

# Chapter 13

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## Closing Considerations

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## § 13:1 Introduction

This chapter deals with two general topics. The first topic is the way in which one lender can take another lender out of a particular credit. This topic is included because the takeout of a prior lender is generally treated as nothing more than a closing condition, even though the issues involved may affect the planning that takes place before the closing. The second topic is the steps that should be taken in connection with any closing, whether it involves a borrower

that is not currently being financed or a borrower that already has a lender that needs to be taken out. Issues as to the structuring of the new lender's loan are considered in the chapters dealing with the particular types of loan transactions even though those issues cut across this chapter as well, in the sense that even if the new lender were to take over the position of the prior lender,<sup>1</sup> the documents would be amended and restated to reflect the deal made with the new lender.

## **§ 13:2     Receivables Finance Takeover**

In all lending situations, the new lender has a basic choice to make in terms of its approach. The discussion here will focus upon the takeover of a receivables financing, but the principles discussed here also apply to most other forms of financing.

### **§ 13:2.1     Alternative Choices**

The customary choices are to purchase the position of the prior lender or to make a new loan and pay the prior lender off.

#### **[A]     Purchase of Position**

The idea of purchasing the position of the prior lender has certain initial attractions. The principal one is that other creditors may have financing statements on file after those of the prior lender and the purchase of the prior lender's position should mean that the new lender does not have to obtain from those creditors the subordinations it would have to obtain in order to gain priority for a new loan. Note, however, that the new lender should run its own current searches to be sure that the old lender actually held the priority it purported to hold.

Other attractions could include the utilization of loan documents with which the borrower is already familiar, to the extent that the documents reflect the new lender's deal; the relative speed of doing the initial takeover through the avoidance of protracted negotiations over a new set of loan documents, at least in the first instance; and possible avoidance of the need for renewed authorization procedures on the borrower's side (although the lender will want those procedures followed to the extent that the new relationship is ultimately to be upon modified terms).

The principal disadvantage is that the new lender does not really know what it is getting. Even though the old lender gives the new lender all formal written documents evidencing the transaction, there

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1.     Discussed below in section 13:2.1[A].

may have been correspondence or other dealings between the parties that could be found by a court to have modified the relationship between the old lender and the borrower. Significantly, there may be offsets or defenses of the borrower against the loan from past transactions, and lenders who are being taken out of a loan relationship are almost always unwilling to give extensive representations and warranties as to the status or validity of the loans.<sup>2</sup>

Another disadvantage, in most cases, is the necessity of preparing one set of papers for the takeover and another to amend the old papers to reflect the terms of the new transaction. Additional disadvantages include concern (if the new lender intends to change the terms of the loan relationship by amendments executed after the takeover) over cases that say that a substantial expansion of the scope of the financing covered by the original financing statements requires a new filing and does not qualify for protection under the umbrella of the original filing<sup>3</sup> and concern by some that after the assignment the transaction is not covered by a financing statement that “provides the name of the secured party,” as prescribed by U.C.C. section 9-502, even though the assignee has become the “secured party of record”<sup>4</sup> and therefore that filing is not effective with respect to advances made after the date of the assignment to the new lender.<sup>5</sup>

### **[B] Payout of Old Lender**

In practice, the easiest way to take out a prior lender is to pay off its debt and have it release all of its security interests. The new lender may have to go to other existing secured creditors, if there are any, to obtain subordinations of their positions that would otherwise be prior to the new lender’s position, but at least the new lender will be in control and will have the option of withdrawing before the closing occurs in the event it discovers insoluble problems. On the downside, there can be timing issues that make the payout route cumbersome,

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2. The most that the new lender is likely to get is a representation that the amount of the loan shown on the books of the old lender is a stated amount, that it has the requisite power and authority to assign the loan, that the loan being assigned is free from any liens, and that the old lender has not previously assigned any interest in the loan to anyone else. See section 13:2.2[A] below for other items that the new lender might ask for in appropriate cases. To some extent, a lack of representations from the old lender can be mitigated by obtaining representations and warranties from the borrower in a cooperative takeover. *See* (f) in section 13.2.2[A] below.
  3. These cases are not supported by the U.C.C., but they exist.
  4. U.C.C. § 9-511(b).
  5. Clearly, security interests securing loans made before the date of the assignment would continue to be covered by the filing. *Id.* § 9-310(c).

but solutions are usually available.<sup>6</sup> In short, though, there do not seem to be any significant disadvantages to this approach as opposed to the takeover approach, other than some essentially logistical problems.

## **§ 13:2.2      *Mechanics***

### **[A]      *Purchase***

The elements to be considered in connection with the purchase of a prior lender's position should include the following:

- (a) Obtain copies of all documents that evidence the prior lender's position. This may sound unbearably elementary, but there will be a great temptation to stop with the basic loan documents and the accompanying guarantees, security agreements, etc. Many times, critical elements of the deal are contained in supplemental documents or in amendments to the basic documents, and they must not be overlooked. As a corollary, all relevant correspondence and memoranda must also be reviewed.
- (b) The documents should be reviewed both for the substance of the transaction between the prior lender and the borrower and for the documents' transferability. Any shortcomings in the agreements between the prior lender and the borrower should be able to be fixed at the time of transfer, because the borrower is (in most instances) cooperating in the transfer. Third parties that have given guarantees, subordinations, or hypothecations may, however, not be so accommodating.
- (c) Related documents of the borrower, particularly other agreements containing negative covenants, must be examined. Even though a party to such agreement gave its consent for the benefit of the prior lender does not mean that the consent is broad enough to permit the new lender to carry out the terms of the new loan facility.
- (d) Run a lien search in all of the places that would be searched if the lender were making a new loan and check to see that this list of filing offices agrees with the list of filing offices where the old lender has actually filed. It is not sufficient to rely on

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6. An example might be the unwillingness of the old lender to release possessory collateral until paid, contrasted with the unwillingness of the new lender to make the advance until it has the possessory collateral in its possession. The old lender is not always willing to cooperate with suggestions as to how to break the deadlock.

the prior lender's acknowledgment copies of its filings. The prior lender may have decided to go ahead with the loan notwithstanding the existence of some prior liens. The search may also reveal some subsequent filing in connection with which, for example, an inventory purchase money notice<sup>7</sup> may have been given that is not reflected in the documents delivered by the prior lender. The search is also important because lenders who are being taken out, even if they are being cooperative, are almost always unwilling to give warranties as to the priority of their liens.

- (e) Prepare appropriate transfer documents. These should convey all right, title, and interest of the prior lender in and to, and all rights of the prior lender under, the entire list of documents disclosed under section 13:2.1[A] above.<sup>8</sup> The warranties that can reasonably be requested from the prior lender in the transfer documents include:
  - (1) A warranty as to the amount owing by the borrower on the closing date. Most lenders will limit this provision to a representation that "the amount owing by the borrower, according to the books and records of the lender, is \$\_\_\_\_\_." The prior lender will rarely warrant the absence of defenses or counterclaims, but may be willing to warrant that it has not itself done anything to reduce or to release the borrower from the obligations under the documents;
  - (2) A representation that the prior lender owns, or has the right to transfer to the purchasing lender, the rights being transferred; and
  - (3) A representation that the transfer will be free and clear of liens and other adverse claims.
- (f) If the takeover is occurring with the consent and involvement of the borrower, the borrower should be required to confirm, in writing, a number of things:
  - (1) the amount of debt outstanding and that the sum is owing without defense, offset, or counterclaim of any kind by the borrower and a waiver of any such defense, offset, or counterclaim (whether known or unknown);

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7. U.C.C. § 9-324(b).

8. The old axiom that "the collateral follows the debt" may cure an omission, *Hager v. Gibson*, 109 F.3d 201 (4th Cir. 1997).

- (2) the completeness and accuracy of the documents furnished to the buyer by the seller, and that there are no agreements or understandings of any kind that are not reflected in such documents;
- (3) the compliance of the documents with all applicable provisions of law and the noncontravention by the documents of any other agreements or restrictions to which the borrower or any of its property is subject;
- (4) the priority of the liens securing the obligations under the documents.

**[B] Payout**

The elements to be considered in connection with a payout of the prior lender's position (in addition to the preparation of the new loan documents and related resolutions, certificates, etc.) should include the following:

- (a) While a detailed review of the prior lender's documentation is less important in a payout, it is nevertheless desirable to conduct a summary review in order to determine whether there are any aspects of the relationship that are handled in a way that discloses some information about the borrower that the new lender may not yet have uncovered. This could include references to outside restrictions or intercreditor agreements, or operational or structural irregularities. The documents may also disclose negotiating positions of the borrower that may be helpful to the new lender in completing the contemplated deal.
- (b) Related documents of the borrower must be examined to see if there are any conflicts or restrictions that must be dealt with either by amendment of such other documents or by the obtaining of simple consents or waivers. These consents or waivers can take several forms, depending on the posture of the other party. They can be limited to the specific new lender and the specific documents or arrangements under contemplation at the time or they can be limited to the type of transaction that is occurring, with limitations spelled out to a greater or lesser degree.
- (c) Run U.C.C. lien searches as described in section 13:5 below. Tax lien and judgment searches are also important, as are litigation searches. The searches for tax liens may be readily conducted at the same time as U.C.C. lien searches. Judgment and litigation searches are harder, if only because judgments

can be entered and lawsuits can be filed almost anywhere in the country, given the liberal jurisdictional requirements that apply. It may be appropriate, in the case of judgments and litigations, to rely on the audited reports prepared for the borrower by its certified public accountants, because anything material in the way of judgments or litigations should show up in the footnotes to the report. Those reports, though, will rely on the evaluation of pending litigations given by borrower's counsel and may, for that reason, omit mention of items that would otherwise be of interest to the new lender. Accordingly, it may be appropriate to select a few key jurisdictions in which the borrower carries on most of its important business and run the litigation searches there, on the assumption that the borrower would be likely to be sued there, but keep in mind that the search should not be considered absolutely comprehensive.

- (d) Based upon the liens disclosed by the searches, releases in appropriate form must be prepared, or intercreditor agreements obtained from the competing creditors. The old lender will, obviously, give a full termination of its liens and security interests.<sup>9</sup> Other creditors, if not paid out at the closing, should either subordinate their liens or security interests to those of the new lender, or the new lender must be prepared to accept the existence of those liens or security interests in making its overall credit judgment as to the risks of the transaction. The ability to prime existing liens by means of one of the purchase money options under U.C.C. section 9-324 is not available in a takeout context. On the other hand, prior liens on property on which the new lender is not specifically relying should not be a problem.
- (e) A payoff mechanism must be established, if a prior lender or prior lien is to be paid out. If the prior lender will not participate in the closing (which rarely occurs), it may be possible to establish an escrow, formal or informal, of the releases so that they will be delivered upon payment of the proper sum. Otherwise, the arrangement would be (and this

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9. Sometimes, the new lender will obtain a so-called "dry" assignment (*i.e.*, without the underlying obligation) of the old secured party's security interest or financing statement. The reaction of the courts to this procedure, so far, has been mixed. *Compare In re Camp Town, Inc.*, 197 B.R. 139 (Bankr. D.N.M. 1996), with *In re Leisure Time Sports, Inc.*, 194 B.R. 859 (Bankr. 9th Cir. 1996). One court even allowed the new lender to succeed, by subrogation, to the old lender's financing statements. *Rinn v. First Union Nat'l Bank of Md.*, 176 B.R. 401 (Bankr. D. Md. 1995).

is the approach taken most commonly with the lien creditors who are to be paid out) to obtain a letter (the payoff letter)<sup>10</sup> from the creditor giving the principal amount of and accumulated interest on its debt as of a current date and also giving the additional amount of interest that would accumulate each day thereafter (that is, the per diem),<sup>11</sup> and agreeing that upon payment of the unpaid principal together with interest up to the actual payoff date its security interests will terminate and it will deliver proper releases of its security interests and all related filings. Occasionally the process can get sticky, with the old lender being unwilling to cooperate in the issuance of a payoff letter or to facilitate the delivery of possessory collateral, particularly pledged interests or instruments, until the money is received. Generally, it is the new lender, being anxious for the business, that will make the leap of faith and allow the money to go out before the collateral package is complete.

- (f) The different methods of payment that can be used include payment by certified or bank check, wire transfer, or internal bank funds transfer. Payment by check is less common in current practice because of the time it takes to convert the check into “good funds” that are freely usable by the old lender. In unfriendly situations, too, there is always the fear that payment on the check will be stopped.<sup>12</sup> The problem with wire transfers is that they require processing through the Federal Reserve Bank wire system, which, at busy times, can

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10. One issue that needs to be analyzed is the payoff letter that will be executed and delivered by the old lender. In most financings, the old lender is not actively participating and will agree that upon receipt of a sum certain its debt is paid in full and its liens are released. Practice varies as to whether this letter is addressed to the new lender or the borrower. The practical problem that the new lender has if it is not an addressee (or otherwise allowed to rely upon the letter) is the possibility that the letter will be shown to it and, subsequently, the old lender and borrower will (perhaps innocently) revise the letter. In such a circumstance, the new lender is funding based upon a misunderstanding of the amount necessary to repay in full the debt owed to the old lender.
11. Payoff letters with a per diem often require that payment be made by a certain time of the day that is earlier than the close of business. Be careful to include the per diem amount in the total payoff amount if it looks like the prior lender will be paid on such current date but after the time deadline set forth in the payoff letter.
12. Contrary to popular belief, it is possible, with the cooperation of the issuing institution, to stop certified or bank checks. This particular banking service, though, is generally available only to the largest customers of the bank.

be frustrating. The recipient of the funds will ask that it be given the Federal Reserve wire number of the transfer, both so that it can look for it at the receiving end and so that there is some comfort that the funds are actually on their way. If the wire system is especially busy, and if the money is not sent until late in the day, it has been known to take a full day before the wire number is available. This is not reassuring to the parties participating in the closing. Under the proper circumstances, namely when the new lender is a bank and the recipient of the funds is a customer of that bank or if both the new lender and the recipient of the funds are customers of the same bank, the funds can be transferred within that bank by debit and credit memos. Another advantage of the internal transfer is that the transfer can take place later in the day than a wire transfer, essentially as late as the internal procedures of the bank will allow it to issue such memos.

Whichever method of payment is adopted, the new lender must obtain from the borrower a funds flow agreement or direction letter setting forth the amount to be transferred and the recipient and authorizing the new lender to transmit the funds in the chosen manner. The document should also indicate whether the transmission is coming directly from the loan proceeds or, if the loan proceeds are first being deposited in the borrower's own bank account, from the borrower's account. The choice on this last point is essentially a trust issue unless there are reasons why the loan proceeds should not be deposited in the borrower's account.<sup>13</sup>

### **[C] Indemnities by New Lender**

Whichever form the transaction takes, if the old lender has issued commitments in its own name for the account of the borrower and is being asked to give up its collateral before those commitments expire, the old lender reasonably should be expected to request indemnities from the new lender with respect to those commitments. In addition, the old lender may have reduced the loan balance on its books by the amount of any checks that it has received either from the borrower or from customers of the borrower even before those checks have finally cleared. The old lender may request an indemnity for this, too. In the case of outstanding commitments, the indemnified items should be identified specifically and the indemnity limited to those amounts

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13. Were there, for example, to be an attachment on the borrower's account at the time, the choice would become more meaningful.

and those transactions (but not any renewals) plus normal charges incurred or accruing in connection therewith. If the outstanding commitment is not itself a letter of credit, it may be possible to get the old lender released from the commitment upon substitution of a commitment from the new lender. The indemnity on outstanding checks will not generally mention an amount, because it is difficult for the old lender to ascertain exactly what checks have not cleared as of a particular date, but the indemnity should be sharply limited as to time, requiring the old lender to make its claim for the amount of the returned checks within a specified number of days of the closing. A letter of credit is not usually required to back up this part of the indemnity.

One issue that is not generally addressed, probably because it is not susceptible of a practical solution, is the possibility that the old lender may be required to repay, as a preference under the bankruptcy laws, amounts received by it on receivables from customers who go into bankruptcy within ninety days of the payment. This risk is enhanced by the turnover to the old lender, in kind, of the customers' checks as they come in, a standard procedure in small commercial financings. The new lender will not give an open-ended indemnity, and a short indemnity is of relatively little value. Even if the customer goes into bankruptcy within ninety days of the payment, there is no guarantee that the preference claim will be asserted at any time soon thereafter.<sup>14</sup>

### **[D] General Closing Steps**

It is not the intention here to deal with all of the possible steps, in addition to those enumerated above, that might be taken in connection with a closing. Virtually all transactions will involve obtaining resolutions and certificates of a general nature from the borrower, any guarantors, and the like. The reader is left to his or her general experience in this area, to the U.C.C., and to general corporate, limited liability company, or partnership principles, as applicable. What follows are a few additional items that are specific to asset-based transactions or otherwise seem sufficiently important to be worthy of mention.

All U.C.C. filings required in order to perfect the new lender's position should be made. In the case of U.C.C. filings, it is desirable from the lender's standpoint to prefile, so that by the time the closing

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14. The old lender may have received guarantees from third parties and those guarantees may contain clauses that would provide some protection to the old lender for this risk by requiring the guarantor to resume its liability on the guarantee if any of the amounts paid to the old lender are recaptured from it.

is held, the lender will have in hand a supplemental search from each office in which a filing is appropriate, showing the lender's new filing on record and also showing that nothing new has been filed ahead of the lender, since the lender's original search was performed.<sup>15</sup> If it is not possible to put the filings of record ahead of the closing, the lender will either have to rely on its prior search plus a certificate from the borrower, or the lender will have to make, where possible, special arrangements to have the filings filed upon receipt of a telephone call from the closing. It may then be possible to run an immediate search to be sure that there is nothing of record that is not already known, but in many filing offices this will not be effective because the filing offices are so far behind in their filing and indexing work that a search in that office is only valid as of a date some days or weeks earlier. The U.C.C. filings should be reviewed at closing to ensure that the correct name of the debtor and the secured party are listed, the description of the collateral is accurate, and the filing office where such U.C.C. filings were filed or will be filed is correct.<sup>16</sup>

Any other steps required in order to perfect or protect the lender's security interests should likewise be taken. This may involve getting warehouse receipts in the lender's name (this may be difficult to arrange if there is a prior lender); delivering certificated pledged interests properly endorsed in blank to the lender;<sup>17</sup> registering liens or certificates or title; filing in appropriate offices with respect to aircraft or intellectual property;<sup>18</sup> obtaining "control" with respect to

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15. If the borrower is nervous about pre-filing by the prospective lender, it would be appropriate for the lender to give the borrower a letter specifically agreeing to terminate those filings promptly in the event that the closing does not take place by a date certain. The lender may even agree to an escrow of the appropriate termination forms.

16. See section 13:5.4, *infra*.

17. For certificated pledged interests, it is advisable to review copies of the front and back of the certificates prior to delivery to ensure that the ownership interest is accurately reflected on the certificates and that there are no problematic restrictive legends. For example, many issuers use a Securities Act of 1933 (the "33 Act") legend that conditions transfer on registration or the issuer receiving a satisfactory opinion of counsel stating that the transfer is exempt from registration under the '33 Act. Any '33 Act legend should simply condition transfer on registration under the '33 Act or exemption therefrom.

18. An international treaty known as the Cape Town Convention went into effect March 1, 2006. It applies to many twin-engine and most jet aircraft and has been acceded to by the United States. Pursuant to the treaty, security interests in aircraft and equipment that are subject thereto must be filed with an international registry in addition to the Federal Aviation Administration registry. It is important to note that the filing with the international registry will supersede the priority date of any documents filed with the Federal Aviation Administration registry.

investment property, electronic chattel paper, letter-of-credit rights, and deposit accounts;<sup>19</sup> or giving notice to third parties (for example, in the case of insurance policies).

With respect to pledged interests, the lender's counsel should review the formation documents of the issuer filed with public authorities, as well as the bylaws (if the issuer is a corporation), limited liability company agreement (if the issuer is a limited liability company), or partnership agreement (if the issuer is a limited partnership). When the issuer is a limited liability company or partnership organized in Delaware, note that Delaware has adopted a nonuniform version of U.C.C. section 9-408 (rendering ineffective certain anti-assignment clauses for the purposes of creating and perfecting security interests), which specifically exempts interests in a limited liability company or partnership from the scope thereof.<sup>20</sup> Accordingly, it is important to look for anti-assignment provisions in the limited liability company agreement or partnership agreement and obtain appropriate consents to the pledge of the interests. Additionally, even if the limited liability company agreement or partnership agreement does not restrict assignments, under the Delaware Limited Liability Act and Uniform Limited Partnership Act, an assignee does not automatically become a member (in the case of a limited liability company) or partner (in the case of a partnership) or have the right to exercise any rights or powers of a member or partner unless the limited liability company agreement or partnership agreement specifically so provides or the nonassigning members or partners consent.<sup>21</sup> Accordingly, the lender should consider requesting appropriate consents or amendments to the limited liability company agreement or partnership agreement to address this issue. Finally, it is worth mentioning that the Delaware Limited Liability Act and Uniform Limited Partnership Act call for the withdrawal of a member (in the case of a limited liability company) or the general partner (in the case of a partnership) upon the bankruptcy of such member or general partner unless the limited liability company agreement or partnership agreement provides otherwise.<sup>22</sup> Depending on the structure of the transaction, this has the potential to create a number of problems and the lender should also consider requesting appropriate amendments to the limited liability company agreement or partnership agreement to address this issue.

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19. U.C.C. §§ 9-104, 9-105, 9-106, 9-107, 9-327(1), 9-328(1), 9-329(1), 9-330(a) & (b).

20. DEL. CODE ANN. tit. 6, § 9-408.

21. DEL. CODE ANN. tit. 6, §§ 17-301, 17-704, 18-702, 18-704.

22. DEL. CODE ANN. tit. 6, §§ 17-402, 18-304.

If the loan is being made in connection with an acquisition by the borrower that requires corporate filings in order to complete the transaction (such as merger documents or recapitalization amendments to a charter), it is, of course, essential that this step occur before the lender is required to advance its funds. The best mechanism, and the one that is usually used, is to have the closing early enough in the day so that the papers to be filed can be held at the filing office subject to receipt of a telephone call, with the expectation that this will occur early enough to permit the transmittal of funds by wire or intrabank transfer. An escrow arrangement for the funds is sometimes considered, but the creation of the escrow requires that the funds be advanced by the lender, and while the lender may be comfortable that it will get the money back if the deal does not close, there may not be anyone willing to be responsible for the payment of interest on that money if the deal does not go forward.

Legal opinions are the subject of much discussion in any transaction, and asset-based loans are no exception. Setting aside the legal questions that may arise in the transaction, the first question is whether to look for an opinion at all. In the larger transactions, there is no question but that an opinion will have to be furnished by borrower's counsel. In the smaller, commercial finance type of transactions, where the borrower is a privately held company, the request for an opinion may raise objections. It may also delay or forestall the transaction because of the borrower's unwillingness to pay the cost of clearing up the problems found. In the small equipment financing or working capital financing, it may be sufficient for the lender to rely upon the certificates of the officers of the company and upon the doctrines of apparent authority.<sup>23</sup>

Appraisals are frequently of value. Appraisals may cover particular assets or they may cover whole businesses or business segments. Appraisals may be obtained from appraisal companies, investment banks, accounting firms, etc., depending on the type and nature of appraisal desired. In some cases, a simple asset appraisal may be sufficient, particularly when the nature of the business is not that complicated and the primary value enhancement comes from an updating of the value of the asset that is carried on the books of the borrower at some low historical value. Where a leveraged buyout depends for its success on the immediate disposition of one or more business divisions, an estimation of value of each of those divisions as well as the remaining business is generally requested.

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23. This is not to suggest that this is a good technical procedure. It is only mentioned as a real-world mode of operation in this context.

In any such case, the appraisal valuation standard will have to be discussed. Appraisals may be obtained, generally speaking, on the basis of

- (1) going-business (that is, at arm's length with a willing buyer and willing seller and under no particular time pressure),
- (2) liquidation (that is, by a quick sale by the owner under pressure), and
- (3) auction values.

As a refinement to this, remember that the different fraudulent conveyance laws contain different standards of valuation, namely "present fair salable value" or "fair valuation."<sup>24</sup> Fair valuation probably fits best under the first category; present fair salable value is probably somewhere between the first and second. The point to be remembered is that even an appraisal valuation will be examined with hindsight if the borrower fails. The existence of proper appraisals may help to show the good faith of the lender, thus giving it a valid lien to the extent of its advances, even if the transaction is otherwise voidable as a fraudulent conveyance.

To the extent that real estate is involved in the collateral package, regulated lenders must consult the appraisal regulations issued by the FDIC at 12 C.F.R. part 323.

Solvency letters go one step beyond simple asset appraisals in that they value the liabilities of the entity as well as the assets, thus enabling their issuers to conclude that the entity is solvent. A business appraisal would, in effect, be the same thing. Up until 1988, accountants were willing to give solvency letters with respect to leveraged entities, but that practice has been discontinued.<sup>25</sup> Solvency or business appraisals may still be available from investment bankers and appraisal or risk management companies and, in the right circumstances, should be used. They tend to be expensive and heavily qualified.

### § 13:3 Factoring

Because the factoring relationship involves the purchase and sale of receivables as well as a lending function, the takeover and closing procedures are somewhat different than for straight lending transactions.

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24. See chapter 10 (Fraudulent Transfers).

25. AICPA interpretation of attestation standards, *Responding to Requests for Reports on Matters Relating to Solvency*, Feb. 1988. See section 10:5.1 for further discussion.

**§ 13:3.1 Differences from Receivables Finance****[A] Re-Assignment of Receivables**

The primary difference between factoring and receivables financing is that the factor has purchased the receivables from the client (as opposed to receiving an assignment of receivables as collateral security) and has assumed the credit risk with respect to at least some of the account debtors.<sup>26</sup> Therefore, the client does not want the old factor to be released from its credit risk responsibilities when the new factor takes over.<sup>27</sup> Because the old factor will not continue on the credit risk unless it retains the ownership rights to the receivables, there will be no general re-assignment of receivables from the old factor to the client. If there are any receivables that have been assigned to the factor without an assumption by it of the credit risk, those receivables can be re-assigned to the client upon payment to the old factor of any amounts that have been advanced by the old factor upon the security of these receivables. However, this latter step will complicate the U.C.C. release issues discussed below.

**[B] Credit Balance**

If the old factor has not advanced to the client the full purchase price of the receivables purchased by the old factor, there will be a credit balance owing by the old factor to the client. This can either be retained by the factor until such time as all purchased receivables have been collected or the factor can remit the amount of the credit balance to the client at the time of takeover.

If the factor retains the credit balance, it will be looking to that balance as its protection with respect to receivables that do not collect out for reasons other than the account debtor's financial inability to pay, and will charge against the credit balance the amount of any purchased receivable that goes into dispute after the takeover date. It will also charge against the credit balance any other costs or claims that it may be able to assert against the client until the relationship is completely closed out.

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26. See chapter 2 for a discussion of the factoring relationship generally. As mentioned in that chapter, the entity that sells its receivables to the factor is called a "client" rather than a "borrower," and that terminology will be continued here.

27. It is possible that the new factor would agree to take the credit risk on the existing receivables, but this is relatively rare. It may also be expensive, because the new factor would want to receive its commission on the receivables, because it is assuming the credit risk. In any event, because the new factor would not want to take the risk on receivables as to which a possible credit problem had already developed, there would still be merit in keeping the old factor on the hook for the risk.

If the credit balance is remitted to the client at the time of takeover, the old factor will be looking to the new factor, under the indemnity discussed below, for its protection on the items that it would otherwise be able to charge against the credit balance had it not been turned over. A turnover of the credit balance is considered more desirable from the client's point of view in that it makes that amount of money immediately available to the client. At the very least, future charges against the credit balance may not add up to the full amount of the credit balance and there is no reason, from the point of view of the client, why the old factor should be holding that excess amount. Should the new factor be called upon to make payment to the old factor under the indemnity, the client will, of course, be obligated for that amount to the new factor, but the time value of the money dictates that a turnover is better for the client. The indemnity obligation will usually (although not necessarily) have a dollar limit and it will have an expiry date.

### **[C] U.C.C. Filings**

Because the old factor retains the receivables purchased prior to the takeover date, the U.C.C. filings made by the old factor will not be terminated, as the filings of a prior lender would be. The old factor will, instead, issue a partial release of its filings in which it will release and disclaim any interest in receivables arising on or after the takeover date. Special provision will have to be made in the event that any pre-existing receivables are actually re-assigned and released by the old factor.

### **[D] Indemnity**

Because of the complexity of the relationship between the factor and its client, the indemnity to be received by the old factor from the new factor is itself more complex than a commercial finance indemnity. The old factor will, broadly speaking, be indemnified for anything that it could have charged to the client under the factoring agreement. The old factor is not protected against a claim by a trustee for a bankrupt customer that the payments made to the factor on the purchased receivables owing by that customer were voidable preferences; however, the old factor and the new factor will protect each other against claims made against them with respect to moneys that were actually paid by one to the other under the takeover letter.

## **§ 13:4 Opinion Issues**

Nowhere does the lawyer's imagination and ingenuity have more free reign than in the area of opinions. While much of this is understandable, because this is where the lawyer's skill, reputation, and

potential liability intersect, it may well be that professional caution causes matters to get out of hand on occasion. The trend is encouraged by the growing number of cases that find ways to upset the lender's expectations on novel theories.<sup>28</sup> Lawyers do not seem to find much consolation in the proposition that a lawyer is not absolutely liable as an insurer on an opinion, but only for negligence.<sup>29</sup>

The bar has been concerned with these issues for a long time and has made efforts to standardize the approach on many of the issues mentioned here. For a more detailed discussion on these points and the recommended standards which alter the drafting approach to certain opinions, reference may be had to the reports cited in the notes.<sup>30</sup>

The following are some of the key elements to be addressed by a borrower's counsel's opinion in the asset-based context, along with some of the more commonly required steps to be taken to be able to give the opinion.

### **§ 13:4.1 General Terms**

Certain issues are common to most opinions. The issues involved are therefore not unique to asset-based transactions.

#### **[A] Organization and Authorization**

The opinion regarding organization and authorization will cover the fact of organization of the borrower as a corporation, partnership, or other entity, and will state that the borrower is validly existing in such capacity and is in good standing under the laws of the state of its organization. This is normally backed up by a certified copy of the certificate of incorporation, certificate of formation, partnership certificate, or other documents filed with public authorities to organize the borrower. Borrower's counsel should review the organizational documents and (if borrower is a corporation) the minute books of the borrower to be sure that the necessary formalities have been carried out to complete its organization. In the case of limited liability companies and partnerships, there is no minute book to review and

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28. See chapter 14 (Lender Liability).

29. See *United States of Kuwait PLC v. Enventure Energy Enhanced Oil Recovery Assocs.*, 755 F. Supp. 1195 (S.D.N.Y. 1989).

30. *Report Regarding Legal Opinions in Personal Property Secured Transactions*, 44 BUS. LAW. 791 (1989); *Opinions in Bankruptcy Context: Rating Agency, Structured Financing and Chapter 11 Transactions*, 46 BUS. LAW. 717 (1991); *Third-Party "Closing" Opening: A Report of the TriBar Opinion Committee*, 53 BUS. LAW. 591 (1998); *Third Party Legal Opinion Report, including the Legal Opinion Accord, of the Section of Business Law, American Bar Association*, 47 BUS. LAW. 167 (1991); *U.C.C. Security Interest Opinions*, 58 BUS. LAW. 1453 (2002–2003).

counsel will have to rely on the limited liability company agreement, partnership agreement, public filings, and certificates of the members or partners to see if all necessary parties have been properly involved.

Lender's counsel, when accepting the opinion, will not generally review the internal documents of a corporation (that is, the minute book), but will rely on certificates of the officers as to authorization. In the case of a corporation, lender's counsel should review the charter and bylaws, and, in the case of a limited liability company or partnership, the limited liability company agreement or the partnership agreement itself, not just the publicly filed certificate of formation, certificate of partnership or doing-business certificate. While rules of law, such as apparent authority (in the case of a corporation), managing member authority (in the case of a limited liability company), or general partner authority (in the case of a partnership), should support the power of the entity and its representatives to enter into the transaction, it is not generally deemed sufficient to rely solely on those rules in major transactions. Resolutions authorizing action on behalf of a corporation can identify individuals by name or they can identify the authorized officers by the office they hold, requiring the additional step, discussed next, of determining that the individual signing the document actually holds that office.

### **[B] Due Execution and Delivery**

The opinion regarding due execution will state that the documents have been duly executed and delivered by the entities involved. This means that the proper officer has executed and delivered the document pursuant to the authority established in the preceding section. While it is rare that an imposter will show up at a closing and attempt to sign, it does happen that an individual will submit a document that has purportedly been signed at some other time and place by the proper party when in fact it has not; guarantees executed by absent spouses are often prime suspects. Accordingly, it is appropriate to obtain incumbency certificates, notarizations, or other appropriate documentation to evidence the fact that the signatures on the documents delivered are the signatures of the persons whose signatures they purport to be and that those persons in fact hold the offices they purport to hold. For greater assurance to the lender, these incumbency certificates or other documents should bear the signatures of officers other than the those who are signing the loan documents. This may not always be possible in the case of closely held entities.

### **[C] Valid, Binding, and Enforceable**

The "valid, binding, and enforceable" opinion (or, the so-called "remedies opinion") is one of the key opinions and is customarily stated in just those words, supplemented with the phrase "in accordance

with their terms.” There are a number of exceptions, discussed in section 13:4.4 below, that are customarily added to this opinion.

#### **[D] Noncontravention of Other Agreements**

Borrower’s counsel is generally asked to echo the representation and warranty given by the borrower to the effect that the instant transaction does not contravene any provision of, cause a default under, or result in the creation of any lien on borrower’s property under, any other document to which the borrower is a party or by which its property may be bound. Obviously, the lender does not want to find out, the day after its loan closing, that the borrower is suddenly required to repay some other obligation that the lender assumed would continue to be outstanding. The problem is that borrower’s counsel, even if it has been the borrower’s general counsel for a long time, will not agree that it knows everything there is to know about the borrower’s business. Accordingly, borrower’s counsel will phrase this portion of the opinion in one or more of the following ways:

- (1) it does not have actual knowledge of any such contravention, but has made no independent investigation;
- (2) it gives such opinion only with respect to those documents as to which it specifically represented the borrower; or
- (3) it gives such opinion only with respect to those documents listed on an attached list.

The final form of this portion of the opinion will be a matter of negotiation.

#### **[E] Noncontravention of Laws**

The lender will also want to know that the transaction does not violate any law, rule, regulation, or restriction applicable to the borrower or its property. This appears to be an even more onerous problem for borrower’s counsel than the noncontravention of agreements, discussed above. The borrower inevitably does business in numerous jurisdictions and is inevitably subject to more and more laws, so it is impossible for counsel to keep tabs on every provision that might be applicable. Accordingly, the opinion on this subject will generally be limited to the laws of the state of the opinion giver and, then, only to such of those laws as are customarily applicable to transactions of the same type.

### **§ 13:4.2 Collateral Security Terms**

In addition to knowing that its loans are valid, the lender will want to know that its liens are valid. There are three levels at which this assurance can be sought.

**[A] Valid, Binding, Enforceable Liens**

The provision that the agreements are “valid, binding, and enforceable” tells the lender merely that its liens are valid as between it and the borrower and that, barring the intervention of third parties, the liens can be enforced.<sup>31</sup> This opinion often states that the documents are “legal, valid and binding.” In New York opinion practice, the word “legal” is regarded as neither expanding nor limiting the generally understood meaning of the enforceability opinion. However, in California opinion practice, an opinion that a document is “legal” implies there is no conflict with any laws. Accordingly, it may be best to state merely that the documents are “valid and binding.” This information is important, but is rarely what the lender is looking for at the time of closing, since the rights between the parties will inevitably be affected by the rights of third parties. It does become important, however, when the lender is dealing with an entity (usually a guarantor rather than the borrower) that has no other creditors besides the lender, and the lender is trying to collect or restructure its loan. Generally, it should not be a problem for borrower’s counsel to give this particular opinion.

**[B] Perfection**

The second level of comfort for the lender is the perfection of the security interest.

A security interest will not be perfected until it has attached and until steps appropriate to the proper means of perfection have been taken.<sup>32</sup> Attachment of a security interest requires, in most cases, that

- (1) the borrower has signed a security agreement,<sup>33</sup>
- (2) value has been given, and
- (3) the debtor has rights in the collateral.

Because the borrower’s counsel will have opined that the borrower has duly executed and delivered the security agreement, that aspect

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31. U.C.C. §§ 9-201, 9-203.

32. *Id.* §§ 9-308 through 9-314.

33. A financing statement by itself is not adequate as a security agreement. *Silver Creek Supply v. Powell*, 521 N.E.2d 828 (Ohio Ct. App. 1987); *In re Ace Lumber Supply, Inc.*, 105 B.R. 964 (Bankr. D. Mont. 1989); *In re Lynch*, 313 B.R. 798 (Bankr. W.D. Wis. 2004). The rule should be even clearer now that financing statements do not require signatures.

attachment is not a problem. The giving of value should also not be a problem, at least as to most transactions.<sup>34</sup>

The giving of value is a more difficult issue to the extent that collateral is given by parties other than the direct borrower, such as guarantors. Where the guarantor is the parent of the borrower, value will generally be found. Where the guarantor is in some other relationship to the borrower, an analysis will have to be made.<sup>35</sup>

It is frequently difficult for counsel to determine whether the borrower has rights in the collateral, except possibly where those rights are being obtained in the course of the transaction being financed by the borrowing. Fortunately for counsel, the determination of those rights (with the same exception) is not something for which a lender will generally look to borrower's counsel. More commonly, the lender will rely on the borrower's own representations and upon the audited financial statements of the borrower for its assurance that the borrower actually owns the property being given as collateral. Of course, if the collateral is real estate, a title policy will often be obtained. When the financed transaction involves the acquisition by the borrower of the property that is given as collateral, borrower's counsel generally will not opine that the transaction has been consummated and that the borrower has obtained that property as a result of that transaction.

When the borrower's rights in the collateral amount to something less than outright ownership, as when the borrower has a contract to acquire some equipment but has not consummated the contract, the exact status of the closing of the acquisition will have to be examined.

The means of perfection of a security interest will depend in large part on the nature of the property involved and, where there are alternative means of perfection available,<sup>36</sup> upon the choices of the

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34. Query, when the ostensible borrower does not retain the proceeds of the loan but passes them up to its parent, whether the named borrower has in fact received consideration. This problem arises in the fraudulent conveyance context, as, for example, in the *Gleneagles* case. *United States v. Tabor Court Realty Corp.*, 803 F.2d 1288 (3d Cir. 1986), *cert. denied sub nom. McClellan Realty Co. v. United States*, 483 U.S. 1005 (1987) ("*Gleneagles*").

35. *See generally* the discussion of fraudulent conveyances in chapter 10. However, "value" for contract consideration purposes is not the same as fair consideration for fraudulent conveyance purposes. In many states, the law of contracts is clear that consideration may be given to a party other than the contracting party.

36. Examples would include: (1) perfection as to goods by filing, direct possession, placement in a warehouse under nonnegotiable receipts, and placement in a warehouse under negotiable receipts; and (2) perfection as to chattel paper by filing or possession, etc.

parties. In most cases, the perfection will be accomplished by filing a financing statement in the appropriate office. In that event, borrower's counsel should be sure that the reference to the collateral covered by the opinion is defined so as to refer only to those types of property as to which perfection may be achieved by filing under the U.C.C.<sup>37</sup> This leads in turn to two alternatives.

If the filings are not actually to be made before the closing,<sup>38</sup> the most that the borrower's counsel would be able to say is that the security interests, upon the due filing of financing statements in a form attached and in specified locations, would then be perfected. This requires borrower's counsel to determine the proper place of filing. This is resisted, many times, by borrower's counsel on the grounds that the lender's counsel can make the determination just as easily. Lender's counsel should not accept this argument. There is no rational reason why the borrower's counsel should not be able to provide that assurance, even if lender's counsel is going to do an analysis of its own.

If the filings are made before the closing, it is appropriate for the opinion to state as of the time of closing that the security interests have been duly perfected. This entails the same due diligence by borrower's counsel as is described above.

### **[C] Priority**

Ideally, the lender would like to be told by the borrower's counsel that the lender's security interests are not only perfected and enforceable, but also prior to any others that may then exist or thereafter arise. The borrower will usually have represented and warranted to the lender that such is the case at least as to existing liens, but that is of little ultimate comfort to the lender, because the borrower is already obligated on the loan and a breach of the borrower's representation or warranty merely adds another cause of action to the already lengthy complaint that the lender would file, without adding any extra value. Many borrower's counsel will decline to give priority opinions at all. In many states, such as California, the prevailing practice is not to give priority opinions except in limited circumstances (such as pledges of certificated interests). In the rare circumstances where priority

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37. The opinion, in such a case, should, to the extent appropriate, exclude reference to types of property as to which filings are made under other statutes, such as titled motor vehicles, aircraft, ships registered with the Coast Guard, and types of property that are not covered by the U.C.C.

38. Prefiling of financing statements is perfectly proper. U.C.C. §§ 9-308(a), 9-502(d). Prefiling will not, however, always be agreed to by the borrower. See note 15, *supra*.

opinions are to be given, there are two approaches that are used, depending on the particular facts:

1. to opine that the security interest is prior to any other liens that are perfected by filing at the same locations, and
2. to opine that the security interest is prior to any other liens.

In either case, extensive exceptions, discussed below, will generally be included in the opinion.

### **§ 13:4.3 Assumptions and Reliance**

Because counsel is not expected to verify all underlying facts on its own, certain assumptions are commonly made.

#### **[A] Genuineness**

Counsel will assume the genuineness of all documents and certificates furnished to it, and the genuineness of all signatures thereon other than signatures of the borrower.

#### **[B] Due Execution by Others**

When the validity of a document is dependent on the due execution of the document by others, the validity of that action will be assumed. If that action is critical to the transaction, presumably the borrower will be obtaining its own opinions from counsel to those other parties, and those opinions can be made available to or can be made to the lender.

#### **[C] Certificates of Officers**

Counsel will assume the accuracy of the information provided to it by officers of the borrower (or others) and will usually not perform its own separate investigation. It is appropriate, though, to ask counsel to state that in performing whatever investigation it has performed as a basis for its opinion it has not become aware of anything that would cause it to believe that the information provided by the certificates is not accurate.

#### **[D] Other Opinions**

Where the laws of other states bear on the transaction, it may be that borrower's counsel is willing (and qualified) to opine as to these matters. Many lawyers, for example, will opine at least as to basic matters of Delaware corporate law. In most cases, though, borrower's counsel will turn to local counsel for support on local questions. The issue is then as to the manner in which the local counsel opinion is to be integrated in the main opinion. The alternatives include:

1. furnishing the local opinion, running to the lender, without comment and without addressing the issue in the main opinion;
2. attaching the local opinion (running to the lender) to the main opinion, with a statement by borrower's counsel in the main opinion that borrower's counsel believes it is not unreasonable for the lender to rely on the local opinion; and
3. giving the applicable opinion in the main opinion letter, but stating that the local law portion of the opinion is given in reliance upon the local opinion that is attached.

From the standpoint of the lender, the alternatives are stated above in the order of increasing desirability.

### **§ 13:4.4 Exceptions**

As indicated above, there are a number of areas in which it is appropriate for the borrower's counsel to qualify its opinion due to factual constraints. There are also a number in which legal issues arise and as to which reservations in the opinion text are in order.

#### **[A] As to Enforceability**

The opinion as to the enforceability of the documents should be qualified by the effect of the Bankruptcy Code, which subjects all obligations of the debtor and all actions against the debtor and its property to a wide variety of limitations preventing the enforcement of rights that arose before the bankruptcy proceeding commenced.<sup>39</sup>

It is also an established principle that equitable remedies, such as specific performance and injunctive relief, are not always available even though the lender may show itself entitled to redress of some kind and courts may apply principles of equity to modify other remedies that the documents purport to grant to the lender. In such a case, it is appropriate to qualify the enforceability opinion by stating either that the remedies of specific performance or injunctive relief may not be available in all cases or, more broadly and more commonly that the availability of remedies for the enforcement of the documents is subject to general principles of equity.

If the borrower's counsel determines that under local law certain provisions of or remedies granted under the documents may be unenforceable, it obviously cannot opine to the contrary. Assuming, however, that such provisions do not undermine the documents to the

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39. Bankruptcy Code §§ 362 (automatic stay), 547 (preferences), and 548 (fraudulent conveyances) are but a few examples.

point of making them entirely unenforceable, it might be appropriate to state

- (1) certain provisions may be unenforceable,
- (2) such provisions do not affect the enforceability of other provisions of the documents, and
- (3) the unenforceability of those provisions will not prevent the lender from enforcing payment of the obligations or from the practical realization of the principal rights and benefits of the transactions contemplated by the documents.

Provisions that may fall into this category include

- (a) certain waivers of rights or notices, the waiver of which may be restricted under the U.C.C. or other applicable law;
- (b) clauses purportedly giving the lender the right to accelerate the debt arbitrarily; and
- (c) the granting of certain self-help remedies, for example, the right to use force to take possession of the collateral after default.

### **[B] As to Priority**

If the borrower's counsel is to give either type of priority opinion mentioned in subsection (1) or (2) of section 13:4.2[C] above, it will be entitled to refer, as exceptions to the general statement, to all of the provisions of law that may allow another creditor to affect the priority of the lender's position. The specific exceptions employed in a particular opinion will depend in part on the specific collateral involved in the transaction at hand. The list of exceptions that should be considered regarding perfection by filing a UCC-1 includes the following:

- (a) security interests perfected in a jurisdiction in which the lender was not already the first secured party prior to a change in the borrower's location to another jurisdiction, under U.C.C. section 9-316(a);
- (b) security interests created by prior owners of the property, under U.C.C. section 9-320;
- (c) security interests in favor of another secured party that are properly perfected by possession of the collateral by the other secured party at the time of the closing, under U.C.C. section 9-313;
- (d) existing security interests in negotiable documents, under U.C.C. section 9-312(f);

- (e) certain statutory liens in favor of persons performing services or furnishing materials, as contemplated under U.C.C. section 9-333;
- (f) subsequent lien creditors, in certain cases, under U.C.C. section 9-323(b);<sup>40</sup>
- (g) subsequent buyers out of the ordinary course of business, in certain cases, under U.C.C. section 9-323(d);<sup>41</sup>
- (h) subsequent buyers in the ordinary course of business, under U.C.C. section 9-320(a);
- (i) purchase money security interests, under U.C.C. section 9-324;
- (j) consignments, under U.C.C. section 9-103(d);
- (k) security interests in certain proceeds, under U.C.C. section 9-315;
- (l) federal tax liens on after-acquired collateral or collateral securing future advances by the lender, under Internal Revenue Code section 6323(c) and (d);
- (m) other federal liens under other federal statutes, such as (but not limited to) 41 U.S.C. section 255;
- (n) rights of a seller of goods, under various provisions of U.C.C. Article 2;<sup>42</sup>
- (o) security interests in negotiable documents issued upon placement of goods with a bailee, under U.C.C. section 9-312(c);
- (p) security interests in goods in the possession of a bailee (other than under the preceding section), under U.C.C. section 9-312(d);
- (q) security interests in less than a significant part of the outstanding accounts or payment intangibles of the borrower, under U.C.C. section 9-309(2);
- (r) security interests in chattel paper acquired pursuant to U.C.C. section 9-330;
- (s) priorities altered pursuant to the Bankruptcy Code;<sup>43</sup>

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40. This exception and the following one would not apply to a transaction in which subsequent advances were not to be made by the lender, or in which it could be found that subsequent advances were made pursuant to a commitment, under U.C.C. § 9-102(a)(68).

41. See note 35, *supra*.

42. The pertinent sections of Article 2 include §§ 2-403, 2-505, 2-702, 2-703, 2-704, and 2-706.

43. Bankruptcy Code §§ 364(d) and 552 are examples.

- (t) security interests in favor of a collecting bank, under U.C.C. section 4-210; and
- (u) rights of a bona fide purchaser of a negotiable document of title, under U.C.C. sections 9-309 and 7-501.

It is easy to see why borrower's counsel may be reluctant to opine as to priority.

### **§ 13:5 U.C.C. Filing Issues**

There are some related issues as to the descriptions of the collateral and the extent of searches that should be made in certain cases that will be discussed here even though, in some of those cases, mention of these issues may have been made in the other chapters.

#### **§ 13:5.1 Used Equipment; Specially Acquired Inventory**

Particularly with equipment or other long-lasting property, the cautious lender will try to learn the identity of the prior owners of the asset. Inventory acquired in bulk (that is, not in the ordinary course of business) is another type of property requiring this type of attention. The lender will then run searches against the prior owners of those assets. This is because the U.C.C. provides something of a trap for the unwary in the interplay between section 9-315(a) and section 9-507(a). Goods acquired from a person engaged in the business of selling goods of that kind will be taken free and clear of liens created by that person,<sup>44</sup> but not liens created by that person's predecessor in title. The sections cited indicate that a transfer of goods, not in the ordinary course, by a debtor that has not been authorized to do so by its secured party will not cut off the lien and that the filing by that secured party against the transferor will continue in effect. Therefore, if the lender wants to be sure that the borrower's goods are free of adverse interests (and the borrower should want to be sure, too), it must check all such predecessors in interest.

#### **§ 13:5.2 Computer Searches**

With the advent of the computer, searches of public records have, in one sense, been facilitated. Computers can search voluminous records with great speed. However, because computers do exactly what you tell them to do, whether that is what you want them to do, new problems may be created. In requesting the search, the lender must be careful

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44. U.C.C. § 9-320(a).

that it has the correct name of the debtor, or else a computer search will not necessarily pick it up. Helpful clerks in the filing offices who did manual searches would report the names of debtors that were close to the name submitted by the lender. Computers will not do this unless instructed to do so by the programmer, and even then the search parameters will probably be narrower than those applied by the accommodating clerks. While some courts struggle with the role computers play in the filing and search process,<sup>45</sup> Article 9 acknowledges their role. Under section 9-503(a), a financing statement must reflect the actual organizational or individual name of the debtor to be sufficient. Section 9-506 provides, however, that a financing statement that does not contain the correct name of the debtor is not seriously misleading if a search of the records of the filing office under the debtor's correct name, "using the filing office's standard search logic, if any," would disclose a financing statement.<sup>46</sup> If a filing office's standard search logic is a program within the computer, that is the standard a court should apply in determining whether a financing statement is seriously misleading.

### § 13:5.3 **Bankrupt Companies**

A lender should be diligent about filing continuation statements to avoid a lapse during a bankruptcy proceeding involving the borrower as financing statements will not continue to be effective during such bankruptcy absent such filing.<sup>47</sup> Nonetheless, while this may be advisable, the official comment number 4 to U.C.C. section 9-516 notes that "[o]f course, if the debtor enters bankruptcy before lapse, the provisions of this Article with respect to lapse would be of no effect to the extent that federal bankruptcy law dictates a contrary result (for example, to the extent that the Bankruptcy Code determines rights as of the date of the filing of the bankruptcy petition)." Section 362(b)(3) of the Bankruptcy Code permits the lender to file a continuation statement without violating the automatic stay and without obtaining the consent of the bankruptcy court.

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45. See *In re Mines Tire Co.*, 194 B.R. 23 (Bankr. W.D.N.Y. 1996) (a poorly reasoned decision requiring the computer searcher to check all similar or related entries a manual searcher might check!); *In re Spearing Tool & Mfg. Co.*, 412 F.3d 653 (6th Cir. 2005) (holding that an IRS notice of tax lien need not be filed under the debtor's name (as specified in U.C.C. § 9-503(9)) to be effective; searchers should also look for filings with abbreviations).

46. U.C.C. § 9-506(c).

47. U.C.C. § 9-515, Official Comment 4.

### § 13:5.4 General Search and Filing Issues

In contrast with Former Article 9, which required a lender to file financing statements where the collateral was located, Article 9 generally only requires the lender to file its financing statement in the jurisdiction where the borrower is located.<sup>48</sup> This does not translate into an immediate simplification of the search process. Any financing statement filed under Former Article 9 may remain effective for up to five years after Article 9 became effective.<sup>49</sup> The lender must therefore perform lien searches under the rules of both Article 9 and Former Article 9 for such five-year period.

Lien and security interest searches must be run on a basis that is appropriate both to the borrower's circumstances and to the collateral that is to be taken. This requires, first, a determination of which entity within the borrower's group (if borrower's business structure includes more than one entity) is the owner of each kind of collateral that is to be perfected. Again, a check may be made to determine the prior ownership of the assets, so that the search may include the prior owners.<sup>50</sup> The correct name of the borrower (or other entity) for which a search is to be conducted should then be established. The lender should also determine if the borrower or such other entity<sup>51</sup> changed its name at any time<sup>52</sup> or changed the location of its place of business at any time.<sup>53</sup> The location, for U.C.C. purposes, of (a) the borrower and each other such entity, and (b) each type of collateral, and the place of filing (if any) with respect thereto, must then be ascertained. Searches should then be run in all appropriate jurisdictions and under all appropriate names.<sup>54</sup> Under Article 9, a financing statement is only effective if a search under the appropriate debtor's correct name would disclose it.<sup>55</sup> Such a search, however, may not disclose financing

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48. U.C.C. § 9-301.

49. U.C.C. § 9-705(c) and (d).

50. See section 13:5.1, *supra*.

51. A failure of a *creditor* to refile after its own name change did not affect perfection because there was still adequate notice on record of a prior perfected interest in the collateral. *Turnbull Oil, Inc. v. N.B. Co.*, 943 P.2d 511 (Kan. Ct. App. 1997).

52. U.C.C. § 9-507(c). Do not be misled by the reference in this section to the four-month period. In the absence of a new filing, § 9-507(c) only cuts off the security interest as to newly acquired collateral. The original filing continues valid for an indefinite period (subject to continuation) as to collateral acquired prior to, or within four months after, the name change.

53. See *generally* chapter 16, Revised Article 9 Transition Rules.

54. There is no requirement that searching service companies have to search under various misspellings in order to catch stray filings. *Chem. Bank v. Title Servs., Inc.*, 708 F. Supp. 245 (D. Minn. 1989); cases cited in note 56, *infra*, but consider the cases cited in note 45, *supra*.

55. U.C.C. § 9-506(c). See also note 58, *infra*.

statements that, while not effective under Article 9, were effective under Former Article 9 and thus remain effective.<sup>56</sup> It is also important to understand the borrower's operations in order to determine whether the borrower may be subject to liens that can be perfected without filing.<sup>57</sup>

For a filed financing statement to be effective, the only requirements are that it include the debtor's name,<sup>58</sup> the name of the secured party or a representative of the secured party, and an indication of the collateral.<sup>59</sup> In order for a financing statement to be accepted for filing by the filing office, certain other information may also be required, including a mailing address for the debtor and for the secured party, whether the debtor is an individual or organization, and, if the debtor is an organization, the type of organization, the jurisdiction of organization and, for certain filing offices, an organizational identification number, if any.<sup>60</sup> If the filing office, however, accepts a financing statement that does not contain this additional information, the financing statement nonetheless is effective.<sup>61</sup>

Unlike Former Article 9, a financing statement is not required to include (and does not provide a signature block for) the borrower's signature. The lender need only be authorized to file the financing statement by the borrower in an "authenticated record."<sup>62</sup> The most logical place for such authorization will be in the security agreement signed by the borrower. In fact, simply by signing or becoming bound by a security agreement, the borrower is deemed to have authorized

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56. Under Former Article 9, some courts validated filings made under trade names or other variant name. *See, e.g., In re Paramount Int'l, Inc.*, 154 B.R. 712 (Bankr. N.D. Ill. 1993); *In re Thriftway Auto Supply, Inc.*, 159 B.R. 948 (W.D. Okla. 1993); *Willson v. Habersham Bank*, 111 B.R. 368 (N.D. Ga. 1990). These cases would not be correct as applied to filings made under revised Article 9.

57. *See* section 11:2.3, *supra*.

58. If the debtor is a registered organization, then its name should be as "indicated on the public record of the debtor's jurisdiction of organization which shows the debtor to have been organized." U.C.C. § 9-503(a)(1). If the debtor is an individual, then its "individual or organizational name" should be listed. U.C.C. § 9-503(a)(5). Pursuant to U.C.C. § 9-503(b), a financing statement is not ineffective if it fails to list the debtor's trade name, but pursuant to U.C.C. § 9-503(c), a financing statement that provides only the debtor's trade name is not sufficient. One court has concluded that U.C.C. § 9-503, "read as a whole," requires financing statements to provide the legal name of an individual debtor—a nickname would be insufficient. *In re Kinderknecht*, 308 B.R. 71, 75 (B.A.P. 10th Cir. 2004).

59. U.C.C. § 9-502.

60. U.C.C. §§ 9-516(b) and 9-520(a).

61. U.C.C. § 9-520(c).

62. U.C.C. § 9-509(a).

the filing of a financing statement with respect to the collateral covered thereby.<sup>63</sup> In order to facilitate the filing of financing statements prior to the signing of the security agreement, however, the lender may want to incorporate an authorization in a letter signed by the borrower.

If the borrower has granted the lender a security interest in all of the borrower's assets, an indication in the financing statement that it covers all assets or personal property of the borrower is sufficient.<sup>64</sup> If the lender's collateral is less than all of the borrower's assets, then the collateral description should reasonably identify the collateral.<sup>65</sup> Whether or not the collateral description in a financing statement indicates that proceeds of collateral are covered, a perfected security interest in collateral continues in any identifiable proceeds of such collateral.<sup>66</sup> The security interest in the proceeds, however, will become unperfected after twenty days if a security interest in such proceeds cannot be perfected by filing a financing statement in the office where the financing statement against the collateral was filed or if the proceeds were acquired with cash proceeds, unless the lender otherwise perfects its security interest in the proceeds.<sup>67</sup> Proceeds include insurance proceeds provided that the insurance proceeds are payable to the borrower or the lender,<sup>68</sup> although it is advisable that the lender be named as a loss payee in order to give the lender control over the payment. Another issue that can arise in connection with the collateral description is whether it is permissible to refer to other documents for the description; the answer seems to be affirmative, with qualifications.<sup>69</sup>

Upon occasion, the parties seek to have the financing statement serve as the security agreement, rather than creating a separate document. Whether this path will be successful has been ruled to be

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63. U.C.C. § 9-509(b).

64. U.C.C. § 9-504. Such a broad statement would not be sufficient for the security agreement which must reasonably identify the collateral described. U.C.C. §§ 9-108 and 9-203(b)(3)(A).

65. U.C.C. §§ 9-108 and 9-504. Nonetheless, an overly broad "all assets" indication should serve to perfect as to the collateral that is described in the security agreements even though that description is narrower.

66. U.C.C. § 9-315(c).

67. U.C.C. § 9-315(d).

68. U.C.C. § 9-102(a)(64).

69. *Chase Bank of Fla., N.A. v. Muscarela*, 582 So. 2d 1196 (Fla. Dist. Ct. App. 1991) (allowing reference to other documents); *In re PA Record Outlet*, 92 B.R. 139 (Bankr. W.D. Pa. 1988) (allowing reference if documents attached to financing statement). Although these cases were decided under Former Article 9, the result should be the same under Article 9 as the standards are the same—the description is sufficient if it reasonably identifies what is described. *Compare* U.C.C. § 9-108 *with* Former U.C.C. § 9-110.

a question of fact under the circumstances.<sup>70</sup> If the lender seeks to rely upon the financing statement as a security agreement, the financing statement would need to be authenticated by the borrower<sup>71</sup> and a blanket collateral description, such as “all of the debtor’s assets,” would not be sufficient.

The perfection of, or at least the filing or recording as to, a security interest in property that is subject to registration or filing requirements under other statutes (such as airplanes and motor vehicles) will be governed by those laws and not the U.C.C.<sup>72</sup> It is not always clear whether a particular statute qualifies to replace the filing provisions of the U.C.C.<sup>73</sup>

## § 13:6 Disbursement and Use of Loan Proceeds

Once the necessary documents have been executed and delivered, it remains for the lender to arrange for the passage of the loan proceeds, that is, the consideration given by the lender in exchange for the promises and collateral of the borrower. Improper handling of this step can cause problems for the lender.

### § 13:6.1 Tying in to Loan Documents

The advance of funds must be made in such a way as to be traceable to the loan transaction. If the funds are deposited by the lender directly to the account of the borrower, or if a check of the lender is issued in the name of the borrower, this is automatic. In many cases, however, the proceeds are paid out at the closing to third parties.

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70. Gibson Cty. Farm Bureau Coop. Ass’n v. Greer, 643 N.E.2d 313 (Ind. 1994); *see also* note 34, *supra*.
  71. U.C.C. § 9-203(b)(3)(A) (requiring an authenticated security agreement in order for a security interest to attach).
  72. U.C.C. § 9-311. Note the effect of section 9-311(d), however, which provides that “[d]uring any period in which collateral subject to a statute specified in paragraph (2) of subdivision (a) [*i.e.*, vehicles that are subject to certificates of title] is inventory held for sale or lease by a person or leased by that person as lessor and that person is in the business of selling goods of that kind, this section does not apply to a security interest in that collateral created by that person.”
  73. Until 1990, it was believed that a U.C.C. filing, rather than a filing in the Copyright Office, was the proper way to perfect a security interest in copyrights and receivables arising from copyrights. *In re Nat’l Peregrine, Inc.*, 116 B.R. 194 (C.C. Cal. 1990), held otherwise. *See* section 4:4, *supra*. Whether or not this case and others like it are based on correct conclusions or good law, a secured party should always file both federally and in the appropriate U.C.C. filing office to be assured of perfection.

In this event, there must be written instructions from the borrower to the lender setting forth, in detail, the amount and destination of the funds and acknowledging that those funds constitute the proceeds of the financing extended to the borrower. At a minimum, if the payment to the third party is made by means of the lender's check, the borrower should acknowledge "payment approved" on the back of the check, followed by its signature. More commonly, the moneys will be wired or internally transferred by the lender to or for the account of the third party, and an instruction letter or funds flow agreement, signed by the representatives of the borrower who are authorized to execute the loan documents, becomes the appropriate evidence of the borrower's agreement.

### **§ 13:6.2 Use of Proceeds**

The lender will want to be fully informed as to the uses to be made of the proceeds of the financing and will often include in the loan documents a representation as to what those uses are. To the extent that the proceeds are not used for valid business purposes that are of benefit to the borrower, the lender's position may be jeopardized.<sup>74</sup>

### **§ 13:6.3 Timing Issues**

#### **[A] Taking of Collateral and Perfection**

If the funds are advanced after the loan documents have been executed and all necessary filings made, the giving of value will be the last step in the creation of the perfected security interests. Problems under the preference section of the Bankruptcy Code<sup>75</sup> will be avoided, because that section is triggered only by transfers on account of an antecedent debt, and the transfer (that is, the grant of the security interest) will have occurred when it is perfected. If the funds are advanced at a time when the necessary filings have not been made, which is probably the case more often than not, those filings will have to be made within thirty days of the passage of the funds in order to come within the relation-back provision of the preference section.<sup>76</sup> If not perfected within that time period, the security interests will potentially be subject to challenge if a bankruptcy case is commenced with respect to the borrower within ninety days or, in some cases, one year of the perfection date.<sup>77</sup>

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74. See chapter 10, dealing with fraudulent conveyances, and section 13:8 *infra*, regarding Regulation U.

75. Bankruptcy Code § 547.

76. *Id.* § 547(e)(2).

77. *Id.* § 547(b)(4).

**[B] Acquired Entities**

If the loan is made to finance the acquisition of the borrower or the acquisition by the borrower of its assets, the transaction should (if possible) be constructed so that it is deemed that the acquisition has taken place by the time the funds are to be advanced. Otherwise, the lender will be making its advance to an empty shell. When the acquisition can be accomplished without a corporate-type filing, this is not difficult; the movement of the funds can be made the last event after all the other papers are signed. When the acquisition involves a corporate filing, such as a merger certificate, there can be some tactical and timing problems with sellers who are reluctant to take the irrevocable step of the corporate filing before they have received the purchase price. If arrangements cannot be made for the filing to be handled on a phone call basis, so that the passage of funds and the filing are essentially simultaneous, the solution may lie in the creation of an escrow fund with the proceeds, to be distributed upon completion of the filing.

**[C] Release of Liens**

When loan proceeds are to be used to pay off other security interests in the lender's collateral, a payoff letter, as discussed above, should be obtained, containing a commitment from the other secured party to release its security interests upon the receipt of payment and setting forth the amount necessary to pay off the debt, including a per-diem interest accrual, in case the payment is not made on the date originally contemplated.

**§ 13:7 Commitment Letters**

A few words are in order about commitment letters. Commitment letters vary in length, complexity, and conditionality depending on the needs of the parties. On the one hand, where the parties want to reach an understanding regarding the key economic terms of the loan transaction, but the lender has not yet completed its underwriting and due diligence regarding the transaction, a short form term sheet or proposal letter, which is not intended to be binding, but rather serves as the outline for the negotiation of a commitment letter or definitive documentation, may be the most efficient way to move forward. On the other hand, when the borrower needs greater certainty regarding both the deal terms and the agreement of the lender to close within the anticipated time frame, such as in the case of acquisition financing, a more complex commitment letter with fewer and more specific conditions is necessary. Commitments can run the gamut from "best efforts" or "highly confident" undertakings to arrange or syndicate a loan, through multibank commitments, where two or more lenders

commit severally to a portion of the financing required, to a fully underwritten commitment from a single bank to provide all the financing required. Even in a fully underwritten commitment, however, the lender will retain the right to syndicate the financing, but syndication may or may not reduce the original lender's obligation to provide the whole of the financing in the event that one or more of the lenders to whom the loan is syndicated fails to fund at closing.

The form of commitment letters has evolved dramatically in the acquisition context and those changes have moved into the rest of the financing market to varying degrees. Prior to 2005,<sup>78</sup> a fully underwritten financing commitment carried with it not only the indemnification and payment of expenses, but also the payment of commitment fees, so that financial sponsors who did not wish to incur financing costs and fees if their bid proved unsuccessful would proceed with a summary of indicative terms without a commitment or with a commitment letter that was subject to conditionality. The conditions include diligence and material adverse change clauses, different in type and breadth than the more circumscribed conditions that were negotiated and set forth in the underlying acquisition agreement. As the acquisition market grew increasingly competitive and eliminated financing contingencies to the buyer's obligation to close, the acquisition finance market was forced to move to match the new terms and lenders became increasingly willing to reduce or remove "daylight" or differences between the conditions to the buyer's obligation to close under the acquisition agreement and those to the lender's obligation to fund under the acquisition financing commitment. Both sellers and buyers had an incentive to eliminate the lender's discretion, and an increasingly competitive financing environment brought pressure upon lenders to match terms so as to have the debt financing available at closing.

Before considering the terms and conditions of commitment letters, it should be noted that oral commitments to lend are typically rendered unenforceable under most (although not all) state statutes of frauds.<sup>79</sup> Even in those states where the commitment must be in

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78. Although the occasional transaction prior to 2005 was financed under a commitment that was not conditioned upon diligence or a material adverse change different than that contained in the acquisition agreement, the SunGard financing announced in the spring of 2005 is widely acknowledged to represent a watershed in the acquisition financing market. Hence, that transaction is the genesis of the description of terms that have become customary in the acquisition financing market and described in the text as the "SunGard" provisions.

79. Over the last few decades, most states have enacted statutes of frauds that require a writing for a commitment to lend to be enforceable. *See* section 14:2, note 21, *infra*.

writing in order to be enforceable, however, a partial or informal writing may suffice at least where accompanied by evidence of intent to be bound and justifiable detrimental reliance sufficient to establish a claim for promissory estoppel.<sup>80</sup> On the other hand, where a writing clearly indicates the lender's intent not to be bound, that intent will also be given effect.<sup>81</sup> As with any contract, there must be sufficient consideration upon which to support a contract and mutual agreement on all material terms. Where key terms are left unresolved, the courts are likely to treat a commitment letter as an "agreement to agree" or an agreement to negotiate in good faith toward a loan agreement, but not as an obligation to lend.<sup>82</sup>

The conditions precedent to the commitment can be of particular significance. Courts have found that even a commitment letter with a detailed term sheet evidences a lack of intent to be bound when it is conditioned upon the completion of definitive loan documentation that contained not only those conditions, but also such "other terms and conditions . . . as [the lender] may require."<sup>83</sup> Thus, private equity sponsors and borrowers often negotiate for all material terms, conditions, and covenants to be set forth in the summary of terms attached to a commitment letter and for the documentation to be described by reference to those terms and otherwise as precisely as possible, oftentimes by reference to a particular agreed upon precedent agreement between the parties or the existing financing agreements of the borrower.

### § 13:7.1 Compensation

The type, amount and timing of consideration payable to a lender for a commitment to lend is, of course, a matter of negotiation between the parties and varies widely from transaction to transaction. Compensation will often be negotiated in advance of a commitment letter in connection with the preparation of a one-page summary of key economic terms<sup>84</sup> and will be affected not only by the credit

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80. Some of these principles are discussed further under "Lender Liability" in section 14:2.1, *infra*.

81. *E.g.*, Budget Mktg., Inc. v. Centronics Corp., 927 F.2d 421 (8th Cir. 1991) (preliminary agreement containing clear disclaimer that party does not intend to be bound by agreement is sufficient not to bind that party).

82. *Cf.* Copeland v. Baskin Robbins, 96 Cal. App. 4th 1251 (Cal. App. 2d Dist. 2002) [letter of intent bound the parties to negotiate in good faith toward a definitive agreement].

83. Amcan Holdings, Inc. v. Canadian Imperial Bank of Commerce, 894 N.Y.S.2d 47, 50 (App. Div. 1st Dep't 2010). *See also* Frutico S.A. de C.V. v. Banker's Trust Co., 833 F. Supp. 288 (S.D.N.Y. 1993).

84. A form of such a term sheet is included as Appendix 13A.

metrics of the borrower and the transaction, but also by the lender's cost of funds, the robustness of the lending markets, the capital markets alternatives, and the general economic conditions at any point in time. Private equity sponsors participating in an acquisition auction usually try to negotiate to avoid payment of expenses or other out of pocket amounts until a transaction closes, although they usually will agree to pay the lender's out of pocket expenses to the extent of a portion of any breakup fee or reimbursement the buyer might receive under the acquisition agreement. The lender will typically expect the borrower to agree to indemnify the lender for any claims asserted against the lender and for liabilities that the lender may incur in connection with the acquisition or the financing. The lender may also want the borrower to provide an expense deposit, while the borrower or the buyer may wish to negotiate a cap on expenses, at least if the financing fails to close. An agreement on expenses can be important, as it will enable the lender to incur the costs related to the diligence and documentation of the transaction without concern about having to pay for these expenses in the event the borrower elects not to proceed with the transaction.<sup>85</sup>

In addition, the lender may also expect an up-front commitment, work fee, underwriting or structuring fee or some other form of consideration for providing the commitment.<sup>86</sup> For example, the lender may request that the borrower pay a fee for the time that the commitment is outstanding and not utilized to compensate the lender for its commitment of capital.<sup>87</sup> While any of these types of fees often would be credited against the amount of the closing fee that the lender would be entitled to receive upon the closing of the transaction, unlike a closing fee, the lender would be entitled to keep the commitment or similar fee in the event that the loan transaction is not consummated. As an alternative, or in addition to the compensation for the commitment, the lender may require that the borrower instead agree to pay a breakup fee to the lender in the event that the borrower enters into discussions regarding an alternate debt or equity financing transaction. This approach provides protection to the lender in the event the borrower pursues an alternate financing transaction, while at the

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85. A typical commitment letter would bind the lender to provide the financing, but would not bind the borrower to request the financing. As a result, absent such an agreement by the borrower to reimburse the lender for the expenses incurred by the lender, the lender could be required to incur documentation expenses for the transaction which may not be reimbursed.
86. Market practice is to specify the fees, together with market flex provisions, in a separate fee letter which is often subject to greater confidentiality restrictions than the commitment letter or the summary of terms.
87. This fee is akin to an unused line fee and is sometimes referred to as a "ticking fee" because it is payable as time "ticks" on.

same time minimizing the amount of cash compensation that is required to be paid to the lender prior to the consummation of the financing transaction. The parties, of course, may also agree to a combination of a breakup fee and a commitment fee, depending on how the parties choose to allocate the risk of the transaction not being consummated.

### § 13:7.2 Conditions

The scope of the conditions that are included in the commitment letter will vary depending on the nature of the financing transaction. In acquisition financing transactions, for example, the conditionality of the commitment will be especially critical. This is due to the fact that the seller typically will not be willing to include a financing condition to the borrower's obligation to close the acquisition. As a result, the buyer (and the seller)<sup>88</sup> will seek to ensure that the commitment letter for the financing of an acquisition transaction mirrors the conditions in the acquisition agreement itself as closely as practicable.

#### [A] SunGard Provisions

So-called SunGard provisions consist of some or all of the following:

- The lender(s) under the commitment letter are not released from their obligations to fund on the closing date even if the loan is syndicated prior to closing;
- The material adverse change clause (MAC) mirrors the acquisition agreement MAC;
- There is no general market MAC or condition regarding disruption in the financial markets;<sup>89</sup>

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88. Because the buyer in most private equity acquisitions is a newly formed company with limited or no assets other than its rights under the acquisition agreement and any corresponding commitments for equity contributions and financing, the seller's remedy against the buyer is of limited utility and, therefore, sellers are keenly interested in limiting the conditionality of the financing commitments for the transaction and in obtaining covenants that the buyer will not modify, and will enforce its rights under those commitments.

89. With the disappearance of so-called market MACs, the flex provisions in fee letters have become increasingly important and are discussed further in connection with syndication. *See* section 13:7.3, *infra*. Market flex refers to the ability of a lender to modify the pricing, structure, tenor, covenants, or other terms of the committed financing, often within specified parameters, in order to achieve or facilitate a successful syndication. These provisions are contained in a separate fee letter subject to confidentiality so as not to adversely affect syndication.

- There are only limited representations and warranties required to be true at closing, consisting of (a) those in the acquisition agreement that are material to the lenders and that would entitle the buyer to terminate the acquisition agreement,<sup>90</sup> and (b) certain additional specified representations that affect the integrity of the financing transaction, such as the buyer's corporate power and authority, the enforceability of the financing documents, margin regulations, investment company act, debt ranking and, in recent market practice, solvency and no conflict with material laws or, sometimes, agreements;
- The final form of documentation is often by reference to an attached summary of terms, which contains an exclusive list of all covenants and events of default required with gaps to be filled in by reference to a specified precedent document. The levels for financial covenants are often specified or set at an agreed variance from agreed projections; and
- The requirement for perfection in collateral at closing is limited to (a) the filing of applicable U.C.C. financing statements, and (b) the delivery of certificated securities representing the equity interests in subsidiaries.<sup>91</sup>

While the borrower will likely want the conditions in the commitment letter to be generally consistent with the conditions in the acquisition agreement, there are circumstances where the conditions may well have to differ. One example of this relates to the definition of material adverse change in the case of a debt commitment to a strategic buyer. In that circumstance, the lender will expect conditions in the commitment letter to include a condition that no material adverse change has occurred since the date of the last audited financial statements of the buyer, even if that is not consistent with the definition in the acquisition agreement.

A further word on MAC clauses<sup>92</sup> may be useful. Although borrowers often ask for language that the condition be stated by reference to the acquisition agreement, for example, "no Material Adverse Change as defined in the Acquisition Agreement shall have occurred," this formulation is not the best. As the lender is not party to the

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90. Many acquisition agreements qualify a buyer's ability to terminate based on any representations by reference to a MAC.

91. Although not part of the original SunGard perfection requirements, a number of acquisition financing commitments have started to include the delivery of an intellectual property security agreement in recordable form as a condition to close as well.

92. So-called "market MAC" clauses are discussed in section 13:7.3, below.

Acquisition Agreement, the lender will not have a voice in whether a MAC “as defined in the Acquisition Agreement” has occurred if the buyer and the seller agree that it has not. Although it is not binding in a legal sense, such a determination would make it very hard for the lender to assert to the contrary. By incorporating an independent definition into the financing commitment, even if it is verbatim from the acquisition agreement, the lender has preserved the ability to make its own determination of the facts and circumstances under an agreement to which it is a party and to evaluate the MAC in the context of the financing itself rather than the acquisition. The other legal issue that often is not highlighted in the context of MAC clause negotiations is that the acquisition agreement and the commitment letter may be governed by the laws of different states. While Delaware law has expressly placed the burden of proof on the party claiming that a material adverse change has occurred to establish that the change is “consequential to the company’s long-term earning power over a commercially reasonable period” described as measurable in “years, not months,”<sup>93</sup> New York law has not set so high a hurdle.<sup>94</sup> By setting forth the definition in the commitment letter, which is governed by New York law, rather than incorporating the MAC by reference from the acquisition agreement, which may be and usually is governed by Delaware or other state law, the lender may succeed in preserving some additional flexibility that the buyer may not have.<sup>95</sup>

Of course, the extent to which the conditions in the commitment letter conform to those in the acquisition agreement will be a matter of negotiation between the parties, and will depend on the amount of risk that the borrower is willing to accept regarding the obligation of the lender to close the financing.

The requirement that the parties negotiate, execute and deliver definitive loan documentation may also vary in form from transaction to transaction, although this condition should be included in any commitment letter to ensure that any necessary loan documents are executed by the loan parties prior to closing. In some transactions,

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93. *Hexion Specialty Chems., Inc. v. Huntsman Corp.*, 965 A.2d 715 (Del. Ch. 2008).

94. *See, e.g., UBS Sec. LLC v. Finish Line, Inc.*, No. 07 Civ. 10382 (LAP), 2008 WL 536616 (S.D.N.Y. Feb. 22, 2008).

95. There are some examples of commitment letters where the choice of law is in fact split so that New York law governs the commitment other than the MAC clause, which then is specified to be governed by Delaware law, but these are a distinct and small minority.

there will be a general condition that the parties enter into loan documents that are acceptable to the lender.<sup>96</sup> While there would likely be an implied duty by the lender and the borrower to negotiate in good faith regarding these loan documents,<sup>97</sup> under this approach so long as the lender satisfies this duty the lender would not be obligated to close if the lender and the borrower are unable to reach agreement regarding the terms of the loan documents. Typically, the commitment letter will include certain details regarding the terms of the loan documentation, such as the economic terms of the loan, the timing of payments for the loan, the maturity date, and the scope of the representations, warranties, covenants and events of default. If the borrower wants to increase the certainty regarding the terms of the loan documentation, the borrower may request that the lender include a detailed and exclusive listing of the categories of the representations, warranties, covenants, and events of default. The extent to which the commitment letter will include these details will, of course, be a matter of negotiation between the parties, and will depend on a number of factors, including the needs of the borrower for certainty regarding these terms, the relationship between the borrower and the lender in other lending transactions, the robustness of the financial markets at the time of the transaction, and the extent to which the lender has completed its diligence regarding the transaction.

### **[B] Modifications to SunGard and Xerox Provisions**

The SunGard financing provisions survived the market downturn and it now seems unlikely that acquisition financing will return to the pre-2005 practice of including diligence and market MAC conditions in financing commitments. There are, however, a few modifications to the limited conditionality that prevailed before the downturn. First, lenders have added some representations required to be correct at closing—notably solvency and no conflicts with applicable law or material agreements. Second, there has been an increasing focus on ensuring that a lender is not required to fund into an event of default under the definitive documents at closing. Thus, a commitment letter

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96. Some private equity sponsors may not be willing to leave the terms of the documentation to the discretion of the lender and may want to establish a reference point for the documentation based either on the transactions to which the private equity sponsor is a party generally, or on other transactions between the lender and the private equity sponsor. The extent to which the lender is willing to agree to such a request will, of course, be a matter of negotiation between the parties.

97. See, e.g., *Auerbach v. Great W. Bank*, 74 Cal. App. 4th 1172 (1999); *Teachers Ins. & Annuity Ass'n of Am. v. Tribune Co.*, 670 F. Supp. 491 (S.D.N.Y. 1987); *999 v. C.I.T. Corp.*, 776 F.2d 866 (9th Cir. 1985).

might include the requirement that there be no event of default under the definitive documents either before or after giving effect to the closing. Third, a number of commitments have a financial test—usually minimum EBITDA or maximum leverage—that must be satisfied at closing after giving effect to the acquisition and the financing.

As with SunGard, the term “Xerox provisions” refers to certain provisions that were first implemented in connection with a financing for the company for which the provisions are named—the acquisition of Affiliated Computer Services by Xerox announced in September 2009. These provisions are relatively simple on their face. First, in response to litigation in multiple forums in connection with unprofitable commitments issued prior to the 2007 downturn,<sup>98</sup> lenders now often require that the acquisition agreement provide for exclusive jurisdiction and exclusive venue in New York courts (usually in the borough of Manhattan) for any action involving the financing or the lender. Second, the acquisition agreement must contain a waiver of the right to trial by jury in any such proceeding. Third, for a time the acquisition agreement, to be acceptable to the lender, must limit the seller’s remedies and damages whether against the buyer or its lenders to a negotiated amount as a reverse break-up fee. Finally, the last so-called Xerox provision is that the lender is an express third-party beneficiary of each of the foregoing provisions of the acquisition agreement, although as the financing markets have remained active, this condition has again disappeared in much of the market. Fourth, a number of commitment letters have added intellectual property

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98. The aborted acquisition of Huntsman Corporation by Hexion Specialty Chemicals resulted in suits in Delaware, *see, e.g., Hexion Specialty Chems., Inc.*, 965 A.2d at 715, Texas, *see, e.g., Credit Suisse USA LLC v. Huntsman Corp.*, 269 S.W.3d 722 (Tex. App. 2008), and New York, *see, e.g., Lifschitz v. Hexion Specialty Chems., Inc.*, No. 08 Civ. 6394 (RMB), 2009 WL 73040 (S.D.N.Y. Mar. 18, 2009). Similarly, the Finish Line/Genesco transaction resulted in lawsuits in Tennessee, *see, e.g., Complaint for Specific Performance of Obligations Under Agreement and Plan of Merger, Genesco, Inc. v. Finishing Line, Inc.*, Civil No. 07-2137-11 (III) (Tenn. Ch. Ct., Davidson Cty., Sept. 21, 2007) and New York, *see, e.g., Lasker v. UBS Sec. LLC*, No. 08-CV-854 (CPS) (RER), 2009 WL 57137 (E.D.N.Y. Jan. 7, 2009), while the Clear Channel transaction was litigated in New York, *see, e.g., Verified Complaint, BT Triple Crown Merger Co. v. Citigroup Glob. Mkts. Inc.*, No. 600899/08 (N.Y. Ct. App. Mar. 26, 2008) and Texas, *see, e.g., Plaintiff Verified Complaint and Application for Temporary Restraining Order, Temporary Injunction, and Permanent Injunction; Request for Expedited Discovery; and Result for Expedited Trial, Clear Channel Commc’ns, Inc. v. Citigroup Glob. Mkts., Inc.*, No. 2008CI04864 (225th Dist. Ct., Bexar Cty., Tex., Mar. 26, 2008).

security agreements to financing statements and certificated securities for the perfection items deliverable at closing.

### § 13:7.3 **Syndication**

The parties will need to consider how the risks regarding the ability of the lender to syndicate the loan transaction will be allocated. If the transaction is sufficiently large such that the lead arranger for the financing facility does not want to hold the entire amount of the loans and commitments and is not able to complete the syndication prior to the date of the closing, or if the borrower needs the commitment to remain outstanding for an extended period of time and is not willing to release the commitment upon pre-closing syndication, then the right to make changes in the commitment under the market flex provisions of the fee letter will come into play and may survive the closing as “post-closing flex.”

One approach to this issue (currently not favored) was the inclusion of a so-called “market MAC” as an additional condition in the commitment letter—that is, the occurrence of any change in the capital markets that could reasonably be expected to adversely impact the syndication of the loans and the commitments under the loan documents would excuse the lender from fulfilling its commitment.<sup>99</sup> Alternatively, the parties could agree to eliminate any condition regarding the syndication of the loans and commitments, and instead agree to increase the fees, interest rates, or other terms of the loan documents to the extent necessary to enable the loans and commitments to clear the syndication markets. Of course, it is also possible to include a combination of the two approaches by imposing a limitation on the extent to which the pricing may be increased, and limiting the condition to material and adverse changes in the capital markets that prevents the lender from being able to syndicate the loans and the commitments or including a more limited “clear market” provision that insures that neither the buyer nor the target will attempt to raise capital during the time that the financing commitment remains

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99. A cautionary note regarding the utility of market MACs is in order as courts may be reluctant to excuse the lender from its commitment, particularly where the borrower has paid a fee, incurred expenses or entered into a purchase agreement without a financing contingency in reliance on the financing commitment. *See, e.g., Capitol Justice LLC v. Wachovia Bank, N.A.*, 706 F. Supp. 2d 23 (D.D.C. 2009) (court found that a “material adverse change in the capital, banking and financial market conditions that could impair the sale of the loan by Lender as contemplated in the term sheet” left a triable issue of fact as to whether a MAC was limited to “an unforeseeable adverse change” or included “any meaningful or significant adverse change” whether or not foreseeable).

outstanding until a successful syndication has been achieved. A combined approach allows the parties to accommodate incremental changes in the capital markets by adjusting the pricing, within an agreed upon range, to the extent necessary to permit the syndication to be completed, while at the same time protecting the lender in the event that there is such a dramatic change in the capital markets that the lender is not able to syndicate the loans and the commitments, even after the pricing is adjusted as agreed to by the parties and protecting the lender from being unable to syndicate the credit due to a competing financing transaction that could create market confusion or limit market capacity. The extent to which these protections are included will also be a matter of negotiation and will depend on the extent to which the parties anticipate that the market for loans of this type will change between the date when the commitment letter is signed and the date when they expect to finalize the syndication process.

While market MAC clauses never completely disappeared from the market, borrowers and sellers in acquisition financings successfully held the line; market MACs have not found their way back into the acquisition market and generally are not present as conditions to acquisition financing commitments. In place of market MACs, lenders have been relying on far broader market flex provisions for protection—in many instances providing for very substantial pricing increases and fees and permitting the complete restructuring of credit facility terms other than as specified if necessary to achieve a successful syndication or if a successful syndication cannot be achieved. This latter point is significant. Borrowers often try to limit flex to the extent necessary to achieve a successful syndication, but that does nothing for the lender in the most difficult of circumstances when the lender may need flex the most, such as was the case in late 2007 and early 2008 when the market collapsed so completely that loans could not be syndicated even on fully flexed terms. Accordingly, it is important for a lender to preserve the ability to impose flex within the negotiated limits even if syndication is impossible, both to mitigate its losses in a broken market and to provide incentive for the borrower to find ways to refinance or repay the debt.

### **§ 13:8 Regulation U**

One additional closing issue that lenders should consider is whether the borrower owns or will acquire any publicly traded securities which would subject the loan to the restrictions of Regulation U. The Federal Reserve Board of Governors adopted Regulation U in 1936 in the aftermath of the 1929 stock market crash. As discussed below, Regulation U subjects credits, which are directly or indirectly secured

by publicly traded securities that constitute margin stock, to certain substantive and reporting requirements.<sup>100</sup>

### **§ 13:8.1 Substantive Requirement**

A credit that is a “purpose credit” and is directly or indirectly secured by margin stock for the purposes of Regulation U is subject to a substantive restriction regarding the aggregate amount of such credit.<sup>101</sup>

#### **[A] Purpose Credit**

The first condition to the application of the substantive requirement under Regulation U is that the credit constitutes a “purpose credit.” Under Regulation U, any credit extended for the purpose (whether immediate, incidental, or ultimate) of buying or carrying margin stock is a purpose credit for the purposes of Regulation U.<sup>102</sup> For this purpose, a credit is extended for the purpose of carrying margin stock if the credit enables a customer to maintain, reduce, or retire indebtedness originally incurred to purchase margin stock.<sup>103</sup>

#### **[B] Direct or Indirect Security**

The second condition to the application of the substantive requirement under Regulation U requires that the credit be directly or indirectly secured by margin stock.<sup>104</sup> For the purposes of Regulation

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100. Margin stock is defined as:

(1) Any equity security registered or having unlisted trading privileges on a national securities exchange; (2) Any OTC security designated as qualified for trading in the National Market System under a designation plan approved by the Securities and Exchange Commission (NMS security); (3) Any debt security convertible into a margin stock or carrying a warrant or right to subscribe to or purchase a margin stock; (4) Any warrant or right to subscribe to or purchase a margin stock; or (5) Any security issued by an investment company registered under section 8 of the Investment Company Act of 1940 (15 U.S.C. § 80a-8), other than (i) A company licensed under the Small Business Investment Company Act of 1958, as amended (15 U.S.C. § 661); or (ii) A company which has at least 95 percent of its assets continuously invested in exempted securities (as defined in 15 U.S.C. § 78c(a)(12)); or (iii) A company which issues face-amount certificates as defined in 15 U.S.C. § 80a-2(a)(15), but only with respect of such securities; or (iv) A company which is considered a money market fund under SEC Rule 2a-7 (17 C.F.R. § 270.2a-7).

12 C.F.R. § 221.2.

101. 12 C.F.R. § 221.3(a)(1).

102. *Id.*

103. 12 C.F.R. § 221.2.

104. 12 C.F.R. § 221.3(a)(1).

U, a credit is indirectly secured by margin stock if the arrangement restricts the borrower's right or ability to sell or pledge the margin stock, or, if the exercise of the right to sell or pledge the margin stock provides or may provide the lender with the right to accelerate the maturity of the credit.<sup>105</sup>

There are certain statutory exceptions to the rule described above regarding the arrangements that are deemed to constitute indirect security. First, if after applying the proceeds of the credit, not more than 25% of the value of the assets subject to the arrangement consists of margin stock, the credit is not considered to be indirectly secured by margin stock. Similarly, an arrangement is not considered to be indirectly secured based on a right of the lender with the right to accelerate the maturity of the credit that results solely from a cross-default to other indebtedness held by a non-affiliate of the lender. Other exceptions include situations when the lender, in good faith, has not relied upon the margin stock as collateral to extend or maintain the credit; and where the lender acts merely in the capacity as custodian, depository or trustee.<sup>106</sup> However, if the collateral for the credit includes margin stock, the loan is considered directly secured for the purposes of Regulation U.

### [C] Maximum Loan Value

If the credit constitutes a purpose credit and is directly or indirectly secured by margin stock, the amount of the credit may not exceed the maximum loan value of the collateral securing the credit.<sup>107</sup> For the purposes of Regulation U, the maximum loan value of margin stock is defined as 50% of the current market value of the margin stock.<sup>108</sup> Options that do not themselves constitute margin stock have no loan value under Regulation U.<sup>109</sup> The maximum loan value of other collateral not constituting margin stock is equal to the amount (not exceeding 100% of the current market value of the collateral) that a lender, exercising sound credit judgment, would lend based on such collateral, without considering the customer's other assets held as collateral in connection with unrelated transactions.<sup>110</sup> As a result, the portion of the loan not fully covered by the collateral that is not margin stock must initially be covered by 50% of the current market value of the margin stock.

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105. 12 C.F.R. § 221.2.

106. *Id.*

107. 12 C.F.R. § 221.3(a)(1).

108. 12 C.F.R. § 221.7(a).

109. 12 C.F.R. § 221.7(c).

110. 12 C.F.R. §§ 221.7(b), 221.2.

A credit originally extended in compliance with this substantive requirement may be maintained, even if the value of the margin stock subsequently decreases so the amount of the loan subsequently exceeds the maximum loan value.<sup>111</sup> By setting a 50% initial collateral cushion on margin stock, the Federal Reserve Board aimed to reduce the likelihood that lenders would call loans based on rapid changes in the value of the margin stock. However, collateral for the credit may only be withdrawn or substituted if, after giving effect to such withdrawal or substitution, the withdrawal or substitution would not cause the amount of the credit to exceed the maximum loan value of the remaining collateral or increase the amount by which the credit exceeds the maximum loan value of the collateral (in the case of a credit where the amount of the credit exceeded the maximum loan value of the collateral prior to such withdrawal or substitution).<sup>112</sup> To determine compliance with Regulation U, the lender will need to obtain information, including a description of the collateral and its value in each case, as of the date of the withdrawal, substitution or subsequent extension of credit.<sup>113</sup>

## **§ 13:8.2 Reporting Requirement**

### **[A] Regulation U Forms**

If the arrangement is directly or indirectly secured by margin stock, the lender and the borrower must comply with the reporting requirements under Regulation U, even if the credit is not a purpose credit. When the lender is a bank and the amount of the credit exceeds \$100,000, the bank must require that its customer execute a form FR U-1, which indicates whether the arrangement is a purpose credit.<sup>114</sup> If the lender is not a bank, the lender must require that its customer execute a form FR G-3, which contains similar information to the information required by the form FR U-1.<sup>115</sup> Once the customer executes these forms, if the credit is a purpose credit, the lender must complete part two of the applicable form, containing a description of the collateral and its value so the lender may determine whether the loan exceeds the maximum loan value of the collateral. Part two of the applicable form need not be completed, however, if the arrangement does not involve a purpose credit.

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111. 12 C.F.R. § 221.3(a)(2).  
 112. 12 C.F.R. § 221.3(f).  
 113. 12 C.F.R. § 221.3(f)(2).  
 114. 12 C.F.R. § 221.3(c)(1)(i).  
 115. 12 C.F.R. § 221.3(c)(1)(ii).

**[B] Revolving Credit Facilities**

If loans or other financial accommodations are extended on a revolving or multiple-draw basis, or if all of the collateral for the agreement is not pledged at the time that the facility is originally established, the form FR U-1 or form FR G-3, as applicable, must be executed at the time that the facility is originally established and amended for each additional extension of credit and at the time that additional collateral for the arrangement is provided.<sup>116</sup> To comply with this requirement, the lender should ensure that the borrower is required to provide the information regarding the collateral and its value that is necessary to so amend the form in connection with the request for such additional extension of credit or the provision of such additional collateral.

**[C] Annual Reporting for Non-Bank Lenders**

If the lender is not a bank that in the ordinary course of business extends or maintains credit directly or indirectly secured by margin stock, or any other person subject to Regulation T, the lender must register with the Federal Reserve Bank by submitting a fully completed and executed FR G-1 form. The FR G-1 must be filed within thirty days after the end of any fiscal quarter, during which either the amount of the credit extended equals or exceeds \$200,000 or the outstanding amount of the credit at any time during such fiscal quarter equals or exceeds \$500,000.<sup>117</sup> Each such non-bank lender must also submit an annual report on form FR G-4 within thirty days after June 30 of each year.<sup>118</sup> All forms must be submitted to the Federal Reserve Bank of the district where the principal office of the lender is located.<sup>119</sup>

**§ 13:8.3 Consequences of Non-Compliance with Regulation U**

While Regulation U was promulgated by the Federal Reserve Board, it is authorized by section 7 of the Securities Exchange Act of 1934 ("34 Act").<sup>120</sup> As a result, all of the penalties for a violation of the '34 Act are available for a violation of the provisions of Regulation U. While a showing of willfulness would be required for a criminal conviction, a violation of the provisions of Regulation U potentially could result in a fine or imprisonment of the bank officer who approves the making of a loan that violates Regulation U.<sup>121</sup>

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116. 12 C.F.R. § 221.3(c)(2).

117. 12 C.F.R. § 221.3(b)(1).

118. 12 C.F.R. § 221.3(b)(3).

119. 12 C.F.R. § 221.3(b)(4).

120. 15 U.S.C. § 78g; 12 C.F.R. § 221.1(a).

121. 12 C.F.R. § 221.3(a).

In addition, any violation of Regulation U by a lender previously could result in the underlying credit agreement being avoided. In 1970, however, Regulation X was adopted by the Federal Reserve Board. Regulation X extended to borrowers the margin limitations set forth in Regulation U.<sup>122</sup> Several courts have held that as a result of such adoption of Regulation X, there is no longer an implied right of private action under Regulation U.<sup>123</sup>

To date, there has been relatively little enforcement activity with respect to Regulation U. Nevertheless, given the potential consequences of failing to comply with the provisions of Regulation U, lenders typically require an opinion of counsel with respect to Regulation U in connection with most loan transactions. In addition, if margin stock constitutes a portion of the collateral (whether direct or indirect), it is important for the lender to make sure that it obtains all information, and takes whatever other steps (including the execution and completion of the relevant regulatory forms), in each case, necessary to comply with the requirements of Regulation U.

### § 13:9 Documentation

It is assumed here that the reader will know how to prepare the basic underlying documents that are necessary for any transaction, not just asset-based ones. These include resolutions, incumbency certificates, and officers' certificates that recite, in the language set forth in the loan agreement, the absence of defaults and the verity of the representations and warranties.

As noted above, commitment letters come in all sizes and shapes. Appendix 13A is a form of a one-page term sheet often used in lieu of a proposal letter, while Appendix 13B represents a relatively standard form of commitment letter for an acquisition financing. Both forms are subject to the execution of final agreements. If the parties are able to agree on such details, the letters may also contain the details of the financial covenants that would be included in the documents. The lender should keep in mind, though, that the more complete the commitment letter, the easier it may be for a court to find that it is an enforceable document. Finally, the forms are offered for illustrative purposes and should not be used for a particular transaction without the advice of counsel.

A factoring indemnity is a fairly complex document, reflecting the fact that factoring, itself, is complex. Appendix 13C is a form of indemnity that is generally accepted in the industry as, if not the standard form, at least the starting point for any individual variations.

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122. 12 C.F.R. §§ 224.1–224.6.

123. *See, e.g.*, *Bennett v. U.S. Trust Co. of N.Y.*, 770 F.2d 308 (2d Cir. 1985).

The form was developed by the Commercial Finance Association (formerly, the National Commercial Finance Association), a nationwide association of commercial finance companies, banks, factors, and other financiers.

Appendix 13D is a form of waiver to be signed by a landlord to effect a waiver of its lien in favor of the secured party. The form is easily modified to become a mortgagee waiver in those states or circumstances in which the mortgagee, either by statute or by contract, has a lien that would interfere with the secured party's rights.

It is typical to prepare a closing memorandum or closing checklist to memorialize the necessary steps to be taken and conditions to be satisfied in connection with the closing of a loan transaction. Appendix 13E is a form of closing memorandum that might be used in a typical asset-based lending transaction.

