Commercial Law Newsletter

Joint Newsletter of the Commercial Finance and Uniform Commercial Code Committees

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IN THIS ISSUE

Joint Report from the Chairs

Dear Members:

Please email either of us if you have any ideas for either of the Committees or wish to participate in any project, subcommittee or leadership role. The Committees have a number of projects underway. Our subcommittees and task forces are very active and always welcome input. Please do not hesitate to volunteer!

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

R. Marshall Grodner
Commercial Finance Committee Chair
mgrodner@mcglinchey.com

Candace M. Zierdt
UCC Committee Chair
czierdt@law.stetson.edu

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Featured Articles

PERFECTION AND PRIORITIES: LESSONS LEARNED FROM *PHILADELPHIA ENERGY SOLUTIONS*

By Ira L. Herman and Mark I. Rabinowitz, Blank Rome LLP

The pressure to "get the deal closed" and give up on important deal points in the course of intercreditor negotiations is often hard to resist. But resistance is not futile. Important priority rights in and to collateral, including insurance, must be preserved by standing firm on substance and making sure the deal is properly documented. This is particularly true when a transaction involves lenders with different priorities in a borrower's property, and whether the transaction is a standard 1L/2L deal, a unitranche deal, or a split lien deal. The message was recently driven home once again by a decision addressing

- Subcommittee on Secured Lending
- Subcommittee on Syndications and Lender Relations
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- Subcommittee on Annual Survey
- Subcommittee on Article 7
- Subcommittee on Commercial Law Newsletter
- Consumer and Commercial Contracts
- Subcommittee on International Commercial Law
- Subcommittee on Investment Securities
- Subcommittee on Leasing
- Subcommittee on Letters of Credit
- Subcommittee on Payments
- Subcommittee on Recent Developments
- Subcommittee on Sale of Goods
- Subcommittee on Secured Transactions
- Forms Under Revised Article 9 Task Force
- Cleared Swaps Task Force

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- Filing Office Operations and Search Logic Joint Task Force
- Legislative Enactment of Article 9
- Model IP Security Agreement Joint Task Force
- Security Interests in LLC and other Unincorporated Entity Interests Joint Task Force
- Survey of Commercial Lending Laws

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perfection and lien priority issues in a split lien deal, in the Philadelphia Energy Solutions ("PES") chapter 11 cases.

On June 21, 2019, an explosion and fire destroyed the Girard Point refining facility owned by PES in South Philadelphia. Shortly thereafter, several PES entities (PES debtors) filed voluntary petitions for relief under chapter 11. At all times relevant, the PES debtors had $1.25 billion in insurance coverage for property damage ("PD") and business interruption ("BI") losses.

Prior to the commencement of their chapter 11 cases, the PES debtors financed their operations with two facilities, a specialized working capital facility with ICBC Standard Bank PLC ("ICBCS"), as lender, and a term loan facility with several lenders and Cortland Capital Market Services LCC, as administrative agent ("Cortland").

By the time the PES debtors filed for chapter 11 relief, their physical assets and the revenue stream generated by the operation of those assets had been destroyed, leaving the PES Debtors, their Creditors' Committee ("UCC"), ICBCS, and Cortland to duke it out over their respective rights and priorities in and to proceeds of certain PD and BI insurance.

The reason both PD and BI insurance policies were at issue regarding PES is the physical destruction of the PES refinery that resulted in the loss of PES's ability to operate. As is true with regard to BI policies in general, the coverage available to PES was limited to situations where the "actual loss sustained by the Insured resulting from **the necessary interruption of business [is] caused by direct physical loss or damage by a peril insured against, to property insured herein** …" (emphasis added). By way of contrast, BI insurance with similar policy language most likely will *not* cover losses suffered by businesses shut down due to the current COVID-19 pandemic, due to the absence of physical damage. However, each policy is different, and lenders would be well advised to review any applicable policy language and factual circumstances before making any determination about the extent of the BI coverage available to a borrower.

The Term Loan Facility

The PES debtors were the borrowers under an approximately $698.6 million term loan facility provided by the term loan lenders, with Cortland as administrative agent.

The term loan facility financed the debtors' exit from chapter 11 in their prior cases and was approved by Judge Gross pursuant to the Court's prior confirmation order. That confirmation order provided that on the effective date of the prior chapter 11 plan, "the liens granted and contemplated by the New First Lien Term Loan Documents shall be valid, binding, perfected, and enforceable liens on the collateral specified in the New First Lien Term Loan Documents for the benefit of the secured parties under the New First Lien Term Loan Documents." Among the covenants in the term loan facility documents was the debtors' affirmative covenant to name Cortland "as insured party or loss payee with respect to applicable insurance policies."

The documents also included a mandatory prepayment provision that would be triggered upon certain "Asset Sales" or "Recovery Events" (both as defined in the term loan facility documents). The mandatory prepayment provision states, "[F]or the avoidance of doubt, any cash proceeds received from business interruption insurance shall not be required to be used by the Loan Parties to prepay the Loans under this Section 2.06(b)." Additionally, the agreement made clear that the defined term recovery event "shall not include proceeds received from business interruption insurance."

In connection with the term loan facility, certain PES entities executed a term loan security agreement with Cortland on Aug. 7, 2019. That agreement was governed by New York law and granted Cortland a collateral security interest in certain assets of each grantor.

On Nov. 1, 2018, Cortland was issued an evidence of property insurance certificate, and on July 3, 2019, Cortland and the PES debtors executed a term loan facility forbearance agreement stating:

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"[T]he Loan Parties hereby acknowledge and agree that, subject to the Intercreditor Agreement, (i) all property insurance proceeds that any Loan Party is or may be entitled to (including, without limitation, casualty and business interruption insurance proceeds ...) as a result of or in any manner related to the fire that occurred in the refinery operated by the Borrower and its Subsidiaries located in Philadelphia, Pennsylvania on or around June 21, 2019 (… and such proceeds, the 'Specified Insurance Proceeds') constitute Collateral securing the Obligations and (ii) the Secured Parties hold valid and perfected liens over any and all such Specified Insurance proceeds."

Additionally, two of the debtors executed separate exit mortgages (effective Aug. 7, 2018) and certain other incremental mortgages (effective April 5, 2019). Under the mortgages, Cortland received a lien on and security interest in "all proceeds of any" insurance policy relating to "Real Estate or Equipment," "including the right to collect and receive such proceeds."

On Aug. 8, 2018, Cortland filed UCC-1 financing statements with the Delaware Department of State covering all of the debtors' assets and disclosing its security interests in "[a]ll assets of the Debtor of every kind and nature, whether now owned or hereafter acquired and wherever located, and all proceeds and products thereof."

The Working Capital Facility

On June 18, 2019, the several PES entities and ICBCS executed an intermediation facility agreement, as part of the exit facility PES obtained when exiting a prior chapter 11 case. Pursuant to the intermediation facility agreement, among other things, the relevant PES entities agreed to "[k]eep [their] property insured at all times" and "name ICBCS as mortgagee, additional insured and loss payee" on the debtors' insurance policies. The Court correctly characterized the intermediation facility as a "working capital arrangement that helps the [] [debtors] run their business. Another way to look at the intermediation facility is that it a specialized type of ABL hybrid with some elements that look like somewhat like a consignment or floor plan financing.

The confirmation order in the prior chapter 11, provides, in relevant part, for the perfection of the security agreement and states that on the plan's effective date, "the liens granted and contemplated by the New Intermediation Facility shall be valid, binding, perfected, and enforceable liens on the collateral specified in the New Intermediation Facility for the benefit of the secured parties under the New Intermediation Facility."

A property insurance certificate stating that ICBCS was an "Additional Insured" and "Loss Payee/Mortgagee" under the policy was issued and provided to ICBCS.

Intercreditor Agreement

On Aug. 7, 2018, certain PES entities, Cortland, ICBCS and Merrill Lynch Commodities Inc. entered into an intercreditor agreement that governs the parties' respective priorities with respect to various categories of collateral.

Discussion of Split Collateral Loan Transactions

In many respects the PES capital structure is a good example of a "split collateral" loan transaction. In a "split collateral" loan transaction, a working capital loan (maybe an ABL) is coupled with a term loan (often referred to as a cash flow loan), where two lenders or sets of lenders (typically, an ABL lender or lenders and a term loan lender or lenders) share liens on a single collateral pool, each with priority over a different set of assets in the pool.

Generally, the ABL lender, will have priority liens on the in its borrowing base (most commonly current assets such as receivables and inventory) often referred to as the ABL priority collateral, and junior liens over the remaining asset base (generally fixed assets). The term loan lender, conversely, will have priority liens over the fixed assets and junior liens over the borrowing base assets. To better understand the split collateral loan structure dynamic, it is important to be aware that a common feature of "split collateral" intercreditor agreements is symmetry – the priority rights of the ABL lender with respect to the ABL priority collateral will for the most part mirror the priority rights of the term lender with respect to the term loan priority collateral. This type of intercreditor relationship

exists in sharp contrast to the more familiar "all assets" intercreditor arrangement between a first-lien and second-lien lender, where the lenders are willing to take shared collateral, but one lender is willing to exchange more risk for better economics.

In contrast, a "split collateral" intercreditor typically involves an ABL lender that is by definition focused on the most liquid collateral of the borrower, and a term lender that may be either collateral-focused (if there are significant fixed assets) or looking almost entirely to cash flows to support the credit. The documentation will include provisions establishing the respective lien priorities, enforcement standstill periods, turnover and application-of-proceeds clauses, a set of bankruptcy right waivers, limits on amending one side's credit documents without the other side's consent, and a buyout right (which is sometimes drafted bilaterally in accordance with the general principle of symmetry in "split collateral" arrangements, but is also often drafted solely in favor of the term loan lender, especially when the ABL facility is relatively small and there is little prospect of the ABL lender desiring to pay out the term loan lender in order to step into its shoes).

In split collateral intercreditor agreements, ABL priority collateral typically is defined by reference to asset classes, while term priority collateral (or the equivalent) is defined as all shared collateral that is not ABL priority collateral (usually inventory, receivables and cash). The lines drawn in the intercreditor agreement have an impact on the underlying credit agreements as well – for example in stating the term loan agreement's mandatory prepayment requirements with respect to dispositions of collateral. The intercreditor agreement also usually specifies how to allocate proceeds of mixed priority collateral – i.e. how much of the proceeds to attribute to the ABL priority collateral and how much to the term priority collateral (for example, by allocating book value to the ABL priority collateral and the remainder of the proceeds to the term priority collateral).

In addition to the core borrowing base assets, such as inventory and accounts receivable, the ABL lender will want the ABL priority collateral to include references to UCC asset classes such as chattel paper, deposit accounts, documents, instruments, supporting obligations and general intangibles, to the extent related to any of the other ABL priority asset categories; products and proceeds of the foregoing should be covered. On the other hand the term loan lender will seek to carve back from the ABL priority collateral any assets that constitute proceeds of the term priority collateral – such as any receivables and payment intangibles owed on account of a disposition of fixed assets, or deposit accounts containing proceeds of fixed assets or other term priority collateral. An excellent example – a carve out of equity interests in subsidiaries.

The Decision of the Bankruptcy Court Concerning the Perfection Issues

After litigation was initiated, U.S. Bankruptcy Judge Kevin Gross of the District of Delaware issued a decision Feb. 28 concerning the relative rights of the parties to proceeds of the PD and BI insurance.

The Court found that Cortland, as term loan agent, had a perfected security interest in the BI policy and BI proceeds at all relevant times, because (i) New York law provides that creditors perfect security interests in insurance policies by being named loss payees and, according to the court's analysis, Cortland is a loss payee, and (ii) the prior confirmation order perfected Cortland's security interest in the policy proceeds.

Similarly, the Court found that ICBCS "has a clear perfected security interest in the BI Policy and Proceeds." To reach this conclusion, the court relies on the blanket lien on the debtors' assets provided in favor of ICBCS, pursuant to the ICBCS security agreement, the BI policy's endorsement naming ICBCS as a loss payee/mortgagee and the fact that the BI policy also names ICBCS as an additional insured.

In reaching this conclusion, the Court rejected rejects the UCC's attempt to invalidate the liens on BI proceeds as "after-acquired property" under section 552(a) of the Bankruptcy Code. As the opinion explains, section 552(b) "provides that a security interest cannot be avoided if the after-acquired property is proceeds of collateral subject to a security interest which the secured creditor held prior to the bankruptcy and extends to the underlying collateral and its proceeds." Therefore, since both Cortland and ICBCS held a security interest in the Bl policy and BI proceeds "as loss payee/mortgagee" before the petition date (as discussed above), the Court found that the liens in the BI proceeds could not be avoided.

Most interestingly, the Court also bases its holding concerning the entitlement of the lenders to insurance proceeds on a completely separate and important legal theory:

> It is also the case [states the Court] that the BI Proceeds are not property of Debtors' estates. Insurance proceeds which a debtor assigns "cannot be reclaimed by the debtor." *In re McLean*, 132 B.R. 271 at 284 (Bankr. S.D.N.Y. 1991); *In re Moskowitz*, 14 B.R. 677 at 677, 680-81 (Bankr. S.D.N.Y. 1981) (reasoning that insurance proceeds a debtor assigns are not property of the estate and payment of the proceeds is not a voidable preference); *In re Suter*, 181 B.R. 116, 119 (Bankr. N.D. Ala. 1994) (reasoning that a loss payee means insurance proceeds are not property of the estate).

The same logic obviously would apply to the assignment of insurance proceeds by the PES Debtors to Cortland, as well as to other situations where a company has similarly assigned insurance proceeds.

Priority of Lender Interests in the BI Policy Proceeds

Having found that both Cortland and ICBCS had perfected security interests in the BI policy, the Court then decided that "by virtue of the Intermediation Facility, ICBCS Security Agreement, and the Intercreditor Agreement, ICBCS's liens have priority over the liens belonging to the Term Loan Agent." According to the Court, the intercreditor agreement "clarifies the priority question, and the result favors ICBCS." The opinion cites two law review articles that, according to Judge Gross, confirm that ICBCS has the priority interest in the BI policy and BI proceeds.

In reaching its conclusion, the court reasons that ICBCS' "non-exclusive priority collateral … comprises all of the Debtors' business assets," whereas Cortland's priority collateral is "primarily real estate, fixtures and equipment based on the Intercreditor Agreement" and "[s]uch collateral does not create a priority security interest in the proceeds from business interruption insurance." Judge Gross cites to a 1992 Western District of Missouri case - *MNC Com. Corp. v. Rouse*, 1992 WL 674733 (W.D. Mo. Dec. 15, 1992) - as "instructive and supportive of the Court's rationale." After considering the various agreements in play and their relevant definitions, the court concludes that "[b]ecause ICBCS has a first-priority interest in Debtors' Accounts, Inventory, and General Intangibles and Money as it relates to Accounts and Inventory, ICBCS has a perfected security interest that takes priority over the Term Loan Agent's perfected security interest."

However, all is not lost for the term loan lenders, as the Court expressly recognized that "ICBCS is very likely not entitled to all of the proceeds from the BI Proceeds, and ICBCS must not prejudice the rights of the Term Loan Agent to recover the remainder or even the bulk of the BI Proceeds for which the Term Loan Agent also has a perfected security interest." The Court also notes, that "[i]t is unlikely, perhaps inconceivable is more appropriate, that the insurers will negotiate with the Term Loan Agent and/or ICBCS without assurance of a full and final release." The Court, perhaps with an air of resignation, therefore acknowledged that the dispute will almost certainly land back in Court for the determination of "how best to apportion the BI Proceeds based on the facts and the size of recovery of insurance proceeds."

Priority of Lender Interests in the PD Policy Proceeds

With respect to the PD proceeds, the Court concluded that ICBCS has priority on proceeds "related to SOA Separate Assets and Collateral and SOA Priority Collateral, which includes Inventory," and Cortland has priority on the PD proceeds "related to all other Common Collateral, which includes all Fixtures, Equipment, and pursuant to the Mortgages, Real Estate." Finally, the court held that Cortland has priority over ICBCS in the PD proceeds for the Girard point plant, while ICBCS had priority in such proceeds with respect to the hydrocarbons and refined products that had been lost.

On March 13, the UCC appealed Judge Gross's decision and order which is now pending with the Third U.S. Circuit Court of Appeals.

Lessons Learned

PES is a textbook case and a road map of how a bankruptcy court reviews and scrutinizes a loan transaction. It is also one of many cases that instruct never to cut corners regarding documentation of liens and assignments. Even though it is obvious, it is worth restating here: when disaster strikes, a good set of loan documents can be the difference between a potential recovery and a possible total loss.

A second lesson of PES, and one that is no less important, is that in the negotiation of any loan transaction involving multiple tranches of secured debt, whether the transaction is a unitranche, split lien or traditional 1L/2L deal, lenders and counsel must never lose sight of the business terms of the deal and take all steps necessary to ensure that the lender's lien priorities are clearly delineated and preserved. Any lender relying on priority collateral will be well served by the use of clear and specific language in documentation to avoid disputes and litigation risk after a default.

Finally, the court's finding that the insurance proceeds assigned to the lenders in PES were not "property of the estate" is important to lenders in many ways. First, properly assigned insurance proceeds cannot be accessed by a debtor seeking to use the proceeds as cash collateral in a bankruptcy case, since the debtor has no interest in such proceeds. And, second, payment of such proceeds to the lender should not be subject to avoidance, or claw back, since the proceeds are excluded from property of the debtor and its bankruptcy estate. Taking assignments, in addition to taking collateral and perfecting under the UCC, should not be overlooked as an important right that can be obtained by a lender when documenting a loan transaction.