from a secure token (a randomly generated number that changed every 60 seconds).[34] The customer received a "phishing" email, similar to legitimate emails it received in the past from the bank, prompting the customer to login to renew its digital certificates. The customer clicked on the link, and was diverted to a fake website that appeared to be the bank's legitimate site. Upon entering its login and confidential codes, the customer became instantly subject to a "man in the middle" phishing attack. The criminal used the customer's confidential information to connect to the bank, and generated 93 fraudulent wire transfer orders, totaling $1.9 million, to various accounts around the world.[35] In an effort to avoid liability under UCC § 4A-202(c), discussed *infra*, the bank contended that it offered the customer the ability to require two individuals to approve wire transfers as an additional security procedure, but the customer had refused the offer.[36] The U.S. District Court for the Eastern District of Michigan rejected this argument, concluding that "requiring confirmation by additional users simply is an option or element within a security procedure. The 'security procedure' is the secure token technology."[37] As discussed *infra*, the court found this security procedure to be commercially reasonable.

2. Commercially Reasonable Security Procedures

The UCC's drafters recognized that a principal issue likely to arise in litigation involving fraudulent EFTs is whether any security procedure in effect was commercially reasonable.[38] To promote uniformity the drafters provided, unlike in UCC Articles 3 and 4, that the issue of "commercial reasonableness of a security procedure is a question of law" under Article 4A.[39] As explained in the Official Comments ("Comments"): "It is appropriate to make the finding concerning commercial reasonability a matter of law because security procedures are likely to be standardized in the banking industry and a question of law standard leads to more predictability concerning the level of security that a bank must offer to its customers."[40] Whether the bank complied with the security procedures, however, remains a question of fact.[41]

A court may find a security procedure to be commercially reasonable in one of two ways. Under the most direct method, a "security procedure" is deemed reasonable if:

> (i) the security procedure was chosen by the customer after the bank offered, and the customer refused, a security procedure that was commercially reasonable for that customer, and (ii) the customer expressly agreed in writing to be bound by any payment order, whether or not authorized, issued in its name and accepted by the bank in compliance with the security procedure chosen by the customer.[42]

The focus in this provision is on the content of the customer agreement. If

> an informed customer refuses a security procedure that is commercially reasonable and suitable for that customer and insists on using a higher-risk procedure because it is more convenient or cheaper[,] . . . the customer has

voluntarily assumed the risk of failure of the procedure and cannot shift the loss to the bank. But this result follows only if the customer expressly agrees in writing to assume that risk.[43]

In the event "a commercially reasonable security procedure is not made available to the customer, subsection [4A-202](b) does not apply. . . . The bank acts at its peril in accepting a payment order that may be unauthorized."[44] Article 4A recognizes that prudent banking practices require that security procedures should be utilized for all EFTs, and that "[t]he burden of making available commercially reasonable security procedures is imposed on receiving banks because they generally determine what security procedures can be used and are in the best position to evaluate the efficacy of procedures offered to customers to combat fraud."[45]

The second method is more complex. Whether a security procedure is commercially reasonable is determined by considering primarily four factors:

(1) "the wishes of the customer expressed to the bank;"
(2) "the circumstances of the customer known to the bank, including the size, type, and frequency of payment orders normally issued by the customer to the bank;"
(3) "alternative security procedures offered to the customer;" and
(4) "security procedures in general use by customers and receiving banks similarly situated."[46]

In applying these factors, "additional guidance" offered by the Comments may make a court's determination more complex. To begin with, the Comments indicate: "the concept of what is commercially reasonable in a given case is flexible." This is a pronouncement seemingly at odds with the stated goal of having the issue decided as a matter of law to create a uniform standard.[47] The Comments contain additional conflicting policy statements that could be cited by both the bank and customer:

> The purpose of subsection (b) is to encourage banks to institute reasonable safeguards against fraud but not to make them insurers against fraud. A security procedure is not commercially unreasonable simply because another procedure might have been better or because the judge deciding the question would have opted for a more stringent procedure. The standard is not whether the security procedure is the best available. Rather it is whether the procedure is reasonable for the particular customer and the particular bank, which is a lower standard. On the other hand, a security procedure that fails to meet prevailing standards of good banking practice applicable to the particular bank should not be held to be commercially reasonable.[48]

The Comments also introduce additional considerations. The first is a cost-benefit analysis:

> Verification entails labor and equipment costs that can vary greatly depending upon the degree of security that is sought. A customer that transmits very large numbers of payment orders in very large amounts may desire and may reasonably expect to be provided with state-of-the-art procedures that provide maximum security. But the expense involved may make use of a state-of-the-art procedure infeasible for a customer that normally transmits payment orders infrequently or in relatively low amounts.[49]

The second "is the type of receiving bank. It is reasonable to require large money center banks to make available state-of-the-art security procedures. On the other hand, the same requirement may not be reasonable for a small country bank."[50] A third is that the bank may offer different security procedures to different customers: "A receiving bank might have several security procedures that are designed to meet the varying needs of different customers."[51]

Numerous lawsuits have been filed in recent years by customers seeking recovery from their banks for fraudulent EFTs arising from malware attacks, presenting the issue of whether the bank's security procedures were commercially reasonable. Most of these cases have settled, and only a few have resulted in judicial decisions.

In *Patco Constr. Co., Inc. v. People's United Bank*,[52] the U.S. Court of Appeals for the First Circuit reversed a district court in Maine,[53] concluding that the bank's security procedures were not commercially reasonable. In *Patco*, a customer's computers had been infected by the Zeus/Zbot malware allowing cybercriminals to steal Patco's login credentials and fraudulently withdraw $588,851 through a series of large ACH transfers over several days in May 2009.[54] Patco had used online banking to make ACH transfers for weekly payroll payments involving recurrent characteristics: they were always made on Fridays; were initiated from computers in Patco's office in Sanford, Maine; originated from a single static Internet Protocol ("IP") address; were accompanied by tax witholdings and 401(k) contributions; and were modest amounts, the largest being $36,634.[55] The security procedure utilized by the bank consisted of: (1) user IDs and passwords; (2) invisible device authentication, which placed "device cookies" to identify computers used to access online banking; (3) risk profiling, consisting of a profile for each customer based on its online banking usage, to compare the transaction at issue; and (4) challenge questions and answers based on a dollar threshold for certain transactions.[56] The bank originally set the challenge question procedure to transactions over $100,000 for all customers, and subsequently lowered the threshold to $1.[57] As the First Circuit noted, "[t]here were several additional security measures that were available to [the bank] that [it] chose not to implement," including (1) Out-of-Band Authentication, such as notification to the customer via telephone or other means; (2) User-

Selected Picture; (3) Password-generating Security Tokens; and (4) Monitoring of Risk-Scoring Reports (with the latter two procedures adopted by the bank after the fraud occurred).[58] The fraudulent withdrawals were directed to new payees, originated from computers not recognized by the bank, and from an IP address that Patco had never used before, resulting in high risk scores of 790, 785, 720, and 563, a "significant departure" from Patco's usual risk scores of 10 to 214, but the bank did not have any procedure in place to monitor high risk scores or to notify the customer.[59]

The First Circuit concluded that the bank's collective failures rendered its security procedures commercially unreasonable:

> In our view, Ocean Bank did substantially increase the risk of fraud by asking for security answers for every $1 transaction, particularly for customers like Patco which had frequent, regular, and high dollar transfers [because it exposed such answers to be captured by malware.] Then, when it had warning that such fraud was likely occurring in a given transaction, Ocean Bank neither monitored the transaction nor provided notice to customers before allowing the transaction to be completed. Because it had the capacity to do all of those things, yet failed to do so, we cannot conclude that its security system was commercially reasonable.[60]

The First Circuit emphasized that the bank's adoption of a "one-size-fits-all" $1 threshold for all customers violated "Article 4A's instruction to take the customer's circumstances into account."[61] The court also based its conclusion on the fact that the bank did not utilize other security measures "not uncommon" in the industry, including manual reviews of high risk transactions and the use of password-generating security tokens.[62]

In two other recent cases, however, the courts focused on the content of bank-customer contracts in finding that the bank's security procedures were commercially reasonable. In *Experi-Metal, supra,*[63] the district court held the security procedure to be commercially reasonable, finding that under the "plain and unambiguous terms of the [deposit agreements, the bank's] secure token technology was reasonable" because the customer so agreed in its contract with the bank. The court rejected as parol evidence the customer's expert's opinion that secure token technology was not a commercially reasonable security procedure.[64] In *All American Siding & Windows, Inc. v. Bank of America, N.A.*,[65] a Texas court similarly relied on online banking agreements in which the customer "agreed that the authenticity of ACH transactions were to be verified using an ID, passcode, and digital certificate verification."[66] Based on those agreements and the bank's affidavit that it "follow[ed] the guidelines of the Federal Financial Institution Examination Counsel and requires multifactor authentication for its online banking customers," the court concluded that the security procedures were commercially reasonable, entitling the bank to summary judgment.[67]

3-4. "Compliance" with Security Procedures and Written Instructions

Under the third element, the bank must prove that it complied with the security procedure in processing the payment order: "If the fraud was not detected because the bank's employee did not perform the acts required by the security procedure, the bank has not complied."[68]

Under the fourth element, the bank must similarly prove that it complied with "any written agreement or instruction of the customer restricting acceptance of payment orders . . . ."[69] The Comments recognize that "[a] customer may want to protect itself by imposing limitations on acceptance of payment orders by the bank. . . . Such limitations may be incorporated into the security procedure itself or they may be covered by a separate agreement or instruction."[70] The Comments provide several examples of the limitations customers may impose:

> the customer may prohibit the bank from accepting a payment order that is not payable from an authorized account, that exceeds the credit balance in specified accounts of the customer, or that exceeds some other amount. Another limitation may relate to the beneficiary. The customer may provide the bank with a list of authorized beneficiaries and prohibit acceptance of any payment order to a beneficiary not appearing on the list.[71]

5. Bank Must Prove it Acted in "Good Faith"

As the fifth and final element, the receiving bank must prove that it processed the payment order in good faith.[72] Under Article 4A, "good faith" is defined as "honesty in fact and the observance of reasonable commercial standards of fair dealing."[73] This definition includes a subjective element of good faith and objective element of the observance of reasonable commercial standards of fair dealing. "Although 'fair dealing' is a broad term that must be defined in context, it is clear that it is concerned with the fairness of conduct rather than the care with which an act is performed."[74] "Honesty in fact" is measured by a subjective standard, requiring a court to examine the facts surrounding the transaction.[75] The bank's "observance of reasonable commercial standards of fair dealing," however, is evaluated by an objective measurement of the fairness of the party's action in light of prevailing commercial standards.[76]

In *Experi-Metal, Inc.*, the customer argued that the bank failed to act in good faith. On January 22, 2009, criminals had hacked into the customer's account, and begun transmitting numerous wire transfer orders to the bank. Between 7:30 a.m. and 10:50 a.m., the bank processed 47 transfers from the customer's account to various accounts in Russia, Estonia, Scotland, Finland and China, as well as domestic accounts. Between 10:53 a.m. and 2:02 p.m., the bank processed another 46 wire transfers. Altogether the bank transferred $1.9 million out of the customer's account.[77] In two previous years, the customer had made only two wire transfers, both in 2007.[78] In these circumstances, the customer contended that the bank's failure to question the wire transfers constituted a lack of good faith.[79] The court agreed, finding a genuine issue of fact existed whether the bank acted in good faith in view of prior wire activity, the number of sudden wire transfers, and the destinations of the payments.[80] At a bench trial, the court ruled in favor of the customer. The bank presented evidence only on the subjective element of good faith, failing to "present evidence from which this Court could determine what the 'reasonable commercial standards of fair dealing' are for a bank responding to a phishing incident such as the one at issue and thus whether" the bank satisfied "the objective prong of the 'good faith' requirement."[81] As a result, the court as "trier of fact [was] inclined to find that a bank dealing fairly with its customer, under these circumstances, would have detected and/or stopped the fraudulent wire activity earlier."[82]

B. Liability When the Customer is Not the Source of the Security Leak

An important exception exists to Article 4A's allocation of liability to the customer. Under section 4A-203(a)(2) a customer will not be obligated to bear the loss where it can prove the payment order was not issued by (a) it or its agent or (b) someone who gained knowledge of the security procedure (*e.g.*, user ID, password, etc.) from it or its agent.[83] This provision specifically eliminates negligence of the customer; the issue is whether the customer was the source, "regardless of how the information was obtained or whether the customer was at fault."[84] The exception functions like an affirmative defense in litigation, for which the customer bears the burden of proof under section 4A-203(a)(2).[85] As the Comments note, while the "burden of making available commercially reasonable security procedures is imposed on receiving banks," the corresponding "burden on the customer is to supervise its employees to assure compliance with the security procedure and to safeguard confidential security information and access to transmitting facilities so that the security procedure cannot be breached."[86] The purpose behind this exception is pragmatic, and based on the reality that criminals have two avenues of attack, against either the bank or the customer.[87]

Conclusion

In assessing whether a bank or its customer should bear the loss for a fraudulent EFT, the key determination is whether the bank's security procedures were commercially reasonable under the UCC and newly developing case law. In this regard, the parties should focus on: (i) the terms of any bank-customer agreements; (ii) whether the bank's security procedures complied with banking agency guidelines; (iii) whether the bank's security procedures were designed to meet the circumstances of the customer, as opposed to a one-size-fits-all approach; and (iv) whether the bank implemented and followed readily available security procedures in connection with the transactions at issue.

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LOAN PARTICIPATIONS – TIME FOR ANOTHER LOOK
Part II
By Andrew Connor

This is the second part of an article about loan participations -- arrangements between lenders in which one makes a loan to a borrower and, then or later, sells an interest in the loan to another lender. In the first part, we looked at the duties of the lead to the participant. In this article, we look at how courts have viewed participations: what sort of claim does the participating lender hold, and against whom?

Our investigation was prompted by a client that held a participation in a loan and was unhappy to learn that the lead was proposing to sell the loan to a third party, apparently without notifying the third party of the existence of the participation. What rights did our client have? Very few, we found, upon review of the participation agreement. It was a one-sided document which gave the lead broad powers to administer the loan as it saw fit, as well as to sell it.

We reviewed the law to see what duties the lead lender owed to the participant and were dismayed by what we found (See part 1 of this article). Having concluded that the caselaw, taken with the wording of our client's participation agreement, failed to impose meaningful duties on the lead with respect to the participant, we turned to considering the nature of the participation interest itself. The participation agreement said that our client owned an *undivided interest* in the loan. That, we thought, should give it status as a creditor of the borrower with recourse to the borrower to enforce the debt, even if the lead failed to seek collection or sold its interest in the loan. But what we found in the cases did not confirm that.

What sort of interest is a participation? Well, there are a few cases which have suggested that a participation might be a joint venture. In *Great American Mortgage Investors v. Louisville Title Insurance Company,*[88] the court said a loan participation was as a "joint adventure" because there were (1) a community of interest between the two lenders, (2) joint rights of control, and (3) sharing of profits and losses and costs and expenses. But, since the lender-borrower relationship remains with the lead lender and most participation agreements give the participant very little control, the element of control was probably missing. The court avoided deciding the point by ruling that, in the alternative, the arrangement was an assignment without recourse and an agency, where the lead lender acted as agent for the other. As a result, the participant, Great American, had imputed to it knowledge which the lead lender had of title restrictions on the property securing the loan and therefore could not have justifiably relied on the title insurer's misrepresentation that no restrictions on title existed.

Royal Bank of Canada v. Interfirst Bank Fort Worth, N.A.[89] concluded that no joint venture existed between the lead and the participant because the participant, Royal Bank of Canada, did not have a joint right of control over the loan. Instead, the court characterized the transaction as one in which the participant was an assignee and the lead was the agent for servicing the loan. Among other things, Royal Bank complained that the lead had breached the participation agreement because, as an assignee, Royal Bank was entitled to all the protections of the loan documents and the lead had waived certain defaults by the borrower without Royal Bank's consent. The court, however, held that the participant could not claim the benefits and protections of the original contract between the lead bank and the borrower.

Thus, even though an assignment is normally viewed as transferring ownership rights in the assigned property, the courts have not viewed a participation as direct ownership of part of the loan. Cases going back to at least 1965 have held that the interest acquired by the participant is something less than direct ownership. Two decisions handed down more than 40 years ago established what now seems the accepted view that the participant has no ownership interest in the actual loan. One is *In re Yale Express System, Inc.*[90] , cited by the court in *Royal Bank*. The other is *FDIC v. Mademoiselle of California*[91].

In *Yale Express*, the court ruled that the participant could not set off deposits of the borrower against the participant's interest in the loan. There, the lead, First National City Bank ("FNCB") made a loan to Yale Express and then sold a participation to Marine Midland Trust Company. According to the court, the participation agreement provided that Marine Midland took an undivided 40% participation in each advance made by FNCB to Yale Express. The participation agreement did not give Marine Midland any right to receive any payment from Yale Express, nor did it give Marine Midland any right to approve changes to the terms of the credit agreement or any underlying security agreement. Marine Midland had only a right to be paid by FNCB an agreed share of whatever FNCB received from Yale Express. Yale Express, however, maintained a deposit account at Marine Midland, which was probably a reason why Marine Midland bought the participation. When Yale Express defaulted and filed bankruptcy, Marine Midland set off some $361,739.71 in deposits it was holding against its share of the loan. Yale Express's trustee challenged the setoff for lack of mutuality and the court agreed, holding that Marine Midland was not a creditor of Yale Express and therefore held no debt to set off against the deposit.

Yale Express was followed by the U.S. Bankruptcy Court in *In re Okura & Co. (America), Inc.*[92] There, a participant sought to file a claim directly against the borrower in bankruptcy. The court held that the participation agreement did not give the participant any rights against the borrower, noting that many courts have "grappled with question similar" and held that participants may not claim directly against the borrower. *Mason Dixon Lines Inc. v. First National Bank of Boston*[93] also followed *Yale Express* and rejected an argument by a borrower in bankruptcy that the lead could not collect with respect to the portion of the loan that had been participated, the court saying that borrower's obligation is only to the lead and for the full amount of the loan.

FDIC v. Mademoiselle of California involved an insolvent lender, rather than an insolvent borrower. San Francisco National Bank ("SFNB") made a loan to Mademoiselle of California and then sold an 80% participation to Union Bank. The wording of the participation document described the interest sold as "a participation of $46,400.00 being a portion of the following described note made payable to [SFNB]". Subsequently, SFNB was declared insolvent and Mademoiselle sought to offset its deposit account balance at SFNB against the loan.[94] The district court held that Mademoiselle was entitled to set off the deposit and that Union Bank was entitled to a "preferred claim" against the assets of SFNB for 80% of the deposit setoff amount, which would have been entitled to priority in payment over the claims of general creditors.

But on appeal, the Ninth Circuit Court of Appeals reversed the latter part of the district court's ruling, holding that Union Bank did not have a preferred claim, thereby leaving Union Bank with nothing but an unsecured general creditor claim against SFNB for an amount equal to 80% of the setoff amount. The rationale advanced for this was that a direct recovery against the receiver for SFNB would only be authorized where it was established that "the property is not that of the [insolvent] bank but that of the claimant" – meaning Union Bank. So Union Bank had to "identify a specific fund or payment in the possession of the receiver cognizable in equity as Union's own property" in order to have a "preferred claim" to share in such fund.

Union Bank argued that it was an assignee of 80% of Mademoiselle's note and to that extent stood in the shoes of SFNB as a creditor of Mademoiselle, subrogated to a banker's lien claim against Mademoiselle's deposits. The court acknowledged that an assignment of payments to be made in the future passes legal title in the proceeds to the assignee, but said that here the offset was not against future payments, merely against "previously established credits" and was therefore insufficient to establish a fund against which Union Bank could claim. Union Bank would have had a preferred claim only if, and to the extent that, there was a "preferred fund"- meaning a payment by the borrower to SFNB. In the court's opinion, deposits existing at the time when SFNB was declared insolvent did not constitute such payments and were not a "preferred fund".

Mademoiselle of California contrasts with *Delatour v. Prudence Realization Corporation*[95], a 1948 case from the Second Circuit Court of Appeals which effectively treated the participants as direct owners of the underlying debt. There, investors were sold participation certificates in a single mortgage of an apartment building and the debt instrument which was secured thereby. The mortgage debt bore interest at 6% but the participation certificates provided for 5.5% interest, with the difference to be retained by Prudence, which serviced the mortgage and also guaranteed the payments of principal and interest on the participation certificates.[96] The mortgagor defaulted and subsequently Prudence defaulted on its guaranty. The property was eventually sold and the certificate holders then claimed that they should receive interest at the mortgage rate of 6%, rather than the lower certificate rate.[97] Each of the certificates provided that it assigned to the purchaser an undivided share or part of the bond and mortgage equal to the face amount of the certificate and bore interest at 5.5%, payable semi-annually.

The certificate holders claimed that they owned their portions of the mortgage as tenants in common and by virtue of such status were entitled to have the mortgage paid in accordance with its terms, including interest at the mortgage rate. The court agreed, finding that "the certificates were made payable by reference to the payments on the mortgage" and that the lower 5.5% rate was applicable only if the guarantor performed its guaranty.

> "When the grace period expired without the guarantor's having made good its guaranty, the limitation upon interest due holders became null and void as of the date the mortgage matured and the certificate holders became entitled to their share of the mortgage itself, or its proceeds, with interest thereon at the mortgage rate from that time."

This result doesn't reconcile with the idea that the participants were creditors of Prudence whose claims were secured by the underlying mortgage loan, because in that case they would only have been entitled to recover the amount owed by Prudence, as to which the applicable interest rate was 5.5%. Instead, this decision suggests that the participants were assignees of the loan and mortgage, subject to a contract under which they agreed that the lead could retain half a percentage point of the interest in return for providing the guarantee and acting as agent for servicing.

Delatour is the exception, however. Almost all courts to have considered the issue have held that participants do not have direct rights against the borrower. For example, in *In re Autostyle Plastics, Inc.*,[98] a second lien lender argued unsuccessfully that participants' claims were against the borrower (a debtor in bankruptcy) rather than against the lead lender (which held a first priority security interest in the borrower's assets). Had the participants' claims been viewed as claims against the borrower, they would have been lower in priority than the second lienholder's position. The court, however, found that the participation agreements in question were "true" participations where the participants' right to repayment only arose when the lead lender was paid and only the lead had rights against the borrower.

Mademoiselle of California can be distinguished from *Delatour* because in *Delatour* the participants were seeking recovery based on the collateral which expressly was stated to secure the participants' participations. *Mademoiselle of California* doesn't say that the deposits were collateral expressly securing the borrower's loans from SFNB or that SFNB's rights against the deposits secured the participation of Union Bank.

This point is also made in *In re Alda Commercial Corporation*[99], where the court held that the participant had no interest in the property of Alda, the bankrupt lead, including the participated loans (which evidently were still performing), even though the participation agreement stated that Alda and the participant agreed to be joint venturers with respect to the subject loans. The court decided that, notwithstanding such provision, the relationship between Alda and the participant was not a joint venture, just a purchase of an interest in the loans and "the participant was limited as to collection to monies obtained by" Alda from the borrowers. The participant apparently believed that it had a security interest in Alda's loans to the borrowers, but since it had not perfected that security interest by filing a financing statement, the court dismissed that assertion as unenforceable as to creditors of Alda.

Alda is unclear about whether the participant would have a preferred claim with respect to subsequent payments actually made to the receiver, stating only that the participant could file his claim as a general creditor of the lead, and that the participant would be limited to monies collected on the loans. Nothing was said as to whether the claim would have priority with respect to any such collections, only that the participant's claim would not be payable from Alda's other assets.

Penn Square Bank, N.A. failed notoriously on July 5, 1982 when it was declared insolvent by the Comptroller of the Currency and the FDIC was appointed receiver. In the ensuing winding up, there arose several cases involving loan participations sold by Penn Square where the "upstream" lenders sought to share in offsets of deposits or other collateral held by Penn Square. The cases present more than one theory of recovery on behalf of the participants, but the courts more or less uniformly rejected these claims and followed the rule, set forth in *Mademoiselle of California*, to the effect that a participation doesn't create rights against the borrower's deposits and there must be a fund to claim against for the participant to have a preferred claim against an insolvent lead.

Chase Manhattan Bank, N.A. v. FDIC[100] is instructive. Chase Manhattan Bank had acquired loan participations from Penn Square. When the FDIC declared Penn Square insolvent, it commenced offsets of funds on deposit against indebtedness owed by the depositors, including borrowers under the loans in which Chase participated. Chase demanded that the FDIC remit to Chase a percentage of such deposits equal to Chase's percentage share of the relevant loans. The FDIC refused. In the ensuing litigation, the FDIC informed the court that it would provide Chase with a "Receiver's Certificate"[101] for Chase's pro rata share of the amounts offset. The FDIC also said that if any payments were made to the FDIC by the borrowers on the loans, the FDIC would remit to Chase its percentage share of those amounts.

The court first noted that the borrowers were entitled to insist on offset, per *Mademoiselle of California*, which it cited as "the leading and in fact only cited authority" with respect to the issue at hand, saying *Mademoiselle of California* "extended the general rule of the depositors' right of offset to situations involving loan participations." Going on, the court said:

> "There [in *Mademoiselle*] the Court held, as a matter of law, that an offset of a deposit against a participated loan does not augment the insolvent estate and therefore does not generate funds which could become the basis for a preferred claim."

Chase, apparently mindful of the requirements laid out in *Mademoiselle*, had alleged the requisite elements – that the offset had created a fund which augmented the estate of Penn Square. But the court disagreed and said that an offset was not a payment but merely a bookkeeping transaction.

Chase also argued that *Mademoiselle* was distinguishable because the borrower did not know of the existence of the participation, whereas at least some of the borrowers of the loans in which Chase held participations knew that Chase had an interest. The court acknowledged that the *Mademoiselle* court regarded the lack of such knowledge as "an additional equity in favor of the borrower-depositor's right of setoff", but did not agree that such distinction should change the outcome.

Finally, Chase claimed that the deposit accounts were collateral to Chase – that Penn Square had granted to Chase a "direct interest" in the collateral security for the participated loans. Had it prevailed on this argument, Chase would have been on a footing with the participants who prevailed in *Delatour*. The court, however, reviewed the language of the participation certificates issued to Chase and disagreed:

> "No security interest in the collateral securing the participated loans was granted to Chase. It is also clear that Penn Square Bank did not assign, either in whole or in part, the participated loans or the collateral securing such loans to Chase. The provisions of the participation agreement state that a participation is "sold" to the participating bank. Penn Square Bank reserved the right to enforce the obligations of the borrower. Security for loans was specifically pledged to Penn Square Bank. Most importantly, Penn Square Bank retained the notes themselves which evidenced the loans and collected the payments on the notes from the borrowers.
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> * * *
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> While an assignee has actual property rights with respect to the assigned accounts . . . the participating bank which is not an assignee has merely contractual rights and no property rights in the participated loans or the collateral securing them."

The *Chase* decision can be viewed narrowly as resting primarily on construction of the actual wording of the participation agreement. But the court ignored the fact that in *Mademoiselle of California* the party demanding offset was the borrower, whose rights clearly should not be prejudiced by the existence of a participation (particularly an unknown participation), whereas in *Chase* the party insisting on offset was the receiver of the lead bank and the lead clearly had obligations to Chase. Had there been no offsets, Penn Square's receiver would have been liable to the customer for the deposits and, up to the insured maximum, the FDIC would have made good to the depositor, who could then have paid the funds received from the FDIC (in its capacity as insurer) in cash to the FDIC (in its capacity as receiver) to be applied against the loans, obligating the receiver to share those payments with Chase. At least to that extent, one might think that the insured deposit amount of each borrower constituted an identifiable fund from a third party (the FDIC, in its capacity as insurer) that would have been available for Chase to claim against. But the court chose to ignore that the FDIC was wearing two hats in the matter, one as insurer and one as receiver.

The participant also lost on this issue in *Hibernia National Bank v. FDIC*,[102] where the court held that the participation agreement did not transfer from Penn Square to the participant Hibernia National Bank an ownership interest in the subject loans. The court made this holding even though the actual participation document expressly acknowledged Hibernia's participation and confirmed that Penn Square was holding for Hibernia's account a pro rata interest in the unpaid principal of the subject note, together with the same proportionate interest in any and all interest on the note, and in *any and all collateral securing the same*, together with any guaranties thereof.

As in *Chase*, the court held that Hibernia did not have a preferred claim to its share of the borrowers' deposits offset by the receiver against the participated loans. The court's description of the relationship between Penn Square and Hibernia was that "The lead [Penn Square] is the only secured party. The participants can look solely to the lead for satisfaction of their claims *because they are not themselves creditors of the borrowers and cannot assert claims against the borrowers*." (Italics supplied.)

The Northern Trust Company also participated in some Penn Square loans, receiving certificates of participation virtually identical to those issued to Hibernia. Predictably, when Northern Trust sued seeking its share of offset deposits, the court ruled in favor of the FDIC.[103] Specifically, the court said that the wording in the certificates did not "create or transfer any ownership or property rights in the participated loan or the supporting collateral". Straining, the court reached this conclusion while at the same time holding that the participation certificates "clearly and unambiguously" established an assignment and agency. It is difficult to see how there could be an assignment from Penn Square to Northern Trust without making Northern Trust into a creditor of the borrower under the assigned note, but Northern Trust's claim was denied.

Yet another Penn Square case reaching a similar outcome is *Seattle-First National Bank v FDIC*,[104] where the court held that Seattle-First National Bank ("Seafirst"), as participant, was not entitled to share in setoffs of deposits. In this instance, there was a Participation Agreement as well as a Certificate of Participation. By its terms, the Participation Agreement controlled, and the full text of the Participation Agreement is set out in the body of the opinion. Unlike the documents in Chase, Hibernia and Northern Trust, this document described the transaction as a sale of the participation and expressly said that Seafirst would own an undivided interest in the loans. Section 2 thereof stated:

> 2. *Owner Trustee*. To the extent of its participation in the loans, Purchaser [Seafirst] shall be the owner of an undivided fractional interest in each such loan, including, but not limited to, all notes and other instruments evidencing indebtedness of the borrower, together with all collateral securing such indebtedness. To the extent of Purchaser's interest therein, including, but not limited to, its pro rata share of all funds and payments received and/or to be received by Seller [Penn Square] from the borrowers. Seller shall be a trustee for the benefit of and accountable to Purchaser, and shall hold all such notes, mortgages, and collateral security instruments together with all such funds and payments in trust for Purchaser for its sole and exclusive benefit.

Notice that the agreement expressly said that Seafirst *owned* an interest in the loans, together with all collateral securing the loans, and Penn Square *shall be a trustee* for the benefit of Seafirst. Notwithstanding that the court found "that the agreement arguably created and conveyed property rights in the participated loans", and acknowledged that the agreement referred to Seafirst as the "owner" of a fractional interest in the loans, it nevertheless concluded that Seafirst "acquired nothing more . . . than an expectation of the borrower's repayment".

Seafirst also claimed that a trust was created and Penn Square was trustee for the benefit of Seafirst, based on the wording in Section 2 but also relying upon wording elsewhere in the agreement obligating Penn Square to immediately place all payments on the loans in a reserve account as soon as collected, and obligating Penn Square to consult with Seafirst on any matter that might affect Seafirst's interest in the loans. The court rejected that argument because other provisions of the agreement indicated that Penn Square retained sole management of the loans and collateral and was the sole secured party, and because Penn Square did not have to take enforcement action requested by Seafirst unless Seafirst first indemnified Penn Square for Seafirst's share of any expense or liability incurred in connection with the requested action. Moreover, said the court, banks engaging in commercial arm's length transactions do not stand as fiduciaries to each other.

The court finished by invoking *Mademoiselle of California*, saying that even if Seafirst were to succeed on its property and trust arguments, the FDIC would prevail if the offsets were proper because such offsets did not create a fund for Seafirst to claim against. So Seafirst's participation was subject to the right of the borrower to require offset, and therefore, according to the court, Seafirst should bear the risk of Penn Square's creditworthiness and solvency.

Arguably, the decisions in *Chase*, *Hibernia* and *Northern Trust* can be justified on the grounds that in each case the participation did not assign or sell an interest in the loan and was nothing more than a contract between the participant and Penn Square under which Penn Square promised to make payments only if it received payments from the borrower, and that the offsets weren't payments from the borrowers within the meaning of the participation agreements. (But why would any of the participants, sophisticated commercial lenders all, have agreed to that -- that Penn Square could reduce the debt without compensating the participant for its share of the reduction? It defies belief.) *Seattle-First National Bank* is harder to explain or accept. Assuming that the parties intended that Seafirst would be a co-owner of the loans, one wonders how that could have been expressed any more clearly. But notwithstanding the clarity of the language, the court concluded that the Participation Agreement was ambiguous as to the existence of both property rights and trust relations, and that it did not confer on Seafirst status as a creditor of the borrower. Instead, said the court, the "ownership interest" acquired was "merely its share of an expectation generated, managed, enforced and collected by the lead bank, Penn Square."

In short, the cases seem to say that the document between the lead and the participant didn't give the participant rights in the loan, regardless of the wording. Instead, a participation only created rights whose scope was to be determined by reference to the performance of the loan. *Shadow rights*, they might be called. Lender B gets paid only if Lender A gets paid and only based on what Lender A receives.

Our client's participation agreement said it was an assignment of an undivided interest in the lead's right, title and interest in and to the loan, loan documents and collateral, but it also gave the lead control of the loan and excluded our client from administration and collection of the loan. We reluctantly concluded that the client would be fighting an uphill battle if it tried to act directly against the borrower. Moreover, legal action by our client against the borrower might be viewed as violating the lead's right to control administration and collection efforts, giving rise to possible breach of contract claims. So where did this leave us? In limbo, it seems. Our client had no right to prevent the lead from selling, no right to make the lead (or its successor) enforce the loan, and no certainty that a court would allow the client to seek collection directly against the borrower, if the client was willing to make the effort to try. A most unsatisfactory answer.

Conclusion

Clearly, it would be in the interest of the participants to have rights that are better defined. As the cases show, the expectations of the participant differ from those of the lead in certain ways. The lead expects that the existence of the participation imposes an extra burden on the lead only in that it must account for and pay over to the participant the participant's pro rata share of amounts collected by the lead on the loan. From the lead's perspective, the presumption is that the lead has no other duties to the participant. Additional responsibilities will exist only if expressly agreed to in the participation agreement.

The participant's expectations appear to include that the lead has underwritten and will administer the loan in a reasonably prudent fashion, as behooves a commercial lender in respect of loans it makes. The participant may also expect that it will be treated as a creditor of the borrower – that it isn't acquiring a "shadow" interest confined only to rights against the lead to the extent that the lead actually gets paid by the borrower. But the participation agreement seldom contains anything suggesting that such expectations are part of the deal. The cases show that these differing expectations have led to participants suing the lead (or its receiver). Such conflicts might be avoided (or at least made more rare) if the parties' expectations were more in sync, which could be achieved by a more comprehensive participation agreement.

Accordingly, we believe that when a participation is being negotiated and a participation agreement being prepared, the parties should consider and address in the document the following:

1. Defining the interest being sold and clearly state that the participant is not making a loan to the lead and will only receive payment if it comes from borrower or collateral or guaranties securing borrower's obligations to the lead. If the participation interest contains unusual features, such as "last-in" or "last-out", or is otherwise on any footing other than a straight pro-rata share of all payments received, that should also be clearly stated. If the participant may assign or subdivide its interest, that should be stated.

2. Acknowledging that the participant did not rely and has no right to rely on the lead's due diligence, credit review or underwriting. But the participant should be assured that the lead has not knowingly misrepresented or omitted any material facts. And the lead should provide, and give assurances, that it has provided complete and correct copies of the loan documents, including UCC filings and judgment, lien and tax lien searches, and any information provided to the lead by the borrower. It is not reasonable for the participant to take documentation risk unless it has been given the documents.

3. It should be clear that if the lead becomes insolvent or a receiver is appointed for the lead, or if the lead becomes unable or unwilling to administer the loan, then participant has the right to collect its proportionate interest in the loan directly from the borrower.[105]

4. The collateral in which the participant is entitled to share should be clearly described and should include setoffs against deposits or other property of borrower held by the lead, *unless the parties explicitly agree otherwise*. If there are assets of borrower which are not part of the collateral for the participated loan, the participation agreement should address whether, and under what conditions, those other assets may become collateral for other extensions of credit by the lead (or the participant) to the borrower and not be required to co-secure the participated loan.

5. Unless the parties agree otherwise, the standard of care to be exercised by the lead should be stated as the care which a reasonably prudent commercial lender would exercise in like circumstances and should include a disclaimer of any fiduciary relationship. In this regard, we note that some participation agreements describe the lead's responsibility in administering the loan as requiring the same level of care that it uses to administer its other loans. In our view, that standard is a potential nightmare in litigation because it could open the door to extensive discovery by a participant as to how the lead has handled its other loans. Use of a "reasonably prudent commercial lender" standard may help prevent such a fishing expedition.

6. The agreement should specify a listing of any actions which the lead may not take without the participant's approval. Typically, these would include prohibitions such as the following:
   - extension of maturity dates;
   - decreases of interest rates;
   - forgiveness of principal, interest or fees;
   - changing scheduled payment dates;
   - waiving mandatory prepayments; and
   - waiving events of default.

7. The agreement should state whether the lead has sold or is free to sell additional participations in the loan, and whether the lead will nevertheless continue to hold at least a specified percentage or amount of the loan until maturity. It should also state whether the lead can grant different consent and approval rights to other participants.

8. The agreement should state whether the lead has a right to repurchase the participation interest if the lead requests a consent or approval and the participant refuses.

9. If the agreement includes a provision requiring the lead to maintain a specific minimum percentage or amount of the loan, or restricting granting of other participations, then the participation agreement should also give the participant a right to "put" the interest back to the lead if the lead breaches any such obligation.

Participations offer a convenient way for lenders to diversify their portfolios and share opportunities, but the parties need to understand what the relationship is and is not. Thoughtful discussion of the issues and careful drafting will lead to clearer understanding and expression of the parties' agreements, resulting in fewer disappointed expectations and consequently fewer disputes when problems arise.

> *The difference between the right word and the almost right word is the difference between lightening and a lightening bug.*
>
> \- Mark Twain

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ARE FACTORING TRANSACTIONS "TRUE SALES"? SHOULD FACTORS CARE?[106]

By Haywood A. Barnes

This article was written in response to questions from my factoring clients regarding whether factoring transactions constitute "true sales" of accounts receivable and, if not, why and what are the ramifications. A number of very good articles on this topic have been written over the years.[107] What I have tried to do a little differently here is explain in some detail how factoring transactions work and then explain and apply true sale analysis to those details. As you will see, I take the position that factoring transactions in almost all instances would not withstand true sale scrutiny, but I also take the position that, in most cases, the lack of a true sale should not be an issue for factors.

I. Factoring Basics

To lay the groundwork for this article, I need to describe how factoring transactions work. I will do this by describing the two principal varieties of factoring transactions: Notification Factoring *Without* Advances and Notification Factoring *With* Advances.

A. Notification Factoring *Without* Advances

In this type of transaction, the factor purchases accounts receivable from the seller (sometimes called the "client" by the factor) with full notification to each account debtor (sometimes called the "customer" by the factor). In some transactions of this type the factor purchases all of a client's accounts, and in others the factor purchases only the accounts a client offers for sale.

The typical "purchase price" of an account sold in this type of transaction is the net invoice amount (i.e., the gross invoice price less discounts for early pay and other amounts deducted by the seller), less the factoring "commission" on such account. The factor collects the factored accounts and "pays" the purchase price to the client by remitting those collections to the client on a periodic basis, less any obligations owing by the client to the factor and any reserves established by the factor.

A client's main reason for entering into this kind of transaction is the factor's assumption of the customer's credit risk on approved accounts. Approved accounts (sometimes called "factor risk" or "warranted" accounts) are accounts on which the factor has assumed the risk that the customers will not pay due solely to their financial inability. If a customer does not pay an approved account by its due date solely due to financial inability, the factor "matures" the account - i.e., it pays the purchase price of the approved account to the client.

Approved accounts become unapproved accounts (sometimes called "client risk" accounts) if the client breaches any of the various reps, warranties and covenants contained in the factoring agreement regarding the approved accounts, including the representation and warranty that the accounts are upon purchase, and will continue to be, owing without "dilution" (i.e., customer disputes and deductions).

Factors charge a factoring "commission" on each factored account, the amount of which varies greatly but usually is in the neighborhood of 0.5% to 1.5% for customers with good credit. The factor deducts such commissions from collections on the factored accounts, but commissions are payable whether or not there are sufficient collections from which to deduct them.

Factors also charge interest on the client's obligations owing to the factor, but since the amount of such obligations is relatively small in a transaction without advances, interest charges in such a transaction are usually small. Larger amounts of interest are more typical in Notification Factoring With Advances transactions as discussed below.

Factoring agreements typically contain few reps and warranties outside of the standard reps and warranties regarding a client's existence, good standing and approval to enter into the transaction and standard reps and warranties regarding the factored accounts (e.g., the seller has good title free and clear of adverse claims, the accounts are not subject to disputes or other setoffs, the account represents a bona fide sale of goods or rendition of services, etc.).

In addition, factoring agreements typically have few covenants, either affirmative or negative, outside of basic covenants regarding the factored accounts (e.g., placing a notification of the sale and remittance instructions on the invoices; notifying the factor of all disputes; etc.) and covenants to provide financial information to the factor.

Factoring agreements typically contain events of default similar to those found in loan agreements (e.g., for non-payment of obligations owing to the factor, false representations and warranties, breach of covenants and insolvency events) but without the detail and breadth found in typical loan agreements.

Similarly, a factor's remedies upon default are not as detailed and broad as those found in loan agreements for a secured lender but do mimic the basic structure of such remedies in that they typically provide for termination of the agreement and acceleration of the obligations following a default, as well as the rights of a secured party under the applicable UCC.

B. Notification Factoring *With* Advances

This type of transaction is similar in all respects to Notification Factoring Without Advances except that the factor makes an "advance" payment of the purchase price of the factored account to the client and applies collections on the factored accounts to pay down the advances.

Advances typically are funded upon the client's request up to a client's "availability". Availability usually is calculated as the net amount of unpaid approved (and sometimes unapproved) accounts, multiplied by the applicable advance rate (something in the 80%-90% range is not unusual, but advance rates can vary widely), less the amount of unpaid obligations and reserves.

Reserves typically may be held in any amount and for any reason, and factors typically retain sole discretion whether or not to make advances, regardless of availability. Collections on factored accounts, as well the proceeds of approved accounts matured by the factor, are applied to reduce the unpaid balance of the advances and other amounts owing by the client to the factor.[108]

Thus, as you can see, the advance rates and funding/paydown mechanics in these types of transactions closely mimic those found in asset-based lending transactions (except with respect to matured accounts, for which no counterpart exists in a lending transaction because lenders do not assume customer credit risk).

Factors may, and often do, obtain additional collateral in these types of transactions in the form of security interests on non-approved and even non-factored accounts receivable, inventory and other assets of a client. Factors also may make loans and advances against the value of such additional collateral as part of the overall credit facility to the client. When possible and required, factors also obtain unconditional payment guaranties by various persons and entities associated with the client. Such additional collateral and credit support may also be found from time to time in Notification Factoring *Without* Advances transactions but are more common in arrangements with advances.

II. Factoring and "True Sale": Background

In a nutshell, a true sale of accounts receivable is a sale that is not subject to recharacterization as a secured loan. That's simple enough, but getting one's hands around just exactly *why* a sale is a "true sale" (and thus not subject to recharacterization) is not as simple.

A. Elements of True Sale

The various factors (no pun intended) evidencing a true sale are not found in any single source but rather have developed over time through case law, scholarly writings and industry practice. Not all such factors need be present in a given transfer for an attorney to opine - or a judge to determine - that a transfer is a true sale. However, the more undiluted true sale factors that are present in a given transaction, the more likely a law firm will opine - or a judge will determine - that such transaction is a true sale.

The following is a list of what I consider the principal true sale factors. Other practitioners' and academics' lists may differ but likely include many, if not most, of the following.

1. <u>Recourse</u>. Probably the most important true sale factor is the absence of recourse by the transferee to the transferor for non-payment of the transferred asset. As with any sale, however, recourse is permitted for the seller's breach of standard reps, warranties and covenants regarding the transferred assets, including in the case of an accounts receivable transfer, the failure to keep the accounts free of dilution. Thus, the type of recourse that is not permitted in a true sale is recourse for non-payment

due to the account debtor's credit risk. This distinction between permissible and impermissible recourse is described at length in the classic Business Lawyer article, Rethinking the Role of Recourse.[109]

2. Intent. The parties' intention to accomplish a true sale, rather than a loan, must be expressed in the transaction documents and otherwise, including in communications between the parties and in each party's records. The substance – rather than the form – of the transaction is what is important. Thus, documentation that describes a transfer as a sale but that also contains indicia of a loan will not be helpful to support a true sale. Neither will credit files and other records that refer to the transaction as something other than a sale.

3. Identification of the Transferred Assets; Administration as a Sale. You can't sell what you can't identify, and in the context of financial assets, that applies to proceeds as well. Thus, accounts receivable transferred in a true sale must be identified with specificity, and if a party other than the transferee is servicing the accounts receivable, the collections should be segregated in a special collection account rather than commingled with the servicer's other funds. Notification of the transfer to the account debtors will also favor true sale.

4. Amount Paid to Seller in Relation to Fair Value. The purchase of any asset ostensibly reflects that asset's fair value - otherwise, the seller would not be willing to part with it. As a result, payment of less than fair value for an asset could be evidence that something other than a true sale was intended. An approximate formula for the fair value of an account receivable might be (a) the net face amount of the invoice (i.e., the gross invoice amount less any adjustments or allowances given by the seller and less any discounts available to the account debtor for early payment), minus (b) the purchaser's per annum cost of funds plus a reasonable margin, pro-rated over a reasonably expected number of days until payment of the account. To reflect the purchaser's permissible recourse against the seller, a dilution reserve may be netted against the purchase price paid, but such reserve must be based on an identifiable formula that bears a reasonable relationship to historical dilution. In addition, any collections by the purchaser reflecting less dilution than what was reserved for must be remitted to the seller periodically. Purchase price reductions other than those set forth above or that are not identified with specificity could be viewed as both indicia of a loan and impermissible recourse.

5. Irrevocability. In a true sale, the risks and benefits of ownership must pass to the transferee upon closing, and those risks and benefits cannot then be reallocated. Lack of irrevocability may be evidenced, among other things, by an agreement that the transferee will receive a specified rate of return on its investment when in fact fluctuations in the dates on which accounts receivable are paid mean that a specified rate of return cannot be guaranteed. Lack of irrevocability may also be evidenced by an agreement to terminate a transaction at a given time and to reconvey any unpaid accounts to the seller in exchange for the outstanding balance of the accounts.

B. The Role of Accountants

Because true sale is a legal concept, accountants do not play a direct role in assessing whether a transfer is a true sale. However, their role in the sale process deserves a brief discussion since accounting principles determine whether a transfer of financial assets (including accounts receivable) will be accounted for as a sale.

The requirements for sale accounting of financial assets are found in FASB Statement No. 166.[110] In general, the transfer of an entire financial asset will be accounted for as a sale if:

1. The transferred asset is legally isolated from the transferor and its creditors – even in a bankruptcy,
2. The transferee has the right to pledge or exchange the transferred asset, and
3. The transferor has no rights or obligations to reclaim the transferred asset (i.e., the transferor does not maintain effective control over the transferred assets).[111]

FAS 166 states that "a true sale opinion from an attorney is often required"[112] to determine whether transferred accounts receivable have been legally isolated from the transferor and its creditors. While I have reviewed many factoring clients' financial statements over the years that characterized factoring as a sale without a true sale opinion, an accounting determination that a transfer of accounts receivable is a sale can, and often does, turn on such an opinion – particularly for larger transactions with audited financial statements.

III. Factoring and "True Sale": Analysis

A. Notification Factoring *Without* Advances

Based on the above discussion, there should not be much dispute that this type of transaction is not a true sale. This is certainly the case with respect to unapproved accounts; i.e., those on which the factor has not assumed the customer's credit risk. Such accounts are merely being serviced by the factor for a fee - a worthy commercial endeavor, no doubt, but not a true sale.

Even with respect to approved accounts, I would argue that there has not been a true sale at the time of the sale as described in the factoring agreement; i.e., at the time such accounts arise. Because there has been no payment of any kind by the factor to the client at such time, the factor has not yet irrevocably taken on the risks and benefits of ownership of such account. The factor has promised to "mature" such receivables, but is such a promise without payment a true sale? In my opinion, the answer is no.

B. Notification Factoring *With* Advances

Because the factor pays the client an advance of the purchase price in this type of transaction, it looks more like a true sale transaction than does a Notification Factoring Without Advances transaction. However, for the following reasons (which track the true-sale factors discussed above), I believe this type of transaction is much more like a secured loan than a true sale.

1. Impermissible Recourse. In a Notification Factoring With Advances transaction, the concept of a non-recourse purchase is accounted for differently than in a structured, true sale transaction. In the latter, a purchase price is paid for an account (which price, as described above, may reflect a deduction for reasonably expected dilution) at the time of purchase or at a periodic settlement date, and if the account doesn't pay due solely to customer credit risk, there are no further transactions between seller and purchaser with regard to that account. The sale was without recourse for credit risk, so the purchaser must turn to the account debtor to attempt to recover its investment.

In Notification Factoring With Advances, however, the factor's payment to the client is typically described as an "advance" of the purchase price equal to a percentage of the net invoice amount, and the unpaid advances are described as an obligation of the client to the factor. If an approved account is not paid due to credit risk, then a factor typically matures the account as described above and credits the purchase price of the account against the outstanding advances.

In the sense that the deduction from the net invoice amount represented by the factor's advance rates reflects a deduction solely for permissible dilution,[113] then the advance rate should not create an impermissible recourse problem. However, factoring agreements rarely state that such deduction is specifically for permissible recourse or how such deduction was calculated in relation to historical dilution of the client's accounts. Without a description of the calculation or a reference for historical dilution, there can be no determination whether such a deduction actually includes a deduction for credit risk.

There also is the issue of the "reserves" a factor may hold in connection with its agreement to make advances to a client. Such reserves reduce the amount available for advances to a factoring client and typically are created to address dilution (i.e., permissible recourse) greater than what is built into the advance rate. However, because the factoring agreement allows reserves to be instituted for any reason at the factor's discretion, the factor could institute reserves for reasons other than permissible recourse.[114]

Finally, there is the issue of a factoring agreement explicitly excusing the factor from maturing an account for reasons that could be due to credit risk. This is most often expressed in a concept known as "extended default risk," which arises when an account has not been paid within a certain amount of time after its due date, but no clear determination has been made that such non-payment is due solely to credit risk. Many factoring agreements provide that such accounts are no longer approved accounts. Factoring agreements also often excuse the factor from maturing accounts that are unpaid due to acts of God or force majeur. Since these provisions give the factor recourse to the client for reasons that may include credit risk, the factor may be considered to have impermissible recourse.

2. Intent. Almost all Notification Factoring With Advances agreements describe the transfer of accounts as a sale, and some even contain explicit statements of the parties' intent to consummate a "true sale". Nevertheless, I believe the substance of such a transaction is more like a loan than it is a sale.

As already described, the calculation and funding mechanics of a factor's advances are very similar to those of an asset-based revolving line of credit. The payment of monthly interest on such advances also is very similar to a loan.

Another interesting similarity is the factor's right to demand payment of all "obligations" (i.e., unpaid advances, interest and fees) owing from the client upon termination of the factoring agreement. It is true that most factoring agreements do not explicitly let the factor off the hook for customer credit risk on approved accounts just because a factoring agreement is terminated. However, assuming an agreement is terminated and factor is paid its obligations, the factor's credit risk at that point is like its credit risk in the "without advances" transaction described above; i.e., it is merely a promise. [115] One thus has to question whether such a transaction can constitute a true sale.

3. Identification of the Transferred Assets; Administration as a Sale. In both varieties of factoring transactions that have been described in this article, account debtors receive notice of the sale (either via a letter from the factor or the client or a notice on the client's invoices or both), the seller's invoices are submitted to the factor, the factor "ledgers" those invoices in its client accounting systems, and the factor collects the accounts. Thus, the administration of factored accounts looks more like a sale than a loan. However, as previously described, the factor's administration of its *advances* to the client looks more like a loan than a sale.

4. Amount Paid to Seller in Relation to Fair Value. As already discussed, the calculation of both the purchase price deduction represented by the advance rate and the factor's reserves is not described so that the amount thereof represented by permissible recourse can be determined. Furthermore, unlike a structured, true sale transaction in which collections in excess of the dilution reserve are remitted to the seller periodically, the factor in effect retains such amounts until all factored accounts are collected and all advances are repaid.

5. Irrevocability. Since factoring agreements typically provide for the payment by the client of periodic interest on the outstanding obligations (which are described in factoring agreements variously as "Funds Employed", "Funds In Use", etc.) at some per annum floating base rate plus a margin, factors are not taking the risk that accounts will not pay as predicted. Factors also reallocate risk by taking additional collateral from their clients in various forms, such as non-approved and non-factored accounts and inventory. In many cases, factors are providing additional liquidity against such assets, but nevertheless the equity in such collateral is available to pay the obligations owing in connection with the approved accounts.

C. Case Law

Case law on true sale in factoring transactions is spotty and, like case law on the issue of true sales of financial assets generally, provides no bright line tests for determining whether a transaction is a true sale. What cases there are, however, do tend to support the conclusions drawn in this article that most factoring transactions are not true sales for the reasons previously described.[116]

IV. Should Factors Care?

Before answering the question of whether factors should care if their deals are not true sales, let me be clear that I am not advocating that every factoring transaction is absolutely *not* a true sale. Some factoring transactions may be structured in ways so as to avoid the difficulties described above. However, as I hope I illustrated above, enough true sale factors are either absent from factoring transactions or present to such a diluted extent that many factoring transactions would be hard-pressed to qualify as true sales if tested. So, assuming a factoring transaction is not a true sale, let's briefly examine the ramifications and then assess whether a factor should be concerned.

A. Recharacterization and Its Impact

As mentioned above, recharacterization changes a sale of accounts into a loan secured by the ostensibly transferred accounts. Thus, instead of the transferee simply continuing to collect the transferred accounts upon the transferor's bankruptcy, the transferee is placed in the position of a pre-petition lender to the now bankrupt transferor with a security interest (duly perfected one would hope) in the ostensibly transferred accounts and their pre- and post-petition proceeds.

In bankruptcy (the venue in which a recharacterization challenge most likely would arise), such proceeds constitute cash collateral that the transferee can use to fund its cash needs, subject to court approval and adequate protection of the transferee's/lender's interest in the accounts.[117] Adequate protection may be provided in the form of one or more of a replacement lien on post-petition accounts, the debtor's maintenance of an equity cushion in the collateral, the payment of post-petition interest on the "loan", or the requirement that the transferor/debtor hew to a rolling 13-week (or other suitable period) cash budget.[118]

B. The Factor's Position

At the risk of stating the obvious, the recharacterization into a secured loan of a pre-petition transfer by parties intending a "true sale" would be an unexpected and highly undesirable event. But is that true for factors? While most factors will assert that their transactions are "sales" (and I am not suggesting they should do otherwise), I argue below that in most cases a factor should care very little if either type of factoring transaction described in this article is not a "true sale" and thus subject to recharacterization.[119]

1. Notification Factoring Without Advances. Because the factor is owed substantially less money in this type of transaction than in a Notification Factoring With Advances transaction, recharacterization would leave the factor with very little in the way of a "loan" to collect and, assuming proper documentation, such a loan would be vastly over-secured by the accounts reacharacterized as property of the estate.

From the debtor's point of view in this situation, there's little to be gained from recharacterization because the factor is deducting only the above-described amounts from collections on the accounts before remitting them to the debtor. Likely for these reasons, I have never seen - and frankly do not expect ever to see - an attempted recharacterization of a transaction of this type.

2. Notification Factoring With Advances. In this type of transaction, the factor is owed substantially more than in a Notification Factoring Without Advances.[120] Recharacterization thus is potentially more impactful on the factor because it will have a larger resulting loan and also potentially more beneficial to the debtor because more cash collateral will be released to the estate. Ironically, however, a factor is unlikely to face recharacterization in this situation for some of the same reasons that the factoring

transaction is subject to recharacterization in the first place.

A factor with advances to a client is usually that client's sole source of working capital and has factored all or most of the client's accounts receivable (and may also have loans to the client secured by its inventory and other assets). Factors are also typically very well margined on their advances due to the visibility into and control over the collateral pool that factoring provides and the discretion factors have to make advances and establish reserves.

For these reasons, factors are much less likely to consider walking away from a newly-bankrupt client that has outstanding advances and attempting simply to collect the factored accounts and be done with the matter. Rather, factors typically will work with such a client to provide some level of post-petition liquidity to bridge the client to the next event in its post-petition life cycle. As a result, even though such a transaction may be highly susceptible to recharacterization as a secured loan, there typically is very little if any incentive for the debtor to attempt to do so.

The foregoing conclusion obviously does not apply if the factor desires simply to have its advances paid down through post-petition collections without any arrangement for post-petition liquidity. If a debtor in such a situation petitions the court for use of cash collateral, and the factor responds by saying there is no cash collateral because the accounts were sold to it in a true sale, the factor may find itself in a fight over the issue that will be difficult to win.

IV. Conclusion

Based on an examination of true sale analysis applied to the two basic forms of factoring transactions – Notification Factoring Without Advances, and Notification Factoring With Advances - such transactions are hard-pressed to qualify as true sales and are thus highly susceptible to recharacterization as secured loans. However, Notification Factoring Without Advances transactions likely will not face recharacterization because there is not enough to be gained by a debtor from bringing such an action. Notification Factoring With Advances transactions, while potentially providing more benefit to a debtor if reacharacterized, will likely not face recharacterization as long as the factor continues to work with the debtor to provide post-petition liquidity similar to what it would provide if it was a post-petition lender.

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UCC Spotlight

By Stephen L. Sepinuck and Kristen Adams

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.

***Canyon Development Co., Inc. v. Holcomb Storage*, 2012 WL 3242076 (No. 2110541, Ala. Ct. Civ. App. Aug. 10, 2012)**

In this case, the court correctly concluded that a creditor enforcing an Article 9 security interest need not comply with the procedures for enforcing the statutory lien that the creditor also held. However, the court failed to consider whether the creditor complied with Article 9.

The case involved the owner of a self-storage facility. Most states provide the owners of such facilities with a statutory lien on the contents of a storage unit to secure payment of the rent for the unit. Alabama, where the case arose, is no exception. See Ala. Code § 8-15-33. After the corporate tenant stopped paying rent, the storage facility unsuccessfully attempted to contact the tenant. Several months later, the storage facility sold the contents. The tenant sued for, among other things, violation of the Alabama Self-Service Storage Act by failing to provide notice of default by certified or registered mail, failing to advertise the sale, failing to provide an opportunity to cure, and failing to make an inventory of the property sold. The court rejected the claim. It concluded that the rental contract gave the facility owner a consensual lien on the unit's contents (thus implicating Article 9, see § 9 109(a)(1) & cmt. 2) – in addition to the statutory lien that the law provided – and that the Storage Act did not require the storage facility to comply with the Act's procedures when enforcing a consensual lien.

The court's conclusion is undoubtedly correct. Not only is it well grounded in the language of the Storage Act itself, but it is also consistent with the rules and principles of Article 9, which expressly indicates that a secured party's various rights are cumulative and the pursuit of one does not interfere with the exercise of others. See U.C.C. § 9-601(a), (c). See also Spencer v. Public Storage, 2012 WL 4479002 (No. 2:11–cv–00357–JEO, N.D. Ala. Sept. 24, 2012) (storage company with a contractual lien on personal property in storage unit did not have to comply with sale procedures under the Alabama Self–Service Storage Act and its sale of the unit's contents was not conversion).

Unfortunately, the court then missed what should have been the real question: whether the storage facility conducted the disposition in compliance with Article 9. Article 9 requires the secured party in most cases to send the debtor reasonable notification of the planned disposition. See § 9-611(b), (c). The failure of the court – and, apparently, the parties – to address this issue is a bit perplexing given that the provision of the Alabama Code that they discussed, § 8-15-33, expressly refers to Article 9's notification provisions. Article 9 also requires that the disposition be conducted in a commercially reasonable manner. See § 9 610(b). In this case, the storage facility allegedly sold for $500 the contents of the plaintiff's unit – claimed to be worth in excess of $350,000 – without taking an inventory or advertising the sale. While a low sales price is not by itself sufficient to prove that the sale was commercially unreasonable, see § 9-627(a), it is sufficient to raise a red flag, see § 9-627 cmt. 2, and combined with the other allegations should have been more than enough to avoid summary judgment in favor of the storage facility.

A few additional thoughts about self-storage facilities and the liens that secure payment of the rent due to them may be of interest. In general, self-storage facilities prefer to be regarded as renters of space rather than as bailees of goods. If they were bailees, their statutory liens would probably have priority over any previously created and perfected security interests in the goods stored, see §§ 7-209, 9-333. However, the facilities would have a duty to care for the goods, see §§ 7-204, 9-207, and these duties would be non-waivable, see §§ 1-302, 7-204 cmt. 2. Moreover, as a bailee, any sale of the goods would be governed by § 2-710, which requires commercial reasonableness. As a renter of space, in contrast, the storage facility need merely comply with the procedures mandated by the applicable state statute. Some of those statutes insulate the storage facility from liability if they conduct the sale in a commercially reasonable manner but stop short of placing an affirmative duty on the storage facility to conduct the sale in such a manner. See, e.g., Ala. Code § 8-15-34(13), (14); Utah Code § 38-8-3(10), (11).

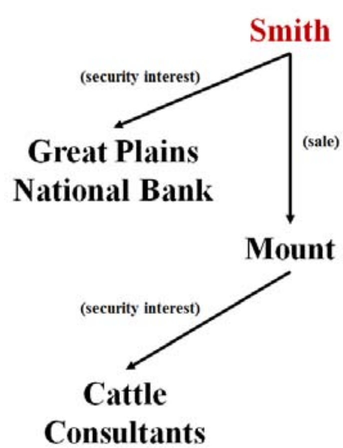
Other states expressly require that the contents of a self-service storage facility be sold in a commercially reasonable manner to enforce the facility owner's statutory lien for rent. Amazingly, one of these states is California, see Cal. Bus. & Profs. Code § 21707, the location where the television show Storage Wars is based. According to that show, the contents of self-storage units are sold as a single lot and the bidders are not permitted to enter the unit or handle the contents before bidding, with the result that they usually have only a vague idea what goods are in the unit. It is not clear how that can possibly be a commercially reasonable procedure. Whether this is an example of Hollywood obscuring reality, storage facility owners ignoring the law, or defaulting renters unaware of their rights is unknown.

Great Plains National Bank v. Mount,
280 P.3d 670 (Colo. Ct. App. 2012)

This case presented an issue of priority under both the Food Security Act and Article 9. Given the arguments made, the court reached the correct result but its reasoning on the Article 9 issue was slightly flawed. However, the court and the parties overlooked a point that should have led them to a contrary result.

The facts can be summarized as follows. In 2009, an Oklahoman cattleman named Smith obtained a loan from Great Plans National Bank and in return granted the bank a security interest in his existing and after-acquired cattle. Great Plains perfected its security interest by filing a financing statement in Oklahoma.

In 2009, a Colorado cattleman named Mount purchased 206 cattle from Smith. That purchase was financed by Cattle Consultants, LLC, which acquired a security interest in the cattle and perfected by filing a financing statement in Colorado. Thus, the parties' relationships can be diagrammed as follows:



Smith covered the sale to Mount using cattle he purchased the day before from supplier in Missouri. Smith paid with a check drawn on insufficient funds but Great Plains honored the check. When Great Plains was unable to collect from Smith, it sought to enforce its security interest in the cattle and filed a financing statement against Smith in Colorado.

In the resulting litigation, the trial court granted summary judgment for Great Plains. The court of appeals affirmed. In doing so, it first noted that Mount could not take free of Great Plains' security interest under § 9-320(a), the provision that generally protects buyers in ordinary course of business, because that section does not apply to "a person buying farm products from a person engaged in farming operations." There was no dispute that the cattle were farm products in Smith's hands or that Smith was engaged in farming operations.

Under the Food Security Act, buyers of farm products can take free of a security interest created by the seller. However, this general rule is subject to an exception if: (i) the farm products are "produced in a State that has established a central filing system"; (ii) the buyer has failed to register with the Secretary of State of such State prior to the purchase; and (iii) the secured party has filed an effective financing statement that covers the farm products being sold. 7 U.S.C. § 1631(e)(2). There was no dispute that Great Plains had filed in Oklahoma and that Mount had failed to register there. So, the question became whether the cattle were "produced" in Oklahoma, where Smith was located, or in Missouri, where the cattle had been raised until the day before Smith acquired and resold them.

The court of appeals concluded that the term "produced" deals with the location from which the farm products are sold, not their geographic origin, since that is the only location of which the buyer is likely to be aware. Interpreting the FSA to mean where the goods were grown or raised would leave buyers with no practical method of discovering prior security interests or knowing where to file, the precise problem that the FSA was designed to address. Indeed, Mount himself had thought that he was acquiring Oklahoma cattle and discovered they came from Missouri only much later. This portion of the court's analysis – and the court's conclusion that Mount acquired the cattle subject to Great Plains' security interest – makes perfect sense.

As for the priority dispute between Great Plains and Cattle Consultants, the court looked to the first-to-file-or-perfect rule of § 9-322(a). Great Plains had filed against Smith in Oklahoma in 2009, re-filed in Colorado within one year of the sale to Mount, and thus, the court concluded, Great Plains' priority dated back to 2009. Cattle Consultants filed and perfected in 2010 and thus was junior.

To avoid this argument, Cattle Consultants claimed purchase-money priority. There was no dispute that Cattle Consultants did in fact have a purchase-money security interest (PMSI). It had, after all, financed Mount's purchase of the collateral. However, the court concluded that Cattle Consultants was not entitled to priority under § 9-324(d) because Cattle Consultants perfected its interest after Mount received possession, not before, cf. § 9-324(d)(1), and because Cattle Consultants had not given prior notification of its PMSI financing to Great Plains, cf. § 9-324(d)(2)-(4).

There are at least three problems with this analysis. First, even if Cattle Consultants had complied with the rules of § 9-324(d), it would still not have been entitled to priority. As the diagram above illustrates, this is a classic case of the so-called "double-debtor" problem. Great Plains' debtor was Smith but Cattle Consultant's debtor was Mount. As long as Mount acquired the cattle subject to Great Plains' perfected security interest – which he did – and that security interest remained perfected – the court so ruled, but more on this below – then even if Cattle Consultant would normally qualify for PMSI priority, section 9-325 would subordinate it. Indeed, even if Cattle Consultants would have won under the first-to-file-or-perfect rule of § 9-322(a)(1) – is it might if it had filed against Mount before Great Plains had filed against Smith – its interest would nevertheless be subordinated by § 9-325. So, while the court's discussion of § 9-324 was interesting, it was irrelevant to the resolution of the case.

Second, in part because § 9-325 trumps § 9-324 in the cases involving the double-debtor problem, it is not clear that the court was correct in concluding that Cattle Consultants was required to give advance notification of its financing plans to Great Plains in order to obtain priority under § 9-324(d). That provision requires the PMSI lender to give notification to the holder of the "conflicting" security interest. It is not clear that the interest granted by a former owner is really conflicting for this purpose of this rule. After all, the reason underlying for the notification requirements in § 9-324(b) and (d) – dealing with inventory and farm products, respectively – is to allow the prior lenders against such property to avoid making further advances to their debtor in reliance on PMSI collateral. But that rationale does not apply in the double-debtor scenario in which the prior debtor already owns the collateral. Moreover, the collateral may not even be inventory or farm products in the hands of the prior debtor, so the concerns relating to the financing of such types of collateral may be completely inapposite.

Neither of these first two criticisms is material to the court's ultimate conclusion. The final criticism, though, may be. Recall that Great Plains re-filed in Colorado, where Mount is located, within one year after the sale to Mount. This is required under § 9-316(a)(3) to maintain perfection, and failure to do so results in a loss of perfection that is retroactive with respect to purchasers for value. See § 9-316(b). Such a loss of perfection would normally allow the buyer to then take free of the security interest. See § 9-317(b). What the court glossed over – presumably because no one argued about it – was that Great Plains filed in Colorado against

Smith, not against Mount.

Section 9-316 is conspicuously silent about whether a re-filing in the state in which the collateral buyer is located should be under the original debtor's name or the buyer's name. The statutory text does not speak directly to the issue, although there is an oblique statement in the comments suggesting that the filing should be against the buyer. See § 9 316 cmt. 2, ex. 4. Several good arguments support this suggestion. First, financing statements are supposed to be filed against the "debtor." Upon purchase of the collateral, the buyer becomes the debtor. See § 9-102(a)(28). See also § 9 509(c) (providing that acquisition of property subject to a security interest gives the secured party authorization to file against the acquirer). Second, the whole filing system is based around the name and location of the debtor. Searchers search for financing statements filed against the debtor's name in the state where the debtor is located. Smith is located in Oklahoma. No one would think to look for a filing against him in Colorado. More important, the collateral is now owned by Mount in Colorado. Searchers would normally search for filings against him in Colorado, but would not really have reason to search against the names of former owners there. If the purpose of re-filing in the new state is to give notice of the security interest to people who search in the new state – that is, to alleviate the burden of searching against former owners if the current owner acquired it more than one year ago – then that only works if the searchers know what name to search against. They know the name of the new owner but may not know the names of former owners. If the law is going to require that they search under the names of former owners, as the court's decision implicitly suggests, it might as well require that they search where the former owners are located. In other words, the court's analysis makes § 9-316 a trap for prior secured parties without doing much of anything to alleviate the burden on current searchers. Still, it is hard to fault the court for making this error given that Article 9 provides little guidance on the point and the parties apparently missed it as well.

In re Doctors Hospital of Hyde Park, Inc.,
474 B.R. 576 (Bankr. N.D. Ill. 2012)

This case involved a creditor's claim to proceeds from the trustee's settlement of avoidance actions brought against other parties. In August 1997, the debtor, Doctors Hospital of Hyde Park ("Doctors Hospital") granted a security interest in its tangible and intangible property to guaranty a $50 million loan. The note, guaranty, and security interest were later assigned to LaSalle National Bank ("LaSalle"). Doctors Hospital subsequently filed for Chapter 11 bankruptcy protection. In that proceeding, the Chapter 11 trustee filed an avoidance action against a number of individuals and entities for fraudulent transfers, breach of fiduciary duty, and wrongful payment of dividends.

Prior to trial, the trustee settled with several of the defendants in return for payments exceeding $6.6 million. LaSalle claimed that the settlement proceeds were subject to its security interest. The trustee, asserting that the security agreement did not cover the settlement proceeds and that, even if it did, the version of Article 9 in effect in New York at the time when the security agreement was executed barred any interest in commercial tort claims.

In addressing the first issue, the court first ruled that because the security agreement was complete on its fact, the court would not consider the other documents executed by Doctors Hospital in association with the loan. Apparently applying the parol evidence rule, the court limited its inquiry to the security agreement itself. The court then concluded that the language of the security agreement, which granted a security interest in "General Intangibles" and defined them as "intangible personal property of Operator with respect to the Facility," included things relating to the operation of the Facility, not merely things related to the physical structure. The court supported this conclusion by pointing out that the security agreement also included inventory "relating to the Facility" and it would make no sense to limit that clause to inventory related to the physical structure.

In resolving the second issue the court's analysis became confused but the decision seems to make the following points (although not in this order). First, some of the settled claims were contract claims, not tort claims. As to these claims, the court agreed that settlement proceeds were subject to LaSalle bank's security interest. As to the settled tort claims, however, the court reached the opposite conclusion for two erroneous reasons.

First, citing to old Article 9, which was in effect at the time the debtor executed the security agreement, the court stated that § 9-104(k) "prohibited the taking of a security interest in tort claims." That is emphatically not true. Old § 9-104 was – like revised § 9-109 is –a scope rule, not an attachment rule. It said merely that Article 9 did not apply to the assignment of a tort claim, not that such assignments were illegal or ineffective. It may well be that applicable law did prohibit such an assignment, but that law was not – and is not – part of Article 9. More to the point, and as the court itself noted, once a tort claim is settled, the settlement agreement gives rise to a general intangible that can be collateralized under Article 9 even if the original tort claim could not be. This point is made expressly in revised § 9 109 comment 15 but was also true under the proper interpretation of old Article 9.

Second, the court ruled that even if revised Article 9 were applicable, the security agreement failed to describe the tort claims with the specificity required by § 9 108(e). Unfortunately, this statement immediately followed the court's correct observation that a right to payment under a settlement agreement "becomes a payment intangible and ceases to be a claim arising in tort." Thus, the court's continued treatment of the rights under the settlement agreement as a commercial tort claim does not make sense. Put simply, although the court correctly observed what § 9-108(e) does, that provision was completely inapposite, given that the court had already

– and correctly – concluded that the settled claims should be treated as arising in contract rather than tort.

***In re Delta-T Corp.*,**
475 B.R. 495 (Bankr. E.D. Va. 2012)

This is the first of two cases dealing generally with when an account arises or accrues. Although the court's opinion is lengthy, the facts are reasonably simple and the issue fairly easy to frame.

In June 2009, the debtor, Delta T Corp., granted a security interest in its accounts to secure a $7.2 million promissory note. The secured party perfected the security interest. Six months later, a different creditor obtained a $6 million judgment against the debtor and, shortly thereafter, garnished one of the debtor's deposit accounts. The deposit account had a $650,000 balance, all of which was traceable to payments the debtor received in connection with its sale of steel to some scrap dealers. The bankruptcy trustee, who received an assignment of the perfected security interest, asserted priority over the garnishing judgment creditor, claiming that the deposit account was proceeds of accounts. The judgment creditor resisted, arguing that the debtor's sales were cash sales that never generated accounts because the buyers paid on either the same day or the day after they picked up the steel.

To answer this question, the court looked closely at the steel sale transactions, specifically at when title to the steel passed. Because: (i) the steel was identified to the contract when the debtor accepted the purchase order therefor; (ii) the buyers were to pick up the steel at the debtor's place of business, and thus the steel was to be delivered to the purchasers without being moved; (iii) no document of title was required; and (iv) the parties had not otherwise agreed, title passed when the contract was made. See § 2 401(3)(b). This, the court reasoned, was when the debtor acquired a right to payment, and because that right preceded actual payment, the sales had generated accounts.

The court's conclusion is undoubtedly correct but its analysis was unnecessarily complicated. When title to the steel passed does not matter. A right to payment for goods sold is an account as long as the right is not evidenced by an instrument or chattel paper. See § 9 102(a)(3). Even if the right to payment is conditioned on the passage of title or some other type of performance by the obligee, the payment right is an account. In other words, the existence of a condition does not prevent the right to payment from qualifying as an account. Article 9 makes this point clearly when it states that a right to payment qualifies as an account regardless of whether it has or has not been "earned by performance." Thus, because the right to payment arises when the agreement to purchase is entered into, that is when an account is created. In short, once the debtor accepted the purchase orders for the steel, the debtor had accounts. The payments made days later were identifiable proceeds of the accounts and remained subject to the perfected security interest later assigned to the trustee.

The judgment creditor correctly asserted that a true cash sale does not generate an account. But for this purpose a cash sale is a transaction in which payment either precedes or is simultaneous with the formation of the sales contract. The paradigm example is the purchase of foodstuffs at a supermarket. In such a case, there is no agreement to buy and sell prior to when the customer offers payment – whether in cash or by some other means – to the sales clerk. Delta T's sales of steel were not cash sales. So the court was correct, but the focus on the passage of title was unnecessary and is regrettable.

***Puritan Finance Corp. v. Bechstein Constr. Corp.*,**
2012 WL 2020970 (No. 1–11–2261, Ill. Ct. App. June 4, 2012)

This second case dealing with when an account arises involves the right of an account debtor to assert defenses and claims against an assignee of the account. Pursuant to § 9 404(a), an account debtor is entitled to assert against an assignee: (i) any defense or claim in recoupment arising from the transaction that gave rise to the account; and (ii) any other defense or claim of the account debtor against the assignor "which accrues before the account debtor receives a notification of the assignment." For this purpose, when does such an unrelated defense or claim "accrue"?

The case pitted Puritan Finance, which had a security interest in the debtor's accounts, against Bechstein Construction, one of the debtor's account debtors. Bechstein admittedly owed the debtor $22,000 on several cartage contracts. However, prior to notification of the assignment to Puritan Finance, Bechstein performed similar services for the debtor. Apparently, Bechstein and the debtor regularly perform cartage work for one another and swapped checks periodically to settle their outstanding invoices. Accordingly, Bechstein sought to reduce its liability to Puritan by the amount of its claim against the debtor.

The court rejected this partial defense. After looking to Black's Law Dictionary for the definition of "claim," the court concluded that a claim "accrues" when a cause of action exists under applicable law. Applying this standard, the court held that Bechstein could not set off against its obligation the amounts the debtor owed to it because even though Bechstein had fully performed its duties under the cartage contracts before it received notification of the assignment, it did not yet have a cause of action, presumably because no invoice had yet been issued and payment was not yet due.

Relying on a 1989 decision from Kansas, the court's analysis and rationale looked at the issue primarily from the perspective of the secured party. After noting that "accrue" could mean either when the obligation to pay is incurred or when the obligation becomes due and payable, the court concluded that the policies of simplicity and commercial certainty underlying the UCC favor the second definition. The court reasoned that, if incurrence of the claim was when it accrued, the value of accounts assigned as security could never be accurately determined because the accounts would always be subject to an independent claim arising against the assignor after the assignment is made, but accruing beforehand. In contrast, if "accrues" means "becomes due and payable," the value of accounts can be determined with reasonable certainty at the time of the assignment. Id. at * 3 (quoting Bank of Kansas v. Hutchinson Health Servs., Inc., 773 P.2d 660, 665 (Kan. Ct. App. 1989).

This rationale is suspect. It is highly doubtful that the difference between the two meanings of when an account debtor's claim accrues significantly affects a potential assignee's ability to value the accounts. In either case, due diligence would require conferring with the account debtors to confirm the accuracy of the account and the nonexistence of any defense or setoff claim. More important, an assignee typically values accounts before deciding to buy or lend against them. Only after making that decision – indeed, after entering the actual assignment – is notification of the assignment given to the account debtors. Thus, there will always be some time lag between when the accounts are valued and when the account debtor receives notification of the assignment. As a result, the assignee will always bear some risk that it has paid or loaned too much because, in the interim, some defense or claim has accrued.

More to the point, this focus on the secured party's ability to value the account confuses the rule's effect with its purpose. The effect of a notification of assignment is to cut off some of the account debtor's setoff rights. The purpose of the notification – a purpose the court ignored – is to inform the account debtor of the assignment, and thus is best understood from the perspective of the account debtor. The notification alerts the account debtor to no longer rely on its outstanding obligation to the debtor (i.e., not to rely on its setoff rights) when deciding whether to enter into a non¬ cash transaction that generates the debtor's reciprocal obligation to the account debtor. Viewed in that light, an account debtor's claim should arise when the debtor's obligation is created, not some time later when a cause of action accrues. The court's analysis was faulty and its conclusion wrong.

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ENDNOTES

[1] UCC Sections 9-102(a)(49) and 9-102 (a)(42).
[2] UCC Section 8-103(c). Note, however, that an interest in a partnership or limited liability company is a security, and therefore investment property, if it is dealt in or traded on securities exchanges or in securities markets.
[3] UCC Section 9-310(a).
[4] UCC Section 9-322(a).
[5] UCC Sections 9-312(a), 9-313(a) & 9-314(a).
[6] UCC Sections 9-312(a) and 9-314(a).
[7] UCC Section 9-328(l).
[8] Note, however, an interest in a general partnership provides that the economic rights and governance rights are bound together; See the definition of "partnership interests" in Section 15-101(15) of the Delaware Revised Uniform Partnership Act.
[9] Section 17-101(13) and 18-101(8).
[10] UCC Section 9-328(l).
[11] UCC Section 9-620.
[12] UCC Section 9-610.
[13] Delaware Limited Liability Company Act Section 18-101(7) and Delaware Revised Uniform Limited Partnership Act Section 17-101(12).
[14] UCC Section 8-303(b).
[15] Delaware Limited Liability Company Act 18-301(b) and Delaware Revised Uniform Limited Partnership Act Section 17-301(b).
[16] Delaware Limited Liability Company Act Section 18-801(4) and Delaware Revised Uniform Limited Partnership Act Section 17-801(4).
[17] FDIC Special Alert, SA-147-2009, *Fraudulent Electronic Funds Transfers* (Aug. 26, 2009).
[18] FFIEC, *Authentication in an Internet Banking Environment* (Oct. 12, 2005).
[19] *Id.* at 4 (footnotes omitted).
[20] FFIEC, *Supplemental to Authentication in an Internet Banking Environment* (June 28, 2011), at 3-8.
[21] ACH transactions are also subject to the Operating Rules of the National Automated Clearing House Association ("NACHA"). Wire transfers conducted over the FedWire system are also subject to Federal Reserve Regulation J, which incorporates UCC Article 4A. *See* 12 C.F.R. § 210.25(b)(1).
[22] UCC Article 4A, Prefatory Note.
[23] The EFTA applies only to transfers of funds involving accounts "established primarily for personal, family, or household purposes." 15 U.S.C. § 1693a(2). For a case involving a determination of whether accounts involved in fraudulent EFTs were primarily business or consumer accounts, *see Shames-Yeakel v. Citizens Fin'l Bank*, 677 F. Supp. 2d 994, 1002-03, 1006-07 (N.D. Ill. 2009) (applying Truth in Lending Act and EFTA)
[24] 15 U.S.C. § 1693g.
[25] A "receiving bank" is the bank receiving the payment order; typically, the customer's bank. UCC § 4A-103(a)(4).
[26] A "payment order" is the instruction to the receiving bank to pay a fixed or determinable amount of money. UCC § 4A-103(a)(1).
[27] UCC § 4A-202(b).

[28] UCC § 4A-204(a). *But see Patco Constr. Co., Inc. v. People's United Bank*, 684 F.3d 197, 214-15 (1st Cir. 2012). After finding the bank's security procedure to be commercially unreasonable, as discussed *infra*, the First Circuit remanded the case because "[i]t is unclear . . . what, if any, obligations a commercial customer has when a bank's security system is found to be commercially unreasonable." *Id.* at 214-15. The parties have yet to brief this issue before the district court.
[29] UCC § 4A-203 cmt. 5.
[30] UCC § 4A-201.
[31] UCC § 4A-201.
[32] UCC § 4A-201 cmt.
[33] No. 09-14890, 2010 U.S. Dist. LEXIS 68149 (E.D. Mich. July 8, 2010).
[34] *Id.* at *11-14.
[35] *Id.* at *7-9.
[36] *Id.* at *11-14.
[37] *Id.* at *14.
[38] UCC § 4A-203 cmt. 4.
[39] UCC § 4A-202(c); *compare* UCC § 3-103(a)(9)(reasonable commercial standards applicable to claims under UCC Articles 3 and 4).
[40] UCC § 4A-203 cmt. 4.
[41] *Id.*
[42] UCC § 4A-202(c).
[43] UCC § 4A-203 cmt. 4.
[44] UCC § 4A-203 cmt. 3.
[45] *Id.*
[46] UCC § 4A-202(c).
[47] UCC § 4A-203 cmt. 4.
[48] *Id.*
[49] *Id.*
[50] *Id.*
[51] UCC § 4A-203 cmt. 4.
[52] 684 F.3d 197 (1st Cir. 2012).
[53] 2011 U.S. Dist. LEXIS 58112 (D. Me. May 27, 2011), *adopted by*, 2011 U.S. Dist. LEXIS 86169 (D. Me. Aug. 4, 2011).
[54] 684 F.3d at 204-06.
[55] *Id.* at 200.
[56] *Id.* at 202-03.
[57] *Id.* at 203.
[58] *Id.* at 203-04.
[59] *Id.* at 204-05.
[60] *Id.* at 211.
[61] *Id.* at 212.
[62] *Id.* at 212-13.
[63] 2010 U.S. Dist. LEXIS 68149 at *16-17.
[64] *Id.*
[65] 367 S.W. 3d 490 (Tex. App. 2012).
[66] *Id.* at 500-501.
[67] *Id.* at 500-502.
[68] UCC § 4A-203 cmt. 3.
[69] UCC § 4A-202(b).
[70] UCC § 4A-203 cmt. 3.
[71] *Id.*
[72] UCC § 4A-202(b).
[73] UCC § 4A-105(d)(incorporating definitions in Article 1); UCC § 1-201(20).
[74] UCC § 1-201 cmt. 20
[75] UCC 1-201 cmt. 20; *Maine Family Fed. Credit Union v. Sun Life Assurance Co. of Canada*, 727 A.2d 335, 340-42 (Me. 1999).
[76] UCC 1-201 cmt. 20; *Maine Family Fed. Credit Union*, 727 A.2d at 340-42.
[77] 2010 U.S. Dist. LEXIS 68149, *6-9.
[78] *Id.* at *19-20.
[79] *Id.* at *21.
[80] *Id.* at *18-19, 21-23 (citing *In re Jersey Tractor Trailer Training, Inc.*, 580 F.3d 147 (3d Cir. 2009) and *Maine Family Fed. Credit Union*, 727 A.2d 335).
[81] *Experi-Metal, Inc. v. Comerica Bank*, 2011 U.S. Dist. LEXIS 62677, *35 (E.D. Mich. June 13, 2011).
[82] *Id.* at *38.
[83] UCC § 4A-203(a)(2).

[84] *Id.*
[85] *Id.*
[86] UCC 4A-203 cmt. 3.
[87] UCC § 4A-203 cmt. 5.
[88] 597 S.W.2d 425 (Tex. Ct. of Appeals 1980)
[89] 1988WL 192369 (N.D. Tax, 1988)
[90] 245 F. Supp. 790 (S.D. N.Y. 1965)
[91] 379 F.2d 660 (9th Cir. 1967)
[92] 249 B.R. 596 (Bankr. S.D.N.Y. 2000)
[93] 86. B.R. 476 (M.D.N.C. 1988), affirmed 883 F.2d 2 (4th Cir. 1989)
[94] The decision doesn't explain why Mademoiselle of California was demanding offset, but it seems likely that the reason was that its deposits exceeded the FDIC insurance coverage. Therefore, it stood to sustain a loss on the uninsured amount unless it could offset against its debt on a dollar for dollar basis.
[95] 167 F.2d 621 (2nd Cir. 1948)
[96] Early participations were often sold to private investors as undivided shares of real estate loans which were guaranteed by the lead or by the servicer. For more history of loan participations, see *What Exactly is a Loan Participation*, an interesting article by Jeffrey D. Hutchins, 9 Rutgers-Camden Law Journal, 447 (1977-78).
[97] Net proceeds of the sale were more than sufficient to pay all the certificate holders at the higher mortgage rate.
[98] 269 F.3d 726 (6th Cir. 2001)
[99] 327 F. Supp. 1315 (S.D.N.Y. 1971)
[100] 554 F. Supp. 251 (W.D. Okla. 1983)
[101] I.e. a written acknowledgment by the receiver that Chase was an unsecured creditor of Penn Square for the amount specified. Such certificates were ultimately worthless.
[102] 733 F.2d 1403 (10th Cir. 1984)
[103] *Northern Trust Co. v. FDIC,* 619 F. Supp. 1340 (W.D. Okla 1985)
[104] 619 F. Supp. 1351 (W.D. Okla. 1985)
[105] Ideally, this should be acknowledged and consented to in writing by the borrower.
[106] This article is intended for educational and informational purposes only and does not constitute the rendering of legal advice. The views and opinions expressed in this article are solely those of the author and do not necessarily reflect the views, opinions or policies of Poyner Spruill LLP or its partners.
[107] *See, e.g.*, Susan J. Klein, *Factoring Accounts Receivable: True Sale Versus Secured Transaction*, The Secured Lender (November/December 2006).
[108] The client accounting structure in most factoring agreements involves (a) debiting an accounts receivable account and crediting a reserve (or similarly named) account, in each case, for the purchase price of the accounts and (b) debiting the reserve account for advances. The net debit balance in the receivables account minus the net credit balance in the reserve account equals a number factors call "Funds Employed" or "Funds In Use" (or something similar), which number generally equates to the amount of unpaid advances owing by the client to the factor. Receivables collections are credited to the receivables account (after being matched with the invoice they are supposed to pay), which in turn reduces the net debit balance in the receivables account and Funds Employed. Thus, receivables collections do not pay down advances *directly* but the mathematical relationship between advances and collections is relatively obvious.
[109] Peter V. Pantaleo (Reporter), Herbert S. Edelman, Frederick L. Feldkamp, Jason Kravitt, Walter McNeill, Thomas E. Plank, Kenneth P. Morrison, Steven L. Schwartz, Paul Shupack and Barry Zetsky, *Rethinking the Role of Recourse in the Sale of Financial Assets*, 52 Bus. Law 159 (1996).
110 *Accounting for Transfers of Financial Assets, an amendment of FASB Statement No. 140*, Statement of Financial Accounting Standards No. 166 (Fin. Accounting Standards Bd. 2009), available at www.fasb.org.
[111] *Id.* at 9-10.
[112] *Id.* at 31.
[113] *See* discussion *supra* part II.A.1.
[114] I am not saying factors routinely create such reserves but rather that the structure of a typical factoring agreement allows it.
[115] *See* discussion *supra* part III.A.
[116] *See, e.g., Major's Furniture Mart, Inc. v. Castle Credit Corp.*, 602 F.2d 538 (3d Cir. 1979) (holding that the factor did not take on the risks of a true sale as a result of, among other things, the factor's high level of recourse to the seller and its description of its advances in a side letter as loans under a line of credit accruing interest); *Reaves Brokerage Company, Inc. v. Sunbelt Fruit & Vegetable Company, Inc. et al.*, 336 F.3d 410 (5th Cir. 2003) (holding that the combination of a factor's excessive recourse, discretionary advances and reserves, among other things, meant that its relationship with the seller was not a true sale) (the court's holding in this case is expressly limited to the facts and arguments presented in the case).
[117] 11 U.S.C. §363(a).
[118] 11 U.S.C. §363(e). The requirements for adequate protection are set forth in 11 U.S.C. §361 and do not explicitly include a reference to a budget, but the use of a budget as part of the package of adequate protection provided to a lender secured by pre-petition accounts has become commonplace.

[119] Of course, the factor's *client* that specifically desires sale accounting for the factoring transaction and cannot obtain it due to the transaction's structure may care a great deal. Whether the transaction can be structured to satisfy the requirements of FAS 166 is beyond the scope of this article.
[120] *See* discussion *supra* part I.B.