

# THE EAGLE 9<sup>®</sup> NEWSLETTER



The First American Corporation  
UCC DIVISION

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UCC EAGLE 9<sup>®</sup> policies insure commercial loan transactions, including

- Mixed-collateral loans
- Asset-based loans
- Mezzanine lending
- Fixtures
- Loan workouts/bankruptcy
- Equipment leasing
- Existing loan portfolios
- Project finance

## INTRODUCTION



First of all, we at the UCC Division of The First American Corporation want to wish all our readers and their friends and families the best for the New Year.

Welcome again to the Newsletter of the UCC Division of The First American Corporation. It is hard for us to believe that this is the sixth issue of the Newsletter, the first for 2006, and we have come to the end of our first full year of publication. Our first Newsletter was issued in January of 2005, with the expectation that we would try to produce additional issues every two or three months. We met that goal. Hopefully you have found the Newsletter useful to your commercial law practice or the lending operations of your financial institution.

Please let us know if there are topics you would like covered in the articles and other information that comprise the Newsletter. We try to be useful as well as topical. The UCC Division of The First American Corporation is the only full service UCC search and filing company integrated into the only full service UCC insurance company. We do not limit ourselves to specific commercial lending market segments, such as mezzanine lending, or limit the dollar size of transactions that we will insure. We have the depth and breadth of expertise and economies of scale to fully service the small SBA lender as well as the major New York investment bank funding mezzanine loans. We insure individual UCC searches as well as §363 sales out of bankruptcy and loan portfolio acquisitions. When all is said and done, UCC insurance is only a risk management tool, to hedge known and unknown risks associated with the UCC attachment, perfection and priority process, including an alternative to relying solely on the representations and warranties of the borrower. We hope to be of service to you.

And now to the Newsletter. In this issue we again offer a summary of significant recent commercial law and bankruptcy cases provided by Seven O. Weise of HellerEhrman LLP, Los Angeles. We also offer an article concerning the Third Circuit's decision regarding corporate separateness in lending to a group of affiliated companies by Patrick J. Potter, Rick B. Antonoff and Andrew J. Love of Pillsbury Winthrop Shaw Pittman LLP. Finally, we have our local filing issues corner discussing the states' "standard" search logics. But first, we want to review another "great" court case justifying the use of UCC insurance. The worse the decision, the better for our marketing efforts!

### \*\*PLANNED FURNITURE\*\*

An example of the "WHY" of UCC insurance is a recent case from the United States District Court for the Middle District of Georgia that further messes up the certainty and simplicity of the search process envisioned by Revised Article 9. In a decision that is, at best, disconcerting to all who thought that the enactment of Revised Article 9 would establish a uniform and strict approach to the perfection rules, the court in *Planned Furniture Promotions, Inc., Plaintiff v. Benjamin S. Youngblood, Inc., d/b/a/ Honey Creek Home Furnishings; Benjamin S. Youngblood; Laura Youngblood; Citizens Bank of Fort Valley, Georgia; United States Internal Revenue Service; State of Georgia Department of Revenue, Defendants*, 374 F.Supp. 1227 (M.D. Ga. 2005) throws the perfection rules of Revised Article 9 to the winds. The result is a strange mixture of barnyard justice and go look for yourself collateral monitoring. The case pays little attention to the perfection rules of Revised Article 9 with respect to the sufficiency of collateral descriptions or the legal exactness of the debtor's name. However, there is some good news. It's the IRS' turn to be on the receiving end of bad law making up in some righteous holistic manner for the IRS's win in *Spearing*. This case is another really good reason to use First American's UCC insurance products.



*“Planned Furniture: It is the IRS’s turn to be on the receiving end of bad law. Revenge for Spearing!”*

The decision of the United States District Court for the Middle District of Georgia, Macon Division, arose out of motions for summary judgment filed by plaintiff Planned Furniture Promotions, Inc. and defendant IRS, in an interpleader action in which all parties to the action claimed entitlement, in varying degree, to \$110,632.24 in proceeds from the liquidation sale of a defunct business venture. The IRS had also moved from summary judgment on its cross-claim against defendant Citizens Bank of Fort Valley, Georgia (Bank).

The facts of the case are fairly simple. On February 4, 1999, Benjamin and Laura Youngblood took out a secured loan from Bank in the amount of \$500,000. The Youngbloods granted Bank a security interest in “all inventory, accounts, furniture, fixtures, equipment, all assets now or hereafter acquired of Old Salem Furniture located at 3565 Hwy 205, Conyers, GA & any other location where business is transacted.” Because the Youngbloods used the loan proceeds to purchase the collateral specified in the security agreement, the Bank obtained a purchase money security interest which was perfected by the filing of a UCC-1 financing statement on February 22, 1999. Both the security agreement and the financing statement listed the debtors as Benjamin Scott Youngblood and Laura B. Youngblood.

Not long after taking out the loan from Bank, the Youngbloods incorporated their furniture business on February 25, 1999 as “Benjamin S. Youngblood, Inc.” Bank was not informed of the incorporation and the financing statement filed by Bank in conjunction with the Youngbloods’ loan was never updated to indicate the change.

On July 9, 2001, the Youngbloods entered into a loan modification agreement with Bank, changing the terms of the original loan to reflect a new loan amount of \$474,872.93. The collateral securing the loan remained the same except that the phrase “Old Salem Furniture” was replaced with “Old Salem Furniture AKA Honey Creek Home Furnishings.” The financing statement record was not amended to reflect the added trade name. The 2001 modification agreement again showed the parties as Benjamin Scott Youngblood and Laura B. Youngblood.

The case facts include other financing arrangements that go to claims against the estate but are not germane to the UCC issues involved in the dispute between Bank and the IRS. What is important is that the IRS assessed deficiencies against Benjamin S. Youngblood, Inc. in the amount of \$106,743.53. These deficiencies reflect unpaid federal employment taxes for the fourth quarter of 2000, all quarters for 2001, and the first quarter of 2002. To protect the validity of its statutory lien interest as against Benjamin S. Youngblood, Inc.’s other creditors, the IRS filed five Notices of Federal Tax Liens against Benjamin S. Youngblood, Inc. during the period from March 11, 2002 through October 21, 2002.

As part of the action, the IRS filed a cross-complaint against Bank seeking disgorgement of certain liquidation proceeds paid to Bank before the initiation of the interpleader action. The proceeds had been paid by Planned Furniture Promotions, Inc., pursuant to a Sales Promotion Consulting Agreement and a letter agreement, to satisfy the Youngbloods’ loan obligations to Bank. The IRS contended that its federal tax lien against the proceeds had priority over the security interest asserted by Bank in the same proceeds and sought turnover for the tortiously converted proceeds. Bank, on the other hand, challenged the claim for disgorgement on the grounds that its perfected security interest was superior to the federal tax lien.

In support of its motion for summary judgment, the IRS offered two arguments. First, the IRS maintained that any security interest obtained by Bank in 1999 was never perfected because the financing statement inadequately described the collateral. Alternatively, the IRS submitted that, if Bank’s interest was initially perfected, it became unperfected four months after the Youngbloods’ furniture business was incorporated because the filed financing statement was never amended to reflect the debtor’s subsequent name change. Before determining whether the IRS or Bank had a superior priority status, the Court first determined whether a valid lien or security interest ever attached to the proceeds at issue in the motion for summary judgment.

The Court had no difficulty concluding that the United States held a valid federal tax lien over the sale proceeds. The IRS was a statutory lien holder with respect to the property of Benjamin S. Youngblood, Inc. – a delinquent taxpayer. The Court also concluded that, at the time Bank loaned money to the Youngbloods in 1999, it acquired an enforceable security interest in all of the furniture store’s inventory and other assets. To ensure the priority of its security interest as against third parties, Bank perfected its interest by filing a UCC-1 financing statement on February 22, 1999. The financing statement listed the debtors as Benjamin Scott Youngblood and Laura B. Youngblood.

Having found that the IRS’s federal tax lien and Bank’s security interest were both valid, the Court then proceeded to determine which interest had senior priority status. If Bank held a perfected security interest under Georgia’s UCC provisions prior to the filing of the federal tax lien notices, its interest in the

sale proceeds would be superior to that of the IRS. On the other hand, if Bank's security interest was unperfected at the time the tax lien notices were filed, the IRS would have the superior interest.

The IRS argued that it was entitled to summary judgment for two reasons. First, it maintained that Bank's security interest was never perfected because its financing statement failed to adequately describe the collateral. Second, the IRS contended that, even if the collateral description was adequate, Bank's security interest nevertheless became unperfected when the financing statement was not amended to reflect the incorporation of the Youngbloods' furniture business. The Court considered each of these arguments in turn.

#### a. Insufficient Description of Collateral

In order to perfect a security interest in a debtor's collateral, a financing statement must, among other things, indicate which collateral is covered by the security agreement. In a financing statement, as opposed to a security agreement, collateral need only be reasonably identified. The Court stated that it had long since been the case that a description of collateral in a financing statement "is sufficient if [it] provides such a key to the identity of the property as would enable a person of ordinary business prudence, upon inquiry, to discover the actual identity of the property described."

The IRS contended that Bank's security interest in all of the proceeds from Honey Creek's liquidation was unperfected and, thus, subordinate to the tax lien of the United States. It supported this conclusion by arguing that Bank's financing statement did not sufficiently describe the collateral because it listed only the assets of "Old Salem Furniture," making no mention of assets held by "Honey Creek Home Furnishings" or "Benjamin S. Youngblood, Inc." However, the Court considered that the IRS had overlooked two important pieces of information. First, the description of collateral in Bank's financing statement provided the address where the collateral was located. The financing statement provided, in pertinent part, that Bank had a security interest "in all Assets, Now Owned or Hereafter Acquired of Old Salem Furniture located at 3565 Highway 20 South, Conyers, Georgia and Any Other Location Where Business is Transacted." Second, as evidenced by subsequent documents, Honey Creek Home Furnishings and Benjamin S. Youngblood, Inc. both transacted business at the very address provided for Old Salem Furniture – 3565 Highway 20 South, Conyers, Georgia.

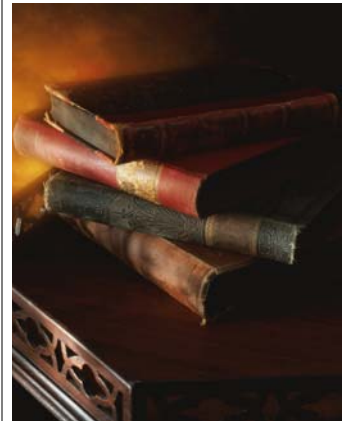
The inclusion in the financing statement of a readily identifiable physical location where the collateral may be found, coupled with the fact that each of the Youngbloods' furniture stores operated at that location, apparently was sufficient for the Court to conclude that the description of the collateral in the financing statement was sufficient under the UCC and the applicable case law. Accordingly, judgment as a matter of law in favor of the IRS was not appropriate as to this argument, and the IRS's motion for summary judgment was denied.

Apparently for the Court, the reasonably prudent searcher standard that may have had some credence in some jurisdictions under former Article 9 and that had been applied to the manner of searching the central filing office for filed financing statements against a debtor, was not only alive and well under Revised Article 9 but could be extended to the physical search for the collateral as well! The searcher was not only required to check name variations to an unspecified extent to find potentially priming security interests. Now the searcher had to seek out the debtor's location and see what was physically there. This case may end up being a significant work relief act for a lender's auditors.

However, the real question before the Court, and totally missed, was the issue of trade names and their appropriateness in UCC filings. Financing statements are to include the name of the debtor according to the standard set forth in UCC §9-503. As stated in Official Comment 2 to UCC §9-503, §9-503 reflected the view prevailing under former Article 9 in that the "actual" individual or organizational name of the debtor on a financing statement is both necessary and sufficient, whether or not the financing statement provides trade or other names of the debtor. Apparently, both "Old Salem Furniture" and "Honey Creek Home Furnishings", leaving aside "Benjamin S. Youngblood, Inc." for the moment, were trade names for furniture businesses conducted by Benjamin and Laura Youngblood.

The security agreement contained the following grant: "ALL INVENTORY, ACCOUNTS, FURNITURE, FIXTURES, EQUIPMENT, ALL ASSETS **NOW OWNED OR HEREAFTER ACQUIRED** OF OLD SALEM FURNITURE LOCATED AT 3565 HWY 205, CONYERS, GA & ANY OTHER LOCATION WHERE BUSINESS IS TRANSACTED." (Emphasis added) Bank's financing statement matched the language of the grant in the collateral description and showed Old Salem Furniture and Benjamin Scott Youngblood and Laura B.

*“Collateral description  
by address of loca-  
tion—a novel  
approach!”*





*We don't see any real difference between Benjamin Youngblood and Youngblood, Inc.*

Youngblood as debtors. Old Salem Furniture was a dba and need not have been listed as a debtor at all. The only debtors for Article 9 purposes were Benjamin Scott Youngblood and Laura B. Youngblood. Further, the facts provide that the Youngbloods' furniture business was incorporated as "Benjamin S. Youngblood, Inc." This seems to imply that all of the furniture businesses of the Youngbloods were folded into Youngblood, Inc. The financing statement was apparently not modified to reflect the loan modification that replaced the phrase "OLD SALEM FURNITURE" with "OLD SALEM FURNITURE AKA HONEY CREEK HOME FURNISHINGS."

What seems to be going on is that Bank had been granted was a security interest in, at least, the Article 9 collateral categories of Inventory, Accounts and Equipment. "All assets" in the security agreement would not be a sufficient description to pick up other collateral types, e.g., as extracted collateral. The fact that the Youngbloods operated under different trade names is irrelevant, unless one wants to make the argument that listing specific trade name reflected an intent to limit the grant of the security interest to the assets of only specified divisional operations— all my inventory used for X, but not my inventory used for Y. However, the issue of the intent of the parties was not raised by the Court or supported by the facts.

The Court never needed to reach the issue of the secured party's failure to look for the collateral physically located at the stated address. The grant of the security interest itself was sufficient and included an after acquired property clause. The Court could have easily held for Bank on the issue trade names and their inappropriateness as debtor names and avoided throwing the Uniform Commercial Code out the window. A little knowledge can be a dangerous thing. The real and only issue in the debate between Bank and the IRS was the correct name of the debtor.

#### **b. Effect of Debtor's Name Change**

The Court correctly observed that in order to perfect a security interest in a debtor's collateral, a financing statement must also provide the name of the debtor. As long as the name of the debtor is included in the financing statement, it is effective "even if it has minor errors or omissions, unless the errors or omissions make the financing statement seriously misleading." If a search of the records of the filing office under the debtor's correct name, using the filing office's standard search logic, if any, would disclose a financing statement that failed sufficiently to provide the name of the debtor in accordance with subsection (a) of UCC §9-503, the name provided does not make the financing statement seriously misleading. If a debtor changes its name after the initial filing of the financing statement and the name change does make the financing statement seriously misleading, and the change is not corrected by amendment, the financing statement "is effective to perfect a security interest in collateral acquired by the debtor before, or within four months after, the change."

The financing statement filed by Bank on February 22, 1999, listed the debtors as Benjamin Scott Youngblood and Laura B. Youngblood. However, several weeks after the financing statement was filed, Mr. Youngblood incorporated his furniture store as Benjamin S. Youngblood, Inc. Bank, which maintained it was not notified about the incorporation, never filed a new or amended financing statement to indicate the name change. The IRS argued that this change in the debtor's name rendered the financing statement seriously misleading and therefore ineffective to perfect a security interest with respect to any collateral acquired by the debtor more than four months after the change. See UCC §9-508(c)(2) ("The financing statement is not effective to perfect a security interest in collateral acquired by the debtor more than four months after the [debtor's name] change, unless an amendment to the financing statement which renders the financing statement not seriously misleading is filed within four months after the change."). Although not specifically addressed, the Court utilized §9-508(c)(2) on the assumption, correctly taken, that the incorporation of the furniture businesses of the Youngbloods' into Youngblood, Inc. resulted in Youngblood, Inc. being a "new debtor" as defined in UCC §9-102(56). See Official Comment 2. to §9-508.

Section 9-508 (a) provides that a Financing Statement filed against an original debtor is effective to perfect a security interest in collateral in which the new debtor has or acquires rights to the extent that the Financing Statement would have been effective had the original debtor acquired rights in the collateral. A "new debtor" is defined in §9-102(56) as a person that becomes bound as debtor under §9-203 (d) by a security agreement previously entered into by another person. Section 9-203(d) completes the thought by providing that a person becomes bound as debtor by a security agreement entered into by another person if, by operation of law other than Article 9 or by contract (1) the security agreement becomes effective to create a security agreement in the person's property, or (2) the person becomes generally obligated for the obligations of the other person, including the obligations secured under the secu-

ity agreement, and acquires or succeeds to all or substantially all of the assets of the other person.

The exception to the general rule of §9-508(a) is set forth in §9-508(b). This section provides that if the difference between the name of the original debtor and the new debtor causes a filed financing statement that is effective under subsection (a) to be seriously misleading. The secured party has a four-month grace period within which to file an initial financing statement against the new debtor in order to maintain perfection.

The Court concluded that a financing statement becomes seriously misleading when the names of the debtors are *completely dissimilar*. However, the Court emphasized that notice was the primary purpose of the UCC's filing requirements. If a filing was sufficient to put a creditor on notice of other potential security interests, it was not seriously misleading. To the Court, a corollary to the rule of complete dissimilarity was that a financing statement is not seriously misleading where, as apparently here in the eyes of the Court, the debtor's changed name was only "nominally" different than the debtor's name as originally listed. One of the debtors listed on Bank's financing statement was "Benjamin Scott Youngblood." The debtor subsequently changed his business structure by incorporating under the name "Benjamin S. Youngblood, Inc." Given this foundation, the Court then stated that the IRS claimed that Bank's security interest, perfected long before the federal tax lien arose, in the collateral of Benjamin Scott Youngblood (his furniture store's inventory and other assets) had lost its perfected priority status with regard to the collateral of Benjamin S. Youngblood, Inc. The Court did not so conclude. As a matter of law, the Court declined to conclude that this name change rendered the original financing statement seriously misleading under O.C.G.A. §11-9-506, reasoning that a search of the filing records under the name "Benjamin S. Youngblood, Inc." would have almost assuredly turned up a financing statement filed under the name Benjamin Scott Youngblood. Given that remarkable observation, the Court considered it reasonable to conclude that the proverbial diligent creditor searching the filing records under the name Benjamin S. Youngblood, Inc. would be put on notice to inquire into the interests of a debtor listed as Benjamin Scott Youngblood. As a result, the name change could not be considered seriously misleading. Accordingly, the Court decided that Bank's security interest remained perfected at all times and the IRS's motion for summary judgment was denied.

Wow! The Court could not have been more wrong, starting with the basics. The Court apparently had absolutely no idea how the UCC filing office in Georgia actually functions. The filing authority for financing statements in the State of Georgia is the Office of the Superior Court Clerk's Cooperative Authority, a central amalgamation of county filing offices organized following the enactment of Revised Article 9. Now, for starters, this office maintains two separate and distinct registries, one for individuals and one for entities. Any search on Benjamin S. Youngblood, Inc. would not bring up Benjamin Scott Youngblood or Laura B. Youngblood or any other individual for that matter. A searcher, to be really reasonable and really prudent and meet the test set down by the Court, would have to search two totally distinct registries. It is unfathomable how searching two totally separate registries meets the requirement of UCC §9-506(c).

More importantly, however, the result of the Court's logic is that when you are searching the records for UCC filings against a corporation, limited liability company, or any other entity, the searcher, to be reasonable and prudent, must search the registry for individuals with similar names. If you are lending against Harris Plumbing, Inc., better search Harris and Plumbing as possible last names. The violence this case does to the searching methodology contained in Revised Article 9 is staggering. Filings under both former Article 9 and Revised Article 9 were to be indexed under the "correct name" of the debtor so that they could be located with minimal guess work by subsequent searchers.

After reading this case and the defeat of the IRS, I felt the UCC god was getting even with the IRS for its win in *Spearing*. Perhaps we should coin a new word – to be "Spearinged" – when a creditor loses on an issue of searching or filing under the UCC because a court has no idea what it is doing. "Spearinged" is a bit easier than to be "Planned Furnitured."

However, we really appreciate such bad cases for they help sell our UCC insurance products. Our UCC policies do not contain a "bad judge" or "what an unbelievable decision" exception to our insuring that the secured creditor is in first priority. What is good for selling insurance is obviously not good for the orderly functioning of commercial law; but how we love these cases. And as for the IRS, what goes around apparently comes around.

*"Benjamin S.  
Youngblood =  
Benjamin S.  
Youngblood, Inc.; under  
whose search logic!"*



## Cases of Interest

### PERSONAL PROPERTY SECURED TRANSACTIONS

#### SCOPE OF ARTICLE 9 AND EXISTENCE OF A SECURED TRANSACTION—GENERAL

*In re Gallagher*, \_\_ B.R. \_\_, 2005 WL 2508138 (9<sup>th</sup> Cir. Bankr. 2005) – In the settlement of a tort claim the plaintiff received a structured settlement obligation. The court held that the structured settlement obligation was a claim “arising” in tort and was therefore excluded from Article 9. UCC §. 9-109(d)(12). The court concluded that public policy favored not having Article 9 apply to the transfer of consumer tort claims. As a result of Article 9 not applying to the transaction, the pro-assignment rules of 9-408 did not apply and the enforceability of an anti-assignment provision in the structured settlement obligation was left to contract law in general.

*Comment:* The court mentioned, but did not follow, a comment that provides that a payment obligation arising out of a tort claim is no longer a “tort” claim: “Note that once a claim arising in tort has been settled and reduced to a contractual obligation to pay, the right to payment becomes a payment intangible and ceases to be a claim arising in tort.” UCC § 9-109, Comment 15.

#### SCOPE OF ARTICLE 9 AND EXISTENCE OF A SECURED TRANSACTION—PRIORITY

*Tucker v Par Wholesale Auto, Inc.*, 329 B.R. 291 (Bankr. D.Ariz. 2005) – A secured party had a security interest in a debtor’s inventory. A seller of inventory exercised its reclamation rights under UCC § 2-702. Those rights are subject to the rights of a “good-faith purchaser.” A secured party is a “purchaser” under the UCC. UCC § 1-201(32) and (33). The court held that the secured party was a “purchaser”, but not a “good-faith” purchaser because the secured party had not perfected its security interest.

*Comment:* UCC § 2-702 does not require the “purchaser” to have perfected its security interest. The UCC knows how to require perfection when perfection is a condition to the rights of a person.

#### SCOPE OF ARTICLE 9 AND EXISTENCE OF A SECURED TRANSACTION—PROCEEDS

*Van Diest Supply Co. v. Shelby County State Bank*, -- F.3d \_\_ (7<sup>th</sup> Cir. 2005) – Secured party had a perfected security interest in the inventory that the secured party had sold to its buyer. Another secured party had a security interest in the buyer’s accounts. The second secured party collected the receivables. The first secured party was unable to “identify” its proceeds by tracing its security interest into specific accounts, so the second secured party was entitled to retain the collections on the accounts.

*Comment:* The court was applying former Article 9. Under Revised Article 9, it should be noted that even if the first secured party could trace the funds, the second secured party might be in a position to retain them. UCC §§ 3-306 (holder in due course), 9-330(d) (person in possession of instrument), 9-332 (transferee of money or funds).



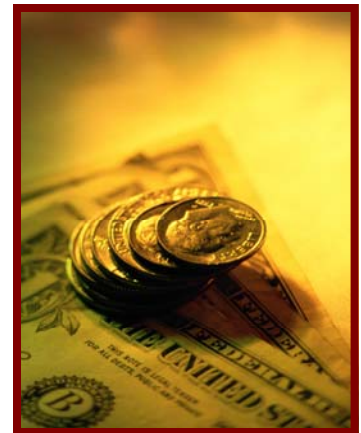
## UCC– SALES AND PERSONAL PROPERTY LEASING

**CONTRACT FORMATION AND MODIFICATION; STATUTE OF FRAUDS; “BATTLE OF THE FORMS;” CONTRACT INTERPRETATION; TITLE ISSUES**

*International Casings Group, Inc. v. Premium Standard Farms, Inc.*, 358 F.Supp.2d 863 (WD Mo. 2005) – Series of seventeen e-mails can form a contract and satisfy the statute of frauds. UCC § 2-201. The e-mails also satisfied the meaning of “sign” in Article 1. UCC § 1-201 (39).

## CONTRACTS

**ADHESION CONTRACTS; UNCONSCIONABLE AGREEMENTS; GOOD FAITH AND OTHER PUBLIC POLICY LIMITS; INTERFERENCE WITH CONTRACT**



*Villacreses v. Molinari*, 132 Cal.App.4th 1223 (2005) – A contract contained the following disclaimer, required by a statute:

“ARBITRATION OF DISPUTES: NOTICE: BY INITIALING IN THE SPACE BELOW, YOU ARE AGREEING TO HAVE NEUTRAL ARBITRATION OF ALL DISPUTES TO WHICH IT APPLIES AND YOU ARE GIVING UP ANY RIGHTS YOU MIGHT POSSESS TO HAVE THE DISPUTE LITIGATED IN A COURT OR JURY TRIAL. BY INITIALING IN THE SPACE BELOW, YOUR JUDICIAL RIGHTS TO DISCOVERY AND APPEAL ARE AFFECTED. IF YOU REFUSE TO SUBMIT TO ARBITRATION AFTER AGREEING TO THIS PROVISION, YOU MAY BE COMPELLED TO ARBITRATE UNDER THE AUTHORITY OF THE CALIFORNIA CODE OF CIVIL PROCEDURE. YOUR AGREEMENT TO THIS ARBITRATION PROVISION IS VOLUNTARY.”

The court held that this disclaimer of itself did not constitute an agreement to arbitrate and that the word “it” in the first sentence referred to a separate agreement to arbitrate, which did not exist in this agreement.

*Comment:* The court admonished the parties to “Read the documents.”

**JURISDICTION; CHOICE OF LAW AND CHOICE OF FORUM**

*Peters Company Inc. v. BLS Sales Inc.*, \_\_\_ F.Supp.2d \_\_\_, 2005 WL 2072109 (ND. Calif. 2005) – A note provided for the application of Minnesota law. The interest rate under the note was 3% a month, which exceeded California’s usury limit. The payee was located in Minnesota and under California’s choice-of-law rules, which follow the *Restatement (Second) Conflict of Laws*, § 187, this was a sufficient “substantial relationship” to the state whose law had been chosen. The interest rate did not violate a fundamental California public policy, so that the choice-of-law clause was enforceable.

*Comment:* This case offers an excellent summary of California cases on usury and choice of law.

# Local Filing Issues

## Standard Search Logic – The Myth

UCC 9-506(c): If a search of the records of the filing office under debtor's correct name, using the *filing office's standard search logic*, would disclose a financing statement that failed to sufficiently provide the correct name of debtor, the financing statement is not seriously misleading.

What does this mean? It means that even if filer didn't "get the name right," its financing statement will remain effective as long as its lien appears on a search of the state records using the "correct" debtor name.

A great misconception among searchers is the assumption that a standard search logic has been adopted universally among filing offices in conjunction with their adoption of Revised Article 9. Not so. Standard search logic is entirely state specific, and the quirks embedded in any given jurisdiction's rules – not to mention database deficiencies – can get a searcher into a lot of trouble.

In this age of technology, searchers have the luxury of accessing state websites or service company databases to self-search any state jurisdiction instantaneously. Unfortunately, this quick fix opens a 'virtual' Pandora's Box. If you're guilty of this type of express searching, you need to ask yourself: "What am I missing?"

Part of the difficulty of this analysis is the fact that 'standard search logic' has not been defined. Some state websites offer several logic options, while their own certified 'paper' searches have different parameters. If multiple search logics reveal their own, unique results... which is standard?

The differences on a national level are staggering. A New Jersey online UCC search for J Smith will reveal any and all names that begin with J, followed by last name: Smith and any and all verbiage to the left of 'Smith.' For example, such a search would display James Smith, Jim Smithy, Julia Smithe. Obviously, such a search could return an infinite number of results yielding a search cumbersome enough to frustrate any seasoned searcher. A more experienced online user may search 'James Smith' in an effort to reduce results. While our search is now more manageable, we would miss all liens under 'Jim Smith,' filings that may be considered effective by a court.

Alternatively, we have the Delaware Secretary of State's certified UCC search logic that is more restrictive. Their individual searches are [last name, first name] with no additional characters provided. Smith, J will pull ONLY J Smith liens.

The International Association of Commercial Administrators (IACA) has published a list of commonly used 'noise word' endings that they are encouraging the various filing offices to adopt. Any noise word ending included as part of the search criteria would be ignored by the search logic. This philosophy would grant: ABC CO., ABC PARTNERSHIP, and ABC CHARTERED BUSINESS TRUST the same result. The searcher would, in essence, be searching ABC and all of the above would appear on the search report. While this strict search logic was intended to be beneficial for the searcher—the pitfalls are obvious.

Certain service companies have online, proprietary databases that can also be accessed by their clients for self-searching. Many of these sites offer a standard 'begins with' search logic. A 'begins with' logic results in a search of the inputted characters followed by any and all endings on record. For example, if I were to enter: XYZ FA, I would find:

XYZ Family Trust  
XYZ Farmers of America  
XYZ Faxing and Imaging Systems

I would *not* find: XYZ Flowers Inc.

Such a search methodology will adversely affect the searcher if he or she is not *well* aware of any given state's published noise words while self-searching on a database. If I don't know that state X has adopted both RR and RAILROAD as noise word endings, and I search: B&R RAILROAD, I will miss B&R RR...probably an effective lien depending on whether the debtor is a registered entity and what the debtor's legal name may be.

The answer? While we wish we could recommend a particular service company, especially our own, as having absolute knowledge of all of these potential search permutations, such a reality is impossible. Add to the existing confusion a state's ability to change its search logic at any given time. If a filing office makes its search logic more restrictive, those filings not using the exact legal name of the debtor that may have been effective when filed will now not be found using the state's standard search, and are now arguably ineffective as seriously misleading. Similarly, a switch to a broader logic could cause a previously ineffective filing to now appear.

The only way for a searcher to really protect itself from this morass is to transfer some of this risk to a service provider through insurance coverage. First American's search policy: The Insured Search™ insures against any Security Interest or Lien of a Lien Creditor filed in the Filing Office against the debtor and not included in our Insured Search Report. Time to relax! Contact us at 800-700-1191 for more information.

## A UCC Article of Interest

### ***Third Circuit Protects Lender Expectations Regarding Corporate Separateness in Lending to a Group of Affiliated Companies***

*Patrick J. Potter, Rick B. Antonoff and Andrew J. Love*

*Pillsbury Winthrop Shaw Pittman LLP*

The Third Circuit's recent decision in *In re Owens Corning* offers comfort to lenders who have relied upon the separate existence and credit of affiliated parties in a financing. An important lesson from the court's decision is that credit underwriting and loan terms should evidence the lenders' reliance on the separateness of guarantors from the related borrowers.

Many lenders are concerned about the potential impact on a financing transaction of a future bankruptcy of a borrower, including the risk that in the bankruptcy the creditors of some members of an affiliated group of companies may try to reach the assets of more creditworthy members of the group (even without a direct claim on those assets). This is particularly true where the financing is a securitization or other structured financing relying on the bankruptcy remoteness of a borrower, a financing that relies on structural subordination, or a financing relying on the financial strength of one party to provide credit support for the financial risks associated with lending to a related party.

The "tool" that creditors use to attempt to reach the assets of creditworthy parties to the detriment of the lender is the argument that the legal separateness of affiliated entities should be ignored and instead the entities should be "substantively consolidated" – i.e., treated as a single entity with all of their assets available to satisfy all creditor claims (effectively eliminating structural subordination, intercompany guarantees and other lender protections). Whether the bankruptcy court orders a "substantive consolidation" turns on factors such as the extent to which the entities involved followed appropriate corporate formalities, the extent of commingling of those entities' assets, the expectations of creditors and the relative harm and benefits to creditors.

The recent case of *In re Owens Corning*, 419 F.3d 195 (3d Cir. 2005), offers comfort to lenders who have relied upon the separate existence and credit of affiliated parties in a financing.

*In Owens Corning*, a syndicate of lenders had provided a \$2 billion unsecured credit facility to Owens Corning and certain of its subsidiaries, and obtained guarantees of certain other Owens Corning subsidiaries. The guarantees gave the lenders direct claims against the guarantors' assets for repayment of the loan.

Owens Corning and seventeen of its subsidiaries subsequently filed for bankruptcy under Chapter 11 of the Bankruptcy Code. Their proposed plan of reorganization included a provision "deeming" that a consolidation of the debtors had occurred. A significant impact of this deemed consolidation would have been that all intercompany guarantees (including the guarantees made for the benefit of the lenders) would be eliminated, effectively diluting the claims of the lenders and permitting all creditors to be paid from the combined assets of all entities (rather than the normal case of non-guaranteed obligations being paid only by the entity liable on the obligation). The lower court granted the plan proponents' request to substantively consolidate the entities over the objection of the lenders and other parties.

On appeal, the Third Circuit held that the deemed substantive consolidation was not appropriate. The court began by agreeing with earlier decisions stating that substantive consolidation should be used sparingly. However, the Third Circuit did not expressly adopt either of the prevailing tests used by courts to determine when substantive consolidation is appropriate, and articulated a standard that may make it even more difficult for creditors seeking to impose that remedy. The court held that the assets and liabilities of entities should be substantively consolidated only if (i) before the bankruptcy case is filed the entities disregarded separateness so significantly that their

creditors relied on the “breakdown of entity borders” and treated them as one legal entity or (ii) after the bankruptcy case is filed their assets and liabilities are “so scrambled that separating them is prohibitive and hurts all creditors.” Applying this test, the Third Circuit found that substantive consolidation did not fit the facts of the *Owens Corning* case, and that the deemed consolidation sought in the plan of reorganization was inconsistent with all the principles that courts should consider when deciding a substantive consolidation request. In the court’s view the lenders “did the ‘deal world’ equivalent of ‘Lending 101’” and, relying on the separateness of the entities, structured their financing to achieve structural seniority (i.e., obtain direct claims against the guarantors and their assets) that other creditors of Owens Corning did not have. The court rejected arguments that the lenders had not in fact been relying on the separateness of the entities because the lenders did not obtain separate financial statements or legal opinions that substantive consolidation was not likely. The court also found that (other than some sloppy bookkeeping) the entities were in fact maintained as separate and distinct legal entities so that the “prohibitive unscrambling” standard had not been met. The court determined that substantive consolidation was particularly inappropriate under the circumstances because the plan proponents were utilizing substantive consolidation as an offensive weapon to achieve leverage in the plan negotiation process rather than its appropriate use of remedying identifiable harms.

In part, the Third Circuit was persuaded that the lenders had in fact been relying on the separateness of the guarantors. The court’s opinion specifically noted that the lenders had required the guarantees from the inception of their discussion of the financing (and would not have made the loans without the “credit enhancement” provided by the guarantees, given Owens Corning’s poor credit rating and growing asbestos liability), and that the loan documents contained covenants intended to protect the legal separateness and the financial strength of the guarantors (such as limitations on merger of subsidiaries into the parent, mergers among the subsidiaries that would adversely impact the guaranty or transactions with the parent that would result in losses to a subsidiary).

Lenders who have relied upon the separateness of affiliated entities in underwriting and documenting a financing should take comfort in the Third Circuit’s approach to substantive consolidation, particularly where the proponents of substantive consolidation are utilizing the doctrine solely as a sword to disenfranchise lenders (as was the case in *Owens Corning*). One important lesson for lenders from the Third Circuit’s decision is that documenting at the outset of the transaction the importance of the legal and financial separateness of the affiliated companies will significantly strengthen the lender’s position if other creditors seek substantive consolidation.

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