

NEWSLETTER

UCC DIVISION



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INTRODUCTION

Welcome again to the Newsletter of the UCC Division of First American Title Insurance Company.

The UCC Division in October reached a great milestone - \$100 Billion in insured UCC insurance coverage! A significant portion of this number is composed of real estate mezzanine financing. We were the lead in both the Blackstone/EOP and Archstone-Smith transactions. However, our UCC coverage crosses all market segments, from real estate mezzanine lending to SBA loans, from asset based lending to mixed collateral transactions such as cellular towers, to insuring the ownership of acquired equity interests in M&A transactions. We look forward to answering your questions concerning the utility of UCC insurance as a cost effective risk management tool and how we may be of assistance.

We have also concluded the first phase of our lecture series on real estate mezzanine finance. The lecture series addressed the "why" of real estate mezzanine lending and the conclusions of the Report by Moody's Investors Service titled "US CMBS and CRE CDO: Moody's Approach to Rating Commercial Real Estate Mezzanine Loans." Moody's concludes that it expects to see the following for a neutral rating posture in CMBS and CRE CDO transactions:

- Pledge of 100% of the equity of the land owning entity
- Opt-in to Article 8 of the UCC
- Certificate the pledged equity
- File a UCC Financing Statement
- Control the ability to opt-out of Article 8 – hardwire in the operating agreement or by proxy
- Obtain UCC insurance

We certainly concur with all points, especially the last. If anyone wants a set of the materials distributed at the lectures, please contact us.

In this issue we again provide brief summaries of recent commercial law and related cases of inter-

In 2000,
we introduced the concept of
UCC Insurance.

\$100 billion later,

we're still offering you leading protection.

est. As always, we thank Steve Weise of HellerEhrman, LLP, Los Angeles, for this contribution. We have our section on UCC Local Filing Issues of note, remembering that we are the only UCC insurance company that is also a national UCC search and filing company. We also offer a discussion of a recent California case concerning usury issues of which lenders should be aware. Also, thank you to our good friend George Hisert of Bingham McCutchen LLP, San Francisco, for this article. And finally, Brad Gibson, our Associate General Counsel, offers us his insights on the law of suretyship and its relevance to secondary obligor pledges. Brad's article highlights the risk of using a primary obligor pledge agreement, where the pledgor of the equity collateral is also the borrower, for a secondary obligor pledge, such as a guaranty. Forgetting to waive suretyship defenses could result in the inadvertent exoneration of the guarantor for any change to the primary obligation, such as in a work out. Beware of grabbing the wrong form!

**If there are topics
you wish us to cover
in the Newsletter,
please email us at
jprendergast@firstam.com.**

Cases of Interest



In re Refco Inc. (SDNY) – Final Report of Examiner (July 11, 2007) – “The Examiner concludes that there is sufficient evidence to allow the Refco estate to state a claim upon which relief may be granted for legal malpractice, aiding and abetting the breach of fiduciary duty, and aiding and abetting fraud.”

“There is evidence that Mayer Brown committed malpractice by conduct that, if proven to be true, would violate DR7-102(a) – specifically, assisting Refco with the Round Trip Loan transactions, which Mayer Brown knew or should have known were fraudulent.”

“Mayer Brown also committed malpractice by conduct that, if proven to be true, would violate DR7-102(a) by failing to disclose material matters and by making affirmative statements that it knew, or should have known, were untrue.”

“In this case, the Examiner concludes there is sufficient evidence to allege that Mayer Brown aided and abetted a breach of fiduciary duty and fraud by: . . . drafting and sometimes negotiating the transaction documents for the Round Trip Loans while knowing that the Round Trip Loans were part of a scheme to fraudulently bolster Refco’s financial appearance to lenders and investors by manipulating Refco’s financial statements;”

Material adverse change/material adverse event clause – Harman purchase, buyers say (per *Wall Street Journal*): “the future prospects of Harman, which builds audio components for home stereos and automobiles, were worsening”. MAC/MAE clause includes: “Material Adverse Effect shall not include facts, circumstances, events, changes, effects or occurrences (i) generally affecting the consumer or professional audio, automotive audio, information, entertainment or infotainment industries, or the economy or financial, credit or securities markets in the United States or any other country.”

City of Santa Barbara v. Superior Court, ___ Cal.4th ___ (2007) – Parents of a child in a summer camp signed a release releasing the camp from liability arising out of “any negligent act.” The child drowned at camp and the parents brought a claim. The Court held that as a matter of “public policy to discourage . . . aggravated wrongs.”

Johnson & Johnson v. Guidant Corporation, ___ F.Supp.2nd ___, 2007 U.S. Dist. Lexis 64114 (SDNY 2007) – Buyer #1 entered into an acquisition agreement with Target. The agreement contained a no-solicitation clause:

“[A]t any time prior to obtaining . . . Shareholder Approval [of J&J’s takeover proposal], in response to a bona fide written Takeover Proposal that the Board of Directors of the Company [Guidant] reasonably determines (after consultation with outside counsel and a financial advisor of nationally recognized reputation) constitutes or is reasonably likely to lead to a Superior Proposal, and which Takeover Proposal was not solicited after the date hereof and was made after the date hereof and did not otherwise result from a breach of this Section 4.02(a), [*6] the Company may . . . furnish information with respect to the Company and its Subsidiaries to the person making such Takeover Proposal (and its Representatives) . . .” (emphasis added)

The agreement defined “representative” as:

“any investment banker, financial advisor, attorney, accountant or other advisor, agent or representative.”

Buyer #2 came along and made a “Superior Proposal”. As part of that proposal, Buyer #2 would sell 15% of the business to Third Party. Target “furnished information” to Third Party. Unless Third Party was a “representative” of Buyer #2, the furnishing of information to Third Party violated the no-solicitation provision. The court held that the “ambiguous” term “representative” should be interpreted to be the “same kind as the terms that precede it.” On that basis, the court held that Third Party did not constitute a “representative.”

River East Plaza, L.L.C. v. The Variable Annuity Life Insurance Company, ___ F.3d ___ (7th Cir. 2007) – A real estate loan had a prepayment yield maintenance provision based on Treasury bonds or notes. The borrower argued that it was a penalty because it was not based on another commercial real estate loan. The court concluded that the fee was not an invalid liquidated damages clause (and therefore a “penalty”). The court concludes that the borrower bargained away the position that the higher commercial loan rate was the appropriate comparable rate to compensate for the risk that it could have lower than the Treasury rates used.

In re Enron Corp. (SDNY 2007) – Holder of claim “sold” the claim post-petition. The original holder was subject to subordination. The court held that the buyer was not because the claim had been “sold” to it, instead of being “assigned” to it.

In re Bear Stearns High-Grade Structured Credit Strategies Master Fund, Ltd., ___ B.R. ___ (SDNY 2007) – Chapter 15 proceeding can involve a “foreign main proceeding.” That is the country where the debtor has its “center of main interest.” Bankruptcy Code § 1502(4). Although the place of registration is presumed to be the COMI, the foreign representative still has the burden of proof that the other location is the COMI. Because the debtor was administered in New York, the court held that the COMI was in New York.

In re: Magnacom Wireless, LLC, ___ F.3d ___, 2007 U.S. App. LEXIS 22151 (9th Cir. 2007) – A licensee of a FCC license failed to make required payments under the license. The court held that the licensor’s consequent termination of the license was not the enforcement of a “security interest”, but rather “just” the enforcement of the licensor’s contractual rights under the license. This means that a terminating licensor is not subject to a secured transactions enforcement regime.

Comment: This decision suggests that secured transaction laws would not get in the way of ordinary licensing transactions.

Douglas v. U.S. District Court, 495 F.3d 1062 (9th Cir. 2007) – An individual entered into an online contract with an Internet service provider. Although not clear from the decision, the contract apparently provided that the service provider could amend the contract by posting the amended contract on its web page. The service provider did that and added terms that required arbitration and waived the ability to bring a class action. The court held that the revisions were not binding on the individual because the service provider had not notified the individual of the additional terms and the posted agreement did not indicate which terms had changed. The individual continued use of the services did not amount to “assent” where the individual had not been notified of the changes. Further, the court held that even if the individual had assented to the new terms, they may be unconscionable. Although the contract provided for the application of New York law, the court applied California law because it determined that the provision violated a “fundamental” public policy of California and on these facts California had a “materially greater interest” in applying its law than did New York. The court found procedural unconscionability because the service provider had “overwhelming” bargaining power and presented a “take-it-or-leave-it” agreement. The court also found substantive unconscionability under California decisions concerning class action waivers.

statement. UCC § 9-506(c).

Comment: An online provider wishing to have the right to amend its agreements should be sure to give notice of changes and make those changes identifiable.

Morrow v. Microsoft, 499 F.3d 1332 (Fed. Cir. 2007) – The holder of a patent went into bankruptcy. Under a bankruptcy liquidation plan, the court created a liquidating trust to which the court transferred the right to bring infringement claims based on the bankrupt’s intellectual property. A separate liquidating trust created in the bankruptcy proceeding had ownership of the patent and all other “sticks” in the “bundle of rights” with respect to the patent. The court held that the first liquidating trust did not have standing because it did not have “all substantial rights to the patent” nor “exclusionary rights” under the patent statutes. The absence of a sufficient “assignment” of the patent itself left the first trust with an insufficient interest to bring the infringement action.

Peoples Bank v. Bryan Brothers Cattle Company, ___ F.3d ___, 2007 U.S. App. LEXIS 24018 (5th Cir. 2007) – An individual engaged in a cattle “pre-conditioning” business granted a security interest in his cattle to SP-1 and SP-2, each of whom properly perfected its security interest by filing a financing statement naming the individual. The individual also owned an interest in an LLC in the same business. A buyer of collateral argued that it had purchased its collateral free of the security interests held by SP-1 and SP-2. The court held that there was a factual question on whether the individual or the LLC had sold the collateral. If the seller was the LLC, the court correctly held that the two secured parties did not have a security interest in the cattle because the individual did not have “rights in the collateral” owned by the LLC. UCC § 9-203. The court also correctly held that if the individual was operating under the dba of the LLC, the financing statements filed against the individual were not insufficient because they did not include the dba. See UCC § 9-503(c). However, the court was incorrect that SP-1’s financing statement was not “seriously misleading” and was therefore sufficient in how it provided the individual’s name. His name is “Brooks L. Dickerson” and the financing statement provided his name as “Louie Dickerson.” The fact that the individual was known in his community as “Louie” nor the fact that SP-2 knew that is not relevant. UCC § 9-503(a).

Comment: The court unfortunately cites decisions under former Article 9 concerning whether the debtor’s name is “seriously misleading.” There was a different test under former Article 9. Under revised Article 9 an incorrect name is seriously misleading unless a search under the filing office’s “standard search logic” finds the erroneous financing



The UCC Division of The First American Title Insurance Company offers an array of UCC insurance products designed to meet the risk management requirements of commercial lenders and law firms. Such products include:

- *The EAGLE 9[®] UCC Lender's Insurance Policy*
- *EAGLE 9[®] Buyers Policy*
- *The Insured Search™ and The Insured Filing™*
- *EAGLE 9[®] UCC Insurance Vacation Interest Policy*
- *EAGLE Protection[®] Vessel-Under-Construction Insurance Policy and Commitment to Issue Vessel Title Insurance Policy*
- *EAGLE 9[®] UCC Cooperative Interest Insurance Policy (NY Only)*
- *Lien Priority Coverage Under the Civil Law of Quebec and PPSA Lien Perfection and Priority Coverage in the Other Provinces of Canada*
- *The Mezzanine/Pledged Equity Endorsement*

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Local Filing Issues



PANDORA'S BOXES

BY JENNIFER KLEMP LIPTAN
ASSISTANT VICE PRESIDENT MANAGER, SPECIALTY SERVICES

For years now, UCC specialists have been preaching the fundamental basics for the preparation of an effective financing statement. Be sure to get the debtor's name right, be sure to file in the legal state of formation or domicile for debtor, and be sure to effectively describe your collateral without unknowingly limiting your security interest. However, we rarely speak of, or pay attention to, the multitude of check boxes available on the National UCC-1, Addendum and UCC-3 forms. When taking a closer look at some of these boxes, we discover that they may involve critical information.

7. Check to REQUEST SEARCH REPORT(S) on Debtor(s) (ADDITIONAL FEE) [optional] All Debtors Debtor 1 Debtor 2

Check Box #6 located on The UCC -1 Financing Statement and Check Box #13 located on

Toward the bottom of the UCC-1 financing statement, filer has the option to check a box with the expectation of receiving a post-filing search report from the Secretary of State reflecting the filing of its financing statement against the debtor party(s). Might the filer be anticipating a search-to-reflect their lien in return? Perhaps; however, the reality is that if the state doesn't completely ignore this request (most of them do), they will probably fulfill it by immediately running a search that would not yet reflect our filer's financing statement. Very few jurisdictions actually place this request within a tickler system to ensure a reflective through date. Filer is not necessarily getting what it paid for.

6. This FINANCING STATEMENT is to be filed [for record] (or recorded) in the REAL ESTATE RECORDS. Attach Addendum [if applicable]

its Addendum reflect Information relative to the lien's status as a Fixture Filing to be recorded within the land or real estate records of the filing jurisdiction. Oftentimes, when lenders use document solutions software to print the necessary forms for their real estate loan origination documents, they will print the recordable fixture filing financing statement and make a photo-

13. This FINANCING STATEMENT covers timber to be cut or as-extracted collateral, or is filed as a fixture filing.

copy of the document for filing with the Secretary of State. Unless a savvy service provider takes note of this and corrects the error by eliminating the check marks - filer is, in effect, filing a fixture filing at the state: Wrong Jurisdiction! Whether or not this results in the filing being seriously misleading remains to be seen. A searcher combing the state records of California, for example, should review the stated collateral and - at the very least - consider that the filer's intent was to file a UCC financing statement against personal property at the state. However, the line may blur in those states that have a central index for filing - one searchable index for which the only differentiation of intent are these check boxes. Hawaii, Georgia and Louisiana are three states wherein the searcher might have to rely solely on these indicators to determine if the lien encumbers personalty or realty.

Oftentimes, when searchers review their search reports, they disregard those financing statements filed more than five years prior and without a subsequent continuation statement.

An inexperienced searcher may simply write the lien off as 'lapsed.' However, if filer correctly indicated in box #18 that the debtor is a Transmitting Utility, the UCC remains effective for the life of the loan. Furthermore, manufactured home transaction and public finance transaction UCCs are eligible for a life of 30 years. Hopefully, the filing clerk caught this detail during their review of the document and accurately calculated the true lapse date of the lien within their database - otherwise, 6 years later, this effective lien may not be seen at all by a searcher.

18. Check only if applicable and check only one box.

- Debtor is a TRANSMITTING UTILITY
 Filed in connection with a Manufactured-Home Transaction — effective 30 years
 Filed in connection with a Public-Finance Transaction — effective 30 years

Our seemingly simple financing statements are fraught with pitfalls. Collateral amendments continue to confound many document preparers, debtor authorized amendments are begging for further investigation, and the complexities of the Trust filing preparation remains an area of debate for even the most tenured professionals in our industry.

Thankfully, First American has developed a wealth of UCC related insurance products intended to shift the risk away from Lender. Call today and discover the products and services created by industry leaders, administrated by trained professionals and insured by First American Title Insurance Company. We look forward to hearing from you. UCC Division [800-700-1191](tel:800-700-1191)/www.eagle9.com/services.html

A UCC Article of Interest



THE CALIFORNIA USURY LAW AND THE NON-EXEMPT LENDER

BY GEORGE A. HISERT
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SAN FRANCISCO, CALIFORNIA © SEPTEMBER 2007

With the proliferation of exemptions from the California Usury Law, it is surprising to find lenders who are not exempt. However, they still exist. And they still take the risk of unintentionally making an interest-free loan, with limited possibility of acceleration, and with all free or under-priced warrants, equity kickers or other consideration for the loan being voided. A recent case underscores the risk of not having an exemption.

Summary of Usury Law

First, here is a brief summary of the California Usury Law. The California Usury Law imposes two separate ceilings on interest rates. First, there is a flat 10% per annum ceiling on loans or forbearances for use primarily for personal, family or household purposes (excluding loans the proceeds of which are used primarily for the purchase, construction or improvement of real property). Second, for all other loans or forbearances the ceiling is the higher of (a) 10% per annum or (b) 5% per annum plus the Federal Discount Rate of the Federal Reserve Bank of San Francisco prevailing on the twenty-fifth day of the month preceding the earlier of the date of execution of the contract to make the loan or forbearance or the date of making the loan or forbearance. There are a number of constitutional and statutory exemptions from the application of the Usury Law to various loans or forbearances, many of which exemptions are tied to the lender's status as a certain type of licensed entity, such as the exemptions for banks, savings and loan associations, and California finance lenders.

If a loan violates the California Usury Law, all interest on the loan is void, including any consideration which might be deemed to be interest such as free or under-priced stock options, warrants, equity kickers and the like. In addition, if interest has been actually paid in excess of the usury ceiling, there is a treble damage penalty based upon the entire interest paid during the year prior to commencement of suit. Also, if a loan is usurious, it cannot be accelerated for non-payment of interest because the interest

provision is void, and all amounts paid on the loan are deemed to be applied to principal.

Cooper Case

In *WRI Opportunity Loans II LLC v. Cooper*, 2007 DJDAR 12930 (Aug. 23, 2007), the lender made a loan to the borrower who planned to build residential townhouses and condominiums in West Hollywood. The loan was guaranteed by the two principals of the borrower. In addition to the regular interest on the loan (a spread over Bank of America's reference rate), the loan documents entitled the lender to receive additional interest according to a fixed schedule if other "contingencies" were to occur. For instance, the lender was to receive a percentage of the sales price of any units sold and was also to receive a specified sum in case the project was not completed. The borrower filed for bankruptcy, and the lender sued the guarantors. The guarantors responded with the defense of usury.

Because the guarantors were individuals, the usury exemption under California Corporations Code Section 25118 was not available. Also, the lender was not a licensed lender in California and did not have available one of the many exemptions from the California Usury Law applicable to various categories of licensed lenders. Hence, the lender first tried to shoehorn itself into the "interest contingency rule" under California common law. Under that rule, interest that exceeds the legal maximum is not usurious when its payment is "subject to a contingency so that the lender's profit is wholly or partially put in hazard," provided "the parties are contracting in good faith and without intent to avoid the statute against usury." Under this common law rule, the non-contingent part of the interest must be materially less than the amount of interest that could have been charged at the highest permissible rate.

Unfortunately for the lender, the "contingencies" in the Cooper case were not true contingencies. No matter what hap-

pened to the project, except in some unlikely scenarios, the lender was entitled to an amount of additional interest that would have put the lender over the usury limit.

The lender then tried to shoehorn itself into the statutory exemption for shared appreciation loans under California Civil Code Sections 1917 through 1917.006. That statute permits additional interest to be collected, regardless of the usury law, from "a share of (1) the appreciation in the value of the security property, (2) rents and profits attributable to the subject property, or (3) both." However, that is not how this lender's additional interest was calculated, and the court found that the statutory exemption for shared appreciation loans was not applicable.

Finally, the lender argued that guarantors had waived the usury defense through the broad suretyship waivers in the guaranty. The court held that, because the usury law voided the interest provision, the suretyship waivers did not apply to the usury defense.

Moral

Investment or private equity funds that lend money frequently overlook or downplay the need for appropriate licenses and usury exemptions. The Cooper case underscores the continuing need to observe the restrictions imposed upon lenders by the usury law. While many lenders rely upon the transactional exemption in California Corporations Code Section 25118, that exemption is not applicable if any of the borrowers or guarantors is an individual, a revocable trust having one or more individuals as trustees, or a partnership in which, at the time of issuance of the debt, one or more individuals are general partners.

For more information, please contact:
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DID YOU KNOW?

Our website contains a library of UCC Articles written by our friends and counsel in the commercial lending field. Here are some examples of what you will find in our Resource Center at <http://eagle9.com/resources.html>. You will also find Policy Descriptions, FAQ's about our Lender's Policy and our information request form. Here are some of the articles relating to Article 9 of the Commercial Code.:

- "New Foreclosure Procedures Under Revised Article 9" by Karen J. De Salvo, Esq.
- "What Comes Around Goes Around for the IRS" by James D. Prendergast
- "Materials on Revised UCC Article 9" by Steven. O. Weise, Esq.
- "When the Borrower Says 'No' to a Lender's Request for a Legal Opinion" by James D. Prendergast
- "How to Perfect Equity Collateral Under Article 8" by James D. Prendergast and Keith Pearson, Esq.
- "Legal Opinions Under Revised Article 9" by James D. Prendergast
- "Opting In To Article 8 - LLC and Partnership Interests As Collateral" by Lynn Soukup, Pillsbury Winthrop
- "Failure to Advise- Is There a Corollary Between Residential Real Estate & Commercial Deals?" by James D. Prendergast
- "Title and UCC Insurance for Mezzanine Financing Transactions" by John C. Murray and Randall L. Scott
- "Secured Real Estate Mezzanine Lending" by James D. Prendergast

Upcoming Mezzanine Lecture Series in Los Angeles, CA

Thursday January 17th, 2008

12:00 PM- 1:30 PM

1.5 hours CLE

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Space is Limited

Please RSVP to ucc.mezzlending@firstam.com or call 1.800.700.1191 for more information.

Visit us online to read a new article “Surety Defenses in Mezzanine Lending”

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<http://www.eagle9.com/articles.html>

