

# BUSINESS LAW TODAY

August 2012

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*The phone rings. It's your client, a secured lender, in a panic. His borrower just defaulted, and he can't find the remedies section in the security agreement. "How am I going to foreclose on collateral," he asks, "without any contractual remedies? What good does a naked security interest do me?"*
- [\*\*Pre-Disposition Preparation and Processing of Collateral\*\*](#)  
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*In today's economy, many businesses operate or own assets in multiple jurisdictions. This reality can give lenders access to a greater collateral pool to secure their loans.*

Departments:

- Keeping Current: [\*\*Delaware High Court: Potential M&A Buyers Have Limited Recourse Prior to Signing Agreement\*\*](#)  
*The Delaware Supreme Court recently reminded potential buyers in M&A transactions that they likely will have very limited, if any, remedies or recourse against the seller in connection with the potential transaction until an agreement is signed.*
- Delaware Insider: [\*\*Is Delaware Alternative Entity Law Cutting Edge or Cutting Loose?\*\*](#) *The Delaware courts have issued a number of interesting and controversial decisions in the last year or so, and there will no doubt be a few more before 2012 ends. Three alternative entity law decisions from 2012 have garnered a fair amount of attention: Auriga Capital Corp. et al. v. Gatz Properties, LLC; Gerber v. Enterprise Products Holdings, LLC, et al.; and In re K-Sea Transportation Partners L.P. Unitholders Litig.*
- Training for Tomorrow: [\*\*Corporate Counsel Checklist for a D&O Protection Program\*\*](#) *The ABA Business Law Section's Director and Officer Liability Committee has this year sponsored two programs titled "Protecting the Corporate Director," one live and another through a national webinar. The programs have received excellent reviews.*

## [\*\*Inside Business Law\*\*](#)

*At the recent ABA Annual Meeting, the Business Law Section's UCC Committee presented a program titled "[\*\*Commercial Law Forms: One Size Does Not Fit All; Tips on How to Use Forms Wisely\*\*](#)," which provided information about using form agreements as a drafting starting point. While using such documents can seem like a great place to begin, "fill in the blank" precedents are often not sophisticated enough to fulfill the requirements of complex situations.*

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## Our Mini Theme: Secured Transactions

Many lawyers work extensively in the secured transactions area. Far more are obliged to delve on a less frequent, or less in-depth, basis. For all of them, our mini-theme is intended to dispel five misconceptions: (1) more collateral is always better; (2) if you can't get the intended collateral, get the "proceeds" from it; (3) without remedies specified in your security agreement, you're out of luck; (4) you can always dispose of collateral "as is"; and (5) Canada has Article 9, too. If these sentences seem too simplistic, or even wrong, you're on to something. Our featured authors will take you pretty deeply into five topics, each in only a few accessible pages. Here's a brief summary.

Many secured financings involve so-called "blanket liens." Nonetheless, certain property should be excluded from the collateral package. Paul D. Brusiloff, Adrienne D. Baker, and Roshelle A. Nagar consider common exclusions and the reasons for them, such as de minimis value (in light of cost), tax considerations (e.g., where

a non-U.S. subsidiary provides credit support for a parent U.S. borrower), stamp or recordation taxes and the like, logistical burdens (e.g., vehicle registrations), compliance with other law and obligations (e.g., corporate benefit tests, existing contracts), and operational flexibility.

Where there are impediments to the transfer of the intended collateral itself, some instead focus on the proceeds of such collateral. FCC licenses are a case in point. Cindy J. Chernuchin explains the limits of this "proceeds" approach, considering Article 9's anti-assignment override provisions and the Bankruptcy Code, in the context of analyzing whether proceeds from a post-petition sale of an FCC license are, or aren't, proceeds to which a secured party is entitled. After discussing the uncertainty resulting from recent and contemporaneous cases in Colorado (*In re Tracy Broadcasting Corp.*) and in the Southern District of New York (*In re TerreStar Networks, Inc.*), Ms. Chernuchin concludes with both

collateral and structural recommendations.

Many security agreements specify the remedies available post-default. What if no such remedies are specified? Kathy Cabral and Teresa Wilton Harmon provide a roadmap of the statutory rights and remedies available under Article 9, Part 6, regardless of their inclusion in or omission from security agreements. These include the right to collect on collateral, to repossess collateral, to sell or dispose of collateral, and to retain the collateral in full or partial satisfaction of debt. Their article also summarizes the obligations and standards of care to which secured parties must adhere and the effects of secured party noncompliance with such standards.

Considering disposition of collateral in greater depth, Anthony R. Callobre and Harold J. Lee consider the seeming simplicity of the relevant UCC text provisions, but note that both commentary and case law require a more nuanced approach.

They discuss the more holistic application of the commercial reasonableness standard, appropriate cost-benefit analysis, consideration of applicable industry custom, and the challenge of finding the balance between doing too little and doing too much—either could fail the “commercially reasonable” test.

Crossing the border? Kiriakoula Hatzikiriakos provides a primer on the creation and perfection of security interests under Canadian law. Beginning with a brief history of the Canadian secured transactions regime, and highlighting differences between the Personal Property Security Act (in the common law provinces) and the Civil Code (in Quebec), this article explains similarities and distinctions between U.S. security interests and their Canadian analogs, examining creation, perfection, conflict of laws, and other issues.

We hope you enjoy these articles as much as we did—whether covering new ground for you, or corroborating understandings you already have.

—**Norman M. Powell**

Chair, [Uniform Commercial Code Committee](#)  
Wilmington, DE

—**James C. Schulwolf**

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## A Blanket Lien Shouldn't Be a Straight Jacket

By [Paul D. Brusiloff](#), [Roshelle A. Nagar](#), and [Adrienne D. Baker](#)

In any secured financing, a borrower's undertakings relating to collateral can have significant implications for its cost of compliance and for its business operations. In leveraged loans, which are commonly used by non-investment-grade borrowers for acquisitions, refinancings, dividends, and other general corporate purposes, the borrower's collateral undertakings deserve special attention because of the numerous categories of property covered by the secured parties' liens, which are often referred to as "blanket liens."

### The "Blanket Lien": What's In and What's Not

To begin with, a blanket lien generally consists of a grant, often to an agent bank for the benefit of the secured parties, by a borrower and its subsidiaries of liens that cover most, if not all, types of property, but can be subject to some very significant

exceptions. Indeed, although parties often refer to a blanket lien as covering "all assets," the reference to "all assets" is a misnomer, as few, if any, financings result in perfected security interests in *all* property. Exclusions are common to address various concerns the borrower has with respect to: cost (in terms of time or out-of-pocket expense), compliance, and operational flexibility.

#### *Exclusions Related to Cost*

*De minimis value.* A great many secured financings exclude property of de minimis value if that property requires incremental effort to create a security interest. Thus, for example, if liens on deposit accounts are not excluded altogether, it is standard for the borrower and the agent bank to agree that deposit accounts with balances below a threshold will not be subject to a deposit account control agreement, which is the

agreement by which a secured party acquires a perfected interest in deposit accounts, and which can be time-consuming to negotiate. Indeed, if deposit accounts are to be included in a collateral package, it is ideal from the borrower's perspective to limit the security interest to those accounts that hold significant amounts of uncommitted cash. Therefore, zero balance accounts, payroll, or other disbursement accounts are commonly exempt from control agreements. Other examples of property that may be excluded when valued below an agreed threshold include immaterial subsidiaries and real estate.

Implicit in all of these de minimis exclusions is a calculus that the benefits of a lien in an asset with so little value are not worth the incremental cost to provide the lien. (By contrast, because little, if any, incremental effort is required for a security interest in personal property,

such as goods, that becomes subject to a perfected security interest with no more than a proper security agreement and UCC filing, a de minimis exclusion rarely, if ever, applies to such property.)

*Explicit Cost-Benefit Tests.* Often, an explicit cost-benefit test is used to exclude assets that the agent bank and the borrower agree are insufficiently valuable to justify the cost of perfecting the lien in such assets. And sometimes cost-benefit considerations apply implicitly, such as when loan documents require a borrower to undertake good faith, commercially reasonable efforts to obtain a lien on an asset before it may be excluded; with the understanding that the cost of such efforts is sufficiently modest in relation to the possibility of procuring the lien.

*Other Costs to be Avoided: Tax.* In addition, several types of property are excluded from a blanket lien for reasons that implicitly relate to cost. For example, the U.S. Tax Code can impose tax costs on a U.S. borrower if a non-U.S. subsidiary provides credit support, including credit support in the form of a pledge of the subsidiary's assets or a pledge (by the U.S. borrower) of more than two-thirds of the subsidiary's stock. For this, and for other reasons explained below, a U.S. borrower typically pledges no more than 65 percent of the stock it owns in a non-U.S. subsidiary, and the non-U.S. subsidiary itself does not provide collateral or other credit support in any form for the obligations of the U.S. borrower.

*Other Costs to be Avoided: Non-U.S. Collateral.* In cross-border financings, for non-U.S. entities that are not subject to these tax considerations, costs of obtaining perfected security interests may still be very substantial, and can include such things as high stamp tax on the creation and/or registration of liens, costly notarization or translation requirements, documentation formalities that require long lead times, or execution of powers of attorney by all secured parties (and not just the agent bank). In addition, the borrower must also consider the time and effort involved in coordinating with local counsel in non-U.S. jurisdictions. Local law documents, including multiple security agreements and opinions, may be required to achieve liens on assets in a particular jurisdiction, and execution formalities outside of the United States can be time-consuming. These burdens, together with the tax considerations for U.S. borrowers outlined above and the regulatory and compliance issues that we mention below, will typically result in total or near-total exclusion of foreign assets owned by U.S. borrowers and significant limitations on collateral to be provided by non-U.S. borrowers and subsidiaries; indeed, if collateral is to be included at all in non-U.S. jurisdictions, borrowers and lenders often specify in detail the particular basis (generally referred to as "Agreed Security Principles") on which collateral is to be provided or excluded.

*Other Costs to be Avoided: Vehicle Registrations, Leasehold Mortgages, and Regulatory Disclosure.* For most

borrowers, vehicles and other goods subject to certificate of title statutes are generally perceived to have little value relative to the borrower's other property, and the cost and burdens of obtaining security interests under certificate of title statutes are almost always deemed not justifiable. When vehicles are in fact significant in value, special forms of secured financings may be deployed. Leasehold mortgages, which require the consent of third parties, are generally perceived to be costly, if not impossible, to obtain, and financing facilities will often exclude them entirely or require no more than good faith, commercially reasonable efforts by the borrower to obtain mortgages in material leased properties. For issuers of secured bonds to be registered under the Securities Act of 1933, the cost of disclosure requirements under the U.S. securities laws can be burdensome. Rule 3-16 of Regulation S-X, for example, requires separate financial statements for any subsidiary whose stock constitutes a substantial portion of the collateral of a class of debt that is registered, with the result that there is a common exclusion in secured bond financings for the pledge of any such stock.

#### *Exclusions Related to Compliance*

Beyond cost issues, borrowers also concern themselves with compliance with law and with other obligations.

Although it is generally the goal of the secured parties to a leveraged loan to include as many assets as possible in the collateral package, local law, especially in civil law jurisdictions, may impose significant limitations on

a non-U.S. borrower's ability to grant liens on its collateral. Local laws may impose, for example, a "corporate benefit" test that must be met in order to justify the board's approval of the grant of a guaranty and/or security. Or a jurisdiction might have laws that make it impractical or even impossible for a lender to obtain liens on a particular category of assets, such as by requiring that the lenders take possession of inventory or continually update schedules of receivables in order to perfect their security interest. In such cases, directors are particularly sensitive to the need to document the corporate benefit to the foreign subsidiary of guaranteeing and/or securing loans of a parent or affiliate, and generally require that there be some evidence that the subsidiary will receive proceeds of the loans (either directly to repay existing indebtedness or for working capital purposes or indirectly by way of documented intercompany loans). In addition, some jurisdictions impose "financial assistance" limitations that effectively prohibit a subsidiary from granting guarantees or collateral in favor of its parent company's debt incurred in connection with acquiring such subsidiary. Noncompliance with some local laws can even result in criminal sanctions. To address all these concerns, the relevant guaranty and security documentation should contain appropriate exclusions, restrictive language, and/or dollar caps.

Nor are compliance concerns limited to law; borrowers must comply with all of their contracts. It is standard for security agreements to exclude contract rights that are subject to

anti-assignment provisions (which prohibit the granting of liens on rights in licenses or in other agreements) in order to avoid a breach of those anti-assignment clauses. Often there is a workaround to this exclusion: UCC § 9-408(a) limits the effect of anti-assignment clauses in general intangibles (a category that includes intellectual property licenses and other contracts), stating that such clauses are ineffective to the extent that the terms (a) would impair the creation, attachment, or perfection of a security interest, or (b) provide that the assignment or transfer or the creation, attachment, or perfection of the security interest may give rise to any default, breach, right of recoupment, claim, defense, termination, or remedy under the agreement. Thus, UCC § 9-408(a) permits the secured lender to have a valid security interest in a borrower's license or other contract right, despite anti-assignment terms. However, it does not go so far as to deprive the third party of all benefit of the anti-assignment terms; it provides, for example, that the secured party may not enforce its security interest in the rights that are otherwise subject to an enforceable anti-assignment term. To further protect a borrower against breaching its anti-assignment obligations, this workaround is typically qualified so that it only applies when section 9-408(a) (or any similar law) is in fact applicable, binding, and enforceable.

#### *Exclusions Related to Operational Flexibility*

Aside from cost and compliance concerns, borrowers require a certain amount of flexibility to use and

dispose of their property in a manner consistent with the operation of their businesses. Thus, security agreements often exclude liens on property when the lien would interfere with business activities of the borrower that are not prohibited by the credit agreement, such as purchase money financings, sales of subsidiaries and of other assets, receivables financings, deposits, and consignments.

For example, a borrower's need to develop and establish trademarks results in a common carveout from the intellectual property collateral package for "intent-to-use" trademark applications (ITU applications), applications for which a statement of use has not been filed. Although U.S. trademark law generally requires actual use of a trademark before an application for registration may be filed, ITU applications are permitted if the applicant has a bona fide intention to use the trademark described. But an assignment of a trademark under an ITU application prior to the filing of a full trademark application or verification of a statement of use, may result in the voiding of both the ITU application and the associated trademark. And, while a security interest in an ITU application alone does not necessarily constitute an assignment, foreclosure may be considered an assignment. So to avoid the possibility that an ITU application and associated trademark may be void if it is assigned prior to the registrant filing a full application or a statement of use, borrowers (and lenders) exclude ITU applications from pledged collateral.

## Ongoing Compliance

Once a collateral package has been agreed to and a leveraged loan with a blanket lien has closed, a borrower will be subject to ongoing compliance obligations, generally consisting of near-term completion of steps to perfect security interests in the collateral, information reporting, and covenants regulating the use and disposition of collateral.

The borrower should make certain that it has allowed enough time to complete any collateral delivery and perfection requirements. While an agent bank may seek the shortest conceivable deadline, the borrower should make its own appraisal of the time required and also should allow for unforeseen circumstances that might cause delay. The borrower should take account of such things as the time needed to locate stock certificates or promissory notes, obtain releases from third parties whose debt has long since been repaid, and negotiate control agreements with depository banks and securities intermediaries. Cross-border transactions in particular tend to have extensive post-closing schedules that have been heavily negotiated amongst local counsel regarding local registration formalities and deliveries.

In addition, the security documentation will contain representations and covenants relating to the collateral that may impose a notice requirement if the borrower changes its name, address, or corporate form, forms new subsidiaries or makes certain types of acquisitions or investments, opens

new bank accounts or acquires a commercial tort claim. Some borrowers prefer, for ease of reference, to have such collateral update requirements in the affirmative covenant section of the credit agreement, together with all other periodic delivery requirements. Other borrowers prepare extensive compliance summaries or implement specific compliance procedures.

In any event, it is important during the loan documentation stage for the borrower to focus on these compliance burdens and negotiate for appropriate materiality thresholds, baskets, and notice requirements. Although it may not seem particularly difficult to keep track of such things as changes in corporate names or addresses, as a practical matter, employees of a borrower have many responsibilities and, in the course of performing them, may inadvertently trip up covenants that require advance notice of such changes. For this reason, it is always better from the borrower's perspective to limit the notice and informational requirements to those that are essential, and to provide that timing of such notices may occur after an event, and within periods that can be extended by an agent bank, which is likely to take a practical and sensible approach to compliance. For similar reasons, the borrower should try to limit the frequency of informational updates to no more than once per year.

## Security Release

When a borrower's obligations are secured by collateral, the credit

agreement will provide that the collateral will automatically be released from the security agreement upon the occurrence of (1) the full repayment of the borrower's underlying secured obligations, and (2) any permitted dispositions of assets. Partial release provisions will often reference the permitted dispositions covenant in the credit agreement and may require a detailed notice to the agent bank. Typical release language will state that the liens are terminated and all rights in the collateral revert to the borrower "automatically," without further action by any party. Nonetheless, a diligent borrower will request that the agent bank provide evidence of even an "automatic" termination.

In connection with the release of collateral, the borrower should obtain from the secured party such things as Form UCC-3 termination statements for which the secured party has provided authorization to file, control agreement terminations, and intellectual property security agreement releases, which are executed by the secured lender. The borrower should promptly file all UCC termination statements and IP releases in the appropriate offices, to ensure that the public records accurately reflect the termination of liens. A security interest that remains on record after the underlying obligations have been released becomes, with the passage of time, increasingly difficult to expunge, as former secured parties may have little incentive to act expeditiously to sign requested releases, may have little institutional knowledge of the obligation that gave rise to the

security interest, and may even cease to exist. For similar reasons, a borrower should remember to request the return of any possessory collateral such as stock certificates with accompanying stock powers.

Although payoff letters should and often do contain further assurances provisions, such that a former secured party will be obligated to take future action (customarily at the borrower's expense) to release its security interests in the collateral and return possessory collateral, timely filing of releases, retrieval of possessory collateral, and proper record-keeping of termination documents help reduce the diversion of cleaning up the records during the negotiation process of the borrower's next secured financing.

### Conclusion

During the course of negotiations of an "all assets" secured financing, it is crucial for both the borrower and its counsel to carefully consider the coverage of the blanket lien and to focus on compliance requirements that will be effective throughout the term of the loan. The principals tend to spend significantly more time reviewing and negotiating provisions of the principal financing agreements that may more directly and obviously impact the economics of the loan, and do not always appreciate how the provisions relating to the collateral can impact the operations of the borrower's business. Lenders and borrowers should endeavor to work together to craft a collateral package that strikes a balance between the lender's desire for collateral coverage to secure its loan

and the borrower's need to limit related transaction costs and retain operational flexibility.

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## Security Interests in Proceeds of Collateral

By [Cindy J. Chernuchin](#)

This article discusses two recent bankruptcy cases that determine whether the secured party's security interest attaches to assets acquired after the debtor files for bankruptcy as proceeds of a Federal Communications Commission (FCC) license if the security interest did not attach to the underlying FCC license. Whether an asset is after-acquired collateral or proceeds of collateral is critical to both decisions. Section 552(a) of the U.S. Bankruptcy Code (Code) limits the secured party's lien generally to the collateral in existence on the petition date. It prevents the grant of a security interest in after-acquired property from attaching to property acquired after the bankruptcy is filed. However, section 552(b) provides that if the postpetition property is proceeds of the secured party's prepetition collateral, then the secured party's lien will attach to the postpetition property. This article concludes with "best practices" for drafting a security

agreement as learned from these cases. But first, to fully understand these cases, we will review the meaning of "proceeds," including identification, attachment, and perfection of a security interest in proceeds, and the anti-assignment override provisions of Article 9 of the Uniform Commercial Code (UCC).

### What are Proceeds?

Section 9-102(a)(64) of the UCC provides that proceeds are whatever is received upon the sale, lease, license, exchange, or other disposition or collection of, or distribution on account of, collateral. This includes (1) claims arising out of the loss or nonconformity of, or interference with, defects in, or damage to, the collateral, (2) collections on account of "supporting obligations," such as guarantees, (3) corporation, partnership, and limited liability company interest

distributions, (4) rentals for the lease of goods, and (5) licensing royalties.

### Attachment of a Security Interest

Upon the disposition or collection of collateral, a secured party's security interest continues in any "identifiable" proceeds. If the proceeds are cash, common law principles of tracing proceeds, including the "equitable principle" of the "lowest intermediate balance rule," are used to identify the cash proceeds. Commingled cash proceeds are identifiable within the meaning of UCC § 9-315(a)(2) as long as the balance in the bank account into which the cash proceeds are deposited does not drop below the amount of the cash proceeds initially deposited. If the balance drops below the amount that was initially deposited, the secured party may treat as identifiable proceeds only the lowest intermediate balance in the account.

### Perfection of a Security Interest

If the proceeds are not identifiable cash proceeds, the perfection of the secured party's security interest in such proceeds continues for a period of 20 days. The secured party must take steps within this 20-day period to continue the perfection of its security interest beyond such period if the proceeds constitute a collateral type that is not already perfected.

### Attachment

To be prepetition property, the security interest must attach to the property. A security interest attaches to personal property upon satisfaction of three requirements: (1) the parties have an adequate security agreement, (2) the secured party gives value, and (3) the debtor has rights or the power to transfer rights in the personal property.

Generally the parties have an adequate security agreement if the debtor makes an agreement to transfer a security interest in the collateral, the collateral is reasonably described, and the debtor authenticates the security agreement. The secured party is deemed to have given value when the security interest secures an obligation. The debtor needs to have rights in the collateral and the power to transfer the rights in the collateral because the secured party can obtain only the rights that the debtor has in the collateral.

If there are contractual or legal limitations on assignment of the personal property, such limitations may not be effective due to the UCC

anti-assignment override provisions. If the anti-assignment provisions are not effective, the secured party's security interest will attach, but to protect the third-party obligor, the secured party may not enforce the security interest. The secured party benefits from the anti-assignment override even though it cannot enforce its security interest because it attaches to the collateral and, if properly perfected, the secured party will have a perfected security interest in the proceeds of a sale of the collateral that occurs after the initiation of a bankruptcy proceeding, since the proceeds are of prepetition collateral. The ability to obtain a security interest in the underlying nonassignable right is critical in bankruptcy proceedings because if the secured party has a security interest in the underlying nonassignable right, then the proceeds exception in section 552(b) of the Code would allow the secured party's security interest to attach to the proceeds of a postpetition transfer. But if the anti-assignment provision is effective, can the secured party's security interest attach to the proceeds of personal property? Courts are not in agreement on this issue.

A security interest in the proceeds of personal property attaches automatically pursuant to UCC § 9-315(a)(2) only if there is a properly perfected security interest in the original personal property. UCC anti-assignment override provisions do not override all anti-assignment provisions. A statute or regulation of the United States preempts the UCC. For example, federal statutory law specifically prohibits the assignment

or other transference of FCC licenses absent the FCC's consent. Prior to 1992, the FCC took the position that a lien could not be placed on an FCC license in any manner.

The Communications Act (Act) provides that "[n]o . . . station license, or any rights thereunder shall be transferred, assigned, or disposed of in any manner" without the advance approval of the FCC. Thus, prior to a transfer of a security interest in an FCC license, the FCC must approve such sale. UCC § 9-408 does not override this anti-assignment provision because federal law trumps the UCC. Thus, an FCC license cannot be original collateral.

In response to cases on the issue, in 1994 the FCC issued a clarifying order in which it concluded that a creditor could take a security interest in the proceeds of a broadcast license. The FCC distinguished between a security interest in a broadcast license and a security interest in the proceeds of the sale of the broadcast license. If a secured party foreclosed on a security interest in the broadcast license, the license would transfer without the approval of the FCC. However, if the secured party had a security interest in the proceeds of the sale of a license, there would be no transfer without the FCC's prior approval.

### *In re Tracy Broadcasting Corp.*

Relying on the FCC's clarifying order, many lenders take a security interest in the future proceeds of the borrower's FCC licenses, rather than in the licenses themselves. The effectiveness of this practice is in

doubt due to the *In re Tracy Broadcasting Corp.* decision.

*In re Tracy Broadcasting Corp.*, 438 B.R. 323 (Bankr. D. Colo. 2010) (10th Cir.), decided on October 19, 2010, by the U.S. Bankruptcy Court of Colorado and confirmed on appeal on August 31, 2011, in *In re Tracy Broadcasting Corp.*, 2011 WL 3861612 (D. Colo. 2011), held that for a security interest in a future license transfer to attach, (1) the debtor has to have a prepetition agreement to transfer the license, and (2) the FCC has to approve the transfer prepetition.

Tracy Broadcasting Corporation, a Nebraska corporation (Debtor), owned and operated a radio station under an FCC license. On or about May 5, 2008, Valley Bank & Trust Company made a loan to Debtor, secured by a security interest in Debtor's general intangibles and proceeds thereof, and perfected its security interest by properly filing an effective UCC-1 financing statement. On August 19, 2009, Debtor filed a petition for relief under Chapter 11 of the Code. On February 16, 2010, the court appointed a Chapter 11 trustee. The bank filed a secured claim against Debtor asserting that its perfected security interest in Debtor's general intangibles and the proceeds thereof extended to any proceeds from the future sale of Debtor's FCC license. Spectrum Scam LLC, an unsecured creditor of Debtor, initiated an adversary proceeding for a determination of the extent of the bank's security interest, arguing that the bank did not have a security interest in the FCC license or its future proceeds. Spectrum relied on

the Act (which prescribes FCC powers), which prohibits a security interest from attaching to an FCC license without the FCC's consent. Since there was no security interest in the FCC license, there could be no security interest in the proceeds of a sale of the FCC license after the filing of the petition for bankruptcy. The parties agreed that the bank did not have a security interest in the FCC license so there was only a question of law: Did the bank's security interest extend to proceeds received by the trustee upon a future transfer of Debtor's interest in the FCC license if there was no contract for transfer of the license in existence when the Chapter 11 proceeding was filed?

The court stated that an FCC license holder has both "public rights" and "private rights." The license holder's right to transfer its license subject to FCC approval is a public right. The right to receive compensation for a transfer of its license is a private right. A license holder can grant a security interest only in its private rights because these rights do not interfere with the FCC's regulatory role. The court then considered section 552 of the Code which set forth the general rule that property acquired by a debtor after the commencement of a case is not subject to any lien resulting from any security agreement entered into by the debtor before commencement of the case. The exception to this rule is that if the security interest attached to property prior to the commencement of the case, then the security interest extends to proceeds of such property acquired postpetition. The court held that Debtor's private right to receive the

proceeds from a license transfer did not exist prepetition because any such right, without an existing agreement to transfer and FCC approval, was too remote. The court said that for a security interest in a future license transfer to attach prepetition: (1) Debtor must have an agreement to transfer the license, and (2) the FCC must approve the transfer. Neither occurred, and in light of the Code section 552(a) prohibition on security interests in after-acquired property, Debtor could not grant a security interest in future proceeds of a license transfer to the bank, so the court denied the bank's motion and granted Spectrum's motion for summary judgment.

The court endorsed the following propositions: (1) a security interest cannot attach to FCC licenses without the FCC's approval, (2) a security interest can be granted in the right to future proceeds from an approved sale of an FCC license, and (3) if on the petition date there is no contract for sale of the license approved by the FCC, a security interest cannot attach to postpetition sale proceeds.

#### ***In re TerreStar Networks, Inc.***

Judge Sean H. Lane of the U.S. Bankruptcy Court for the Southern District of New York held that the secured noteholders of TerreStar Networks, Inc., and certain of its affiliates had a valid lien on the economic value of TerreStar's FCC licenses, notwithstanding the abundance of court decisions prohibiting a secured party from having a lien on an FCC license itself (including the *Tracy* decision). *In re*

*TerreStar Networks, Inc.*, 2011 WL 3654543 (Bankr. S.D.N.Y. 2011).

TerreStar, a provider of mobile satellite services, held various FCC licenses. TerreStar granted a lien on the proceeds of a disposition of the licenses including the economic value of the licenses to the noteholders.

In 2008, Sprint filed suit against TerreStar and other licensees in the U.S. District Court for the Eastern District of Virginia to recover the relocation costs allocable to certain licenses. On October 19, 2010, TerreStar filed for Chapter 11 bankruptcy relief. Thereafter Sprint filed proofs of claim for \$104 million of bandwidth clearing costs allegedly allocable to TerreStar. In addition, Sprint filed an adversary proceeding seeking a judicial determination that the noteholders had no lien on the economic value of TerreStar's FCC licenses. If Sprint were successful, the value attributable to TerreStar's FCC licenses would be available for distribution to unsecured parties of TerreStar, including Sprint.

In July 2011, the Bankruptcy Court approved a sale of substantially all of TerreStar's assets, including, subject to FCC approval, its FCC licenses. After that sale the noteholders and the unsecured creditors filed motions for summary judgment to obtain the proceeds from the sale.

The unsecured creditors used the *Tracy* court's reasoning: the noteholders' lien could not attach to the proceeds of the sale of the FCC licenses because (1) the noteholders did not have a lien on the FCC licenses themselves, and (2) the sale

agreement for the licenses was entered into and approved by the FCC after TerreStar filed for bankruptcy, so pursuant to section 552(a) of the Code a lien cannot attach to the proceeds because it is postpetition after-acquired collateral.

The noteholders argued that section 552 of the Code was not applicable because the lien attached to the economic value of the FCC licenses prepetition, when the parties entered into an adequate security agreement and the noteholders gave value.

Judge Lane rejected Sprint's argument and, persuaded by the reasoning in the FCC's 1994 declaratory ruling and related case law, held that the TerreStar noteholders had a valid lien on the economic value of TerreStar's FCC licenses even if they could not have a lien on the FCC license itself.

#### Practice Points

These decisions affect how creditors secure their broadcaster financings to ensure the priority of their liens against third parties in bankruptcy. It is best practice for secured parties to get a pledge of both (1) the equity interest in the company that owns the FCC license (have the transfer of the equity interest occur upon the approval of the FCC), and (2) the economic interests of the FCC license. Experience confirms that it is best to require the broadcaster to opt into Article 8 of the UCC and be a special-purpose entity with no other voluntary liabilities or liens.

To obtain a perfected security interest in (1) the equity interest of a

company that owns an FCC license, secured parties should (a) require broadcaster to opt into Article 8 of the UCC, (b) have the parent of the broadcaster grant a security interest in all its general intangibles and investment property, and (c) perfect such security interest by properly filing a UCC-1 financing statement and taking possession (along with instruments of transfer executed in blank) of the securities; and (2) the economic interests of an FCC license, secured parties should (a) require that the grantor be a special-purpose entity with no other voluntary liabilities or liens, and (b) include in the granting clause all general intangibles and proceeds derived from the personal property, including all economic rights, and exclude from the granting clause the FCC license. To ensure that the transaction does not violate the FCC rules, the pledge and security agreements need to include (1) a prohibition on transfers of an FCC license in any way that could violate the Act, (2) requirements that any transfer of an FCC license be made in compliance with the Act, (3) covenants that upon the occurrence of an event of default, the debtor will take any action the secured party requests in order to transfer the FCC license, (4) appointment of the secured party as debtor's attorney-in-fact to take such actions on debtor's behalf, (5) an agreement that these provisions may be specifically enforced, and (6) an exclusion of the FCC license from collateral.

The security agreement for the TerreStar noteholders granted a security interest in

[a]ll General Intangibles . . . and all FCC License Rights . . . including all FCC Licenses, including, without limitation, the right to receive monies, proceeds, or other consideration in connection with the sale, assignment, transfer, or other disposition of any FCC Licenses, the proceeds from the sale of any FCC Licenses or any goodwill or other intangible rights or benefits associated therewith, including without limitation all rights of each Grantor to (A) transfer, assign, or otherwise dispose of its rights, title and interests, if any, under or in respect of such FCC Licenses, (B) exercise any rights, demands and remedies against the lessor, licensor or other parties thereto, and (C) all rights of such Grantor to receive proceeds of any insurance, indemnities, warranties, guaranties or claims for damages in connection therewith. . . .

Licenses, and the right to receive monies, consideration and proceeds derived from or in connection with the sale, assignment, transfer, or other disposition of FCC Licenses. . . .

### Conclusion

Whereas some courts have encouraged financing to broadcasters by ruling that a security interest attaches to the proceeds of a sale of an FCC license even if the contract for sale and FCC approval of the sale become effective after a bankruptcy proceeding is initiated, there can be no assurance of this result given the diversion in court decisions. Whereas *TerreStar* gives hope, secured parties must proceed with caution because *Tracy* was confirmed on appeal 12 days after *TerreStar* was decided.

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In addition, the *TerreStar* security agreement specifically carved out the FCC license from the lien:

[S]uch security interest does not include at any time any FCC License to the extent (but only to the extent) that at such time the Collateral Agent may not validly possess a security interest directly in the FCC License pursuant to applicable federal law, including the Communications Act of 1934, as amended, and the rules, regulations and policies promulgated thereunder, as in effect at such time, but such security interest does include at all times all proceeds of the FCC

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## Remedies Outside the Box: Enforcing Security Interests Under Article 9 of the Uniform Commercial Code

By [Kathy Cabral](#) and [Teresa Wilton Harmon](#)

The phone rings. It's your client, a secured lender, in a panic. His borrower just defaulted, and he can't find the remedies section in the security agreement. "How am I going to foreclose on collateral," he asks, "without any contractual remedies? What good does a naked security interest do me?" The client sends you the security agreement and you find that while there is a clear security interest and default, the agreement is silent on applicable remedies and timing of enforcement. How do you advise your client?

Thankfully, your client has hope. While it may be unusual to have a security agreement without express remedies, in this case, your client merely needs to think outside the box—or at least outside of the four corners of the agreement. Article 9, Part 6 of the Uniform Commercial

Code (UCC), sets forth statutory remedies available to all secured lenders, whether or not they are expressly provided by agreement. These rights include the right to collect on collateral, the right to repossess collateral, the right to sell or dispose of collateral, and the right to retain the collateral in full or partial satisfaction of the debt with the borrower's consent. See UCC §§ 9-607, 9-609, 9-610, 9-620. This article provides a roadmap of these statutory rights and remedies, as well as the obligations and standards of care to which secured parties must adhere and the effects of secured party noncompliance with such standards.

### Article 9 Remedies—Overview

Article 9 remedies, including the remedies in Part 6, are available to any secured party after its borrower,

or in Article 9 terms, "debtor," defaults under a security agreement (but the exercise of such remedies may be limited and subject to court approval if the debtor is in bankruptcy). What constitutes a "default" is not defined in Article 9; rather, such determination is left to the agreement of the parties pursuant to the applicable security agreement or loan agreement. Contractual defaults commonly include failure to pay or comply with covenants, misrepresentations, judgments against the debtor, bankruptcy, and defaults under other agreements.

While Article 9 does not contain any explicit requirement that a default be material to afford a secured party the right to enforce against collateral, it does generally obligate a secured party to act in good faith when

exercising such rights. For example, if a secured party pursues Article 9 remedies after a debtor delivers satisfactory financial statements one day late, such action could be an overreaction to a relatively minor breach. The secured party should thus assess materiality in terms of whether the applicable default puts the credit at risk. See, for example, *Banc of Am. Leasing & Capital, LLC v. Walker Aircraft, LLC*, 2009 U.S. Dist. LEXIS 94657 (D. Minn. 2009).

### Collection and Enforcement

#### *The Right to Collect: Provisions and Benefits*

UCC § 9-607 provides secured parties with the remedy of collection. This remedy applies to certain types of liquid assets, including accounts receivable, general intangibles, chattel paper, notes, deposit accounts, and other intangible assets that oblige an underlying obligor to make payment or render performance to the debtor. See UCC § 9-607(a). Section 9-607 allows the secured party to collect directly from the underlying obligor, but the secured party must account to the debtor for any surplus in the collection of the collateral. See UCC § 9-608. The right to collect is an attractive remedy for secured parties because it is often the fastest remedy available, allows the secured party to act without disrupting the debtor's business, and provides access to liquid assets.

The secured party may exercise the right to collect from underlying obligors at any time if its security agreement so provides. If the

agreement does not address that right, the secured party may still collect directly from underlying obligors (or other persons obligated to make payment on that collateral) upon the debtor's default. See UCC § 9-607(a). For example, after default the secured party may collect on pledged accounts receivable or apply funds from a pledged deposit account in which a security interest has been appropriately perfected to reduce the outstanding secured obligations. Article 9 even allows a secured party to foreclose a pledged mortgage (if applicable state law permits it) or enforce payments under a pledged promissory note (provided, of course, that the underlying obligations are in default). UCC §§ 9-607(a); 9-607, Comment 6 and Comment 8.

#### *Specific Requirements and Duties: Commercial Reasonableness*

A secured party must act in a commercially reasonable manner when exercising its direct collection rights. UCC § 9-607(c). This requirement includes notifying underlying obligors of impending collections. UCC § 9-607(a)(1). As a practical matter, in order to provide notice, the secured party must have access to the debtor's current records and accounting with respect to underlying receivables. The secured party may obtain access via judicial action if the debtor is uncooperative. The commercial reasonableness requirement is not waivable by agreement of the parties. UCC § 9-602(3).

#### *Defenses*

An underlying obligor on an account,

chattel paper or payment intangible generally has an obligation to pay the secured party if the debtor or secured party properly notifies it that payment is required. UCC § 9-406(a). Such notice is sometimes referred to as a cutoff notice as it is viewed as cutting off payments to the debtor. If an underlying obligor has a valid defense to payment (such as prior exercise by the debtor of setoff rights against such underlying obligor), though, it need not pay so long as the defense arose before it received the cutoff notice from the debtor or secured party. UCC § 9-404(a)(2). Earlier collection notification by the secured party, then, is beneficial because it also cuts off defenses for the underlying obligor.

### Repossession

#### *The Remedy of Repossession*

The remedy of repossession is quite powerful, as the threat of repossession can incentivize a debtor to comply with the security agreement and repay its obligations. Repossession also assures the secured party that, if something goes awry, it can recoup some value on its investment by taking the collateral. Note, however, that repossession is only a temporary solution if used in isolation. The secured party cannot hold collateral indefinitely, and has duties with respect to the collateral it holds, including maintenance, reasonable disposition, and the duty to take reasonable care of collateral in its possession. See UCC §§ 9-601, 9-207. The debtor also has the right to redeem collateral held by the secured party in exchange for fulfillment of the secured obligations

(in other words, repayment of the loans). UCC § 9-623.

### *Basic Rules of Repossession*

After default, the secured party may take possession of collateral either with judicial process, or without judicial process if there is no breach of peace. UCC § 9-609(b). If repossession without judicial process does result in a breach of peace, the secured party may be liable for conversion or trespass. The UCC does not define a breach of peace, and a significant body of case law has developed in response. See UCC § 9-609, Comment 3. In assessing breaches of peace, courts balance the secured party's right to repossess collateral against possible danger to the public.

Lenders should be aware of several other key repossession issues. First, if the collateral is an object too large to move, such as a piece of equipment, the secured party may render the collateral unusable and dispose of it on the debtor's premises after default. UCC § 9-609(a)(2). Additionally, the secured party is responsible for its agent's actions and will face liability for any unreasonable repossession conducted on its behalf by an independent contractor. UCC § 9-609, Comment 3. Lenders should also be aware that using a law enforcement officer to accomplish repossession may result in a breach of peace if the officer's services were not obtained via judicial process. Finally, the secured party and the debtor cannot waive the breach of peace requirement or contractually define a breach of peace because the requirement protects the general

public and others who are not in contractual privity. UCC §§ 9-602, 9-603(b).

### **Disposition**

#### *Disposition Generally*

Disposition is the secured party's primary Article 9 remedy. Disposition includes any sale, lease, license, or other disposition of collateral. UCC § 9-610(a).

#### *Secured Party's Duties before Disposing of Collateral*

The secured party may dispose of any or all collateral either in its existing condition or following commercially reasonable processing, subject to certain limitations. UCC § 9-610(a). Reasonable processing typically means any minimal preparation that could impact the sale price. For example, if a vehicle or piece of equipment would fetch a higher price if cleaned prior to sale, it could be unreasonable not to clean it. See, for example, *Liberty Nat'l Bank & Trust Co. of Okla. City v. Acme Tool Div. of Rucker Co.*, 540 F2d 1375 (10th Cir., 1976). If collateral is incomplete, though, it is sometimes unreasonable to expect the secured party to complete it prior to sale. See UCC § 9-610, Comment 4. For instance, the secured party may lack the requisite knowledge to complete an unfinished computer program, and so the secured party could sell the collateral in its then-present state. As with other Article 9 rights, such sale will be subject to a commercial reasonableness test. UCC § 9-610(b). Price is not necessarily a factor in this test, but the process, time, and place

of the sale will be considered.

#### *Public versus Private Sale*

The secured party may dispose of property through a public or a private sale. UCC § 9-610(c). In a public sale or auction, a public notice is given and any purchaser may bid, subject in some cases to eligibility criteria established by the secured party. In a private sale, the secured party seeks out interested parties and agrees on sale terms without an auction. The decision whether to pursue a public or private sale must be made in a commercially reasonable manner. UCC § 9-610, Comment 2.

With the exception of certain types of collateral such as publicly traded securities, the secured party cannot purchase its own collateral in a private sale. UCC § 9-610(c)(2). The policy reason for this requirement is that collateral should be tested by the market to determine the best price. See UCC § 9-610, Comment 7. Therefore, the secured party may buy in a private sale collateral of a kind that is customarily sold on a recognized market or is the subject of widely distributed standard price quotations, because there is already an established market for such collateral. UCC § 9-610(c)(2). In a public sale, the secured party may buy any collateral on which it bids. UCC § 9-610(c)(1).

#### *Notification before Disposition of Collateral (§ 9-611)*

Prior to disposition, the secured party must send notification of its intent to dispose of collateral to the debtor (unless, after default, the debtor



waives the right to notification), secondary obligors (such as guarantors), other secured parties or lienholders who have requested in advance to be notified, and any secured parties or lienholders of record. UCC § 9-611(c). The secured party must run UCC searches before disposition to identify such parties. The UCC provides a safe harbor here, presuming notification compliance if the secured party searches no later than 20 days or earlier than 30 days prior to the notification date and notifies the secured parties or lienholders of record at that time. UCC § 9-611(e)(1).

The secured party must also provide the notice of disposition within a reasonable time. In commercial transactions, a 10-day notice period is considered per se reasonable. UCC § 9-612(b). Any shorter time frame will be subject to a reasonableness test. In consumer transactions, there is no safe harbor, and notice is always subject to a reasonableness test. UCC § 9-612(a). Parties often add safe harbor provisions to their security agreements, agreeing that a specified number of days' notice will be commercially reasonable. UCC § 9-603(a) supports the enforceability of such provisions, so long as the stated notice period is not manifestly unreasonable.

#### *Application of Proceeds to Disposition; Liability for Deficiency and Right to Surplus (§ 9-615)*

Section 9-615 sets forth the priority in which payments should be made from sale proceeds. The foreclosing secured party's expenses take first priority, followed by its secured

obligations, and then the secured obligations of any junior secured parties who have provided a demand. If excess surplus exists after all expenses are paid and obligations are satisfied, the secured party must remit the remaining proceeds to the debtor. If the sale results in a net deficiency, the debtor is liable for that deficiency. If the foreclosing secured party is not the senior secured party, the foreclosure sale does not extinguish the senior secured party's lien and the purchaser at the disposition sale takes subject to that senior lien.

#### **Acceptance of Collateral**

Under UCC § 9-620, a secured party may accept collateral in total satisfaction of the secured debt (or partial satisfaction for non-consumer agreements) if it complies with two requirements. The first requirement is acquiescence. In the case of partial satisfaction, the debtor must explicitly consent to the amount of partial satisfaction in an authenticated record created after default. UCC § 9-620(c)(1). In the case of full satisfaction, the debtor may consent either in an authenticated record or by deemed consent if it fails to respond to the secured party's notice of proposal to accept collateral within 20 days. UCC § 9-620(c)(2).

The second requirement to effect acceptance of collateral is to confirm that no parties entitled to notice thereof object to the acceptance of collateral. UCC § 9-620(a)(2). The parties entitled to notice are the debtor (who may waive the right to notice after default), a secondary obligor entitled to notice under UCC §

9-621(b), and other secured parties or lienholders that have filed lien records within 10 days prior to the debtor's consent. Each such party has 20 days to object before the partial satisfaction agreement becomes official. UCC § 9-620(d)(1). If the secured party searches lien records and simultaneously sends notice to the debtor so the 10-day filing period and the 20-day objection period run concurrently, the secured party can search again within 10 days of debtor consent to ensure that no new secured parties have filed. UCC § 9-621(a)(2). If new filings occur, those secured parties must be notified and given their 20 days to object to the partial satisfaction agreement.

If any person, whether entitled to notice of the proposal to accept collateral or otherwise, makes a timely objection to the secured party's proposal, such objection prevents the acceptance of collateral from taking effect. See UCC § 9-620, Comment 8. An objection from any person entitled to notice is timely if received by the secured party within 20 days of the date such person received the requisite notice, and an objection from any other person is timely if received before the debtor agrees to (or is deemed to agree to) the acceptance.

#### **Secured Party Noncompliance**

While Article 9 is generous in supplying statutory remedies to secured parties, these gifts come with a price—the requirement that the secured party comply with the rules and standards set forth in Article 9. Failure to comply can have serious consequences for a secured party.

If the secured party fails to comply with Article 9's requirements, the debtor, secondary obligors, or other lienholders can attempt to enjoin the secured party from proceeding. UCC § 9-625(a). Additionally, if the secured party breaches Part 6 of Article 9 during a disposition, perhaps by acting in a commercially unreasonable manner or failing to give required notice, it may be liable to the debtor, secondary obligors, or other secured parties or lienholders for losses resulting from such noncompliance, and may be required to pay statutory damages. UCC §§ 9-625(b), 9-625(e). This liability exists alongside non-UCC remedies, such as trespass for breach of peace or conversion in the case of an unreasonable disposition.

Noncompliance can also impact a secured party's ability to charge debtors for any deficiency in the amount of the secured party's recovery and a secured party's obligation to pay over any surplus recovery to the debtor. In a commercial transaction where the amount of a deficiency or surplus is at issue, a secured party typically does not have to prove compliance with the Part 6 remedies of the UCC. UCC § 9-626(a)(1). If, however, a debtor questions the steps taken by the secured party, the secured party carries the burden of demonstrating compliance. UCC § 9-626(a)(2). For this reason, the secured party should keep detailed records when exercising remedies to provide evidence of commercial reasonableness and compliance with other statutory remedies if necessary.

In the event of a dispute over a

secured party's compliance with Article 9 in a non-consumer transaction, UCC § 9-626(a) sets forth specific rules for determining the amount of any deficiency judgment the secured party can collect from the debtor. Under these rules, a non-complying secured party may be prevented from recovering any deficiency at all or may have its deficiency amount reduced. For example, unless the secured party can prove the actual amount it would have recovered in a compliant sale, the secured party will not be entitled to a deficiency payment because the presumption under Article 9 is that the proceeds which would have been recovered in a compliant sale would have equaled the amount of the outstanding secured obligations. UCC § 9-626(a). Courts have more discretion to determine deficiency payments or surpluses in consumer transactions. UCC § 9-626(b). Courts can also assess additional statutory damages in consumer transactions under UCC § 9-625(c).

### Conclusion

Article 9 of the UCC provides a valuable set of tools to a secured party wishing to enforce its rights following a debtor default. These tools are helpful to secured parties even when security agreements are silent on remedies. Such statutory remedies provide comfort to a secured party that even if the contract is silent, the secured party nevertheless has certain rights available to it as a matter of law. All it has to do is think outside the box.

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## To Improve or Not to Improve? Pre-Disposition Preparation and Processing of Collateral

By [Anthony R. Callobre](#) and [Harold J. Lee](#)

This article examines whether a secured party who seeks to dispose of collateral after default has an obligation to improve the collateral prior to disposition. Section 9-610(a) of the Uniform Commercial Code (UCC) states that a secured party after default may dispose of collateral "in its present condition or following any commercially reasonable preparation or processing." This provision suggests that a secured creditor has the option on default to dispose of collateral as is, without any cleaning, painting, or other preparation or processing. Despite the plain language of section 9-610(a) of the UCC, the official comments to section 9-610 and the prevailing case law on post-default collateral disposition tell a different story. After default, a secured party might, in fact, have a duty to fix up collateral before

selling, leasing, licensing, or otherwise disposing of it.

### Commercial Reasonableness

Comment 4 to section 9-610 of the UCC indicates that a secured party does not have the right to dispose of collateral "in its then condition" under *all* circumstances." Specifically, Comment 4 provides that "[a] secured party may not dispose of collateral 'in its then condition' when, taking into account the costs and probable benefits of preparation or processing and the fact that the secured party would be advancing the costs at its risk, it would be commercially unreasonable to dispose of the collateral in that condition."

What constitutes commercial reasonableness in preparing and

processing collateral for disposition is not expressly set forth in the UCC. The case law provides some context, but the conduct required of a secured party remains unclear. A general rule of thumb has developed under UCC lore: The secured creditor about to dispose of a car on default should wash the car, but probably should not overhaul its engine. This crude example is clear enough, but in between the two extremes of washing a car and overhauling its engine lies an immense middle ground, where the duties of a secured party are not so clear.

### Cost Benefit Analysis

A few outlying cases in the Ninth Circuit require a secured party to use its "best efforts" to improve the collateral, using whatever means are available to the secured party,

without regard to time or expense, so that the secured party can obtain the highest price and best recovery possible upon disposition of the collateral. See, e.g., *Mitchell v. Burt & Vetterlein*, 1996 WL 144233 (9th Cir. 1996). At the other end of the spectrum, some courts have read the UCC literally and stated that “a creditor may, but is not required to, repair, improve, or otherwise spruce up collateral before it is sold.” See, e.g., *C.I.T. Corp. v. Duncan Grading & Construction Inc.*, 739 F.2d 359, 361 (8th Cir. 1984).

The majority of the cases, however, suggest that secured parties should employ a cost-benefit analysis in determining whether to prepare or process collateral before disposition. Consistent with Official Comment 4 to section 9-610 of the UCC, these cases have held that a secured party must weigh the costs and probable benefits of preparation or processing of the collateral, including the fact that the secured party would be advancing these costs to improve the collateral and would be bearing the risk that the resulting increase in value of the collateral is insufficient to allow recovery of these costs—which would force the secured party to seek recovery of the deficiency through litigation with the debtor. The secured party must evaluate whether the benefit, in the form of the anticipated increase in value of the collateral, exceeds the cost of improving the collateral.

In conducting its cost-benefit analysis of whether to improve the collateral, the secured party essentially must weigh two related issues: what the secured party *must do* to avoid being

held to have acted commercially unreasonably; and what the secured party *must not do* to avoid this consequence. One category of cases involves debtors who claim that the secured party improperly failed to improve the collateral. See, e.g., *Franklin State Bank v. Parker*, 346 A 2d 632, 18 UCC Rep. 266 (NJ Super. Ct. 1975); *Weiss v. Northwest Acceptance Corp.*, 546 P.2d 1065 (Or. 1976). The debtors in these cases claim that the secured party missed the opportunity to sell the collateral for more money and therefore should not be entitled to pursue the debtor for a deficiency. On the other side are cases involving debtors who claim that the secured party spent too much money improving the collateral and that the secured party’s excessive preparation expenses therefore should not be properly charged against the proceeds of the sale of the collateral under section 9-615(a)(1) of the UCC. See, e.g., *First Fidelity Acceptance v. Hutchins*, 717 A.2d 437, 439 (N.J. Sup. Ct. Law Div. 1998).

The investment by the secured party must actually be expected to result in a net benefit. The secured party is required to improve the collateral if the expense and effort of preparation is small compared to the benefit of such improvement. Barkley Clark, *The Law of Secured Transactions Under the Uniform Commercial Code*, v. 1 (Third Edition). For instance, as suggested above, cleaning the collateral or conducting minor repairs to it is almost always required.

If a better price cannot be obtained after the repair than if the repair had not been undertaken, the preparation

of collateral is not commercially reasonable. *Richardson Ford Sales, Inc. v. Johnson*, 676 P.2d 1344 (N.M. Ct. App. 1984). And, of course, if the cost of the repair would exceed the price that the collateral would bring at sale, a secured party cannot be expected to undertake the repair—nor should the debtor be expected to tolerate such a repair. For example, in *First Fidelity Acceptance v. Hutchins*, the Superior Court of New Jersey held that spending \$1,655.33 to prepare a car for sale that would likely sell for \$500 was not commercially reasonable. *Hutchins*, 315 N.J. Super. at 204, 717 A2d at 439. In addition, where the cost of improving the collateral is uncertain or expensive, or burdensome or extensive, such effort by the secured party is not required. See *Whitney Nat’l Bank v. Air Ambulance by B & C Flight Mgt., Inc.*, 516 F.Supp.2d 802 (S.D. Tex. 2007).

### Work in Progress/Raw Materials

Custom in the industry is also relevant to the analysis. If the proposed preparation is customary for the type of collateral in question, it is more likely to be commercially reasonable for the secured party to do the preparation. In a Tenth Circuit case, the court found that dismantling, cleaning, and painting an oil rig before sale was a usual practice with respect to oil rig collateral and that it was not commercially unreasonable to expect the secured party to perform such acts before disposing of the collateral. *Liberty Nat. Bank & Trust Co. of Okla. City v. Acme Tool Div. of Rucker Co.*, 540 F.2d 1375 (10th Cir. 1976).

A particularly vexing issue is whether a secured party must complete production of the debtor's work in process or upgrade the debtor's raw materials. The debtor might argue that, to be commercially reasonable, a secured party must complete work in process inventory so that the secured party will end up with far more marketable and valuable finished goods. A debtor might also argue that it would be commercially reasonable for a secured party to take steps to process the debtor's raw materials to increase their value (for example, by converting less valuable insulated raw material copper wire to more valuable "pure" raw material copper wire by removing the plastic cover from that wire), even if a ready market exists for the sale of the debtor's raw materials in their existing form.

There is little case law to guide a secured party on what to do with raw materials and work in process. Nevertheless, since the bulk of the cases on post-default preparation and processing pertain to superficial repairs or clean up, one might conclude that courts would consider any significant processing of repossessed raw material or work-in-process inventory too complicated and burdensome a duty to place on a secured party. Presumably, factors such as the extent of the secured party's access to, and the cost to the secured party of, equipment, employees, insurance, permits, utilities, and other required production elements should have a bearing on whether it is commercially reasonable to expect a secured party to process raw materials or complete production of work in process of the

debtor. And if, for example, the debtor operates in an environmentally sensitive industry, a court might not find commercially unreasonable the secured party who elects not to complete the work in process or upgrade the raw materials of the debtor.

The secured party may, however, eliminate uncertainty in the collateral disposition process and insulate itself from claims of commercial unreasonableness by agreeing with the debtor in advance upon appropriate disposition mechanics. Section 9603(a) of the UCC allows the secured party and the debtor to agree as to what method of disposition of the collateral and what degree of preparation and processing of the collateral will be deemed by the parties to be commercially reasonable. Such agreement will be respected provided that the disposition standards are not "manifestly unreasonable." Rev. UCC § 9603(a). In a recent Fifth Circuit case, the bankruptcy court held that the bank's carefully constructed definition of "commercial reasonableness" and explicit authorization to sell collateral at a public or private sale at any time or place, with cash or credit bids, was not "manifestly unreasonable." *In re Adobe Trucking, Inc.*, 2011 Bankr. Lexis 4929, 76 UCC Rep.2d 365, 2011 WL 6258233 (Bankr. W.D. Tex. 2011). The court accepted such contractual provisions in the bank's credit agreement language as a guideline for commercial reasonableness, and such agreement also stated it was commercially reasonable for the bank to fail to incur expenses reasonably seen by the bank as significant in

preparing collateral for disposition. However, secured parties should be careful to structure any proposed disposition arrangements as a voluntary agreement by the debtor, rather than as a waiver by the debtor of the secured party's duty, under section 9610(b) of the UCC, of commercial reasonableness with respect to every aspect of the disposition. The UCC does not permit the debtor to waive this duty of the secured party. Rev. UCC § 9602(7).

### Conclusion

Comment 4 to section 9-610 of the UCC advises that courts "should not be quick to impose a duty of preparation or processing on the secured party." Rev. UCC § 9-610, Comment 4. Nevertheless, it is clear that a secured party must prepare the collateral for sale in at least some circumstances. A secured party may not rely on the plain language of section 9-610(a) of the UCC as a "safe harbor" to dispose of collateral without further consideration of whether the secured party may be required to improve its value. Instead, the secured party must be aware that section 9-610(a) does not exist in isolation, but, rather, is part of a statutory scheme that also includes UCC section 9-610(b) (which provides that every aspect of a disposition of collateral, presumably including the secured party's decision whether to improve the collateral, must be commercially reasonable) and the duty of good faith imposed by UCC Article 1 (which duty is defined in UCC section 9-102(a)(43) as including the observance of reasonable commercial standards of fair dealing). (See also Official

Comment 19 to Rev. UCC § 9-102.) What constitutes "commercially reasonable" conduct by the secured party in preparing collateral for disposition is ultimately a factual question that requires a cost-benefit analysis. The secured party must conduct this analysis carefully. Failure to meet the obligation of commercial reasonableness impairs the secured party's right to collect a deficiency judgment against the debtor (Rev. UCC §§ 9-607(c), 9-626(a)(3)), and the debtor may not waive the obligation of the secured party to exercise commercial reasonableness in the disposition of collateral. (Rev. UCC § 9-602(7)). The secured party and the debtor may, however, agree as to what method of disposition and type of preparation and processing of the collateral will be deemed by the parties to be commercially reasonable. So long as such disposition arrangements are structured as a voluntary agreement by the debtor, rather than as a waiver by the debtor of the secured party's duty of commercial reasonableness, they should be enforceable.

*Anthony R. Callobre is a shareholder and Harold J. Lee is an associate at Buchalter Nemer in Los Angeles. The authors gratefully acknowledge the invaluable assistance of Neil B. Cohen, Jeffrey D. Forchelli, professor of law, Brooklyn Law School, and of counsel to Bingham McCutchen LLP, and of their colleague, Richard Jay Goldstein, of Buchalter Nemer, each of whom reviewed and commented upon prior drafts of this article.*

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## Taking Security in Canada: The Rules of the Game

By [Kiriakoula Hatzikiriakos](#)

In today's economy, many businesses operate or own assets in multiple jurisdictions. This reality can give lenders access to a greater collateral pool to secure their loans. However, creating and perfecting security interests across borders can present certain challenges that only knowledge can overcome.

Understanding the Canadian secured transactions regime can help the lender to better structure its security package and be on top of the game.

### Fictitious Case Study

Border Line Co. is an American textile manufacturing company incorporated in Delaware, with its main operations in New York. It also operates two manufacturing facilities in Canada through its wholly-owned subsidiaries, both incorporated under Canadian corporate law (Canada Business Corporations Act):

Wildnorth Co. 1 (with places of business in Ontario and Quebec and its registered and chief executive office in Quebec) and Wildnorth Co. 2 (with places of business in British Columbia (BC) and Ontario and its registered and chief executive office in Ontario).

Wildnorth Co. 1's and Wildnorth Co. 2's assets consist mainly of inventory, equipment, and accounts receivable deposited in accounts of Canadian financial institutions. Wildnorth Co. 1 owns the building in which it operates in Quebec, whereas Wildnorth Co. 1's and Wildnorth Co. 2's operations in Ontario and BC are located on leased premises. Wildnorth Co. 2 owns an important investment securities portfolio held in a securities account (the securities account agreement is governed by Ontario law). Both Wildnorth Co. 1 and Wildnorth Co. 2 own five trademarks for the

inventory, registered at the Canadian Intellectual Property Office (CIPO), as well as property and casualty insurance policies in each province where property is located.

You are representing a U.S. lender financing Borderline Co. and its Canadian subsidiaries. The US\$30 million credit facility will benefit all of Borderline Co.'s operations, both in the United States and in Canada. A portion of the facility will be financing the acquisition by Wildnorth Co. 1's acquisition of equipment for its manufacturing facility located in Quebec. You begin by creating and perfecting valid security interests against the assets of Borderline Co. under Article 9 of the Uniform Commercial Code (UCC Article 9), but the value of Borderline Co.'s assets in the United States is not sufficient to cover the credit commitment. In the event of Borderline Co.'s default to

repay the loan, your client may not be able to recover what is owed to it if the Canadian assets are not included in the collateral pool. Fearing that scenario, you “cross” the border and gaze at the Canadian landscape. You are overwhelmed by its dimensions. A closer look makes you realize that beyond its size, you come face to face with a country with two official languages (English and French) and a bijuridical legal system. At first, all this may seem so foreign, until we delve into the principles of Canadian secured transactions law. By the end of this article, you may have changed your mind and cross over the Canadian border to re-enter the United States with less qualms about taking security in your neighboring country. The goal is to answer your “where,” “why,” and “how” queries: “where do I take my security,” “why do I create and perfect my security in such province,” and “how do I create and perfect my security”?

This is a primer on the Canadian legal regime relating to creation and perfection of security interests. To the extent the Canadian assets form a valuable part of the collateral, you should seek legal advice in the provinces where you are taking your security. Canadian counsel can also guide you with understanding and dealing with third-party rights that can “trump” your security. Let’s begin with a brief history of the Canadian secured transactions regime.

### Canada: Bijuridical Legal Regime

As previously mentioned, Canada’s legal system is bijuridical: common law inherited from the English and civil law from the French. Canada has

two main government levels: federal and provincial (or territorial). Secured transactions laws are of provincial jurisdiction and based on the following statutory framework: the Personal Property Security Act (PPSA) in the common law provinces and territories and the Civil Code (CCQ) in Quebec. The structure of the PPSAs is based on pre-2001 UCC Article 9. The CCQ draws its origins from the French Napoleonic Code. All Canadian provinces and territories (except Quebec) have a PPSA. There are essentially two models of PPSA: the “Model Act” or “Western Model” (on which are based the PPSAs of most Canadian provinces/territories) and the Ontario PPSA. The PPSAs are basically similar, with a few local variations. As for Quebec, the CCQ contains a “Book” (section) dealing with “hypothecs” (Articles 2660–2802). The next section of this article will guide you through some of the Canadian secured transactions concepts. Given the similarities between the PPSAs and UCC Article 9, we will focus on some of the distinct elements of Quebec law. Also, we must keep in mind that certain property charged as collateral may be regulated by federal law (e.g., intellectual property), as is the case also in the United States. In such circumstances, we must take into account the relevant federal statutes and file the security with the relevant federal registries (e.g., filing of security in trademarks with the Canadian Intellectual Property Office—a similar approach is taken under U.S. law where lenders record their security interests in trademarks at the United States Patent and Trademark Office).

### Concepts

The PPSA concept of a “security interest” is very similar to the UCC Article 9’s security interest: an interest in personal property that secures payment or performance of an obligation. It also includes all assignments of accounts or chattel paper and the interests of a lessor of goods under a lease for a term of more than one year, whether or not such assignments or interests secure payment or performance of an obligation. Certain transactions are excluded from the PPSA scope. These exclusions are also similar to those found under UCC Article 9. For example, the assignment of insurance claims under a policy of insurance (in the PPSAs, with the exception of the Ontario PPSA, this exclusion does not extend to the proceeds of the insurance resulting from the loss or damage to collateral) and real property interests are not covered by the PPSA. In those cases, provincial legislation (other than the PPSA) sets out the requirements for creating and perfecting security (e.g., insurance statutes for assignments of insurance policies, and mortgages and land registration statutes for real property security).

The CCQ includes the concept of “security” in its section dealing with conflict of laws on secured transactions. However, the term is not defined. Quebec’s conceptual and functional equivalent of a “security interest” is the “hypothec.” This word finds its origins in the Latin *hypotheca* and in the Greek *hypothéke*, and refers to a legal right over a debtor’s property that remains in the debtor’s possession. That explains the



definition of a “hypothec” in Article 2660 of the CCQ: “a real right on a movable or immovable property made liable for the performance of an obligation. It confers on the creditor the right to follow the property into whose hands it may be, to take possession of it or to take it in payment, or to sell it or cause it to be sold and, in that case, to have a preference upon the proceeds of the sale ranking as determined in this Code.” From the CCQ’s definition, we note that a hypothec can be created on both personal and real property. Some Quebec terminology: “movable property” is “personal property”; “immovable property” is “real property”; “corporeal property” refers to “tangible property;” and “incorporeal property” is “intangible property.” The CCQ does not provide for “collateral types” or categories of collateral (e.g., goods, equipment, and inventory), as is the case under the PPSAs and UCC Article 9. In contrast to the PPSAs/UCC Article 9, the CCQ’s section on the creation of hypothecs applies both to personal and real property. A “movable hypothec” is security on personal property and an “immovable hypothec” is real property security.

Another important distinction between the PPSA/UCC Article 9 and the CCQ is that the latter does not necessarily apply to any transaction which is intended to create a security interest in personal property. In principle, conditional sale agreements and leases (true or financing) are not treated as “security” under the CCQ. (For more on this, see K. Hatzikiriakos, “An Attempt to ‘Demystify’ Quebec Secured Transactions Law,” *Commercial*

*Finance/Uniform Commercial Code Newsletter*, [Summer 2010, Part I](#), and [Spring 2011, Part II](#).) In fact, the CCQ distinguishes “hypothecs” from what is commonly referred to as “title retention devices” (TRDs) (a filing relating to a TRD evidences the seller’s/lessor’s ownership in the asset sold/leased). Leases, leasing contracts and “installment sales” (conditional sales) are considered TRDs. In 2004, the Supreme Court of Canada held that these types of transactions are not “security.” (*Ouellet (Trustee of)* [2004] 3 S.C.R. 348 (leases), at <http://canlii.ca/t/1j0td>; *Lefebvre (Trustee of); Tremblay (Trustee of)* [2004] 3 S.C.R. 326 (installment sales), at <http://canlii.ca/t/1j0tc>). These rulings opened the door to a looming uncertainty over whether the CCQ’s articles relating to hypothecs (e.g., conflict of law rules) apply to TRDs. In Quebec, it is important to properly qualify the TRD used in a transaction. The device’s nature will determine the type of filing that is required and the delay in which it should be made. For example, the rights resulting from an “installment sale” (conditional sale) must be registered within 15 days of the date of the sale. Leases with a term of more than one year in respect of a road vehicle (e.g., personal vehicle, motorcycle, or aircraft) or other movable property determined by regulation or, in principle, of any movable property required for the service or operation of a business enterprise must be registered. It is also important to note that, unlike the PPSA and UCC Article 9, the CCQ does not distinguish between a “true lease” and a “financing lease.” A leasing contract is

akin to the “finance lease” of Article 2 UCC.

Another difference between the PPSA/UCC Article 9 and the CCQ is that assignments of property for the purpose of securing the performance of an obligation are not valid in Quebec. Practically speaking, this means an assignment of accounts receivable as “security” is not valid in Quebec. If a creditor wants its debtor’s accounts in its collateral pool, it must “hypothecate” the accounts. This does not mean that an outright sale of accounts is not permitted under Quebec law, such as the sale of accounts in a factoring transaction or in a securitization scenario, (i.e., sale of assets from the originator/seller to a special purpose entity). An absolute sale of accounts (“assignment of claims”) is possible under the CCQ. However, it must follow the “assignment of claims” rules (Articles 1641–1650 CCQ) which are distinct from the rules relating to hypothecs. The seller can render enforceable the assignment vis-à-vis third parties either by filing the assignment at the Quebec personal property registry (Register of Personal and Movable Real Rights (RPMRR)) (if the sale relates to a “universality,” i.e., an entire category of accounts receivable) or by giving notice of the assignment to the account debtor (if the sale relates to specific accounts). For more on assignment of claims, consult Part III of the article titled “An Attempt To ‘Demystify’ Quebec Secured Transactions Law” (to be published in a subsequent issue of the *Commercial Finance/Uniform Commercial Code Newsletter*).

Bearing the conceptual framework of Canadian secured transactions in mind, we will now turn our attention to the creation and perfection of security interests and hypothecs.

### Security Creation

Similar to UCC Article 9, PPSA security interests are created and rendered enforceable through attachment. The rules of attachment are the same: attachment occurs when value is given, the debtor has rights in collateral, and a signed security agreement with a sufficient description of collateral is made (or secured party obtains possession of the collateral).

The concept of “attachment” does not exist in Quebec. However, the principles of creation of a hypothec are very similar to the PPSA attachment. A hypothec without “delivery” (i.e., non-possessory security) must be created in an “act constituting a hypothec” (i.e., written security agreement). Typically, pledges are created by physical delivery of the property or title to the creditor; however, we do see written agreements put in place for evidentiary purposes.

The deed of hypothec (i.e., security agreement) must *expressly* provide that the grantor “hypothecates” its property. The property should be sufficiently described and can essentially consist of (permit us to use the Quebec terminology) a universality (an entire category of) or specific movable (corporeal or incorporeal) property. An “all present and after-acquired personal property” grant clause (i.e., the

universality of the grantor’s present and after-acquired movable property) is considered a “sufficient description” under the CCQ. As is the case under the PPSA and UCC Article 9, the hypothec will “attach” to the after-acquired property once the grantor acquires “title” to the collateral (title in the CCQ refers to the “right of ownership”), which includes the right to dispose of property. The same deed of hypothec can charge both movable and immovable property (in contrast to the PPSA and UCC Article 9 jurisdictions, where a separate “mortgage” or “debenture” is typically used to charge real property). However, when real property is being charged, the CCQ requires the deed to be notarized (executed in the presence of a notary). The deed of hypothec must describe the obligations secured and—an important distinction from the PPSAs/UCC Article 9—the specific amount, stated in Canadian dollars, for which the hypothec is granted, commonly referred to as the “hypothec amount.” This amount corresponds to the maximum amount for which the hypothec can be enforced. Typically, this amount represents the indebtedness amount (i.e., total credit commitment, and perhaps a little buffer to allow for future indebtedness increases, and an additional 20–25 percent “bump-up” targeted to cover enforcement expenses). Interest on the hypothec amount can also be stated (it can be fixed or floating, but must be determinable). As mentioned, the hypothec amount must be stated in Canadian dollars. This necessarily implies that where the indebtedness amount is in a currency other than

Canadian dollars, this amount needs to be converted in Canadian dollars (an amount to factor in fluctuations in foreign exchange rates must be added). In some cases, we see “extravagant” hypothec amounts (set in the billions!). However, in a realization scenario, the creditor will only be able to enforce the hypothec for the amount due when enforcement occurs.

### Security Perfection

Under both the PPSA and the CCQ, a validly created security interest/hypothec in collateral must be perfected so it can gain priority vis-à-vis third party unsecured creditors, including a trustee in bankruptcy. Similar to UCC Article 9, there are three methods of perfection under the PPSA and the CCQ (the CCQ refers to “publication”): registration, possession, and control.

Registration of a financing statement (in CCQ, “application for registration”) perfects security interests/hypothecs in all personal property collateral and can be done electronically. Under the PPSA, the lender can choose the length of the filing (from one year to perpetuity). CCQ filings are valid for 10 years and can be renewed. In the PPSA provinces, pre-filing (i.e., filing before execution of the security agreement) is permitted (except for consumer goods). Pre-filing is advantageous in that the lender’s security interest will gain priority from the date of filing, even if the security agreement bears a later date. Pre-filing is not allowed in Quebec, where the application for registration must refer to the date the deed of hypothec was signed. To

the extent the Quebec assets form a valuable part of the collateral, disbursement should factor in the delays for Quebec hypothec filings. The “good” news is that filing processing times are relatively quick at the RPMRR, so, under normal circumstances, one can expect to obtain filing confirmation within a day or two of filing. As previously mentioned, TRD rights (and their assignment to third parties, e.g., a lender financing an installment sale) must also be filed at the RPMRR in order to be enforceable against third parties. (For a more detailed discussion on the topic, see “An Attempt to ‘Demystify’ Quebec Secured Transactions Law,” *Commercial Finance/Uniform Commercial Code Newsletter*, [Summer 2010, Part I.](#)) Although real property security is not discussed in this article, note that immovable hypothecs are registered in the land registry (as is the case in the other Canadian provinces under the land title and land registration statutes).

Whether under the PPSA or the CCQ, the general rule is similar: priority between competing registered security interests is determined from the date of filing. This “first-in-time” rule does not always guarantee the secured party’s priority on the debtor’s collateral. Certain rights can defeat the secured party’s priority (e.g., statutory liens, and PMSIs in all Canadian provinces, except Quebec). A lengthy discussion of priority rules and the methods of possession and control as methods of perfection is beyond the scope of this article. As for possession, note that it is available for collateral similar to what is provided under UCC Article 9 (e.g.,

negotiable documents of title and instruments).

Control perfects security interests in investment property. The PPSA and CCQ rules relating to control on investment property were modeled on UCC Article 9. One important distinction between UCC Article 9 and the PPSA/CCQ: “control” is not available for the perfection of security interests/hypothecs on deposit accounts. The method for perfecting security interests in deposit accounts remains the filing of the security interest in the jurisdiction where the debtor is located (see next section for “debtor location” rules). Funds on deposit in a bank account are “intangibles” under the PPSA and “incorporeal property” under the CCQ. Changes to the Ontario PPSA are on the horizon to make available perfection by control for deposit accounts. (See <http://www.oba.org/en/pdf/perfectingSecurityInterests.pdf>).

In addition to filing with the provincial personal property registries, some collateral falls under federal jurisdiction and filings with certain federal registries would be commendable (e.g., filing of security interests in the intellectual property registries) or even necessary (e.g., registered vessels under the Canada Shipping Act).

Now that we have a better handle on the basics of “how” to create and perfect security in Canada, let’s turn our focus on the “where” and “why” queries. The answers lie in the conflict of laws provisions relating to security.

## Conflict of Laws

Seeing how the PPSAs are very similar to UCC Article 9, counsel to the U.S. lender may be tempted to use a U.S.-law governed general security agreement to create and perfect a security interest in the PPSA provinces (Ontario and BC in our example). While this may seem appropriate at the outset, counsel should be wary of Canadian conflict of law rules relating to the validity and perfection of security interests, as well as the costs that may be related to proving U.S. law before a Canadian court (assuming, of course, that the Canadian court will accept to apply U.S. law). Under the PPSA, security interest enforcement matters are generally governed by the *lex fori* (i.e., law where enforcement procedures are taken). We say “generally” because the PPSA distinguishes between procedural (steps involved in the enforcement) and substantive (right to enforce) matters. In fact, the PPSA provides that “procedural” enforcement issues are governed by the *lex fori*. However, “substantive” matters are governed by the law of the contract between the secured party and the debtor. Considering all this, it may be wiser to use a security agreement governed by the law where the lender may ultimately conduct enforcement. In contrast to the PPSA, the CCQ contains no express conflict of law rule regarding enforcement. However, the analysis tends to be similar to the one made under the PPSA. In practice, when Quebec assets are involved, given the specificities of the Quebec “hypothec,” lenders typically require

a deed of hypothec to charge the Quebec assets.

So, which law applies to the validity and perfection of a security interest/hypothec? The PPSA and CCQ conflict of law rules relating to the validity and perfection of a security interest or hypothec are essentially the same. The conflict of laws provisions relating to security interests or hypothecs apply to the validity, perfection and effect of perfection of the security (in contrast to UCC Article 9, which sets out the rules for perfection and effect of perfection, but section 1-301 of the UCC provides the rule for validity of the security, i.e., law of contract). It is also important to note that a reference to the law of a jurisdiction in the conflict of law provisions of the PPSA and the CCQ is a reference to the internal law of that jurisdiction, excluding its conflict of laws rules (which is also the case under UCC Article 9). This has the obvious advantage of avoiding the *renvoi*. The *renvoi* could result in the application of laws of different jurisdictions—this approach would be contrary to the goals of certainty and predictability pursued by secured transactions laws.

The *lex situs* (law of jurisdiction where charged property is situated at the time the security interest/hypothec attaches) governs the validity and perfection of a security interest/hypothec in tangible property (and possessory security interests/hypothecs). This rule is similar to what existed under former section 9-103 of the UCC, with multiple filings being required if the debtor's inventory is located in many jurisdictions. As we pointed out

earlier, in Quebec, the security conflict of law provisions may not apply to TRDs. Instead, it is arguable that, in those cases, we may need to apply the conflict of laws relating to real rights and sales. It would be prudent for the lender to file the relevant TRD at the RPMRR (within the delays prescribed under the CCQ) if the debtor is domiciled in Quebec, the asset leased or sold is situated (or is destined to arrive) in Quebec or the TRD contract is governed by Quebec law.

The debtor's location governs the validity and perfection of a security interest/hypothec in intangible property and mobile goods. Under the PPSA, the debtor shall be deemed to be located at the debtor's place of business, or if there is more than one place of business, at the debtor's "chief executive office." This term is not defined under the PPSA and this can lead to uncertainty when trying to determine the debtor's location (e.g., if a company has its registered office in one province and executive offices in many provinces). For those who are familiar with secured transactions laws, this situation certainly brings back some "fond" memories from the former equivalent section 9-103(3)d of the UCC). Some PPSA provinces (e.g., Ontario and British Columbia) have begun proposals to amend the PPSA conflict of laws to define the debtor's location by referring to the debtor's jurisdiction of incorporation. These amendments will bring the PPSAs in line with the rules under UCC Article 9. Under the CCQ, a debtor's location is its "domicile." The domicile of a corporation is the "place and address of its head office" (registered office).

The PPSA/CCQ conflict of rules relating to security in investment property are essentially the same as those found under UCC Article 9. In fact, the PPSA and the CCQ rules were modeled on the UCC Article 9 rules. For the purposes of solving our case study (i.e., investment property of Wildnorth Co. 2), the validity and perfection of the security interest/hypothec in the securities account is governed by the law of the securities intermediary's jurisdiction (see rules in section 8-110(e) of the UCC). In our case study, this law would be Ontario since the securities account agreement is governed by Ontario laws.

The conflict of law rules have helped us understand "where" we must create and perfect our security. We are now ready to assist the U.S. lender in preparing a preliminary Canadian security "closing checklist":

- ✓ *For Wildnorth Co. 1:* An Ontario-law governed security agreement charging all of Wildnorth Co. 1's personal property, presently owned and after-acquired, filed with the Ontario PPSA registry (for validity and perfection of security interest in inventory and equipment located in Ontario); a deed of hypothec charging the universality of Wildnorth Co. 1's property (both movable and immovable, presently owned and after-acquired) (for validity and perfection of hypothec on inventory and equipment located in Quebec and all intangibles, e.g., on accounts receivable, including deposit accounts, trademarks) filed at the RPRMM and at the Quebec Land Register

(for the hypothec on the real property owned by Wildnorth Co. 1); filing at the RPMRR of the transfer of reservation of ownership of vendor for equipment financed by U.S. lender (such transfer to U.S. lender may be evidenced in sale agreement between vendor and Wildnorth Co. 1); filing of the hypothec on the trademarks owned by Wildnorth Co. 1 at the CIPO; assignment of insurance policies and proceeds to U.S. lender and notification to insurer to name U.S. lender as loss payee on the policy).

- ✓ *For Wildnorth Co. 2: An Ontario-law governed security agreement charging all of Wildnorth Co. 2's personal property, presently owned and after-acquired, filed in the Ontario PPSA registry (for validity and perfection of security interest in inventory and equipment located in Ontario and accounts receivable, including deposit accounts) and the BC PPSA registry (for validity and perfection of security interest in inventory and equipment located in BC); an Ontario-law governed securities account control agreement; filing of the security interest in the trademarks at the CIPO; assignment of insurance policy and proceeds to U.S. lender (and notification to insurer to name U.S. lender as loss payee on the policy).*

and in the United States are very similar. Of course, every transaction is unique and prudence dictates that you consult with Canadian counsel when Canadian property is an important part of your collateral.

*Kiriakoula Hatzikiriakos is senior legal counsel (Commercial/ International Sector), National Bank of Canada. The opinions expressed in this article are solely those of the author and do not necessarily represent the viewpoint of the National Bank of Canada. I dedicate this article to the memory of my mother whom I lost on July 7 and who will always be my source of strength and inspiration.*

In the end, despite the differences that exist between UCC Article 9 and the PPSA/CCQ, it is safe to say that the Canadian personal property secured transaction regime in Canada

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## Inside Business Law August 2012

### Contract Drafting: The Use of Form Agreements

- At the recent ABA Annual Meeting, the Business Law Section's UCC Committee presented a program titled "[Commercial Law Forms: One Size Does Not Fit All; Tips on How to Use Forms Wisely](#)," which provided information about using form agreements as a drafting starting point. While using such documents can seem like a great place to begin, "fill in the blank" precedents are often not sophisticated enough to fulfill the requirements of complex situations. Developing an expert system that provides explanations as to the role served by a provision in the document, statutory and case law authority underlying the provision, alternative wording depending on the situation or bargaining power

of the party, supplementary provisions to be used in particular situations, and additional resources that discuss the transaction are all essential elements of developing an expert system that will start the drafting process off a little more efficiently, thus providing a better product for your client. The program further includes guidelines on how to turn form agreements into effective contracts and tips on ethically using forms in drafting retention agreements.

- The Business Law Education Committee also presented topics on contract drafting. The materials of the presentation can be found at "[Contract Drafting: What Litigators Wish You Would Include](#)." The materials provide an overview of merger clauses, choice of law clauses, forum

selection clauses and jurisdictional waivers and indemnification provisions. Sample IP agreements are also included in the conference materials.

### Corporate Counsel

At the recent ABA Annual Meeting in Chicago, a program that identified the significant challenges corporate litigation presents and that offered advice to help inside and outside counsel address these challenges as effectively as possible was presented to attendees. The materials, which can be found at "[Corporate Litigation Problems That Keep General Counsel Awake at Night and How to Solve Them](#)," addressed how in-house and outside counsel can assist their corporate client in minimizing financial liability, regulatory risk, and reputational harm arising from litigation. Additionally, the program

focused on how in-house and outside counsel can assist their corporate client in managing and staffing litigation cost-effectively.

### **Common Mistakes of M&A Practitioners; Critical Cross-Border Issues**

- At the recent ABA Annual Meeting in Chicago, the Mergers and Acquisitions Committee presented "[Common Mistakes Made by M&A Lawyers](#)," which outlined common mistakes made by the M&A practitioner at the due diligence stage, as well as during the drafting stage of the transaction. Tips were given on how to avoid accidental indemnification, achieving clarity in ensuring proper survival language, and indemnification concerns, to name only a few common mistake areas that were covered. The program also addressed international M&A issues and ethical challenges. A must read for any M&A practitioner!
- Several practitioners also discussed critical issues in cross-border M&A at the ABA Annual Meeting: "[Cross-Border M&A: Critical Issues for U.S. Counsel](#)." The presentation at the meeting in Chicago addressed topics more specifically on the due diligence review in foreign jurisdictions, bilateral investment treaties in investments in emerging economies, bribes, bank secrecy and changes to the U.S. Patriot Act, and business in Argentina.

- The White Collar Crime Committee in August presented recent trends in anti-corruption compliance. The committee discussed recent U.S. enforcement trends and penalties. The materials are available at "[What Every M&A and Private Equity Transactional Lawyer Needs to Know About the Foreign Corrupt Practices Act](#)," and provide an overview of applicable anti-corruption laws.

### **Legal Practice and Professionalism: Pathways to Success for Young Lawyers**

- The first few years of a young lawyer's practice can set the tone for the years ahead. Therefore, getting off on the right foot is a must. The Young Lawyer Committee recently presented a very informative program that focused on effective professional-development and career-management strategies for young lawyers at every experience level and addressed specific challenges and strategies for young lawyers wanting to take charge of their careers, with particular attention to issues confronting diverse attorneys. Additionally, the use of social media to advance professional-development goals was also discussed. The presentation materials can be found at "[Taking Charge: Pathways to Success for Young Lawyers](#)."
- For young lawyers wishing to work with nonprofit organizations, the Young Lawyer Committee also discussed basic

concepts and best practices in nonprofit formation and governance. The materials from their presentation at the ABA Annual Meeting can be found at "[One Foot in Front of the Other: Basics and Best Practices in Nonprofit Formation and Governance](#)."

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## Keeping Current:

### Delaware Supreme Court Ruling Suggests Potential Buyers in M&A Deals Likely Have Limited Recourse Against Sellers Prior to Signing Agreement

By [Allison C. Handy](#) and [William R. Kucera](#)

The Delaware Supreme Court recently reminded potential buyers in M&A transactions that they likely will have very limited, if any, remedies or recourse against the seller in connection with the potential transaction until an agreement is signed. In *RAA Management, LLC v. Savage Sports Holding, Inc.*, the Delaware Supreme Court upheld a superior court ruling dismissing a claim by RAA (a private equity firm) seeking due diligence and negotiation costs that RAA incurred while pursuing an acquisition of Savage prior to learning late in the due diligence process of certain significant liabilities that Savage failed to disclose earlier in the process. *RAA Mgmt., LLC v. Savage Sports Holding, Inc.*, 2012 WL 1813442, at \*1, \*10 (Del. Mar. 28, 2012). The dismissal

was upheld based on the non-disclosure agreement (NDA) between the parties that included broad, though relatively standard, non-reliance and waiver clauses.

#### Background

When RAA first expressed interest in purchasing Savage, the parties entered into a non-disclosure agreement prior to RAA obtaining confidential documents and information from Savage to initiate due diligence. The NDA stated that Savage was not “making any representation or warranty, express or implied, as to the accuracy or completeness of . . . any . . . information” it provided to RAA during due diligence. Additionally, the non-disclosure agreement stated that “[o]nly those representations or

warranties that are made . . . in the [s]ale [a]greement when, as and if it is executed, and subject to such limitations and restrictions as may be specified [in] such a [s]ale [a]greement, shall have any legal effect.”

Upon executing the non-disclosure agreement, RAA conducted preliminary due diligence on Savage. A few months later, the parties entered into a letter of intent, after which RAA conducted further due diligence. During such further diligence, now several months after signing the NDA and commencing the diligence process, RAA learned of three significant liabilities of Savage, any one of which, according to RAA, “would have caused RAA to have never attempted to acquire Savage.” Additionally, according to RAA,



Savage was aware of these liabilities long before they were finally disclosed to RAA and made affirmative statements to RAA during the earlier stages of the diligence process that no such liabilities existed. In light of this new information, RAA terminated negotiations before a final sale agreement was executed and brought suit against Savage in the Delaware Superior Court, demanding payment for “sunken due diligence costs” of \$1.2 million.”

The superior court dismissed RAA’s suit for failure to state a claim. RAA appealed, arguing, among other things, that the non-reliance and waiver clauses of the non-disclosure agreement were not intended to bar claims based on “willful falsehoods” and that the “peculiar knowledge” of Savage with respect to the liabilities removed RAA’s claims from the scope of the non-reliance provisions under New York law.

### Delaware Supreme Court Opinion

In affirming the dismissal, the Delaware Supreme Court emphasized the intent and language of the non-disclosure agreement and the context in which it was entered into—namely, between two sophisticated parties negotiating a sophisticated M&A deal. The court noted that the intent of the non-disclosure agreement was clear: it was “designed to require . . . [waiver of] any deficiencies in due diligence as basis for suit, unless that deficiency constituted a breach of representation or warranty in the resulting merger agreement.” Furthermore, the court found the language to be unambiguous and

“virtually identical” to non-disclosure language enforced in other instances.

The court cited several previous cases for the proposition that express disclaimers should be enforced, even in the context of potential fraud or intentional misrepresentation. The court relied on policy considerations, along with the weight of the precedent, in reaching its conclusion. In summarizing its analysis, the court wrote:

The efficient operation of capital markets is dependent upon the uniform interpretation and application of the same language in contracts or other documents. The non-reliance and waiver clauses in the NDA preclude the fraud claims asserted by RAA against Savage. Under New York and Delaware law, the reasonable commercial expectations of the parties, as set forth in the nonreliance disclaimer clauses in Paragraph 7 and the waiver provisions in Paragraph 8 of the NDA, must be enforced.

### Takeaways from *RAA Management*

Given the court’s straightforward and unambiguous decision in the face of arguably egregious facts, much can be learned from this opinion. Buyers should be aware that they will likely have limited, if any, recourse against the seller for sunken costs or any other losses incurred by the buyer in connection with the transaction if a definitive agreement is not signed, unless they are able to negotiate explicit exceptions or modifications to standard non-reliance and waiver clauses that are ordinarily included in NDAs signed in connection with M&A

deals (which may not be possible depending on the deal dynamics and the parties’ relative leverage) or otherwise negotiate expense reimbursement or other protections in case the deal is not consummated for various reasons. Buyers should recognize that this is true even if the reason for the failed deal is less-than-fulsome, or even fraudulent, disclosures by the seller in the due diligence process. In light of this reality, buyers should enter into the due diligence process with full knowledge of this potential risk and consider whether it is possible, under the circumstances, to delay relatively expensive aspects of the due diligence review (e.g., outside consultants) until later in the due diligence process when a deal is more certain.

On the other side, sellers should ensure that their NDAs contain standard non-reliance and waiver clauses of the type at issue in *RAA Management* and resist making any changes to these clauses. Given the clear statements in *RAA Management* that standard non-reliance and waiver clauses generally result in no potential liability for sellers, any deviation from standard language may be interpreted as meaning the parties meant something different, thereby potentially exposing sellers to unclear results.

As the court in *RAA Management* explained, sellers have a distinct interest in ensuring that buyers have no ability to bring claims against them based on alleged misstatements or omissions in the due diligence process out of fear that any failed deal could be the source of an action for expense reimbursement based on

such theories, however warranted. Therefore, in most instances, sellers would be well-served by sticking with standard disclaimers in this context.

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## Delaware Insider:

### Default Fiduciary Duties, Conflicted Transactions, and Special Approval: Is Delaware Alternative Entity Law Cutting Edge or Cutting Loose?

By [Dominick T. Gattuso](#)

The Delaware courts have issued a number of interesting and controversial decisions in the last year or so, and there will no doubt be a few more before 2012 ends. Three alternative entity law decisions from 2012 have garnered a fair amount of attention: *Auriga Capital Corp. et al. v. Gatz Properties, LLC*; *Gerber v. Enterprise Products Holdings, LLC, et al.*; and *In re K-Sea Transportation Partners L.P. Unitholders Litig.* In *Auriga*, Chancellor Leo E. Strine, Jr., ruled that traditional fiduciary duties of care and loyalty apply by default to managers of Delaware limited liability companies absent a contractual provision that clearly alters or eliminates such duties. Old news, you say? True, many practitioners have long-believed that default fiduciary

duties applied to LLC managers, and numerous decisions from the Court of Chancery suggested as much. However, *Auriga* was the first instance where the court made such an unequivocal pronouncement. Indeed, one commentator on Delaware law went so far as to refer to the opinion as “epic,” for that very reason. On the other hand, in *Gerber* and *In re K-Sea*, Vice Chancellors Noble and Parsons, respectively, dismissed plaintiffs’ claims that the defendants violated their contractual and fiduciary duties to the minority investors by approving conflicted transactions, because the defendants satisfied the contractual standards of review set forth in the partnership agreements, which displaced default fiduciary duties and constrained

application of the implied covenant of good faith and fair dealing.

The *Gerber* decision prompted one person to ask: “How far will Delaware courts allow an agreement to permit self-dealing in an LLC? The case I’ve found allowing the most leeway is *Gerber*. . . . Any comments on whether this case shows the wisdom or the folly of Delaware law? Does anyone have a better case to offer?” UCLA Law School Professor Stephen Bainbridge posted this inquiry on his blog along with the following response from another individual: “It is pretty clear that under Delaware limited partnership and LLC law, the partnership/operating agreement can entirely legitimize self-dealing, subject to the non-waivable

contractual covenant of good faith and fair dealing. What's remarkable about *Gerber* is the extent to which the case permits an agreement to restrict the operation of the non-waivable duty of good faith and fair dealing." So, are the decisions in *Gerber* and *In re K-Sea* the result of wisdom or folly, and how does one square those decisions with *Auriga*?

### ***Auriga*: Default Fiduciary Duties Exist**

The dispute in *Auriga* centered on the acquisition of Peconic Bay LLC by Gatz Properties, LLC (Gatz Properties), which was the company's sole manager, and which held majority voting control in Peconic Bay. Defendant William Gatz (Gatz) and certain of his family members owned and controlled Gatz Properties, which held title to property owned by the Gatz family in Long Island, New York. Gatz Properties leased the property to Peconic Bay under a ground lease with a 40-year term. The ground lease restricted the property's use to a high-end, daily fee, public golf course. In 1998, Peconic Bay sublet the property to American Golf Corporation, which ran the day-to-day operations of the golf course until 2004. Upon learning that American Golf did not intend to renew its sublease, Gatz engaged in a series of actions that placed Peconic Bay in an economically vulnerable position so that he could acquire the company at a steep discount and, thereby, avoid the long-term ground lease that prevented him from developing the property into a private, residential golf course. The *coup de grace*—a "sham" auction to squeeze out Peconic Bay's minority investors—led the investors to sue Gatz and Gatz

Properties. The minority investors alleged that Gatz breached both his fiduciary duties and Peconic Bay's operating agreement. Gatz countered that he owed no fiduciary duties, because such duties had been eliminated by the operating agreement.

Chancellor Strine began his analysis by answering the question of whether traditional fiduciary duties apply to managers of a Delaware limited liability company affirmatively. His approach was straightforward. Section 18-1104 of the Delaware Limited Liability Company Act, which states, in part, that "[i]n any case not provided for in this chapter, the rules of law and equity . . . shall govern," is more explicit than its corporate counterpart "in making the equitable overlay [of traditional fiduciary duties] mandatory" in the LLC context to the extent that those duties have not been altered or eliminated by the relevant operating agreement. As the court explained, the "manager of an LLC has more than an arms-length, contractual relationship with the members of the LLC." Rather, an LLC manager is "vested with discretionary power to manage the business of the LLC." As such, the manager qualifies "as a fiduciary of that LLC and its members." Because "the rules of equity apply in the LLC context by statutory mandate," "because LLC managers are clearly fiduciaries, and because fiduciaries owe duties of loyalty and care," it is only logical that Delaware LLCs start "with the default that managers of LLCs owe enforceable fiduciary duties."

In reaching this conclusion, the court squarely rejected a competing view

that fiduciary duties should not apply to LLC managers by default. First, if the Delaware courts "judicially excised" the equitable overlay of fiduciary duties in the statute, "those who crafted LLC agreements in reliance on equitable defaults that supply a predictable structure for assessing whether a business fiduciary has met his obligations to the entity and its investors will have their expectations disrupted." In other words, the "equitable context in which the contract's specific terms were to be read will be eradicated, rendering the resulting terms shapeless and more uncertain." The second problem follows directly from the first: "judicial eradication of the explicit equity overlay in the LLC Act could tend to erode [Delaware's] credibility with investors in Delaware [alternative] entities."

The court next considered whether Gatz owed default fiduciary duties—a more specific inquiry based on the facts of the case. Peconic Bay's operating agreement contained no provision expressly eliminating default fiduciary duties. Nor were those default duties displaced by Section 15 of Peconic Bay's operating agreement, as Gatz claimed. Section 15 stated: "[n]either a manager nor any other member shall be entitled to cause the Company to enter . . . into any additional agreements with affiliates on terms and conditions that are less favorable to the Company than the terms and conditions of similar agreements which could be entered into with arms-length third parties, without the consent of a majority of non-affiliated members. . . ." In *Gotham Partners, L.P. v. Hallwood Realty Partners, L.P.*,

the Court of Chancery interpreted similar contractual language “as imposing the equivalent of the substantive aspect of entire fairness review, commonly referred to as the ‘fair price’ prong.” However, as Chancellor Strine explained in *Auriga*, the “fair dealing” prong of the entire fairness review does not “fall away, because the extent to which the process leading to the self-dealing either replicated or deviated from the behavior one would expect in an arms-length deal bears importantly on the price determination.” In other words, Section 15 “distill[s] the traditional fiduciary duties as to the portion of the Minority Members’ claims that relates to the fairness of the Auction and Merger into a burden to prove the substantive fairness of the economic outcome.” Thus, to enjoy Section 15’s safe harbor, and thereby avoid the need for minority member approval of the auction and merger, “Gatz [had] the burden to show that he paid a fair price to acquire Peconic Bay, a conclusion that must be supported by a showing that he performed, in good faith, a responsible examination of what a third-party buyer would pay for the Company.” The remainder of Gatz’s alleged misconduct leading up to the auction and merger, however, were governed by traditional fiduciary duties of loyalty and care because the operating agreement did not alter those duties.

The court held that Gatz breached both his contractual and fiduciary duties to the minority members of Peconic Bay by engaging in a series of acts and omissions over the years that left Peconic Bay in a tenuous financial position, which Gatz

exploited “by buying [Peconic Bay] at an auction on terms that were well-designed to deter any third-party buyer, and to deliver the LLC to Gatz at a distress sale price.” Because Gatz acted in bad faith, the exculpatory provision in Peconic Bay’s operating agreement did not absolve him of monetary liability for his wrongdoing.

### ***Gerber and In re K-Sea: Contracting Away Judicial Protection***

In contrast to the Peconic Bay operating agreement, the partnership agreements in *Gerber and In re K-Sea* displaced default fiduciary duties and constrained application of the implied covenant of good faith and fair dealing with a contractual standard of review, thereby limiting the Court of Chancery’s broad remedial powers.

In *Gerber*, plaintiff Joel A. Gerber filed a class action suit on behalf of the former public holders of limited partnership units of Enterprise GP Holdings, LP (EPE) against Enterprise Products Partners, LP (Enterprise Products), Enterprise Products Holdings, LLC (Enterprise Products GP), members of Enterprise Products GP’s Board of Directors (the Director Defendants), the estate of Dan L. Duncan (Duncan), which controlled the foregoing entities, and an affiliate of Enterprise Products—Enterprise Products Company (EPCO), alleging, among other claims, fiduciary and contractual breaches relating to EPE’s sale of Texas Eastern Product Pipeline Company, LLC (Teppco) to Enterprise Products and the later merger of EPE with Enterprise Products.

In 2007, EPE purchased Teppco from a Duncan affiliate for \$1.1 billion in

EPE limited partnership units. Two years later, Enterprise Products acquired Teppco from EPE in exchange for \$39.95 million in Enterprise Products limited partnership units, and Enterprise Products’ general partner, which EPE owned, received an increase in its general partner interest in Enterprise Products worth \$60 million (the 2009 sale). The Audit, Conflict, and Governance Committee of the Enterprise Products GP Board of Directors (the ACG Committee), which was comprised of three independent directors, approved the sale following receipt of a fairness opinion from Morgan Stanley. The Enterprise Products GP Board approved the sale upon the recommendation of the ACG Committee. The following year, Enterprise Products proposed a merger with EPE, whereby each EPE limited partnership unit would be converted into the right to receive 1.5 Enterprise Products limited partnership units. The ACG Committee received another fairness opinion from Morgan Stanley, opining that the merger was fair to the holders of EPE limited partnership units. In reliance on the fairness opinion, the ACG Committee recommended the merger to the full board. The merger closed in November 2010.

The court began its analysis by noting that Enterprise Products GP, the Director Defendants, Duncan and possibly EPCO owed fiduciary duties to EPE and its minority investors. However, because the 2009 sale and the merger were conflicted transactions, default fiduciary duties were supplanted by four alternative

standards of review set forth in Section 7.9(a) EPE's partnership agreement:

Unless otherwise expressly provided in this Agreement, whenever a potential conflict of interest exists or arises between [Enterprise Products GP] or any of its Affiliates, on the one hand, and [EPE] or any Partner, on the other hand, any resolution or course of action by [Enterprise Products GP] or its Affiliates in respect of such conflict of interest shall be permitted and deemed approved by all Partners, and shall not constitute a breach of this Agreement or of any agreement contemplated herein or therein, or of any duty stated or implied by law or equity, if the resolution or course of action in respect of such conflict of interest is (i) approved by Special Approval, [which means "approval [of the transaction] by a majority of the members of the [ACG Committee]". . . .

Because the ACG Committee, which was comprised of independent directors, unanimously approved the 2009 sale and the merger, the court reasoned that the conflicted transactions were "permitted and deemed approved by all Partners, and [did] not constitute a breach of [the partnership agreement]." The inquiry did not end there, however, because the court had determined in an earlier, related action that the implied covenant of good faith and fair dealing constrains the special

approval process and, thus, must be considered.

Enterprise Products GP, the only defendant that signed the partnership agreement, had an obligation to employ the special approval process in good faith. However, Section 7.10(b) provided Enterprise Products GP with a safe harbor. If Enterprise Products GP acted in reliance on the opinion of an investment banker "as to matters that [Enterprise Products GP] reasonably believes to be within such Person's professional or expert competence[, the act] shall be *conclusively presumed* to have been done . . . in *good faith* and in accordance with such opinion." In connection with both the 2009 sale and the merger, the ACG Committee received and relied upon fairness opinions from Morgan Stanley. Though the members of the ACG Committee were a subset of the Enterprise Products GP Board, the "only reasonable interpretation of the well-pled facts of the complaint is that Enterprise Products GP relied upon the fairness opinions in deciding whether to use the special approval process to take advantage of the contractual duty limitations provided by Section 7.9(a)." Having "conclusively presumed" under the terms of the partnership agreement that Enterprise Products GP acted in good faith in deciding to use the special approval process, the court asked whether the plaintiff could plead a claim for breach of the implied covenant of good faith and fair dealing in the negative. Because Section 7.10(b) applies to any action taken by Enterprise Products GP, the court concluded that it was protected

from any good faith claim "arising under the duty of loyalty, the implied covenant, and any other doctrine."

In contrast to *Gerber*, the merger at issue *In re K-Sea* did not involve an affiliate of the general partner of the limited partnership. Therefore, Vice Chancellor Parsons relied on the contractual standard of review in the limited partnership agreement relating specifically to mergers, rather than the partnership agreement's more general "special approval" process in dismissing the complaint against the defendants.

In March 2011, K-Sea Transportation Partners L.P. ("K-Sea" or the "Partnership") entered into a merger agreement with Kirby Corporation (Kirby), whereby Kirby agreed to acquire all of K-Sea's equity interests. The parties allocated \$18 million of the merger consideration to acquire incentive distribution rights (IDRs) held exclusively by K-Sea's general partner (K-Sea GP). Recognizing a potential conflict of interest, K-Sea's board directed a committee of independent directors (the Conflicts Committee) to review Kirby's offer and make a recommendation. A few months before the merger negotiations began, the K-Sea Board granted "phantom units" to each member of the Conflicts Committee, which entitled the holders to one K-Sea unit or its cash equivalent with vesting of the units occurring immediately upon a change of control transaction. Plaintiffs attacked the merger, arguing that the Conflicts Committee's approval process was defective, and that K-Sea GP, its affiliates and the K-Sea Board

committed contractual and fiduciary breaches.

The court began its three-step analysis of the plaintiffs' claims with a review of the partnership agreement. Articles 7 and 14 of that agreement supplanted the defendants' default fiduciary duties with a contractual standard of review, governing the approval of mergers. Sections 7.8 and 7.10 of the partnership agreement established a contractual standard of review: "K-Sea GP, KSGP, and the members of the K-Sea Board may be liable for money damages for a breach of the LPA, or of any default fiduciary duty not eliminated by the LPA, only if that breach resulted from an act or omission done in bad faith, and K-Sea GP is conclusively presumed to have acted in good faith if it relied on an expert it reasonably believed to be competent to render an opinion on the particular matter." Next, the court looked to Article 14 of the partnership agreement, which dealt with mergers, because the alleged contractual and fiduciary violations related to defendants' approval of the merger. Sections 14.2 and 7.9(b) of the partnership agreement afforded K-Sea GP discretion in deciding whether to approve a merger. Though K-Sea GP was "entitled to consider only such other interests and factors as it desires," and need not consider the interests of the partnership or the limited partners, it could not exercise its discretion "in a manner inconsistent with the best interests of the Partnership as a whole." When Sections 14.2, 7.9(b), and 7.10(d) are read together, the court reasoned that for plaintiffs to state a claim predicated on defendants' approval

of the merger agreement, plaintiffs must establish that K-Sea GP approved the merger agreement in bad faith. However, Section 7.10(b) entitled K-Sea GP to "a conclusive presumption of good faith whenever it acts in reliance on an expert opinion. . . ." K-Sea GP relied on a fairness opinion from Stifel Nicolaus & Co., stating that the merger was fair to K-Sea's common unitholders.

The court rejected plaintiffs' reliance on Section 7.9(a) of the partnership agreement, which applied in the case of a conflicted transaction. That section was virtually identical to Section 7.9(a) of the partnership agreement in *Gerber* discussed above, and expressly permitted "special approval" of a conflicted transaction. However, nothing in Section 7.9(a) or Article 14 of the partnership agreement required that the merger be "fair and reasonable," because Kirby was an unaffiliated third party. Though K-Sea GP could have used the special approval process to immunize the merger, its decision not to do so did not mean that liability followed automatically. Rather, as discussed, K-Sea GP had to establish that it exercised its discretion in good faith. Consistent with its earlier decision in *Gerber*, the court held that a plaintiff cannot plead a claim for breach of the implied covenant of good faith and fair dealing where a defendant is conclusively presumed to have acted in good faith by the terms of the governing agreement. Because K-Sea GP was conclusively presumed to have acted in good faith by relying on Stifel's fairness opinion, the court found that plaintiffs could not identify any reasonably conceivable set of

circumstances susceptible to proof that would support a finding that any defendant breached a duty by approving the merger.

### ***Auriga, Gerber, and In re K-Sea: Investors' Folly***

Though some may disagree, the decisions in *Auriga, Gerber, and In re K-Sea* exhibit the court's wisdom, not folly. Moreover, these decisions are entirely consistent with each other. *Auriga* provided needed clarity to Delaware alternative entity law by confirming what practitioners have long thought: those in control of Delaware alternative entities owe traditional fiduciary duties by default unless those duties are expressly altered or eliminated by the partnership or operating agreement. *Auriga* also reaffirmed the Court of Chancery's respect for the investors' right to contract away those default rights and protections. To put it more bluntly, the decision in *Auriga* should be recognized for what it is—judicial recognition of the parties' right to order their affairs by contract, and for what it is not—judicial paternalism. The parties in *Auriga* chose not to, or failed to, eliminate default fiduciary duties and, in doing so, left intact the court's very powerful gap-filling and remedial powers. The court simply exercised those powers to address the parties' dispute.

By contrast, in *Gerber* and *In re K-Sea*, the parties effectively displaced default fiduciary duties and constrained the application of the implied covenant of good faith and fair dealing in the partnership agreements, thereby eliminating the court's most powerful "remedial and

gap-filling powers,” as the Court of Chancery explained in *Loneragan v. EPE Holdings LLC*:

When parties exercise the authority provided by the LP Act to eliminate fiduciary duties, they take away the most powerful of a court’s remedial and gap-filling powers. As a result, parties must draft an LP agreement as completely as possible, and they bear the risk of incompleteness. If the parties have agreed how to proceed under a future state of the world, then their bargain naturally controls. But when parties fail to address a future state of the world—and they necessarily will because contracting is costly and human knowledge imperfect—then the elimination of fiduciary duties implies an agreement that losses should remain where they fall. . . .

Respecting the elimination of fiduciary duties requires that courts not bend an alternative and less powerful tool into a fiduciary substitute. . . . To use the implied covenant to replicate fiduciary review “would vitiate the limited reach of the concept of the implied duty of good faith and fair dealing.”

Indeed, as the court noted in *Gerber*, the implied covenant is nothing more than a gap-filler. Where the contract has no gaps, as was the case in *Gerber* and *In re K-Sea*, the implied covenant is not applicable. Thus, the

folly, if any, in *Gerber* and *In re K-Sea* was not the court’s, but the minority investors’. After all, in Delaware, as in many states, investors are charged with assessing and accepting the risks that come with investing in an alternative entity, where the operating or partnership agreement eliminates or drastically alters default fiduciary duties and constrains the application of the implied covenant.

Stay tuned. The decisions in *Gerber*, *Auriga*, and *In re K-Sea* are all on appeal to the Delaware Supreme Court, which may issue a ruling in each case by the end of the year.

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## Training for Tomorrow:

### Corporate Counsel Checklist for a D&O Protection Program

The ABA Business Law Section's Director and Officer Liability Committee has this year sponsored two programs titled "Protecting the Corporate Director," one live and another through a national webinar. The programs have received excellent reviews. They were intended to introduce the following [Corporate Counsel Checklist](#). The Checklist is intended to give corporate counsel—who are not and cannot be experts in the intricacies of this area of the law—a basis to supervise and manage the creation or renewal of an executive protection program by making sure that the firm's professional advisers and risk manager have expressly considered each of the items on the list. The list was created in response to requests by corporate counsel tasked with managing such a program for a guide to ensure that the rights and exposures of both corporations and executives are properly balanced.

The Committee's programs partially explored the history of and justification for the Checklist's provisions directed at Fifth Amendment and document access rights of indemnified directors and officers, reviewed recent case law bearing on a number of other checklist issues, and then discussed in considerable detail the nature, purpose, and extent of Side-A only "difference-in-conditions" cover, an increasingly important component of responsible executive protection programs. The latter discussion was enhanced by involving a strong representative from the D&O insurance broker industry who added a perspective and experience rarely heard at ABA gatherings.

What emerged from these programs is a realization that the overwhelming mass of corporate by-laws and D&O insurance policies presently in use fail to take account of the fact that the

most dangerous and potentially catastrophic exposure faced by executives is that of being without the legal right to enforce advancement of defense costs they may incur incident to an internal or governmental investigation. Existing policies and by-laws were written in the pre-*Arthur Andersen* context where executives may have been added as personal defendants in claims and lawsuits primarily directed against their corporations, and where both parties could generally share joint counsel.

Since *Andersen*, however, executives, not their corporations, find themselves in the front line of potential criminal liability with interests adverse to the corporation and other executives. This is because, under America's system of plea-bargaining, other executives and the corporation itself seek to "cooperate" with enforcement authorities, leaving

those who may be only marginally aware of wrongdoing, or falsely accused by others, without assistance or protection at great personal cost. The ethical implications of this for house counsel and others who preside over the creation or renewal of executive protection programs where the executives are mostly without separate representation, remains largely unexplored and will likely be the subject of further attention by the Committee. They appear to be significant.

Final take-aways from the programs were:

1. The Committee endorses the "three-legged stool" approach of Delaware commentary, i.e., every executive protection program should rest on a combination of (a) maximum use of statutory exculpation opportunities where possible, (b) indemnity by-laws (usually) that not only express the concept of mandatory advancement and indemnity rights "to the fullest extent permitted by law," but do their best to make those rights real; and (c) effective D&O insurance that truly protects them against undue erosion of limits and catastrophic loss by accessing the best cover available in a rapidly-changing market.
2. Historically, D&O insurance and corporate indemnity programs focused on protection from claims from third parties such as shareholders, employees, competitors, and regulators who generally directed their attention at both corporations and their

executives equally. But since *Arthur Andersen*, that is no longer true, given that corporations can obtain deferred prosecution agreements by cooperating with enforcement authorities, thereby placing executives in the front line of corporate criminal exposure, sometimes under laws that substantially water down the government's need to show *mens rea*. One of this Committee's functions is to educate corporate practitioners to this new reality and suggest balanced solutions consistent with the above "three-legged stool" approach to executive protection.

3. Under modern practice, this means that in-house or outside counsel whose client is exclusively the corporation is in the position of supervising the creation of what amounts to an unregulated benefit program for directors and officers. While protection "to the fullest extent permitted by law" is expressed as the goal, the interests of the corporation in being able to manage costs and to be able to deal with true bad actor scenarios conflict with executives' expectations that the corporation will stand behind them, at least in grey area circumstances. Balancing these competing interests is not easy.
4. The Delaware cases already make clear that a corporation's desire not to advance or indemnify for such things as insider trading, claims of diversion of corporate opportunity, embezzlement, etc., should be expressly negotiated

into a by-law or indemnity agreement at the outset. Similarly, the corporation's right to terminate a director or officer for "taking Five" in a corporate internal investigation and to refuse advancement if the executive declines to expressly assert his or her *innocence* (yes, *innocence*) should be disclosed at the time a protection program is instituted or renewed. These discussions should encourage the parties to discuss possible limits to the corporation's total monetary advancement and indemnity liability as part of an overall conversation of aggregate insurance limits and the possible acquisition of "Side-A only" cover for some key executives. Only a negotiated resolution of these issues in an atmosphere of disclosure can hope to satisfy counsel's ethical duties, protect the board from criticism by shareholders that it has unknowingly made overly-expansive promises of advancement and indemnity to perceived miscreant executives, and guarantee that the right executives receive advancement to the correct extent.

The Committee intends to monitor developments on these fronts in both the insurance markets and through results of litigated cases. It intends to revise its checklist annually to reflect new developments. In this manner, the Committee's work hopes to provide best practice support to corporate counsel in developing responsible, comprehensive, and balanced executive protection programs.

/s/ James D. Wing, co-chairman, D&O Insurance Subcommittee of the [Director and Officer Liability Committee](#) of the Business Law Section. Mr. Wing acknowledges the extensive contributions to the checklist of his partner, Thomas A. Bentz. Mr. Wing's email address is [james.wing@hklaw.com](mailto:james.wing@hklaw.com).

*To access the Committee's Corporate Counsel Checklist, please turn to the next page.*

## Corporate Counsel Checklist for Supervising Creation/Renewal of D&O Protection Program

To obtain and retain effective directors and officers (executives), corporations employ risk managers, outside counsel, and insurance brokers to protect them from personal financial and criminal liability. Their task is to create a comprehensive program to protect them from claims that they have been guilty of wrongful acts or omissions while serving the corporation. The protection consists of four elements: (1) legal immunity from claims for damages resulting from directors' failure to exercise due care; (2) advancement to selected executives of defense costs and expenses until any claim is resolved and then relieving them from any duty to repay the amounts advanced; (3) indemnifying them for any additional amount they may agree to pay in settlement of such a claim or that they may be compelled to pay by judgment; and (4) a credible program of D&O insurance coverage.

The first element, statutory exculpation, is simply a matter of verifying whether the correct language appears in the corporation's certificate or articles of incorporation.

The second, third, and fourth elements—rights to advancement of defense costs, relief from the duty to repay the advances, and indemnity against settlements and judgments—is found usually in corporate by-laws. By-laws frequently state that some number of executives will be advanced defense costs and indemnified "to the fullest extent permitted by law." While this phrase is facially expansive, it is in fact a limitation, because no corporate statute permits indemnity for all conceivable claims against executives. Further, developing case law and prosecutorial techniques create significant hurdles to realizing the goal implicit in that phrase: making sure that the entity's by-laws actually provide the maximum rights to advancement and indemnity that the law permits.

Directors' and Officers' (D&O) liability insurance is the fourth element of a protection program and is intimately related to the issues of advancement and indemnity. Indeed, the corporation's obligation to indemnify its executives "to the fullest extent permitted by law" is these days written into most D&O insurance policies as a de facto covenant of the corporation procuring the coverage for them.

What follows is a checklist intended to guide an attorney serving as counsel to a corporation tasked with overseeing specialists in risk management and insurance who recommend an executive protection program:

### **I. Director Exculpation under Certificate/Articles of Incorporation**

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## II. Advancement and Indemnity

Executives may be given a right to advancement of reasonable defense costs for all claims against them arising from their service, and a mandatory right to be relieved from repaying these advances. They may also be indemnified for any ultimate settlement or judgment against them under corporate by-laws or formal indemnification agreements. In all cases, however, these rights exist only if and to the extent that advancement and indemnity is permitted by governing law.

Checklist issues are:

- A. Are the advancement and indemnity rights contractually mandatory, or are they only to be conferred by separate action of the board on a discretionary basis after a claim arises?
- B. If granted in by-laws, is the board prohibited from amending the by-laws to eliminate protection for circumstances that accrue during the executive's tenure but before a claim is made?
- C. Does the right to advancement accrue at a sufficiently early stage to protect the executive without causing premature "lawyering up" that is detrimental to corporate collegiality and informal communication?
- D. Does the right to advancement cover derivative demand, special litigation committee, and corporate internal investigations?
- E. If the corporation has foreign subsidiaries on whose boards executives are expected to serve or if they are expected to otherwise supervise foreign operations, is the corporation obligated to post bonds or otherwise pay to secure the release of the executive's person from physical arrest and the executive's personal assets from sequestration orders issued by a foreign court or governmental agency?
- F. If the executive is in any way implicated in a matter that creates potential personal criminal exposure, does the executive:
  - i. have access to (but not possession, custody, or control over) all relevant corporate documents useful to the executive's defense?
  - ii. have the express right to assert Fifth Amendment privileges (and his or her lawyer the right to assert work product privileges) without jeopardizing the executive's advancement and indemnity rights or limiting the amount of defense costs for which the executive is entitled to advancement? Does the by-law specify a mechanism for resolving privilege disputes?
  - iii. have the right to receive advancement of defense costs until at least the first "final adjudication" (i.e., after appeal) of facts that forbid the corporation from indemnifying the executive under the relevant corporate law, provided these facts are found in a criminal case against the executive or in a U.S. civil case in which the executive has participated without asserting Fifth Amendment rights? Is the corporation prohibited from instituting or continuing any civil case against the executive that requires the executive to assert Fifth

- Amendment rights before final adjudication of any actual or threatened claim that gives rise to the right to advancement?
- iv. have the right to subrogate to the corporation's Side B coverage should the corporation refuse to advance defense costs and the D&O pay such a cost directly?
  - v. have the right to judicially compel advancement at the corporation's expense without making any assertions of fact, good faith, or innocence? If the governing corporate law requires such an assertion as a condition to advancement, is the executive protected by insurance? (See next section in respect of DIC cover.)
- G. If the executives' advancement and indemnity rights cover claims that are broad in scope, does the board understand that the broad definition may include a duty to advance reasonable defense costs in an unlimited amount in respect of claims for insider trading, embezzlement of the corporation's assets, or allegedly criminal conduct against third parties, leaving the corporation in a delicate public relations situation should such a claim occur and uninsured defense costs rise to a substantial level? If the corporation elects not to advance or indemnify for claims in which an executive is accused of obtaining an improper personal benefit, is that intention adequately expressed in the bylaws and is it consistent with similar exclusionary language contained in the corporation's D&O insurance policies?

### III. D&O Insurance

A corporation typically obtains what is called "Side A and B" or "Side ABC" insurance to backstop its advancement and indemnity obligations and to provide its executives direct coverage for certain defined claims. It may then expand protection to particular executives for certain matters for which the corporation may not legally indemnify, financially cannot indemnify, or for which the corporation refuses to indemnify. This type of cover is excess over both the corporation's duty to advance and indemnify under the corporation's by-laws and the Side A and B cover. This type of insurance is called "Side A-Only Difference-in-Conditions" (DIC) cover. To the extent any refusal by the corporation or the Side A and B insurer to advance or indemnify the executive is unlawful, the DIC carrier is subrogated to the executive's rights against them.

Checklist issues are:

- A. Are all individuals that the board wishes to insure in fact covered? Are those it does not wish to cover excluded from the policy definition of insured?
- B. Has the board made a reasoned and appropriate decision on policy limits, particularly given that under its Side B coverage, it seeks to cover its complete advancement and indemnity exposure to all covered executives beyond its agreed retention? Are all parties cognizant of the phenomenon of competition among insureds for access to policy limits and the accepted means for reducing such competition?
- C. Does the policy cover defense costs within overall limits or through sublimits for matters such as derivative investigations (both those that arise immediately after demand and those that arise after the creation of a special litigation committee) and corporate internal investigations, even

though there is no definition of any charge or claim nor assertion that the executive may be personally implicated in misconduct, which facts may not otherwise constitute a defined "claim" subject to policy coverage?

- D. Where advancement coverage incepts under "C" above before a defined "claim" under the corporation's ABC policy arises, does the policy contain a provision that gives the insured the option of not treating an event less than a defined "claim" as a reportable claim or mandatorily-reportable circumstance?
- E. Does the policy cover employment practice claims, crisis management costs, and claims against employed lawyers? If the latter have separate professional liability cover, is it clear which cover is primary?
- F. Is the policy definition of "wrongful act" sufficiently expansive so that "all risk" coverage is obtained, assuming such is the desire?
- G. Does advancement coverage expressly continue until there has been a final adjudication of facts in the underlying proceeding for which advancement is given that permits the application of the "willful or intentional act" policy exception, and is the insurer prohibited from bringing any suit to accelerate that process?
- H. Is the insurer prohibited from recovering its advances should the conduct fall within the "willful or intentional act" exclusion?
- I. Is the definition of "loss" sufficiently expansive? Does it exclude the types of claims for which the board may not wish to grant advancement and indemnification rights such as insider trading, embezzlement, and money laundering?
- J. Does the policy contain an exclusion for claims against executives that seek to recover amounts that the corporation should have paid in addition to amounts it did pay in a merger, share exchange, or sale transaction? If so, are executives entitled to advancement and indemnity if personally sued in such a case without being required to allocate their defense costs between other covered claims and the claims seeking an increase in consideration? Generally, are executives permitted to be advanced and indemnified against all legal costs in any matter that also includes uncovered claims or parties so long as the facts or issues relevant to the covered and uncovered claims overlap?
- K. Are the exclusions for illegal conduct, "other insurance," and timing of claims (including the provisions relating to giving of notice of claim or circumstance), reasonable and readily understandable? Are the "notice of circumstance" provisions objective, subjective, or both; mandatory or permissive?
- L. Is there an "insured-versus-insured" exclusion and, if so, is it phrased narrowly to exclude only truly collusive claims?
- M. Does the insured entity have in place reporting mechanisms to ensure that the risk manager is kept fully informed of any potential claim or circumstance requiring notice to the insurer? Does

the insurer bear the burden of establishing prejudice from late notice and is its remedy for late notice limited to the actual damage it sustains as a result?

- N. Does the policy permit an executive subject to potential or actual criminal charges to assert Fifth Amendment rights, and his or her counsel assert work product privileges, without violating the policy's cooperation clause or limiting the executive's recovery of defense costs due to a claim by the insurer that the executive's counsel has provided insufficient descriptions of services rendered in billings or otherwise? Is there a severability clause that protects "cooperating" executives should "non-cooperating" executives be held to violate a cooperation clause
- O. Is the policy's definition of "application" reasonably narrow and understandable? Are the covenants and representations made by the corporation and any insureds in either the application or the policy reasonable and understandable?
- P. Is there an application severability provision that insulates innocent executives from a claim of application fraud due to the guilty knowledge of less than all of their number?
- Q. Are there appropriate limits on the insurer's right to rescind a policy, such as an incontestability clause? Is the insurer's right to cancel the policy appropriately limited?
- R. Is there a settlement "hammer" clause and has it been appropriately drafted to avoid unfair and unintended results?
- S. Does the policy sufficiently define the parameters of the consent-to-settlement clause and the clause permitting the insurer to associate counsel to eliminate micro-management of the defense?
- T. Is there an "order of payments" provision sufficient to reasonably mitigate the effects of a corporate insolvency?
- U. Are the claim reporting time limits reasonable? Does a broad definition of "claim" result in an undesirable expansion of the insureds' duties to give notice of claims or circumstance?
- V. Have the implications of "DIC" or "dedicated limits" coverage for directors as a group, or outside directors only, been appropriately vetted and explored to provide advancement and indemnity coverage (1) for claims that the corporation's by-laws and the underlying ABC policy does not cover, (2) where the corporation refuses or is unable to advance defense costs and indemnify, and (3) to mitigate the risk of program failure due to competition among competing insureds for policy limits?
- W. Does the policy insure executives for costs of obtaining release from incarceration and release of sequestered personal assets if they act as directors or agents of a foreign subsidiary or act for the parent corporation in a foreign country?
- X. Does the carrier selected have a reasonable financial rating and a good reputation for claims handling and payment?



- Y. Do the insureds have the right to recover their attorneys' fees under applicable law should they be required to litigate coverage with the insurer?
  
- Z. Are there to be one or more excess policies above the negotiated first-tier policy that do not "follow the form" of the first-tier policy, and, if so, have questions "B" through "Y" above been asked in respect of each of the excess policies? Has there been separate consideration of the effects of arbitration and choice of law clauses in these policies as potentially derogating from the executives' contemplated protection, particularly if they mandate arbitration in jurisdictions unfamiliar with U.S. plea bargaining? Do these policies have appropriate provisions relating to when each layer of excess coverage attaches so as to avoid gaps in protection, including provisions requiring that upper tiers "drop down" should insureds reach a settlement with the lower-tier carrier below its policy limits?
  
- AA. Have the appropriate locally issued D&O policies been obtained in respect of foreign subsidiaries and operations?

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## Training for Tomorrow: Corporate Counsel Checklist for Supervising Creation/Renewal of D&O Protection Program

To obtain and retain effective directors and officers (executives), corporations employ risk managers, outside counsel, and insurance brokers to protect them from personal financial and criminal liability. Their task is to create a comprehensive program to protect them from claims that they have been guilty of wrongful acts or omissions while serving the corporation. The protection consists of four elements: (1) legal immunity from claims for damages resulting from directors' failure to exercise due care; (2) advancement to selected executives of defense costs and expenses until any claim is resolved and then relieving them from any duty to repay the amounts advanced; (3) indemnifying them for any additional amount they may agree to pay in settlement of such a claim or that they may be compelled to pay by judgment; and (4) a credible program of D&O insurance coverage.

The first element, statutory exculpation, is simply a matter of verifying whether the correct language appears in the corporation's certificate or articles of incorporation.

The second, third, and fourth elements—rights to advancement of defense costs, relief from the duty to repay the advances, and indemnity against settlements and judgments—is found usually in corporate by-laws. By-laws frequently state that some number of executives will be advanced defense costs and indemnified "to the fullest extent permitted by law." While this phrase is facially expansive, it is in fact a limitation, because no corporate statute permits indemnity for all conceivable claims against executives. Further, developing case law and prosecutorial techniques create significant hurdles to realizing the goal implicit in that phrase: making sure that the entity's by-laws actually provide the maximum rights to advancement and indemnity that the law permits.

Directors' and Officers' (D&O) liability insurance is the fourth element of a protection program and is intimately related to the issues of advancement and indemnity. Indeed, the corporation's obligation to

indemnify its executives "to the fullest extent permitted by law" is these days written into most D&O insurance policies as a de facto covenant of the corporation procuring the coverage for them.

What follows is a checklist intended to guide an attorney serving as counsel to a corporation tasked with overseeing specialists in risk management and insurance who recommend an executive protection program:

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