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Headnote

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STEVEN A. MEYEROWITZ

Cross-Border Resolution of Banking Groups: International Initiatives and U.S. Perspectives – Part I

PAUL L. LEE

This article, the first of three parts, analyzes the efforts of international bodies with regard to creating effective resolution regimes for systemically important cross-border financial institutions.

The pandemic financial crisis of 2007-2009 has prompted a re-examination of much of the legal and prudential framework underlying the international financial system. This re-examination has occurred at the national level, as reflected, for example, in the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") in the United States and in the legislative proposals flowing from the Vickers Report and other initiatives in the United Kingdom. It has also occurred at the international level, as reflected in the work of the Basel Committee on Banking Supervision (the "Basel Committee") and the Financial Stability Board (the "FSB"). One of the key components in this effort is the re-examination of the resolution regimes for cross-border financial institutions, particularly those that are perceived as systemically important.

National legal regimes represent the starting and, in most cases, the ending point for the current analysis of the effectiveness of resolution regimes for cross-border financial institutions. In recognition of the primacy of national

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law, the work of the international standard-setting bodies such as the Basel Committee and the FSB has focused on the adoption of more robust national resolution regimes in the near term and on greater coordination among national resolution regimes in the medium term. Part I of this article analyzes the efforts of these international bodies and their prospects for success. As discussed in this part, progress toward adoption of robust national resolution regimes in response to the international standard-setters' calls remains fitful and progress toward broad international coordination elusive. National reform efforts are typically characterized by more introspection than circumspection. In any case, the events of the 2007-2009 financial crisis, as compounded by the subsequent events during the Eurozone crisis, have demonstrated the need for trust-building (or rebuilding) — even among jurisdictions that historically have enjoyed close relations — as a prelude to renewed coordination and cooperation. Part II of this article discusses some of the prominent national and regional efforts aimed at promoting more effective cross-border resolution of banks, with a particular emphasis on developments in the European Union.

Part III of this article analyzes the U.S. legal regimes applicable to the resolution of cross-border banking groups as an important component of any future framework for international cooperation. The development of options for the orderly resolution of the largest U.S. cross-border firms under Title II of the Dodd-Frank Act, particularly through the use of a single-point-of-entry model, holds the theoretical promise of more effective cross-border resolution with less disruption in foreign jurisdictions. Implementation of all the required elements of such an approach, however, is not yet assured. Acceptance by the markets and by the foreign authorities themselves will be essential to establishing credibility for this approach in a cross-border setting. If this approach can be made credible to all the essential stakeholders, the United States will be assured a leading role in promoting more effective cross-border resolution. At the same time, other regulatory proposals in the United States, particularly those relating to foreign banking organizations, may be seen as regressive in nature and as potentially complicating the cross-border resolution of such firms. The emerging cross-currents in U.S. practice are discussed in Part III of this article.

CALLS FOR AN INTERNATIONAL REVIEW

In the immediate wake of the destabilizing market events of September 2008, involving the bankruptcy of Lehman Brothers and the bailout of the American International Group ("AIG"), the Group of Twenty ("G20") in November 2008 adopted an action plan to implement reforms in the international financial markets.[1] The plan contained 47 specific action points, signaling the broad ambitions of the reform effort. One of the immediate action points in the financial supervisory area was for national supervisors to establish supervisory colleges for all major cross-border financial institutions to strengthen surveillance of cross-border firms. One of the medium-term action points in the financial supervisory area was for national and regional authorities to review their resolution regimes and bankruptcy laws to ensure that they would permit an orderly wind-down of large complex cross-border financial institutions.[2] The resolution regime action point was scarcely more specific than that. Nonetheless, much was subsumed in this general directive. The events of the financial crisis had confirmed in the minds of many observers that existing national legal regimes were wholly inadequate to address the failure of systemically important financial institutions ("SIFIs"). Recognition of this fact led to the enactment of the Dodd-Frank Act in the United States. Title II of the Dodd-Frank Act creates a new resolution regime (as an alternative to the Bankruptcy Code) designed to facilitate the orderly liquidation of systemically important U.S. financial institutions.[3]

A G20 Working Group on Reinforcing International Cooperation and Promoting Integrity in Financial Markets (the "G20 Working Group") in March 2009 provided further guidance on achieving the goals set in the G20 action plan.[4] With respect to the resolution regime action point, the G20 Working Group indicated its support for ongoing efforts to develop an international framework for cross-border resolution that would address the issues of ring-fencing and financial burden-sharing. It is precisely the issues of ring-fencing and financial burden-sharing that stand as the greatest impediments to the development of any international framework for resolution. As a consequence, the development of an international framework for cross-border resolution of financial firms must be adjudged at best a long-term project. "In the absence of international arrangements to deal with the insolvency of cross-border financial institutions," the G20 Working Group said that the international bodies should explore in the medium term a framework to advance the coordination of regional cross-border resolutions.[5] The G20 Working Group also requested the Financial Stability Forum (which was subsequently reconstituted as the FSB) and the Basel Committee to explore "the feasibility of common standards and principles as guidance for acceptable practices for cross-border resolution schemes thereby helping reduce the negative effects of uncoordinated national responses, including ring-fencing."[6]

BASEL COMMITTEE INITIATIVES

The Basel Committee committed the review request from the G20 Working Group to its Cross-border Bank Resolution Group (the "CBRG"). The CBRG consists of representatives from the central banks and bank supervisory authorities of 15 of the 27 member countries of the Basel Committee. The United States plays a prominent role in the CBRG, with its delegation consisting of representatives from the Federal Deposit Insurance Corporation (the "FDIC"), the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System (the "Board"), and the Federal Reserve Bank of New York.

CBRG RECOMMENDATIONS

In response to the request from the G20 Working Group, the CBRG released a consultative document with a set of ten recommendations relating to cross-border bank resolution in September 2009.[7] After a comment period, the CBRG issued its recommendations on cross-border bank resolution (the "CBRG Report") in final form in March 2010 (with no significant changes from the consultative document).[8] The ten recommendations in the CBRG Report were generally high-level, arising from the CBRG's consensus-bound process. The first recommendation was the most elementary: that national authorities should have appropriate tools to deal with all types of financial firms in difficulty so that an orderly resolution could be achieved, minimizing both systemic risk and moral hazard.[9] Examples of the kind of tools that would improve national resolution frameworks identified by the CBRG included the power to create bridge financial institutions and the authority to transfer the assets, liabilities, and business operations of a failing firm to other institutions. The CBRG noted that these tools would be particularly important in promoting continuity of systemically important functions in a resolution setting. In truth, the first recommendation laid bare a fundamental problem facing cross-border resolution of banking groups. The basic building blocks for orderly resolution of banking entities were lacking in many national jurisdictions, thus undermining any prospect for an orderly resolution across borders. The CBRG specifically recommended that national jurisdictions have special resolution regimes to deal with failing financial firms (instead of relying on general bankruptcy or insolvency laws) and that these regimes incorporate a set of tools that address the special issues that arise in the insolvency of a financial firm. As the FSB noted in a subsequent report, "[m]any countries entered [the] crisis without a proper resolution regime, and no country had a regime that could cope with failing SIFIs [systemically important financial institutions]."[10] Creating robust resolution regimes at the national level was seen to be the first order of business.

The CBRG's second recommendation was related to, and almost as elementary as, the first recommendation. The second recommendation was that each jurisdiction should establish a national framework to coordinate the resolution of legal entities of financial groups and financial conglomerates *within* its jurisdiction.[11] The second recommendation laid bare a second fundamental problem in the resolution of failing financial firms. Even where a national jurisdiction had specialized resolution regimes for its financial firms, there were generally different specialized resolution regimes for different types of financial firms. Without exception, there was no regime for the resolution of a financial group as a group distinct from the separate resolution regimes for its constituent parts. In the absence of a resolution regime for a financial group, the resolution processes for its constituent parts can become conflictive and may actually devolve into legal warfare among the resolution proceedings. The combatants include not only shareholders and creditors of the various legal entities in the proceedings, but also representatives of the resolution authorities themselves. Even in the relatively simple case of a holding company and a bank subsidiary, significant challenges and conflicts between the resolution regimes can arise, as the Washington Mutual case in the United States has amply demonstrated. The CBRG Report itself used other examples from the United States to demonstrate this basic point. The CBRG Report observed that no one agency in the United States had the authority or power to resolve all the significant entities in the Bear Stearns, Lehman Brothers, or AIG groups.[12] This problem is by no means limited to the United States. As the CBRG observed, a similar pattern of different resolution regimes for deposit-taking institutions, insurance institutions, and investment firms exists, for example, under the regulations and winding-up directives of the European Union. The existence of differing resolution regimes creates complicating factors for the resolution of firms even within a domestic context. The lack of coordination within a domestic context compounds the inherent risk of disarray in the near- and far-flung arms of a cross-border resolution.

Reflecting other lessons learned in the financial crisis, the CBRG made several high-level recommendations specifically aimed at facilitating the orderly resolution of large, complex financial institutions. One recommendation was that supervisors should work closely with home and host resolution authorities to understand how group structures and their individual components would be resolved in a crisis.[13] More specifically, the CBRG recommended that if national authorities believe that their financial institution groups are too complex to permit orderly and cost-effective resolution, they should consider imposing regulatory incentives through capital or other prudential requirements to encourage simplification in a manner that would facilitate effective resolution.[14] Among the factors that the supervisors were encouraged to analyze were legal, financial, and operational intragroup dependencies, such as those that might arise from the centralization of liquidity, risk-management, information technology, and other support or business functions.

Another critical recommendation was that there should be planning in advance for orderly resolution. The CBRG called for all systemically important cross-border financial institutions to prepare contingency plans that address the means to preserve the firm as a going concern during a period of financial distress and, if necessary, to facilitate a rapid resolution or wind-down of the firm.[15] The recommendation for contingency plans, subsequently restyled as recovery and resolution plans, or more colloquially as living wills, has been adopted by many national jurisdictions as a regular component of their supervisory oversight of large regulated entities. It is now a truth universally acknowledged that advance planning by both supervisory authorities and large complex firms is a necessary (but not sufficient) condition to any prospect for the orderly resolution of such firms. The recommendations in the CBRG Report for dealing with large, complex institutions were influenced by experiences in the financial crisis as well as the legislative steps already in train in the United States. The version of financial reform legislation, initially adopted by the House of Representatives in December 2009 and ultimately enacted in July 2010 as the Dodd-Frank Act, included a new authority for the orderly liquidation of systemically important U.S. financial institutions, a requirement for resolution plans to promote orderly liquidation, and other measures designed to incentivize or require simplification of complex institutions.[16]

The CBRG recommendations outlined above were principally directed at the adoption of robust resolution regimes at the national level. Moving from the national level to the international level, the CBRG recommended that national authorities seek convergence of the national resolution tools described above to facilitate coordinated resolution of financial institution operations in multiple jurisdictions.[17] The differences in procedural and substantive approaches to insolvency regimes among national jurisdictions compound the problem of effective coordination of cross-border resolutions. For example, many jurisdictions rely on a court-administered winding-up process rather than an administrative process for the resolution of financial firms. Among regimes, some are regarded as pro-debtor, others as pro-creditor. Similarly, the triggers for the initiation of insolvency proceedings differ widely among jurisdictions. While recognizing that the management and resolution of failing financial firms remain a “domestic competence,” the CBRG noted that having similar resolution tools at the national level and similar early intervention thresholds may facilitate coordinated solutions across borders.[18] A quizzical observer might conclude that adding similar tools to national resolution regimes will prove an easier task than assuring that national authorities actually use the tools in an expanded toolbox in a similar manner, especially those relating to early intervention or (as discussed below) bail-in.

As a more direct matter, the CBRG also recommended that national authorities consider the development of procedures to facilitate the mutual recognition of crisis management measures and resolution proceedings.[19] This recommendation comes against a backdrop of differing approaches among national regimes to the recognition of foreign resolution proceedings. On the one hand, in the European Union, the principle of recognition of other Member States' insolvency proceedings, including for branches located in host Member States, has long been established.[20] On the other hand, the UNCITRAL Model Law on Cross-Border Insolvency, which seeks to promote cross-border recognition of foreign insolvency proceedings, does not encompass banks and insurance companies. Chapter 15 of the U.S. Bankruptcy Code, which represents the U.S. adoption of the UNCITRAL Model Law, expressly excludes from its scope foreign banks with branch or agency operations in the United States.[21] Recognition of crisis management measures and foreign resolution proceedings will require changes to many national laws. Without such changes to national laws, the use of various resolution tools, such as the use of a bridge bank by the home country resolution authority and the transfer of assets and liabilities of host country branches of a failing bank to the bridge bank, may be subject to serious impediments under home and host country laws.

In what at first glance may seem a relatively straightforward proposition, the CBRG also recommended the development of cross-border cooperation and information sharing measures. This recommendation was based on the observation that crisis management and resolution of cross-border financial groups require "a clear understanding by different national authorities of their respective responsibilities for regulation, supervision, liquidity provision, crisis management and resolution."[22] The CBRG noted that such arrangements were required to ensure the sharing of needed information both for purposes of contingency planning during normal times and for crisis management and resolution during troubled times. The CBRG also specifically noted that material adverse developments should be shared among key authorities as and when they arise. The latter observation signaled that the recommendation for cooperation and sharing of information may not be as straightforward as it seems at first glance. In fact, in its discussion of this recommendation, the CBRG related both technical and practical problems that had arisen in the context of information sharing between home and host supervisors during the financial crisis. Some problems arose from legal constraints under national laws on sharing of information. Other problems arose from more practical considerations.

The CBRG generally noted that supervisors have entered into memoranda of understanding ("MOUs") and other letter exchanges setting out expectations for the sharing of information, but that these arrangements are not legally enforceable. More revealing was a CBRG observation that given the experience during the financial crisis, there were reasonable concerns that MOUs would not be followed in times of crisis "as national authorities are accountable to national governing bodies with respect to how they take local interests into account."[23] Developing this theme further, the CBRG noted that home country authorities may be reluctant to provide information that they perceive as negative out of the fear that the host authorities will then be prompted to take actions "adverse to the national interests of the reluctant authorities."[24] The CBRG identified the essence of the underlying dilemma: in some cases, better information sharing might reduce the risk of ring-fencing by host authorities; in other cases, better information sharing may simply reinforce a ring-fencing impulse. In the end, the CBRG settled upon the simple norm that material adverse developments should be shared among key supervisory authorities as and when they arise. The discussion of the information sharing experience in the financial crisis confirms that a trust-building (or rebuilding) exercise is in order in the official sector. Through the efforts of the FDIC, the United States has been actively involved in negotiating new understandings on cross-border information sharing and resolution planning. The FDIC recently released a joint paper on cross-border resolution with the Bank of England and announced the signing of an MOU with the Canada Deposit Insurance Corporation on information sharing.[25] The full range of FDIC efforts aimed at international coordination is discussed in Part III of this article.

In addition to these high-level recommendations, the CBRG also offered several more specific recommendations. One was that the jurisdictions should promote the use of risk-mitigation techniques, such as enforceable netting agreements, collateralization, and segregation of client positions.[26] The CBRG Report noted that while significant progress had been made over the last two decades on certain risk-mitigation techniques such as confirming the legal framework for termination, liquidation, and close-out netting of OTC derivative contracts in the event of insolvency, there were still areas of uncertainty such as the effect under foreign law of such provisions, as well as variations in home country regimes. Similarly, there was an observation that greater risk-reduction could be achieved by encouraging greater standardization of derivative contracts, migration of standardized contracts onto regulated exchanges, clearing and settlement of such contracts through regulated central counterparties, and greater transparency through trade repositories.[27] Another specific recommendation was that the national resolution authority should have the legal authority to temporarily delay operation of contractual early termination clauses in order to permit a transfer of financial market contracts to another sound financial institution or a bridge financial institution.[28] Where such a transfer is not possible, the contractual rights to terminate, net, and apply pledged collateral should be preserved, subject to a short delay in the operation of termination clauses. Many of these recommendations likewise reflect measures that were then being considered in the United States as part of the legislative reform process and were ultimately adopted as part of the Dodd-Frank Act. For example, the power to delay (for one business day) termination rights on derivative contracts is an important feature of the Title II regime in the Dodd-Frank Act, discussed in Part III of this article.

The final recommendation from the CBRG was of a higher order. This recommendation encouraged the national authorities to consider and incorporate into their planning clear options or principles for exiting the kinds of public intervention that were required during the financial crisis. This recommendation was made in the name of restoring market discipline, minimizing moral hazard, and promoting the efficient operation of the markets. The CBRG noted that various national authorities had been "creative" in developing *ad hoc* government assistance for large financial institutions during the financial crisis, but without a clear understanding of how these public support mechanisms could ultimately be exited in favor of private mechanisms.[29] As recent reports indicate, the problems created by the bailouts during the financial crisis and the difficulty of exiting from those bailouts continue to plague government decision-makers.[30]

CBRG COMMENTARY

In addition to the recommendations themselves, the CBRG Report offered a broader-ranging commentary on the challenges facing international coordination and the development of an international framework for insolvency. Several observations in the commentary stand out. The first observation is that "[t]here is no international insolvency framework for financial firms and a limited prospect of one being created in the near future."[31] The first half of this observation comes as no surprise. The second half, on the other hand, is more revealing because it appears to reflect a concession not only to current reality but also to future reality that there will not be a comprehensive international framework for the resolution of financial firms. The reference to a "limited" prospect for an international insolvency framework in the "near future" suggests an element of understatement.

The CBRG commentary offered several explanations for the dim prospects for a comprehensive international framework. The first explanation is based on challenges facing cross-border resolutions in general:

> Challenges in resolving a cross-border bank crisis arise for many reasons, one of which is that crisis resolution frameworks are largely designed to deal with domestic failures and to minimize the losses incurred by domestic stakeholders. As such, the frameworks are not well suited to dealing with serious cross-border problems. Many earlier discussions of these issues have been framed in terms of either a so-called universal resolution approach that recognises the wholeness of a legal entity across borders and leads to its resolution by a single jurisdiction — or a territorial or ring fencing approach — in which each jurisdiction resolves the individual parts of the cross-border financial institution located within its national borders. Neither characterisation corresponds to actual practice, though recent responses, like prior ones, are closer to the territorial approach than the universal one.[32]

These general challenges are further compounded when the failing enterprise is a large, complex financial institution. Here the challenges involve not only issues of national creditor protection, but also national taxpayer protection. As noted in the commentary:

> The absence of a multinational framework for sharing the fiscal burdens for such crises or insolvencies is, along with the fact that legal systems and the fiscal responsibility are national, a basic reason for the predomi-

> nance of the territorial approach in resolving banking crises and insolvencies. National authorities tend to seek to ensure that their constituents, whether taxpayers or member institutions underwriting a deposit insurance or other fund, bear only those financial burdens that are necessary to mitigate the risks to their constituents. In a cross-border crisis or resolution, this assessment of the comparative burdens is complicated by the different perceptions of the impact of failure of a cross-border institution and the willingness or ability of different authorities to bear a share of the burden.[33]

The issue of burden-sharing in the resolution of large cross-border financial firms is a recurring theme in virtually all the policy discussions surrounding cross-border bank resolution. The CBRG observed that the alternative to a territorial approach would be to reach broad *and* enforceable agreement on the sharing of financial burdens by stakeholders in different jurisdictions, but that the development of mechanisms for sharing of financial burdens for the future resolution of cross-border financial institutions would face "considerable challenges" and appeared unlikely in the "short term."[34] This observation too appears to incorporate an element of understatement.

The CBRG itself appeared to be divided over the comparative merits of a universal approach versus a territorial approach. The CBRG Report discussed the arguments in favor of both approaches, including the supervisory ring-fencing approach (through asset pledge and asset maintenance requirements) imposed by some jurisdictions on branches of foreign banks.[35] The CBRG Report noted that some members of the CBRG believe that the presence of supervisory ring-fencing measures and a territorial approach by a host country encourage early intervention by the authorities.[36] Under this approach, the host jurisdiction has a strong incentive to ensure that the assets of a local branch exceed the liabilities of that branch. This has the effect of more closely aligning the supervisory approach of the host country with the assets available to pay stakeholders of the local branch. A related effect is that the threat of ring-fencing may put pressure on the home jurisdiction to resolve the problems of the institution. Also, as noted in the CBRG Report, a ring-fencing approach can contribute to the resiliency of the separate operations within host countries by promoting the separate functionality of the local operations.[37]

Other members of the CBRG maintained that ring-fencing could exacerbate the problems for a bank and increase the probability of default.[38] Ring-fencing, if done as an *ex ante* supervisory matter, could also create inefficiencies in the allocation of capital and liquidity. These members observed that *ex post* ring-fencing by host authorities might undermine an orderly liquidation process being undertaken by the home country supervisor that seeks to transfer the bank and all its foreign branches to a bridge bank or other purchaser.[39] Against the background of these competing considerations, the CBRG Report offered a sobering observation based on the events of the financial crisis:

> The fact that ring fencing has occurred between national jurisdictions with pre-existing cross-border rules providing for allocation of responsibility for deposit insurance and similar types of public commitments and with long histories of close supervisory cooperation, demonstrates the strong likelihood of ring fencing in crisis management or insolvency resolution. This is particularly so where host supervisors are faced with the prospect of the failure of the home office to whom liquidity has been upstreamed. The crisis has also demonstrated that in a period of market instability there is rarely time to carefully weigh cooperative cross-border management of crises.[40]

In the end, the CBRG suggested a middle approach that recognizes "the strong possibility of ring fencing in a crisis, and helps ensure that home and host supervisors focus on needed resiliency *within national borders*."[41] This middle approach would require "discrete" changes to national laws to create a more complementary legal framework that would permit the continuity of key financial services across borders. Several of the CBRG Report's recommendations, such as those relating to the availability of bridge financial companies and transfer provisions for financial contracts, would create such complementary elements among national regimes. The CBRG provided this rationale for its middle approach:

> While not denying the legitimacy of ring fencing in the current context, this [middle] approach aims at improving, inter alia, the ability of different national authorities to facilitate continuity in critical cross-border operations….[42]

The commentary in the CBRG Report was clearly informed by the experience of individual members of the CBRG during the financial crisis, especially in the cross-border failures (*de jure*) of Lehman Brothers and Kaupthing and (*de facto*) of Fortis and Dexia. The experiences with Fortis and Dexia appear to have been particularly searing for some of the European members of the CBRG. In respect of the Fortis situation, for example, the CBRG Report observed, in a most diplomatic fashion, that "[d]espite a long-standing relationship in ongoing supervision and information sharing, the Dutch and Belgian supervisory authorities assessed the situation differently."[43] It apparently came as a surprise to some that in a financial crisis, national supervisors might act on the basis of what they perceive to be their own national interest. In any event, the CBRG Report did little to question the probability (or even the legitimacy) of a territorial approach, notwithstanding the concern expressed in the G20 Working Group report. In progressive legal circles, any tendency toward territorialism is regarded as faintly atavistic. In the best of all possible worlds, universal impulses would prevail over baser territorial instincts. The CBRG observation about the strong likelihood of a ring-fencing response in a crisis situation is more grounded in recent experience than some progressive legal thinkers might have hoped.

IMF STAFF PAPER

At the same time that the CBRG was preparing its report, the staff of the International Monetary Fund (the "IMF") was also considering the issues surrounding the resolution of cross-border banks. In June 2010, the IMF staff released its own paper on the resolution of cross-border banks.[44] The premise of the paper was that the most far-reaching solution to the problem of cross-border bank insolvency, namely, an international treaty obligating countries to defer to the resolution decisions of the jurisdiction where the financial institution or group has its main activities, would necessitate a "considerable sacrifice of national sovereignty" and hence was not feasible in the foreseeable future.[45] The IMF staff paper suggested a "pragmatic" alternative in the form of a nonbinding framework for enhanced coordination, which would be subscribed to by those countries that are in a position to satisfy its elements. The staff paper proposed four key elements for the framework:

(1) countries would amend their laws to require national authorities to coordinate their resolution efforts with other countries to the maximum extent consistent with the interest of creditors and domestic financial stability;

(2) the enhanced coordination framework would only apply to those countries that have in place “core-coordination standards” relating to the design and application of their resolution systems;

(3) although a key objective of the framework would be to minimize the need for public funding, because public funding at least on a temporary basis may be needed, the framework would specify the principles to guide the burden sharing process among subscribing authorities; and

(4) subscribing countries would agree to coordinated procedures to enable resolution actions to be taken as quickly as possible and to have cross-border effect.[46]

The staff paper suggested the stakes in this exercise are high. It noted that because of concern with domestic financial stability and the potential fiscal costs of bank failure, the authorities in many countries have been unwilling to surrender control over the issues relating to cross-border bank resolution through treaty or other binding arrangement. However, if pragmatic cooperation cannot be achieved, the IMF staff paper posited that “financial stability concerns may require a ‘de-globalization’ of financial institutions so that they fit within existing local resolution frameworks.”[47]

The IMF staff paper put the following gloss on the first key element of the framework described above: the authorities of a country should be required to coordinate with resolution authorities in other countries, but only to the extent that the authorities determine that such coordination is consistent with their own national interests. The IMF staff paper stated that the authorities in a host jurisdiction would assess whether, under a coordinated approach, creditors of branches or subsidiaries in the host country are likely to receive “at least what they would receive had the branch or entity been liquidated on a territorial basis by the host jurisdiction.”[48] This statement appears to recognize and accept ring-fencing when imposed by host country law or perhaps even by supervisory practice. A subsequent statement in the IMF staff paper, nonetheless, appears to indicate that the proposal is not intended to encourage ring-fencing.[49]

The second key element, core-coordination standards, is intended to establish a "reasonable level of high quality convergence" among the home and host jurisdictions subscribing to the framework.[50] The core-coordination standards identified by the IMF staff paper are themselves four. The first is nondiscrimination against foreign creditors. The IMF staff paper indicated that host jurisdictions will need to be satisfied that the other jurisdictions will not discriminate against creditors of a local branch. A domestic depositor preference in a home country, based on the nationality or location of the depositor, would be inconsistent with this core standard.[51] The second core-coordination standard is effective intervention tools. The IMF staff paper identified as the most critical tools the following: early intervention authority, power to restructure debt claims, authority to suspend termination provisions in certain financial contracts, power to transfer assets and liabilities to other institutions (including a bridge bank) without consent of third parties, power to provide bridge financing, and ability to assume public ownership of the institution on a temporary basis.[52]

The third core-coordination standard is appropriate creditor safeguards. The IMF staff paper recognized that the extraordinary powers given to a resolution authority, including the power to interfere with contractual rights, must be accompanied by basic safeguards, including a right to compensation to ensure that a creditor is left no worse off as a result of the resolution than if the bank had not been resolved but instead had failed and been liquidated.[53] The fourth core-coordination standard is sufficiently robust and harmonized rules on priority to recognize the interests of host country insured depositors and deposit guarantee schemes. As the IMF staff paper acknowledges, this may require a broader harmonization of deposit guarantee scheme features across jurisdictions, including categories of insured depositors and amounts of protection.[54] The practical prospect of harmonizing divergent national deposit guarantee schemes is not assessed by the IMF staff paper.

The point on insured depositors and deposit guarantee schemes is related to the third key element in the framework proposal: that the framework would specify principles to guide the burden-sharing process among cooperating jurisdictions. Here the IMF staff paper simply noted that home countries are likely to be unwilling or unable to provide all the public funding necessary to stabilize a large international financial group.[55] Accordingly, host countries may need to contribute if they want to keep the international group (or parts of it) intact. As the IMF staff paper states, a host country's decision whether to contribute ought to be informed by the fact that funding from the host country will likely be required even if a strictly national resolution is pursued.[56]

The fourth key element of the framework recognizes that if basic coordination standards have been accepted by the subscribing jurisdictions, then the ability to coordinate rapidly will be enhanced if there is an established set of procedures. Here the IMF staff paper suggests that when a financial firm with branches in a foreign jurisdiction encounters financial difficulty, it would appear most appropriate for the lead role to be played by the home authorities, particularly as the home jurisdiction is likely to be the principal source of public funds to support the resolution.[57] However, the framework would reserve for host jurisdictions the discretion to act independently, if necessary, to protect their national interests. The IMF staff paper suggests that the framework could apply not only to a banking institution with cross-border branches, but also to a banking group operating cross-border through subsidiaries. The dynamics of resolution coordination for a group is likely to be even more complex than the dynamics for a situation involving principally an institution with cross-border branches. The IMF staff paper does not discuss in any detail the additional challenges facing coordinated resolution of a complex group structure.

FSB INITIATIVES

The FSB functions as an umbrella body overseeing and coordinating the work of the other international financial standard-setting groups, such as the Basel Committee. While the member jurisdictions of the FSB largely overlap with the membership of the Basel Committee, the national representatives to the FSB typically include not only a representative of the central bank or other bank regulatory authority, but also a representative of the ministry of finance or treasury, providing a broader policy (and, dare one say, political) perspective. One of the principal goals of the FSB is to develop and promote the implementation of effective regulatory and supervisory policies among its members. Among the techniques used to promote these policies is the development of "international financial standards" endorsed by the FSB. Under the charter of the FSB, each member jurisdiction has specifically committed to implement the international financial standards agreed upon by the FSB.

POLICY FRAMEWORK FOR G-SIFIS

The FSB assumed overall responsibility for the development and implementation of international financial standards to address a broad range of issues arising from the 2007-2009 financial crisis. As one of its early tasks, the FSB assumed responsibility for recommending and implementing a policy framework for addressing the systemic risks and moral hazards associated with global systematically important financial institutions ("G-SIFIs"). In October 2010, the FSB issued its recommendations in a document entitled "Reducing the moral hazard posed by systemically important financial institutions."[58] The recommendations encompassed various measures to address systemic risk and the "too-big-to-fail" problem, including provisions for higher loss-absorption, increased supervision, and viable resolution options. The FSB document noted that any effective approach to the "too-big-to-fail" problem must have "effective resolution at its base."[59] The FSB posited that an effective resolution regime for a G-SIFI must allow the continued operation of the firm's essential financial functions, including uninterrupted access by depositors to their funds, wherever located, and the transfer and sale of viable parts of the firm, while apportioning losses to creditors in a fair and predictable manner. Against these objectives, the FSB document offered a negative assessment of the then-prevailing state of affairs:

> While some jurisdictions have enacted or are considering legislative changes, most existing arrangements do not meet these objectives. Internationally, impediments to cross-border resolution derive from major differences in national resolution regimes, absence of mutual recognition and agreements for joining up home and host regimes, and lack of planning for handling stress and resolution. The complexity and integrated nature of group structures and operations, with multiple legal entities spanning national borders and business lines, make rapid and orderly resolutions under current regimes virtually impossible.[60]

The initial recommendations in the FSB document thus focus on the need for robust action by national jurisdictions to implement legal reforms to their individual resolution regimes. The FSB concluded that the national reforms should include a designated resolution authority for financial institutions with the kinds of powers proposed in the CBRG Report. Among the tools that the national jurisdictions should consider is a restructuring mechanism to allow recapitalization of a financial institution as a going concern by way of a contractual and/or statutory (*i.e.*, within resolution) debt-to-equity conversion and write-down tools. The FSB also recommended that the resolution authority in each jurisdiction should be provided with the legal capacity *and* obligation to cooperate and share information with foreign resolution authorities. These legal powers would facilitate another recommendation made by the FSB, namely, that there should be an institution-specific cooperation agreement between home and host authorities for each G-SIFI. The FSB urged the development of institution-specific cooperation agreements as the easiest and most flexible approach to cross-border coordination and cooperation because the adoption on a multilateral basis of all the necessary elements of an effective resolution approach was likely unachievable.[61]

To address other perceived impediments to cross-border cooperation, the FSB recommended that the national authorities should review, and where appropriate, eliminate provisions in national laws that impair fair cross-border resolution, such as depositor priority rules that give preferential treatment to domestic depositors over those of foreign branches.[62] Other recommendations included that recovery and resolution plans should be mandatory for G-SIFIs and that the national authorities should have the power, exercisable under clear criteria, to require a financial institution to make changes in its legal and operational structure and business practices to facilitate the implementation of recovery and resolution measures. The FSB document further suggested that resolvability under existing resolution regimes should be an important consideration in a host country's determination of any changes to be required in a hosted institution's operations. The FSB volunteered the following advice:

> Host jurisdictions may wish to decide, in light of the systemic significance (or otherwise) of the hosted foreign institution for their financial

> system and economy, and in light of the applicable resolution regimes and cooperation agreements, whether to permit a branch presence, or to permit a subsidiary presence, so that resolution is a local responsibility, but with co-ordination with the home (or group) regulatory and resolution authority.[63]

The FSB thus expressly invited a rethinking of existing supervisory practices with respect to the form of cross-border operations of financial firms. As discussed in Part II of this article, several major jurisdictions appear to have accepted that invitation. It is likely that the FSB included this comment to encourage home countries to reform their resolution regimes. In the absence of such reform by particular countries, however, the comment provides the policy (and political) cover for a host country to revise its approach to the acceptance of branches from other countries or, at a minimum, its approach to the supervision of such branches, *e.g.*, by requiring additional asset or liquidity buffers in the host country.

CBRG SURVEY REPORT

Further evidence of the challenges facing cross-border resolution emerged from a detailed survey report released by the CBRG in July 2011.[64] The report provided an analysis of the resolution regimes for all the member jurisdictions of the Basel Committee. The survey confirmed the wide variety in the existing national resolution regimes for financial institutions. The variety encompassed such matters as whether there is a specialized resolution regime for banks or other financial institutions, whether the regime applies to holding companies of financial institutions or to financial groups or conglomerates, and whether there is a specific resolution regime for systemically important financial institutions. Similar variety was found in the triggers for the invocation of resolution authority and in the availability of powers (such as the power to transfer liabilities) once a resolution regime is invoked. In many countries, the resolution authority appears to lack the legal power to delay temporarily the operation of early termination provisions in financial master agreements. As might also be expected, the survey found significant differences among national depositor protection arrangements.[65]

The report also noted that limited progress had been made in the cross-border area in most jurisdictions. Even where particular jurisdictions had made improvements to their domestic resolution regimes, uncertainty still exists as to the mechanism to implement recognition of new resolution measures, such as with respect to bridge banks and transfer powers, in a cross-border case. Equally important, the report found that few changes had been made with respect to cross-border information sharing arrangements.[66] As a result, there would be constraints on sharing information for resolution planning purposes, as well as in actual crisis situations. The report found that there had been no progress toward the development of a framework for cross-border enforcement of resolution actions, such as cross-border mutual recognition agreements between home and host jurisdictions. As to the concomitant need for agreement on burden-sharing, the report simply noted that because of "the complexity of the issue and the possible impact on national budgets, the process of considering burden-sharing arrangements is at a preliminary stage."[67] This observation, like previous observations from the CBRG on this subject, partakes of understatement.

FSB CONSULTATIVE DOCUMENT ON EFFECTIVE RESOLUTION

The findings of the CBRG survey report confirmed to the FSB the need to accelerate the reform of domestic resolution regimes and the development of frameworks for cross-border enforcement of resolution measures.[68] The work of the CBRG and the IMF staff laid the conceptual foundation for reform of bank resolution regimes by establishing the overarching principles that should apply to the reform process and by identifying the practical tensions that would have to be resolved among jurisdictions in the process. It fell to the FSB to convert these principles into specific standards that could be adopted by individual jurisdictions and monitored by international bodies as part of an implementation process. This the FSB did by releasing in July 2011 a Consultative Document on Effective Resolution of Systemically Important Financial Institutions (the "Consultative Document on Effective Resolution").[69]

The Consultative Document on Effective Resolution proposed a set of 52 key attributes (the "Proposed Key Attributes") covering twelve broad areas for national resolution regimes. The Proposed Key Attributes were designed at bottom to improve the capacity of national authorities to resolve SIFIs without systemic disruption and without exposing taxpayers to the risk of loss. The FSB proposed that these key attributes would constitute "international financial standards," thereby invoking the commitment under the FSB charter of each member jurisdiction to implement these standards and to be subject to assessment on these standards under the IMF/World Bank Financial Sector Assessment Program.[70] The FSB acknowledged that not all the measures in the Proposed Key Attributes would be suitable for all financial sectors or circumstances.[71] The FSB also recognized that legislative and regulatory changes would be required in many jurisdictions to implement the Proposed Key Attributes.

The principles reflected in the Proposed Key Attributes were similar to those outlined by the FSB in its October 2010 release and by the CBRG in its March 2010 report. The Proposed Key Attributes simply provided greater specificity and delineation of these principles. Thus, the Proposed Key Attributes called for each jurisdiction to have a designated administrative authority responsible for exercising resolution powers over financial institutions, and where there are multiple resolution authorities for different types of financial firms, for the jurisdiction to identify a lead resolution authority.[72] The resolution regime should provide for "timely and early" entry into resolution before the financial institution is balance-sheet insolvent, with clear standards for the threshold conditions for such entry into resolution.[73] The Proposed Key Attributes called for resolution authorities to have a full set of powers, including the power to establish temporary bridge financial institutions, to transfer assets and liabilities without regard to consent or novation requirements, to carry out "bail-in within resolution," to stay temporarily the exercise of early termination rights on financial contracts, to impose a moratorium with a suspension of payments on unsecured creditors and a stay on creditor actions to attach assets, and to override rights of shareholders to approve a merger, sale or other restructuring of the failing firm.[74] Other Proposed Key Attributes called for the establishment of institution-specific cross-border cooperation agreements between home and host authorities, cross-border crisis management groups among home and key host authorities, resolvability assessments, and detailed recovery and resolution plans.[75] Each of these Key Attributes would be critical to the process of managing the financial difficulties encountered by a SIFI and ultimately to any prospect of managing an orderly resolution of a troubled SIFI. To facilitate the implementation of all these measures, the Proposed Key Attributes also called for jurisdictions to ensure that there were no legal, regulatory or policy impediments to hinder the exchange of information.[76]

In addition to this set of 52 Proposed Key Attributes, the Consultative Document on Effective Resolution included a number of other annexes, discussing in further detail the key elements of a bail-in within resolution regime, institution-specific cross-border cooperation agreements, resolvability assessments, and recovery and resolution plans. The Consultative Document on Effective Resolution also included two discussion notes on creditor hierarchy, depositor preference, and depositor protection, and on the conditions for a temporary stay on early termination rights for financial contracts. To the untutored eye, the Consultative Document appeared to set an ambitious agenda, suggesting that the FSB had put aside any doubts about the practical feasibility of achieving convergent national resolution regimes. Nonetheless, some industry observers actually perceived a lack of ambition in the FSB's proposals. For example, one industry respondent noted that the recommendations did not attempt to address *ex ante* the fundamental issue of sharing the costs of resolution among national authorities, and that until this issue is resolved, there would always be an incentive for national authorities to act in their own interest.[77] Other respondents saw a lack of resolve in the failure by the FSB to set a specific timeline or deadline for the introduction of national legislation to implement the proposed regime and for the ultimate convergence of national regimes.[78]

FSB KEY ATTRIBUTES

After receiving comments on the Consultative Document on Effective Resolution, the FSB issued a final document, Key Attributes of Effective Resolution Regimes for Financial Institutions ("Key Attributes") in November 2011.[79] The Key Attributes largely follow the course set in the Proposed Key Attributes. As a result of comments received from various respondents on the Proposed Key Attributes and the annexes to the Proposed Key Attributes, however, the FSB revised, clarified, and in some cases, provided greater specificity to, the Key Attributes. The Key Attributes expanded to 62 in number, reflecting the incorporation into the Key Attributes of certain points covered in annexes to the Proposed Key Attributes.

The FSB published an overview of the responses to the Consultative Document on Effective Resolution.[80] That overview could not do justice to the full range of comments received on the Consultative Document on Effective Resolution. But it nevertheless provides an insight into what the FSB itself regarded as the most important issues raised in the Consultative Document on Effective Resolution and how the FSB sought to mediate between conflicting views on some of these issues. The FSB noted that the respondents agreed that special resolution regimes are needed to ensure the continued performance of systemically critical functions of a failing SIFI. This includes the power to create a bridge entity or to write down liabilities, powers not generally available under ordinary corporate insolvency laws.[81] The FSB also noted that a majority of respondents supported the proposal in the Consultative Document on Effective Resolution that entry into resolution should be initiated when an institution is or is likely to be no longer viable and before it becomes balance-sheet insolvent.[82] While there appeared to be support for triggering resolution when an institution is likely to be no longer viable, respondents expressed concerns about the use of "hard" or simplistic numeric measures to establish an intervention threshold and about the reference to "early" entry to resolution.[83] As with many other of the Proposed Key Attributes, respondents agreed with the basic principle underlying this Proposed Key Attribute, but raised significant questions about the lack of specificity in implementing the principle.

This pattern of agreement in principle with the principle, but concern about the specifics of implementation of the principle was reflected in the comments on many of the Proposed Key Attributes. For example, the FSB noted that a clear majority of global financial institutions supported the introduction of statutory "bail-in within resolution" as an additional resolution option.[84] This option would allow for creditor recapitalization by way of an exchange of debt claims for equity in the failing firm or by way of transferring systemically important and other viable operations of the failing firm to a bridge institution and exchanging debt claims against the failing firm for equity in the bridge institution. A number of respondents raised questions about the appropriate scope of liabilities to be subject to a statutory bail-in mechanism. Some respondents recommended a broad scope for application of bail-in, including wholesale deposits.[85] Other respondents urged that various categories of liabilities, such as repos, derivatives, and other secured debt be excluded from the bail-in regime.[86] Some bank trade associations indicated that their members were not yet in agreement on such issues as whether short-term liabilities should be excluded from any bail-in mechanism and whether there should be any provision for a depositor preference in the insolvency scheme.[87] In response to the diversity of views on the appropriate scope of bail-in within resolution, the FSB observed that Key Attribute 3.5, which provides for the availability of bail-in within resolution as an option, does not specify the types of liabilities that should be subject to bail-in (other than to exclude secured claims and insured deposit claims).[88] Key Attribute 3.5 does provide that bail-in within resolution should be applied in a manner that respects the hierarchy of claims in liquidation. As discussed in Parts II and III of this article, a creditor recapitalization or bail-in approach, particularly using a single-point-of-entry model, is now considered the preferred methodology by the FDIC under its orderly liquidation regime in Title II of the Dodd-Frank Act. Bail-in presents a set of complex issues that are not fully addressed in the Key Attributes, including, for example, whether the supervisory authorities should specify a minimum amount of "bail-in-able" liabilities to be maintained by a banking institution. Further development of both the principles and mechanics of bail-in will be required as part of any national resolution regime.

The FSB also noted that all the respondents stressed the importance of effective cross-border coordination, but differed as to how best to achieve that coordination. Some respondents recommended focusing on MOUs and bilateral agreements because they considered multilateral coordination to be unachievable in the near or medium term.[89] Others advocated moving quickly to a binding multilateral agreement and mutual recognition framework.[90] The FSB observed that while falling short of a binding framework for national recognition and international cooperation, Key Attributes 8.1 and 8.2 relating to crisis management groups and Key Attributes 9.1 and 9.2 relating to institution-specific cross-border cooperation agreements represent significant steps toward a cross-border framework, and that more binding mechanisms would not be feasible at this time.[91] An institution-specific cross-border cooperation agreement is, of course, nothing more than *entente cordiale*. Such an agreement will work as long as the interests of the parties are generally aligned or complementary. If the interests diverge significantly, the commitments under such an agreement are less likely to be observed. As noted above, the CBRG Report specifically analyzed the effects of the latter circumstance on the efficacy of nonbinding cooperation agreements during the financial crisis.

The fundamental question of the allocation of resolution authority between home and host countries also provoked extensive comment. The FSB noted that a majority of industry stakeholders suggested that resolution should be carried out by the home country on a group-wide basis.[92] In fact, most industry respondents argued that the home jurisdiction of a group should have exclusive control over the resolution process for the group, coordinating as appropriate with host country supervisors in any crisis management group. Some industry groups suggested that a host jurisdiction should be able to initiate a resolution proceeding for operations in the jurisdiction only with the consent of the home country jurisdiction. Other industry groups took the flat position that a host jurisdiction should have no resolution powers in respect of a local branch.[93]

These comments reflect the underlying reality captured in former head of the Bank of England Mervyn King's now famous observation that large banks live globally, but die locally. Many of the largest financial firms are managed to the maximum extent legally possible *as if* there were no national borders. These firms posit that in the hypothetical case of their resolution, they should likewise be resolved without regard to national borders. This desire of course must confront the reality that for legal purposes their component parts (most obviously, separately incorporated subsidiaries, but, for many purposes, also branch operations) are subject to host country boundaries and constraints. The tension between the global business model and the national legal framework is nowhere more evident than in a resolution scenario. This fundamental tension underlies many of the features of the Key Attributes. The FSB did not recede from its general position in Proposed Key Attribute 1.1 on the resolution of branches. Key Attribute 1.1 provides that each jurisdiction should have a resolution regime that extends not only to domestic firms, but also to branches of foreign firms within the jurisdiction (except for a jurisdiction that is subject to a binding obligation to respect the resolution of financial institutions under the authority of the home country, as is the case in the European Union). In the United States, federal and state banking laws govern the operation and, if necessary, the closure and liquidation of branches and agencies of foreign banking organizations. These federal and state laws are discussed in Part III of this article.

In its overview document, the FSB observed that the comments suggesting that the home countries should have primary or exclusive responsibility over a group resolution did not consider the circumstances under which a home country might be unable or unwilling to resolve a cross-border SIFI as a whole and the possibility that this would have significant consequences in host countries.[94] As a result, the FSB sought to strike a balance between the need to achieve a cooperative group-wide resolution and the need to provide a host jurisdiction with the authority to protect the financial stability of its own jurisdiction. The FSB addressed these comments by providing in Key Attribute 7.3 (as it had in the Proposed Key Attributes) that a national resolution regime should extend to local branches of foreign firms and should have the capacity either (i) to support a resolution carried out by a foreign home country authority or (ii) in "exceptional cases," to take measures on its own initiative when the home country is not taking action or acts in a manner that does not take sufficient account of the need to preserve the local jurisdiction's financial stability.[95]

The first alternative under Key Attribute 7.3 would ensure that a host authority could cooperate with a home country authority in the application of special resolution tools to local operations, such as through the transfer of property in the host jurisdiction to a foreign bridge institution or private sector purchaser. The second alternative under Key Attribute 7.3 would allow the host jurisdiction to take independent domestic action, where necessary, to protect domestic stability in the absence of effective international cooperation and information sharing. This Key Attribute appears to be more reliant on *detente* than *entente* between home and host jurisdictions. On the one hand, it seems unlikely that jurisdictions with existing regimes that provide the local resolution authority with broad discretion to initiate action against a branch of a foreign institution will surrender any of that legal authority. At best, it can be hoped that they would consult with or provide prior notice to a home country before taking action under local law. On the other hand, the existing legal regimes in many host countries may not provide the host resolution authority with the power to recognize a transfer of local branch assets to a foreign bridge institution. The default setting in such jurisdictions will be to the second alternative of the Key Attribute unless amendments are made to the national resolution laws to permit at least discretionary recognition of foreign resolution proceedings.

The requirement for recovery and resolution plans presented similar concerns about the respective roles of home and host jurisdictions. As the FSB noted, the majority of industry respondents expressed strong interest in a single plan approach, under which the home country would lead the development of a group resolution plan for a G-SIFI in coordination with the members of the crisis management group.[96] The FSB noted that the development of a group resolution plan led by the home authorities is a core component of the Key Attributes, but that to safeguard host country interests, the FSB needed to consider circumstances under which a home country may not have the capacity or willingness to coordinate the effective resolution of a cross-border SIFI as a whole.[97] The relevant Proposed Key Attribute (11.6) thus provided that the home country should lead the development of a group resolution plan in coordination with the members of the firm's crisis management group, and where a host jurisdiction deemed the group resolution plan insufficient, or otherwise with the agreement of the home country, a host resolution authority could maintain its own resolution plan for the parts of the firm active in its jurisdiction. Reflecting further sensitivity to the concerns of host jurisdictions, the FSB made revisions to the relevant Key Attributes. As revised, Key Attribute 11.8 provides that, at least for G-SIFIs, the home resolution authority should lead the development of a group resolution plan in coordination with the members of the firm's crisis management group. But Key Attribute 11.9 now expressly provides that host resolution authorities may maintain their own resolution plans for the firm's operation in their jurisdiction, cooperating with the home country authority to ensure the plan is as consistent as possible with the group plan.[98]

These changes were a concession to political and practical reality. Certain host jurisdictions have legal or regulatory requirements for a resolution plan for domestically incorporated entities, including a domestically incorporated subsidiary of a foreign entity, and even for a local branch of a foreign entity. These requirements must be met under host country law without regard for the fact that a home country authority may be preparing a group-wide plan. As discussed in Part III of this article, the Dodd-Frank Act has been construed by the Board to require a U.S.-based resolution plan for the U.S. operations, including U.S. branches, of a foreign bank with $50 billion or more of worldwide assets.[99]

A proliferation of recovery and resolution plan requirements holds the potential for fragmentation in the planning process and ultimately in the resolution process itself. A host country resolution planning process may also lend itself more readily to ring-fencing approaches if conducted in isolation. Industry participants and other commentators have adopted the term “balkanization” to characterize the risk that they see in the proliferation of separate resolution planning requirements for cross-border firms and other kindred supervisory initiatives.[100] The planning processes, even if multiple and hence incrementally burdensome to a firm, may still have some value for the firm if they help to alert the firm to evolving expectations from host authorities. These processes may also have an additional value for the supervisory and resolution authorities if they become an occasion for trust-building through consultation and coordination exercises.

The FSB has incorporated into the Key Attributes a requirement for resolution authorities to undertake regular resolvability assessments of G-SIFIs. This concept had been included in an annex to the Proposed Key Attributes, but now is formally part of the Key Attributes. Key Attribute 10.3 provides that group resolvability assessments should be conducted by the home authority of the G-SIFI and coordinated within the firm’s crisis management group, taking into account national assessments by host authorities.[101] Key Attribute 10.4 further provides that host authorities that conduct resolvability assessment of subsidiaries in their jurisdictions should coordinate as far as possible with the home authority conducting the resolvability assessment for the group as a whole.[102]

Many of the comment letters expressed strong reservations about any proposed supervisory intervention into group structure based on a resolvability assessment exercise. One common theme in the comments was that impediments beyond an institution's power to control (such as the state of resolution law in a jurisdiction) should not be used as a justification for requiring institutions to change their business or legal structure or otherwise be factored into a resolvability assessment.[103] One comment letter sought to draw a distinction between the structure of a form as an endogenous factor that should be considered in a resolvability assessment and the national legal framework as an exogenous factor that should not be counted against a firm in the resolvability assessment.[104] Many comment letters asserted that resolvability assessments and recovery and resolution plans should not in any event be used for supervisory intervention into the structure or operation of healthy financial institutions.[105]

A number of comment letters also raised concerns with the suggestion that the use of intra-group guarantees should be restricted as part of a resolvability assessment.[106] Various respondents noted that intra-group transactions can increase the resilience of a group and must be balanced against concerns for the possible effect of intra-group exposures on resolvability. The FSB in response to these comments said that it would continue to consider the question of group structure and intra-group transactions as part of its ongoing work on resolvability.[107] But on the fundamental question of the ultimate supervisory authority to require changes in structure or operations of a financial firm, the FSB itself was firm. The FSB has provided in Key Attribute 10.5 that supervisory authorities should have the power, where necessary, to require changes in a firm's business practices, structure, or organization to reduce the complexity and costliness of resolution, including the power to require systematically important functions to be segregated in legally and operationally independent entities that are shielded from group problems.[108] The latter suggestion may be seen as a form of functional ring-fencing for critical business functions.

The Key Attributes address issues with respect to creditor protection in more detail that the Proposed Key Attributes, which provided a discussion of certain creditor protection issues in an annex devoted to the topic.[109] One core point is included in Key Attribute 7.4 (as it was in Proposed Key Attribute 8.5): national laws and regulations should not discriminate against creditors on the basis of their nationality, the location of their claim, or the jurisdiction where it is payable.[110] This proposition, sounding perhaps in principles based on natural law, may be unobjectionable in theory, but it may present significant problems in practice. The United States, for example, could be deemed to be a major offender of this principle because of the so-called "national depositor preference" provision in the Federal Deposit Insurance Act (the "FDIA") .[111] This depositor preference provision has generally been thought not to apply to deposits payable only at a branch of an insured bank outside the United States. Various options, short of amending the FDIA (which might be difficult to achieve), are potentially available to address this issue. The FDIC itself has recently proposed that U.S. banks by contract expressly make deposits at their foreign branches payable both at the foreign branch and in the United States, thus giving such deposits the benefit of the depositor preference provision.[112] Other industry parties have argued that the FDIC has the legal ability to revisit an earlier informal interpretation of the depositor preference provision and provide a new interpretation that extends the benefit of the depositor preference provision to deposits at foreign branches, even if they are not payable at a location in the United States.[113]

Resolution of this depositor treatment issue may play a significant role in facilitating a more cooperative approach toward cross-border resolution of banking groups. The U.K. Financial Services Authority (the "FSA") elevated this issue in the international discourse when it issued a Consultation Paper in September 2012, suggesting that it would restrict firms from non-European Economic Area countries with national depositor preference regimes from accepting deposits in the U.K. unless arrangements were made to ensure the U.K. depositors would be no worse off than the depositors in the home country if the firm fails.[114] The Consultation Paper identified the United States, Australia, Singapore, and Turkey as countries with offending national depositor preference regimes.[115] The potential operation of national depositor preference provisions may lead host jurisdictions to respond with ring-fencing measures or restructuring proposals like those included in the Consultation Paper to protect host jurisdiction depositors. Such responses are not calculated to inspire faith in coordination or cooperation. The Consultation Paper provides *en passant* another insight into the effectiveness of the FSB process. In the Consultation Paper, the FSA notes that despite the call in the Key Attributes for the removal of national depositor preference laws, "there has been little evidence that countries that operate such regimes have made any attempt to change or amend their existing laws or that any change is envisaged."[116] The FSA has apparently concluded that only unilateral action by a host jurisdiction will induce "cooperation" by the offending home jurisdictions.

The Key Attributes also address the treatment of claims in a creditor hierarchy as well as a fundamental protection for creditors in the form of the principle: "no creditor worse off than in liquidation." The FSB noted that a large number of respondents called for strong assurance that the hierarchy within the capital structure and statutory ranking of creditor claims would be respected whatever special resolution measures were used.[117] At the same time, the FSB also noted other comments to the effect that it may be necessary to depart from an absolute priority rule and from a rule of equal treatment of similarly situated creditors in a class in order to contain the potential systemic impact of a firm's failure. More specifically, the FSB noted that depositors or other parties who provide critical funding for a SIFI's operations may need to be paid in full or guaranteed to be transferred to a creditworthy bridge entity to ensure continuity of important parts of the SIFI's business or to avoid a larger run throughout the financial system.[118] Key Attribute 5.1 provides for such flexibility. At the same time, Key Attribute 5.2 provides that creditors should have a right to compensation where they do not receive at a minimum what they would have received in a liquidation of the firm under the applicable insolvency regime.[119] This implements the "no creditor worse off than in liquidation" principle. This approach essentially parallels the approach taken in the orderly liquidation provisions of Title II of the Dodd-Frank Act.[120]

CONCLUSION

The promulgation of the Key Attributes represents an important step in promoting the adoption of more robust national regimes for bank resolution. To be clear, however, it is only the first step in the process. The member jurisdictions of the FSB must now implement the Key Attributes, initially by legislative changes and then by regulatory and supervisory changes. The word from the FSB to its member jurisdictions is now *adelante*, *avanti*, and *vorwärts* with implementation! Even with this directive, the pattern of national implementation will likely vary. Several jurisdictions, including the U.S., the U.K., and Switzerland, have already adopted major reform measures, incorporating many but not all of the principles reflected in the Key Attributes. Progress in other countries will require more time and will be less certain as to individual outcomes.

Observers should not lose sight of the fact that substantial policy choices lie embedded in many of the Key Attributes themselves.[121] These policy issues will occasion discussion and dispute in individual jurisdictions as they are considered. The scope of eligible bail-in liabilities and the breadth of any depositor preference provision are examples of two important policy issues entwined in the Key Attributes. A number of jurisdictions have asked the FSB to provide more detailed guidance on a range of issues implicated by the Key Attributes. Without definitive guidance, it is likely that jurisdictions will vary in their approach to these issues, resulting ultimately in more divergent national regimes than might be expected from a process designed to promote greater convergence among resolution regimes.[122]

Observers should also not lose sight of the difference between adopting changes in law and effecting changes in behavior. It will prove easier to achieve apparent convergence of national regimes (or elements of national regimes) by adopting changes to law than to achieve actual convergence in practice by the coordinated use of the new powers, particularly where a measure of discretion is left (as it inevitably will be) to the individual national authorities exercising those powers. Undue reliance should not be placed merely on the fact that a jurisdiction has revised its insolvency laws along the lines recommended in the Key Attributes. The political willingness of a national authority to impose a broad-ranging bail-in on senior creditors and uninsured depositors or to fund the critical cross-border functions of a large complex institution in resolution will only be known when a crisis event actually arises.

Nonetheless, progress on the adoption of robust national regimes is still a predicate to any potential convergence of laws and practices in cross-border resolutions. The efforts in the European Union to devise a convergent legal regime for the resolution of banks and credit institutions in its Member States provide useful insights to the difficulties and demands of the process. The success of the efforts in the European Union, home to 14 of the 28 banking institutions currently designated as global systematically important banking institutions by the FSB, together with the efforts in the United States, will largely determine the success of the FSB standard-setting process. The efforts of the FSB in providing additional guidance on implementation of the Key Attributes and the efforts of the European Union in crafting a convergent regional regime are explored in Part II of this article.

NOTES

[1] Leaders of the Group of Twenty, *Declaration: Summit on Financial Markets and the World Economy* (Nov. 15, 2008), *available at* http://www.g20.utoronto.ca/2008/2008declaration1115.html.

[2] *Id.* at 2.

[3] Pub. L. No. 111-203, Title II, 124 Stat. at 1442-1520 (codified at 12 U.S.C. § 5381 (2012). For a discussion of the policy considerations underlying the enactment of Title II of the Dodd-Frank Act, see Paul L. Lee, *The Dodd-Frank Act Orderly Liquidation Authority: A Preliminary Analysis and Critique — Part I*, 128 Banking L.J. 771 (2011), & Part II, 128 Banking L.J. 867 (2011).

[4] G20, *G20 Working Group on Reinforcing International Cooperation and Promoting Integrity in Financial Markets (WG2): Final Report* 5 (Mar. 27, 2009), *available at* www.astrid-online.it/Dossier--d1/Documenti/The-London/G20_wg2_27_03_09.pdf.

[5] *Id.* at 5.

[6] *Id.* Shortly after the issuance of the G20 Working Group Final Report, the staff of the International Monetary Fund and the World Bank issued an extensive conceptual paper on bank insolvency issues. *See* IMF and the World Bank, *An Overview of the Legal, Institutional, and Regulatory Framework for Bank Insolvency* (Apr. 17, 2009), *available at* http://www.imf.org/external/np/pp/eng/2009/041709.pdf. The paper contained a broad-ranging discussion of the issues underlying domestic bank insolvency regimes, but it explicitly excluded from its scope any discussion of cross-border insolvency. *Id.* at 4.

[7] Basel Committee, *Consultative Document, Report and Recommendations of Cross-border Bank Resolution Group* (Sept. 2009), *available at* http://www.bis.org/publ/bcbs162.htm.

[8] Basel Committee, *Report and Recommendations of Cross-border Bank*

Resolution Group (Mar. 2010), *available at* http://www.bis.org/publ/bcbs169.htm [hereinafter *CBRG Report*].

[9] *Id.* at 22-24.

[10] FSB, *Consultative Document, Effective Resolution of Systematically Important Financial Institutions* 8 (July 19, 2011), *available at* http://www.financialstabilityboard.org/publications/r_110719.pdf [hereinafter *Consultative Document on Effective Resolution*].

[11] CBRG Report, *supra* note 8 at 25-27.

[12] *Id.* at 8.

[13] *Id.* at 29-31.

[14] *Id.*

[15] *Id.* at 31-34.

[16] *See* Pub. L. No. 111-203, § 165, 124 Stat. at 1423-32 (codified at 12 U.S.C. § 5365), Title II, 124 Stat. at 1442-1520 (codified at 12 U.S.C. § 5381) (2012).

[17] CBRG Report, *supra* note 8 at 26-27.

[18] *Id.* at 27.

[19] *Id.* at 28-29.

[20] *Id.* at 17. The *CBRG Report* notes that even in jurisdictions such as those in the European Union that adhere to a "universal" insolvency procedure for banks and their branches, each national authority is likely to attach most weight to the pursuit of its own national interests in the management of a crisis. *Id.* at 4. The operation of the European Union insolvency regime for banks and other credit institutions is discussed in Part II of this article.

[21] 11 U.S.C. § 1501(c)(1) excludes from the application of Chapter 15 a proceeding for an entity that is excluded from eligibility as a debtor under 11 U.S.C. § 109(b). A foreign bank that has a branch or agency in the United States is excluded from eligibility as a debtor under 11 U.S.C. § 109(b)(3)(B). For a discussion of this exclusion, see Paul L. Lee, *Ancillary Proceedings Under Section 304 and Proposed Chapter 15 of the Bankruptcy Code*, 76 Am. Bankr. L.J. 115, 180-82 (2002).

[22] CBRG Report, *supra* note 8 at 36.

[23] *Id.* at 35.

[24] *Id.*

[25] FDIC and the Bank of England, *Resolving Globally Active, Systemically Important, Financial Institutions* (Dec. 10, 2012), *available at* www.fdic.gov/about/srac/2012/gsifi.pdf; FDIC and the Canada Deposit Insurance Corporation, *Memorandum of Understanding Concerning the Resolution of Insured Depository*

Institutions and Certain Other Financial Companies With Cross-Border Operations in the United States and Canada (June 11, 2013), *available at* http://www.fdic.gov/news/news/press/2013/pr13051.pdf. *See also* Joe Adler, *FDIC's Global Wind-Down Tour Makes More Stops*, AMERICAN BANKER, Mar. 25, 2013 (discussing the FDIC's efforts aimed at coordination of cross-border resolutions and the obstacles confronting those efforts). For a detailed discussion of the challenges posed by the bankruptcy of complex international financial institutions, *see* Government Accountability Office, *Bankruptcy: Complex Financial Institutions and International Coordination Pose Challenges*, GAO-11-707 (July 2011), *available at* http://www.gao.gov/new.items/d11707.pdf.

[26] CBRG Report, *supra* note 8 at 36-38.

[27] *Id.* at 39.

[28] *Id.* at 42.

[29] *Id.* at 43.

[30] *See, e.g.*, Mark Scott & Julia Werdiger, *Pressure in Britain Over What to Do With Bailed-Out Banks*, N.Y. TIMES, June 7, 2013, at B7; Max Colchester & David Enrich, *Bank Bailout Blues Stall U.K. Recovery*, WALL ST. J., May 14, 2013, at A1.

[31] CBRG Report, *supra* note 8 at 4.

[32] *Id.*

[33] *Id.*

[34] *Id.* at 4-5.

[35] *Id.* at 16-17.

[36] *Id.* at 18.

[37] *Id.* One may surmise that part of the support for a territorial approach came from certain members of the U.S. delegation to the CBRG. *See, e.g.*, Thomas C. Baxter, Jr., Joyce M. Hansen, & Joseph H. Sommers, *Two Cheers for Territoriality: An Essay on International Bank Insolvency Law*, 78 AM. BANKR. L.J. 57 (2004) (discussing features of U.S. bank insolvency law that incorporate concepts of territoriality). The authors of this article are members of the senior staff of the Federal Reserve Bank of New York. They are active participants in the international dialogue on bank insolvency issues, including those in the CBRG, and estimable members of the supervisory *nomenklatura*.

[38] *CBRG Report*, *supra* note 8 at 18.

[39] *Id.* at 19.

[40] *Id.* The *CBRG Report* further expanded on this point as follows:

In the absence of ex ante agreement between home and the major host jurisdictions on the sharing of financial burdens for the resolution of cross-border financial institutions designed to maintain the cross-border functionality of the financial institution, most jurisdictions are likely to opt for separate resolution of a failing financial institution operating within their jurisdiction. At this stage, reaching such broad international agreement appears both unlikely and unenforceable as the practical implications of burden sharing give rise to considerable challenges. However, some further progress in this respect should not be ruled out in a regional or bank-specific context. *Id*.

The travails of the regional effort in the European Union at reaching agreement on burden-sharing are discussed in Part II of this article.

[41] *Id.* at 19 (emphasis added).

[42] *Id.*

[43] *Id.* at 11.

[44] IMF Legal and Monetary and Capital Markets Departments, *Resolution of Cross-Border Banks—A Proposed Framework for Enhanced Coordination* (June 11, 2010), *available at* www.imf.org/external/np/pp/eng/2010/061110.pdf.

[45] *Id.* at 3. The IMF staff notes that the only exception to this statement may be on a regional basis among closely-integrated groups of countries.

[46] *Id.* at 3-4.

[47] *Id.* at 5.

[48] *Id.* at 18.

[49] *Id.* at 19 (suggesting that local laws that encourage ring-fencing of assets of a branch do not facilitate coordination).

[50] *Id.* at 19.

[51] *Id.*

[52] *Id.* at 20.

[53] *Id.* at 20-21.

[54] *Id.* at 21.

[55] *Id.* at 24.

[56] *Id.*

[57] *Id.* at 25.

[58] FSB, *Reducing the moral hazard posed by systemically important financial institutions* (Oct. 20, 2010), *available at* www.financialstabilityboard.org/publications/r_101111a.pdf.

[59] *Id.* at 3.

[60] *Id.* at 3-4.

[61] *Id.* at 4-5.

[62] *Id.* at 4.
[63] *Id.* at 5. The FSB noted that this advice was not applicable to Member States of the European Union because of the freedom to establish branches and subsidiaries guaranteed by the Treaty of the European Union. *Id.* at 5 n.1.
[64] Basel Committee, *Resolution policies and frameworks — progress so far* (July 2011), *available at* http://www.bis.org/publ/bcbs200.htm.
[65] *Id.* at 3-4.
[66] *Id.* at 4-5.
[67] *Id.* at 5.
[68] *Consultative Document on Effective Resolution*, *supra* note 10, at 7.
[69] *Id.*
[70] *Id.* at 11.
[71] *Id.* The FSB specifically noted that it would be working with other international standard-setting bodies, such as the International Association of Insurance Supervisors and the International Organization of Securities Commissions, to develop sector-specific guidance on resolution issues for non-bank SIFIs. *Id.*
[72] *Id.* at 24-25.
[73] *Id.* at 25.
[74] *Id.* at 25-26.
[75] *Id.* at 29-32.
[76] *Id.* at 33.
[77] *See* Letter from the British Bankers' Association to the FSB 1-2 (Sept. 2, 2011), *available at* http://www.financialstabilityboard.org/press/c_110909k.pdf [hereinafter BBA Letter].
[78] *See* Letter from the International Banking Federation to the FSB 2 (Sept. 5, 2011), *available at* http://www.financialstabilityboard.org/press/c_110909gg.pdf [hereinafter IBFed Letter]; Letter from the Institute of International Finance to the FSB 3 (Sept. 2, 2011), *available at* http://www.financialstabilityboard.org/press/c_110909gg.pdf [hereinafter IIF Letter]; Letter from the European Banking Federation to the FSB 1 (Aug. 16, 2011), *available at* http://www.financialstabilityboard.org/press/c_110909w.pdf [hereinafter EBF Letter].
[79] FSB, *Key Attributes of Effective Resolution Regimes for Financial Institutions* (Oct. 2011), *available at* www.financialstabilityboard.org/publications/r_111104cc.pdf [hereinafter Key Attributes]. The *Key Attributes* were issued as a core component of a set of policy measures to address systemically important financial institutions, released at the same time by the FSB and endorsed by the G20 leaders. In addition to the *Key Attributes*, the policy measures included requirements for additional

loss- absorption capacity above the Basel III minimum for global systemically important banks (an initial group of 29 such banks were identified by the FSB) and requirements for more intensive and effective supervision of SIFIs. *See* FSB, Press Release: FSB issues International Standard for Resolution Regimes (Nov. 4, 2011), *available at* www.financialstabilityboard.org/press/pr_111104dd.pdf. *See also* FSB, Press Release, FSB announces policy measures to address systemically important financial institutions (SIFIs) and names initial group of global SIFIs (Nov. 4, 2011), *available at* http://www.financialstabilityboard.org/press/pr_111104cc.pdf.

80 FSB, *Effective Resolution of Systemically Important Financial Institutions: Overview of responses to the public consultation* (Nov. 4, 2011), *available at* http://www.financialstabilityboard.org/publications/r_111104dd.pdf [hereinafter *Overview of Responses*].

81 *Id*. at 1.

82 *Id*. at 2.

83 *See, e.g.*, IBFed Letter, *supra* note 78 at 3; EBF Letter, *supra* note 78 at 1; IIF Letter, *supra* note 78 at 12.

84 *Overview of Responses*, *supra* note 80 at 2.

85 *See, e.g.*, IBFed Letter, *supra* note 78 at 4; EBF Letter, *supra* note 78 at 3.

86 *See, e.g.*, BBA Letter, *supra* note 77 at 7; IIF Letter, *supra* note 78 at 20.

87 *See, e.g.*, BBA Letter, *supra* note 77 at 7; IIF Letter, *supra* note 78 at 20.

88 *Overview of Responses*, *supra* note 80 at 3.

89 *See, e.g.*, IBFed Letter, *supra* note 78 at 5; EBF Letter, *supra* note 78 at 23.

90 *See, e.g.*, EBF Letter; *supra* note 78, at 15; Letter from the Fédération Bancaire Française, to the FSB (Sept. 2, 2011), *available at* http://www.financialstabilityboard.org/press/c_110909aa.pdf [hereinafter FBF Letter].

91 *Overview of Responses*, *supra* note 80 at 3-4.

92 *Overview of Responses*, *supra* note 80 at 4.

93 *See, e.g.*, EBF Letter, *supra* note 78 at 8; BBA Letter, *supra* note 77 at 4.

94 *Overview of Responses*, *supra* note 80 at 4.

95 *Key Attributes*, *supra* note 79 at 13. Key Attribute 7.3 indicates that it would not apply to jurisdictions that are subject to a binding obligation to respect the resolution of financial institutions under the authority of a home jurisdiction, as is the case under the European Union winding-up directives. *Id.*

96 *Overview of Responses*, *supra* note 80 at 5.

97 *Id.*

98 *Key Attributes*, *supra* note 79 at 17-18.

[99] *See* Resolution Plans Required, 76 Fed. Reg. 67,323, 67,336 (Nov. 1, 2011) (discussing the application of the resolution plan regulation to foreign banking organizations in the United States).
[100] *See, e.g.*, Peter Lee, *The Balkanization of European Banking,* Euromoney (Oct. 31, 2012), *available at* http://www.euromoney.com/Article/3111003/The-balkanization-of-European-banking.html. *See also* Letter from the IIF to the Board of Governors of the Federal Reserve System 12 (April 30, 2013) (commenting on proposed regulations relating to the treatment of the U.S. operations of foreign banking organizations), *available at* http://www.federalreserve.gov/SECRS/2013/May/20130502/R-1438/R-1438_043013_111122_562504653776_1.pdf.
[101] *Key Attributes*, *supra* note 79 at 16.
[102] *Id.*
[103] *See, e.g.*, IBFed Letter, *supra* note 78 at 7; FBF Letter, *supra* note 90 at 9; EBF Letter, *supra* note 78 at 17; BBA Letter, *supra* note 77 at 9.
[104] *See, e.g.*, FBF Letter, *supra* note 90 at 9.
[105] *See, e.g.*, IBFed Letter, *supra* note 78 at 7; FBF Letter, *supra* note 90 at 2; EBF Letter, *supra* note 78 at 1.
[106] *See, e.g.*, IBFed Letter, *supra* note 78 at 7; EBF Letter, *supra* note 78 at 20; BBA Letter, *supra* note 77 at 11.
[107] *Overview of Responses*, *supra* note 80 at 5.
[108] *Key Attributes*, *supra* note 79 at 16.
[109] *Consultative Document on Effective Resolution*, *supra* note 10 at 67-70.
[110] *Key Attributes*, *supra* note 79 at 13.
[111] *See* 12 U.S.C. § 1821(d)(11).
[112] *See* Deposit Insurance Regulations; Definition of Insured Deposit, 78 Fed. Reg. 11,604 (Feb. 19, 2013).
[113] Letter from Wayne A. Abernathy, Executive Vice President, American Bankers Association, & Cecelia Calaby, Executive Director and General Counsel, ABA Securities Association, to Robert E. Feldman, Executive Secretary, FDIC (April 19, 2013), *available at* https://www.fdic.gov/regulations/laws/federal/2013/2013-ae00-c_03.pdf.
[114] Financial Services Authority, *Consultation Paper CP 12/23: Addressing the implications of Non-EEA national depositor preference regimes* (Sept. 2012), *available at* http://www.fsa.gov.uk/static/pubs/cp/cp12-23.pdf.
[115] *Id.* at 9.
[116] *Id.* at 6.
[117] *Overview of Responses*, *supra* note 80 at 6.

[118] *Id.*
[119] *Key Attributes*, *supra* note 79 at 11.
[120] 12 U.S.C. § 5390(a)(7) & (d)(2) & (3).
[121] For a detailed discussion of the issues that confront the efforts for devising an insolvency framework for cross-border resolution of financial institutions, including those surrounding the Key Attributes, see IIF, *Making Resolution Robust — Completing the Legal and Institutional Frameworks for Effective Cross-Border Resolution of Financial Institutions* (June 2012), *available at* http://www.iif.com/download.php?id=vVrz1cqvQzI=.
[122] For an example of additional guidance recently given by the FSB on the recovery planning requirement in the Key Attributes, see Brooke Masters, *Banks' living wills start to take form*, FIN. TIMES, Aug. 5, 2013, at 15.

Unitranche Financing Facilities: Simpler or More Confused?

BRAD B. ERENS AND DAVID A. HALL

The unitranche financing facility, versus a more traditional two-loan structure, is widely thought to generate efficiencies, ease the process of closing, streamline administrative functions, and, ultimately, to pass along cost savings to lenders and borrowers. The authors of this article examine unitranche financing facilities, and conclude that while unitranche deals offer clear benefits, there are significant elements of uncertainty associated with such deal structures that the careful practitioner must be aware of in drafting loan documents and advising clients.

Unitranche facilities are a relatively recent innovation in the middle market lending sector designed as an alternative to the typical first and second lien loan structure. The unitranche facility, versus a more traditional two-loan structure, is widely thought to generate efficiencies, ease the process of closing, streamline administrative functions, and, ultimately, to pass along cost savings to lenders and borrowers.

A middle market loan is often structured as two separate loans — a first lien facility and a second lien facility. The first lien facility generally consists of the larger portion of the overall borrowing, including, potentially, both a term and revolving loan. The first and second lien lenders commonly will take security interests in the same collateral — substantially all of the borrow-

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ers' assets — with the relationship between the first and second lien lenders governed by an "intercreditor agreement" that delineates the priorities of the lenders in the collateral and sets forth the rights and obligations among the lenders. More specifically, the intercreditor agreement typically will subordinate the liens and rights of the second lien lenders (including rights to payment) to those of the first lien lenders and may require the second lien lenders to "standstill" on any enforcement actions in respect of the collateral until such time as the obligations owing under the first lien facility are paid in full.

The intercreditor agreement also contains a myriad of other provisions that govern the rights of the first and second lien lenders in the context of a bankruptcy proceeding, including the rights of the lenders to object to asset sales or the borrower's proposed plan of reorganization, credit bid in asset sales, receive adequate protection or postpetition interest, consent to the use of cash collateral, or provide debtor in possession financing, among other things. The borrower is typically a party to the intercreditor agreement.

Importantly, the first and second lien facilities are entirely separate credit arrangements, although particular lenders may hold first or second lien debt. Each loan in this two-loan structure is governed by its own fully negotiated set of lending documents (although the documentation likely will be similar between the facilities), including, among others, a credit agreement, security agreement, guaranties, collateral trust agreements, and other supporting documentation negotiated and prepared by separate counsel and other advisors. Each loan also will be administered independently by separate collateral and administrative agents. Fees and costs associated with negotiating, documenting, and administering each of the first and second lien facilities — including agent fees and professional expenses — are borne by the borrower independently.

The unitranche facility offers an interesting alternative in middle market deals, where cost sensitivities have driven lenders to offer more streamlined products. The unitranche structure has found a popular audience as a potentially simpler, more cost-effective method of funding a middle market company than traditional structures. While trends in the unitranche space are beginning to emerge, it is important to remember that these deal structures are still somewhat nascent, and, thus, terms may vary widely between deals and will turn on the relative negotiating positions of the parties.

In contrast to the first lien/second lien deal structure described above, a unitranche facility is structured as a single loan, secured by a single first lien in collateral, but with two tranches of debt — a "first out" tranche and a "last out" tranche. The first out tranche also may contain a revolver. As the names imply, the first out tranche of the facility has priority in payment over the last out tranche. Fees and interest, and any amortization, are allocated disproportionately among first out and last out lenders based on the relative risk of the lenders, and, typically, the last out tranche accrues at a higher rate of interest than the first out tranche. The borrower pays one blended interest rate on the entire amount of the facility, and the entire loan balance is amortized over a single amortization schedule. In some instances, the loan may be weighted more heavily in the last out tranche.

The relationship between the first out and last out lenders is governed by an "agreement among lenders" ("AAL"). The AAL operates much like an intercreditor agreement and sets forth many of the operative provisions of the unitranche structure, including those provisions that subordinate the interests of the last out lenders to those of the first out lenders. Interestingly, unlike an intercreditor agreement, the borrower is typically not a party to the AAL, and, as a general matter, the borrower may have very little visibility into the two-tiered nature of the credit facility. This may ultimately prove a disadvantage to the borrower, as there is a general lack of transparency with respect to the lender group and the varying economic interests among them, which could complicate any effort to restructure a unitranche loan.

A CLOSER LOOK AT THE UNITRANCHE SUBORDINATION STRUCTURE

Among the lenders, the AAL contains important features that distinguish between first out and last out lenders, the most important of which are discussed below. From a practice perspective, it is critical to note that issues not adequately addressed in the AAL are resolved by reference to the underlying credit agreement. Thus, in order to maximize predictability, it is critical to ensure that the key elements of the parties' agreement are adequately resolved by the express terms of the AAL or credit agreement.

Payment Waterfall

The chief function of the AAL is to establish the payment waterfall among the first out and last out lenders. The common structure of a unitranche facility provides that interest payments, and, in some instances, principal payments, made by the borrower in the ordinary course of the loan will be apportioned among the first out and last out lenders by the administrative agent in accordance with their pro rata shares of the debt, with the blended rate of interest and method of apportionment, unique for each deal.

Proceeds of collateral, however, following an enforcement of remedies by the collateral agent, or, in some cases, any payments received from the borrower following a material event of default (such as a bankruptcy filing, violation of a leverage ratio covenant or a payment default) will typically be paid: first, to the administrative and/or collateral agent on account of fees and expenses; second, to the first out lenders on account of fees and expenses; third, to the agents for interest and principal owing on any advances, and fourth, to the first out lenders on account of first out debt obligations, including principal and interest. Only once these amounts have been paid in full (including postpetition interest in the case of a bankruptcy filing) are the last out lenders entitled to receive any payment on account of their fees and expenses, or the principal and interest owing in respect of the last out debt.

Additionally, it is common for optional and mandatory prepayments, and in some deals, amortization payments, to be applied first toward the principal of first out loans until paid in full, and only then to the principal of the last out loans. However, in some instances, mandatory prepayments from excess cash flow or equity proceeds may be made ratably among first out and last out lenders.

Voting Rights – Remedies Enforcement and Amendments

It is typical in larger credit facilities, which contain more than one level of secured debt and one or more syndicate of lenders, for the applicable loan documents to delineate clearly the voting rights among lenders within a facility, and to award some composition of "required lenders" the power to direct the administrative and collateral agents to act in certain instances, including in the face of an event of default. As credit facilities have grown larger and more widely syndicated, disputes regarding the power of the majority lenders to direct the agent to act, and an agent's ability to bind dissenting lenders on important issues have arisen, with fairly consistent results in the courts, as discussed in greater detail below.

In the unitranche context, these issues are perhaps of greater complexity given the unique relationship between the first out and last out lenders. As with many of the more important aspects of unitranche deals, there are no set market terms for how voting rights should be apportioned among the first out and last out lenders, or governing which lenders should have the power to direct the agent.

A common variation, however, allows "required last out lenders" (i.e., holders of at least 50 percent of last out debt) to participate in decision-making with respect to the enforcement of remedies or the amendment of key credit documents until there is a material event of default — typically, the violation of a leverage ratio covenant, a payment default, or the commencement of a bankruptcy or insolvency proceeding. Following an event of default of this nature, only the "required" first out lenders (i.e., holders of 50 percent or more of the first out debt) can direct the agent to exercise remedies or amend the lending documents. Moreover, irrespective of whether there is a continuing event of default, first out lenders typically have the exclusive right to agree to any amendments to the credit documents that impact material financial terms of the first out debt or any financial covenants.

Buy-Out Option

The typical AAL contains a "buy-out" option under which the last out lenders have the right, under certain defined circumstances, to buy-out the 100 percent interests of all, or a certain sub-set of the first out lenders. Triggering events for the buy-out option typically include (but are not limited to) the following situations:

- a maturity of the loan obligations has been accelerated based on an event of default under the terms of the applicable loan documents;
- another event of default under the applicable loan documents;
- the collateral agent is required to commence remedies, including enforce-

ment actions, or has exercised any secured creditor remedies with respect to any loan party;

- violation by the borrower of certain leverage ratio covenants; or
- the occurrence and continuance of an insolvency proceeding.

All, or some sub-set, of the last out lenders may elect to initiate the buy-out option by giving notice to the administrative agent of their intention to buyout the first out interests following the occurrence of one of the aforementioned trigger events. Within a period of time that notice has been received by the agent — typically five to 10 business days — the electing last out lenders are committed to buy 100 percent of the first out interests in a pro rata amount based on their holdings of last out interests. The purchase price is, generally speaking, equal to the outstanding obligations (principal and interest) owing in respect of the first out loan obligations, including term and revolving loans, committed letters of credit, and the fees and expenses owing to the first out lenders.

Certain AALs additionally give last out lenders a buyout option in the event that the required last out lenders have agreed to certain modifications or amendments to the loan documents, and the required first out lenders have not given such consent. In these, or similar instances, the last out lenders may be permitted to buy-out the amount of the "hold out" first out loan interests as necessary to permit the amendment or modification.

In either instance, the buy-out option is designed to give the last out lenders some element of control in instances where the loan has become a troubled credit and the payment of the last out debt may be in jeopardy. While these provisions may impact the liquidity of the loans, the careful practitioner will consider these provisions closely before including them in an AAL.

Right of First Refusal

Another common feature of an AAL is a right of first refusal, whereby the lenders — both first out and last out — agree that before selling or otherwise transferring their interests in any of the debt to a third party, the selling lender must offer its right in the debt position to the administrative agent (who may also be a lender) prior to consummating a sale to a third party. In some instances, it is only the last out lenders who may have this right of first refusal. As with the buy-out right, the right of first refusal is designed to give the existing parties to the loan some element of control within the lending syndicate.

Agreements on Conduct in Bankruptcy

An AAL may also address certain issues relating to the parties' conduct in a bankruptcy proceeding, which may or may not resemble those set forth in a typical intercreditor agreement depending on the relative negotiating power of the parties. For instance, AALs will typically place restrictions on the ability of first out and last out lenders to commence involuntary insolvency proceedings against the borrower. AALs will also commonly preserve the ability of lenders to object to proceedings in their capacity as unsecured creditors. Moreover, and importantly, AALs will set forth procedures for requiring and obtaining any necessary consent with respect to the use of cash collateral or debtor-in-possession financing, as well as for conducting or objecting to sales of assets under Section 363 of the Bankruptcy Code.

Nevertheless, last out lenders will not typically agree in advance to any kind of asset sale, debtor in possession financing, use of cash collateral or other important bankruptcy proceeding matter. Moreover, it is not uncommon for the first out lenders to agree not to object to a sale of any collateral free and clear of their liens, provided that the collateral agent and the last out lenders have consented to the sale. In such situations, however, the first out lenders' liens will typically attach to the proceeds of the sale, and the waterfall scheme set forth in the AAL would apply to the distribution of the proceeds.

First out lenders also may agree not to object to debtor-in-possession financing provided by the last out lenders so long as the first out lenders are not primed as part of the bankruptcy financing, the first out lenders are afforded adequate protection liens on postpetition assets to the same extent as the postpetiton lenders, and the amount of postpetition financing does not exceed a certain express cap. In each instance, the first out lenders will commonly retain their rights to object in their capacities as unsecured creditors, or to the extent the proposed transaction is not in accordance with the AAL.

COMMON BENEFITS OF THE UNITRANCHE FACILITY

There are a number of reasons why the unitranche structure is attractive in smaller sized deals. As a general matter, transaction costs are lower in unitranche deals than the typical first lien/second lien structure because there are fewer financing agreements and fewer parties to the negotiations. For the same reasons, unitranche deals can close more quickly than a more traditionally structured deal. Additionally, unitranche loans are not typically syndicated widely, if at all, and thus, there is greater certainty of closing on schedule and in accordance with the originally agreed upon terms. Moreover, with fewer lenders in a unitranche deal, a borrower may benefit from streamlined due diligence.

On the administration side, a unitranche deal features a single administrative agent and collateral agent, which reduces costs, and fewer lenders can mean more streamlined decision-making. With respect to pricing, there is some perception that a unitranche deal may offer some interest savings in that a single rate for the borrower may be less than the blended rate of first and second lien debt under a more traditional structure. Nevertheless, as discussed at greater length below, the uncertain nature of certain key issues with respect to the treatment of a unitranche facility in bankruptcy may offset, at least in part, some of the perceived benefits of the more streamlined loan structure.

ENFORCEMENT AND BANKRUPTCY RELATED ISSUES

The relatively recent advent of the unitranche structure raises some interesting questions in the context of a bankruptcy proceeding, where the enforcement of an AAL, and the various issues that commonly arise between lenders in a bankruptcy proceeding are, to date, untested. Many of these issues are addressed below.

Enforcement of an AAL as a Subordination Agreement

To our knowledge, a bankruptcy court has never passed on the issue of whether an AAL is enforceable in a bankruptcy proceeding, and thus, binding in that context. Pursuant to Section 510(a) of the Bankruptcy Code, a "subordination agreement is enforceable under [the Bankruptcy Code] to the same extent that such agreement is enforceable under applicable nonbankruptcy law."[1] Thus, to the extent an AAL is considered a "subordination agreement" and is otherwise enforceable under applicable state law, the AAL should fall within Section 510(a) of the Bankruptcy Code and would be enforced by its terms.

A key threshold issue, however, is whether the bankruptcy court would have jurisdiction over a dispute arising out of the AAL given that the borrower is not a party to the agreement. Bankruptcy courts are generally loathe to preside over purely third party disputes, and in particular, intra-creditor fights that do not implicate the debtor. Given that any dispute between a first out and a last out lender would necessarily require the bankruptcy court to delve into the minutiae of an agreement between lenders to which the debtor is not even a party, a bankruptcy court could very well determine that any dispute between the lenders is not properly before it. In such case, the parties would presumably end up in the appropriate state court to settle the contract dispute.

Nevertheless, Section 510(a) of the Bankruptcy Code does not state that the debtor must be a party to the contract for the subordination agreement to be enforceable in bankruptcy. Moreover, to the extent a dispute relates to a lender's treatment under a Chapter 11 plan (such as classification, payment of postpetition interest, etc.), a court may very well decide the issue.[2] Some agreements we have seen go so far as to expressly state that the AAL shall constitute a subordination agreement for purposes of Section 510(a) of the Bankruptcy Code, and, therefore, are enforceable by their terms in a bankruptcy proceeding. It is unclear, however, that such language would be dispositive of the issue.

To the extent a bankruptcy court did entertain a dispute among lenders with respect to an AAL, the court could look to existing law in the subordination agreement context for guidance. In that regard, bankruptcy courts have consistently enforced subordination agreements to subordinate a junior lienholder's right to payment under a plan of reorganization.[3] And, as discussed in greater detail below, courts have specifically enforced subordination agreements in the context of a senior lender's ability to collect postpetition interest prior to any recovery by a junior creditor.[4]

In some instances, however, courts have not enforced a subordination agreement when such agreements infringed on what the courts considered to be fundamental bankruptcy rights, such as preventing a party from voting on a plan of reorganization or objecting to key issues within a bankruptcy proceeding.[5] But even then, courts are hardly uniform on the issue.[6] Some courts have also refused to enforce a subordination agreement where its subordination provisions were not sufficiently specific to give the junior creditor notice of the subordination.[7]

Thus, to the extent a bankruptcy court were to treat an AAL as a subordination agreement, and further entertain a dispute between first out and last out lenders regarding its subordination provisions, a court would, based on existing precedent, likely enforce the agreement except to the extent, potentially, that the last out lenders had been forced to forego what courts have considered to be fundamental bankruptcy rights. Many of the AALs we have seen expressly preserve the right of respective lenders to participate in proceedings in their capacity as unsecured creditors, to vote on a plan of reorganization, to provide and object to debtor in possession financing and use of cash collateral, and to partake in, or object to, the sale of assets in a proceeding. Consequently, these agreements would appear to comport with existing case law on the enforcement of a subordination agreement, and most notably, the *203 North LaSalle* case. Nevertheless, enforcement of an AAL is not certain in bankruptcy no matter how tight the drafting, which could result in the first out and last out lenders dueling in an applicable non-bankruptcy court.

Collection of Postpetition Interest

Assuming an AAL is enforced as a subordination agreement in bankruptcy, another interesting issue that may arise in the bankruptcy context is the ability of a first out lender to collect postpetition interest on its claim prior to a last out lender collecting on its claim. As has been well established, the general rule in bankruptcy is that creditors — secured and unsecured — are not entitled to collect interest that accrues on their prepetition claims following the filing of a bankruptcy petition.[8] An exception to that general rule is set forth in Section 506(b) of the Bankruptcy Code, which allows a secured creditor to recover reasonable fees, costs and interest that accrue postpetition and which arise under the express terms of a credit agreement, to the extent that such secured creditor is "oversecured" by its collateral.[9]

In the typical first lien/second lien scenario, the determination of whether a first lien creditor is oversecured, and thus entitled to postpetition interest, is a relatively simple matter after the amount of the claim is settled and the collateral securing the claim has been valued. Provided the collateral is worth more than the claim, the first lien lender is entitled to postpetition interest; and pursuant to the typical intercreditor agreement between the first and second lien lenders, the first lien lender may be entitled to collect such interest prior to any distribution to the second lien lender.

In the unitranche structure, determining whether a first out lender is entitled to postpetition interest is a more complicated endeavor given that the first out and the last out lenders hold different tranches of the same first lien claim. Unlike the first lien/second lien scenario, there are not separate claims against the debtor that can be easily delineated in a unitranche deal. Moreover, the debtor is not even a party to the AAL, the operative document that arguably bifurcates the first out and last out claims. Thus, a court could decide that first out and last out claims are simply one claim against the debtor. Thus, if the entire claim is worth less than the collateral, the first out lenders (even if otherwise "oversecured") are undersecured for purposes of 506(b), and therefore, not entitled to postpetition interest.

The court in *Ionosphere* faced a similar factual scenario and reached that very conclusion. In that case, the debtor had issued three series of notes under the same indenture, each in differing amounts, at differing interest rates, and each with separate trustees.[10] Each issuance was secured by a first lien on the same collateral — a pool of aircraft and engines.[11] As of the petition date, the aggregate outstanding amounts owing under the notes was $453,765,000, with $187,934,000 owing on the first series, $168,665,000 owing on the second series, and $97,166,000 owing on the third series.[12] The debtor ultimately sold the collateral in the bankruptcy proceedings for approximately $232,000,000.[13]

The debtor and the collateral trustee agreed by stipulation to a turnover of nearly all of the proceeds (save for a small holdback for certain expenses and claims), and thereafter, the first series noteholders instructed the collateral trustee to turn over all of the proceeds on account of first series noteholder claims, which represented both the principal and interest owing on the petition date, as well as postpetition interest.[14] The first series noteholders argued their claim was oversecured because the proceeds exceeded the amount of their claim on the petition date, and, pursuant to an intercreditor agreement among the various series of noteholders, the first series noteholders were entitled to the full payment of postpetition interest prior to any recovery by the second or third series noteholders.[15] Conversely, the second series holders argued that only $187,934,000 of the proceeds should be turned over to the first series holders — the principal and interest owing on account of their claims as of the petition date — with the remainder turned over to the second series holders on account of their claims.[16]

The first issue addressed by the court was whether the three series of notes should be considered three separate claims, as argued by the first series holders, such that the first series could be considered "oversecured." The court held the claims should be considered one claim — and thus, undersecured — writing that:

> It is clear that if the three Series held separate liens against the Collateral, then the First Series would be oversecured and would be entitled to post-petition interest, but that is not the structure of this transaction. The Debtor granted only one lien, only one secured claim, in favor of all the Certificateholders. How the rights to proceeds of the lien collateral were to be distributed under the Indenture was an intramural matter for the Collateral Trustee and the various series, not the Debtor.[17]

Because there was only one secured claim against the debtor, the court found the claim to be undersecured as a whole, and thus, the first series were not entitled to postpetition interest from the debtor.[18]

That conclusion did not end the court's analysis, however. The court went on to discuss the relative rights of the secured lenders under their subordination agreement, which the court found to be enforceable in bankruptcy under Section 510(a) of the Bankruptcy Code.[19] The first series argued that if postpetition interest could not be recovered under Section 506(b) of the Bankruptcy Code from the debtor, the first series noteholders were still entitled to recover postpetition interest on their claims out of the recovery to junior creditors to the extent provided by the terms of the intercreditor agreement between the parties.[20] The court ultimately held that applicable state law (New York) requires any right of the first lien lenders to recover postpetition interest out of the recovery to the second lien lenders to be clear and explicit, and that the intercreditor agreement was not sufficiently clear on this point to notify the junior noteholders that their claims might be subordinated in this fashion.[21] Nevertheless, the court held out the possibility that if clear and explicit, an agreement of this nature could be enforced.[22]

Since the ruling in *Ionosphere*, the jurisprudence on the ability of an undersecured creditor to collect postpetition interest on its claim from a junior creditor under the terms of an intercreditor agreement is fairly well developed. In that regard, courts have held that a senior creditor under a subordination agreement can assert that its claim is entitled to postpetition interest, with the payment of interest coming not from the debtor's estate, but from the dividend that would otherwise be paid in respect of the subordinated claim.[23] Courts have followed this logic, provided that the agreement in question is consistent with applicable state law, which generally requires the subordination to be clear and explicit.[24] Prior to the enactment of Section 510(a), this was known in jurisprudence as the "rule of explicitness," which was replaced with the enactment of Section 510(a) and reference to applicable state law.[25]

Based on the foregoing, it seems likely that, pursuant to the reasoning in *Ionosphere*, a unitranche facility would be considered a single secured claim based on the single facility and the single lien granted in respect of the claim. Thus, to the extent that the total aggregate unitranche claim was undersecured, an "in the money" first out lender is unlikely to be able to recover postpetition interest from the borrower's estate under 506(b) of the Bankruptcy Code.

Nevertheless, under the reasoning of *Ionosphere* and related cases, a first out lender may still be able to collect postpetition interest at the expense of a last out lender under the terms of the AAL, provided that the right to recovery is clear and explicit, particularly when the agreement in question is governed by New York law (which still follows the rule of explicitness). As such, simply providing that all first out obligations are to be "paid in full" prior to the receipt of funds by the last out lenders is insufficient in this regard. Instead, the AAL should make clear that no recovery in a bankruptcy proceeding is to be had by the last out lenders unless and until all the claims of the first out lenders are paid in their entirety, including, without limitation, all claims for postpetition interest and other fees and expenses associated with the bankruptcy.

Classification of Claims, Claim Treatment and Confirmation Related Issues

Probably the most critical, and complicated issues that arise in the bankruptcy context — which potentially weigh on how much flexibility a borrower has to restructure a unitranche facility — relate to the classification and treatment of the first out and last out claims. These issues are of particular importance if a unitranche deal is more heavily weighted in the last out tranche. In such instances, if first out and last out claims are classified together, the last out lenders could hold a blocking position within the class of lenders on any Chapter 11 plan despite having been subordinated under the AAL, thus potentially making the last out lenders a relevant negotiating party.

Section 1122(a) of the Bankruptcy Code sets forth the rules for classifying claims in a plan, providing that "a plan may place a claim or an interest in a particular class only if such claim or interest is substantially similar to the other claims or interests of such class."[26] While the Bankruptcy Code provides that substantially similar claims *may* be classified together, the Bankruptcy Code does not *require* that they be classified together.[27]

Nevertheless, courts have constructed some limitations on a debtor's ability to classify similar claims separately. For example, in *John Hancock*, the Third Circuit noted that:

> [I]t seems clear that the Code was not meant to allow a debtor complete freedom to place substantially similar claims in separate classes. The critical confirmation requirements set out in section 1129(a)(8) and section 1129(a)(10) would be seriously undermined if a debtor could gerrymander classes.[28]

Thus, the Third Circuit explained that, while the Bankruptcy Code does not necessarily prohibit the placement of similar claims in different classes,

> There must be some limit on a debtor's power to classify creditors in such a manner [to assure that at least one class of impaired creditors will vote for the plan and make it eligible for cram down consideration by the court]. The potential for abuse would be significant otherwise. Unless there is some requirement of keeping similar claims together, nothing would stand in the way of a debtor seeking out a few impaired creditors (or even one such creditor) who will vote for the plan and placing them in their own class.[29]

Consequently, a classification scheme must be reasonable in light of the purposes that classification serves under the Bankruptcy Code — voting to determine whether a plan can be confirmed, and the treatment of claims under the plan. For purposes of cramming down a plan on a class of dissenting creditors, this means that each class must represent a voting interest that is sufficiently distinct and weighty to merit a separate voice in the decision-making process on a plan.

In the context of secured claims, creditors with liens of different priority in the same property will usually be classified separately in a Chapter 11 plan.[30] This is particularly the case where treatment among secured creditors will vary.[31] Thus, secured claims are very commonly classified together when such claims arise from the same agreement and are secured by, and have the same priority in, the debtor's property.[32]

Based on the foregoing well-established law, in the typical first lien/second lien structure first lien lenders and second lien lenders are almost uniformly classified separately, as the claims held by each group arise out of different credit agreements and have different priorities in the debtor's collateral. Moreover, given the different priorities in the debtor's assets, first and second lien lenders also typically receive quite different treatment under a plan. Due to their subordinated nature, the second lien lenders may have little control over the plan process, or the treatment of the first lien lenders in a restructuring. Sometimes, the debtor may negotiate almost exclusively with the first lien lenders regarding the terms of a restructuring, with the second lien lenders playing a more minor role in any negotiations.

In a unitranche scenario, however, it may not be clear how a debtor should classify and then treat the first out and last out claims under a plan of reorganization. Assuming a unitranche facility where the last out lenders hold a blocking position if classified with the first out lenders, and further assuming that there is no consensus among the debtor and the last out lenders with respect to a restructuring, the debtor will need to seek confirmation of its plan over the objection of the dissenting last out lenders through cramdown. Section 1129(b) of the Bankruptcy Code sets forth the requirements for approving a plan of reorganization over the objections of a secured creditor, providing that in order to cramdown a plan on a dissenting class of secured creditors, the plan must avoid unfairly discriminating against such class, and the plan must be fair and equitable in the treatment of the claims of such class, requirements discussed at greater length below.[33] Section 1129(a)(10) (applicable in a cramdown) also requires that at least one class of impaired, non-insider creditors votes to accept the plan.

From the debtor's perspective, the simplest plan structure would be to classify the first out and last out claims together, and provide all lenders the same treatment under the plan with any distributional true-up under the AAL administered by the lender's administrative agent. From a legal perspective, this classification and treatment of the unitranche lender claims would be the least controversial, and would not appear to run afoul of any bankruptcy jurisprudence. Moreover, the debtor would not be burdened with the complicated task of determining the varying economic interests among the lenders in proposing the treatment of lender claims.

Nevertheless, by classifying all of the lenders together, the plan could be voted down by the unitranche lender class because the dissenting last out lenders would hold a blocking position on the plan vote. Thus, the debtor could have to cram down the plan on the entire class of unitranche lenders, thus triggering the "fair and equitable" requirements of Section 1129(b) of the Bankruptcy Code.[34] In order for the plan to be fair and equitable, the lender class would need to retain its liens on the debtor's assets, and the plan must provide for a stream of payments to the lenders over a reasonable period of time and accruing at an interest rate that reflects the "present value" of the lenders' claims as of the effective date of the plan. Presumably, under this plan structure, the debtor would propose replacing the prepetition debt with a secured note that reflects the full facility amount, accruing interest at a rate that protects the present value of the entire facility, and would not otherwise give effect to the economic variables set forth in the AAL.

As noted, the debtor needs to secure the affirmative vote in favor of the plan by at least one class of impaired, non-insider creditors. Thus, if the debtor does not have sufficient support of the lenders to carry the plan through to confirmation, attention will need to be given to gaining the support of some other voting constituency to obtain the necessary affirmative vote of an impaired class. Although beyond the scope of this article, there are well established restrictions on a debtor's ability to create what courts consider to be "artificially" impaired classes of creditors for the purpose of securing the vote of an impaired class.[35] Thus, the careful practitioner will ensure that there is at least one truly impaired class of creditors that supports the plan — the most likely being general unsecured creditors, to the extent they can be convinced that the plan offers them enhanced recovery over the alternatives. Absent the affirmative vote of an impaired class, this classification and treatment strategy will not succeed.

In an effort to avoid the classification issue altogether, we have seen AALs where the first out and last out lenders simply agree among themselves that their respective claims shall be classified separately in a bankruptcy. Given that the debtor is not a party to the AAL, as noted, it is unclear that such an agreement would be enforceable against the debtor. Thus, if the debtor chose to classify the first out and last out lenders together, it is unclear that the lenders could force a different result by virtue of the AAL. Nevertheless, the debtor may choose to give effect to this classification agreement and separately classify the lender claims. The question at that point, is what treatment to provide each class of lenders.

For simplicity of administration, the debtor could provide each class with the same treatment (i.e., a secured note, for instance) with any distributional true-up under the AAL to be administered by the lenders' administrative agent. Under ordinary circumstances, a treatment such as this would be very controversial, as separately classifying, and yet providing the same treatment to, creditors of the same priority would draw scrutiny as potential vote gerrymandering.

Along those lines, the last out lenders could resist this approach arguing that separate classification is impermissible in this instance because, although the AAL sets forth differing priorities among the lenders, the debtor is not a party to the AAL, and, thus, cannot be enforced by the debtor. Moreover, vis à vis the debtor, the first out lenders and the last out lenders each hold a single first lien claim against the same collateral, which arises out of the same credit agreement. Thus, under existing case law, the last out lenders might argue there is no basis for separately classifying the first out and last out lenders, particularly if separate classification is proposed to simply influence the outcome of plan voting, which appears obvious given the similar treatment among classes.

The debtor could nevertheless cogently assert that an agreement regarding the classification of first out and last out claims, while not enforceable *against* the debtor (because it is not a party to the agreement), could very well be enforced *among* the lenders as parties to the AAL, consistent with the *Ionosphere* opinion.[36] Moreover, the debtor could assert that by agreeing to separate classification in the AAL, the last out lenders implicitly waived any right to object to separate classification and are thus estopped from opposing the plan on that ground.

There are also arguably substantive bases for separately classifying the first out and last out claims. For instance, the debtor could argue that by virtue of the AAL, the first out and last out claims are substantially different, and have different rights to recovery, thus creating very different legal rights against the estate, thus justifying separate classification. Moreover, providing what appears to be the same treatment in this context simply is designed to give effect to the distributional agreement among the lenders, which results in different recoveries among such lenders and is best enforced by the lenders' administrative agent, not the debtor. It could be further asserted that the fact that the debtor is not a party to the AAL should be of no moment because, as noted above, Section 510(a) of the Bankruptcy Code simply provides that subordination agreements are enforceable in bankruptcy and contains no requirement that the debtor be a party to such agreement.

Nevertheless, it is unclear how a court would decide this issue. From a drafting perspective, it may be best practice to include language in an AAL expressly providing that not only do the lenders agree to separate classification, but that the last outs expressly agree to give the AAL economic effect under any Chapter 11 plan and waive any objections they may have to a plan based on classification.

The debtor's other option would be to classify the lender claims separately and to provide different treatment to the first out and last out lenders, consistent with the economic terms of the AAL. This may be the most complicated plan structure of the various potential options, raising a myriad of issues that are not easily answered. Aside from the classification issues that have been analyzed above with respect to separately classifying the first out and last out claims, if the debtor has little visibility into the economics of the agreement among the lenders, how would the debtor propose a plan that gives express legal effect to the AAL? How would the rights among the lenders be governed post-confirmation with respect to distributions if the parties are issued new debt documents pursuant to the plan — would the AAL still control, or would the plan control?

Moreover, if the plan provided the last out lenders with significantly different, and worse treatment than the first out lenders, the last out lenders would have an argument that the plan is presumed to discriminate unfairly against the last out lenders because it provides secured creditors with the same priority in the debtor's assets with markedly different treatment.[37] The debtor could rebut such presumption by arguing that there is a valid distinction between the lenders based on the prepetition AAL.[38] Nevertheless, the outcome of this legal issue is uncertain and further complicates any effort to achieve confirmation in this context.

Unlike the traditional first lien/second lien scenario, where the classification and treatment of lender claims is relatively straightforward, the unitranche structure creates an interesting power dynamic among first out and last out lenders that is not easily resolved.

Fiduciary Duty Issues

Another issue worth exploring in this context is the fiduciary obligations of the agent where there is a single agent acting on behalf of all the lenders – the first out, and last out lenders, when they have such disparate economic interests, and yet, the same agent is tasked with administering the loan on their behalf. As noted above, most AALs provide that following a material event of default, the agent is to follow the direction of the required first out lenders in enforcing remedies and liquidating collateral. This may be, in certain instances, to the detriment of the last out lenders (particularly when the collateral value is below the par value of the debt), raising the issue of what, if any, duty the agent owes to the last out lenders in this regard.

As a general matter, so long as an agent follows the express terms of the governing loan documents, courts have held that an agent has the power to bind a class of lenders, even when an agent's actions may be objectionable to a sub-set of lenders.[39] Similarly, in the unitranche scenario, the agent's obligations to the lenders should be delineated and set forth in the governing loan documents. Moreover, unless the loan documents provide otherwise, no fiduciary or other duty should arise between the agent and the lenders.[40] From a drafting perspective, it is important that any fiduciary duty be clearly disavowed by the agent. There is almost assuredly going to be discord among lenders in any meaningful decisions being made under a credit facility, especially in situations of distress. Thus, it is key that the loan documents are clear that an agent's obligations are to follow the terms of the loan documents, and there is no liability to any party for doing so.

CONCLUSION

Unitranche facilities offer a simpler, potentially much more cost effective method of funding a middle market company than a traditional first lien/second lien deal structure. In particular, unitranche deals offer, among other things, a simplified structure, an ease of closing, and streamlined administration, all of which reduce costs and otherwise generate mutual benefits to both borrowers and lenders. Nevertheless, interesting and unique issues arise in respect of a unitranche deal when the credit becomes troubled, and enters the Chapter 11 realm. Given the relatively recent rise of the unitranche structure, these issues are, to date, untested in bankruptcy courts. Consequently, while unitranche deals offer clear benefits, there are significant elements of uncertainty associated with such deal structures that the careful practitioner must be aware of in drafting loan documents and advising clients.

NOTES

[1] 11 U.S.C. §510(a).

[2] *See, e.g.*, *In re Ionosphere Clubs, Inc.*, 134 B.R. 528, 535 (Bankr. S.D.N.Y. 1991) (deciding dispute between lenders under terms of subordination agreement).

[3] *See Chemical Bank v. First Trust of New York (In re Southeast Banking Corp.)*, 156 F. 3d 1114, 1121 (11th Cir. 1998) (finding that Section 510(a) directs courts to enforce subordination agreements to the extent the agreements are enforceable under applicable nonbankruptcy law); *In re 203 North LaSalle Street Partnership*, 246 B.R. 325, 330 (Bankr. N.D. Ill. 2000) ("Pursuant to §510(a), it is certain that a subordination provision that violates no principle of bankruptcy law – such as the present one – must be enforced as it would be under nonbankruptcy law."); *see also In re Erickson Retirement Communities, LLC*, 425 B.R. 309, 313 (Bankr. N.D. Tex. 2010) (holding that junior creditor does not have standing to bring a motion for appointment of examiner pursuant to the terms of a subordination agreement); *In re Ion Media Networks, Inc.*, 419 B.R. 585, 597 (Bankr. S.D.N.Y. 2009) (finding that indenture prevented junior from objecting to plan).

[4] *See Ionosphere Clubs, Inc.*, 134 B.R. at 535; *accord In re Bank of New England Corp.*, 364 F.3d 355, 368 (1st Cir. 2004) (finding that subordination agreement may allow first lien lender to collect postpetition interest at the expense of junior lender if enforceable under applicable state law); *In re Plymouth House Health Care Center*, 2005 WL 2589201 (Bankr. E.D. Pa. Mar. 15, 2005) (enforcing subordination agreement to allow senior lender to collect postpetition interest under Section 506 of Bankruptcy Code); *Wolohan Lumber Co. v. Robbins (In re Robbins)*, 21 B.R. 747, 751 (Bankr. S.D. Ohio 1982) (holding that subordination agreement was enforceable to allow first lien lender to collect postpetition interest prior to any recovery by junior lender).

[5] *See 203 North LaSalle Street P'ship*, 246 B.R. at 330, 331-32 (holding that subordination agreement allowing senior lender to vote junior lender's claim could not be enforced); *see also Beatrice Foods Co. v. Hart Ski Mfg. Co. (In re Hart Ski Mfg. Co.)*, 5 B.R. 734, 736 (Bankr. D. Minn. 1980) ("The intent of section 510(a)…is to allow the consensual and contractual priority of payment to be maintained between creditors among themselves in a bankruptcy proceeding. There is no indication that Congress intended to allow creditors to alter, by a subordination agreement, the bankruptcy laws unrelated to distribution to assets.").

[6] *See e.g. In re Aerosol Packaging, LLC*, 362 B.R. 43, 47 (Bankr. N.D. Ga. 2006) (enforcing subordination agreement to allow senior lender to vote junior lender's claim in respect of plan of reorganization).

[7] *See In re Boston Generating, LLC*, 440 B.R. 302, 320 (Bankr. S.D.N.Y. 2010) (refusing to enforce subordination agreement to prevent second lien lenders from objecting to sale transaction where agreement was insufficiently drafted to put

second lien lenders on notice of subordination).

[8] *See In re Tribune Company*, 472 B.R. 223, 250 (Bankr. D. Del. 2012); *203 North LaSalle Street P'ship*, 246 B.R. at 330; *Ionosphere Clubs, Inc.*, 134 B.R. at 531.

[9] 11 U.S.C. §506(b); *see also Tribune*, 472 B.R. at 250; *203 North LaSalle Street P'ship*, 246 B.R. at 330.

[10] *Ionosphere Clubs, Inc.*, 134 B.R. at 529.

[11] *Id.*

[12] *Id.* at 529-30.

[13] *Id.* at 530.

[14] *Id.*

[15] *Id.*

[16] *Id.*

[17] *Id.* at 532.

[18] *Id.*

[19] *Id.* at 532-33.

[20] *Id.* at 533.

[21] *Id.* at 535.

[22] *Id.*

[23] *See Tribune*, 472 B.R. at 250; *203 North LaSalle Street P'ship*, 246 B.R. at 330.

[24] *See Tribune*, 472 B.R. at 250; *In re Washington Mutual, Inc.*, 461 B.R. 200, 249 (Bankr. D. Del. 2011) (following Rule of Explicitness under New York law to interpret whether postpetition interest was due under subordination agreement); *203 North LaSalle Street P'ship*, 246 B.R. at 330 (holding that applicable state law controls the inquiry under Section 510(a)).

[25] *See Tribune*, 472 B.R. at 250; *accord In re Southeast Banking Corp.*, 179 F.3d 1307, 1310 (11th Cir. 1999) (looking to applicable state law to determine whether junior lender was subordinated to senior lender with respect to postpetition interest); *HSBC Bank USA v. Branch (In re Bank of New England Corp.)*, 364 F.3d 355, 367-68 (1st Cir. 2004) (applying New York law to question of whether subordination agreement allowed senior lender to collect postpetition interest at the expense of junior lender); *see also Wolohan Lumber Co. v. Robbins (In re Robbins)*, 21 B.R. 747, 751 (Bankr. S.D. Ohio 1982) (allowing recovery of senior creditor of postpetition interest over claim of junior creditor in same collateral); *In re Plymouth House Health Care Center*, 2005 WL 2589201 (Bankr. E.D. Pa. 2005) (same).

[26] 11 U.S.C. §1122(a).

[27] *John Hancock Mutual Life Ins. Co. v. Route 37 Business Park Assocs.*, 987 F.2d 154,158 (3d Cir. 1993) ("Section 1122(a) expressly provides only that claims that are not "substantially similar" may not be placed in the same class; Section 1122(a) does not expressly provide that "substantially similar" claims may not be placed in separate classes.").

[28] *See John Hancock Mutual Life Ins. Co*., 987 F.2d at 158; *see also Heartland Federal Savings & Loan Assoc. v. Briscoe Enterprises, LTD., II (In re Briscoe Enterprises, LTD., II)*, 994 F.2d 1160, 1167 (5th Cir. 1993) (holding that a classification scheme must be supported by sound business reasons); *In re Greystone*, 948 F.2d 134, 139 (5th Cir. 1991) (espousing the oft-quoted rule, "thou shalt not classify similar claims differently in order to gerrymander an affirmative vote on a reorganization plan.").

[29] *John Hancock Mutual Life Ins. Co.,* 987 F.2d at 158.

[30] *See In re Dilts*, 126 B.R. 470, 471 (Bankr. W.D. Pa. 1991) ("Classification of secured claims under 11 U.S.C. §1122 is ordinarily determined on the basis of priority, nature of collateral and agreements among creditors with respect to subordination."); *see also In re Buick*, 126 B.R. 840, 854 (Bankr. E.D. Pa. 1991) (classification of secured claims in same class in plan, despite differing collateral and disparate treatment among secured creditors, was impermissible); *In re Holthoff*, 58 B.R. 216, 219 (Bankr. E.D. Ark. 1985) (finding that "[s]ecured creditors with liens in different property, or liens in the same property may not be classified together since their legal rights are not substantially similar.").

[31] *See Buick*, 126 B.R. at 854.

[32] *See Keck, Mahin & Cate*, 241 B.R. 583, 590 (Bankr. N.D. Ill. 1999) (holding that holders of sub-debt that have the same priority in the same collateral of the debtor were properly classified in the same class).

[33] Section 1129(b) specifically provides:

(1) Notwithstanding section 510 (a) of this title, if all of the applicable requirements of subsection (a) of this section other than paragraph (8) are met with respect to a plan, the court, on request of the proponent of the plan, shall confirm the plan notwithstanding the requirements of such paragraph if the plan does not discriminate unfairly, and is fair and equitable, with respect to each class of claims or interests that is impaired under, and has not accepted, the plan.

(2) For the purpose of this subsection, the condition that a plan be fair and equitable with respect to a class includes the following requirements:

(A) With respect to a class of secured claims, the plan provides—

(i) (I) that the holders of such claims retain the liens securing such claims, whether the property subject to such liens is retained by the debtor or transferred to another entity, to the extent of the allowed amount of such claims; and (II) that each holder of a claim of such class receive on account of such claim deferred cash payments totaling at least the allowed amount of such claim, of a value, as of the effective date of the plan, of at least the value of such holder's interest in the estate's interest in such property;
(ii) for the sale, subject to section 363 (k) of this title, of any property that is subject to the liens securing such claims, free and clear of such liens, with such liens to attach to the proceeds of such sale, and the treatment of such liens on proceeds under clause (i) or (iii) of this subparagraph; or
(iii) for the realization by such holders of the indubitable equivalent of such claim.

11 U.S.C. §1129(b). *see also In re TCI2 Holdings, LLC*, 428 B.R. 117, 158 (Bankr. D.N.J. 2010).

[34] In this scenario, there would be no "unfair discrimination" issue, because each of the first out and last out lenders would receive the same treatment, and are classified together.

[35] *In re Combustion Eng'ring, Inc.*, 391 F.3d 190, 243 (3d Cir. 2005) (noting that although the Bankruptcy Code does not expressly prohibit "artificial impairment," courts have found the practice troubling); *John Hancock Mut. Life Ins. Co.*, 987 F.2d at 158 (noting the problematic nature of class manipulation in Chapter 11 confirmation process); *In re Windsor on the River Assocs., Ltd*, 7 F.3d 127, 132-33 (8th Cir. 1993) (paying trade claims 60 post-effective date not legitimate impairment); *In re Global Ocean Carriers Ltd.*, 251 B.R. 31, 41-42 (Bankr. D. Del. 2000) (holding that artificial impairment violates multiple confirmation requirements); *But see Western Real Estate Equities, LLC v. Village at Camp Bowie I, LP (In re Village at Camp Bowie I, LP)*, 710 F.3d 239 (5th Cir. 2013) (Fifth Circuit joined the Ninth Circuit in holding that Section 1129(a)(10) of the Bankruptcy Code, which contains the impaired-class acceptance requirement, "does not distinguish between discretionary and economically driven impairment," but that artificial impairment may be relevant in assessing whether a Chapter 11 plan has been proposed in bad faith).

[36] *Ionosphere Clubs, Inc.*, 134 B.R. at 533 (holding that subordination is enforceable among the parties, even if not enforceable against the debtor).

[37] *Tribune Company*, 472 B.R. at 241 (unfair discrimination is presumed "when there is (1) a dissenting class, (2) another class of the same priority, and (3) a

difference in the plan's treatment of the two classes that results in either (a) a materially lower percentage recovery for the dissenting class (measured in terms of the net present value of all payments), or (b) regardless of percentage recovery, an allocation under the plan of materially greater risk to the dissenting class in connection with its proposed distribution).

[38] *Id*. Interestingly, to the extent that the plan offered the last out lenders with *better* treatment than is contemplated in an AAL – for instance, by allowing for immediate amortization under a plan-issued note – the debtor could potentially confirm the plan over the objection of the first out lenders provided that all of the requirements of Section 1129(b)(2) were satisfied. *See Id*. 472 B.R. at 241 ("The only logical reading of the term 'notwithstanding' in section 1129(b)(1) seems to be: "Even though section 510(a) requires enforceability of [a] subordination agreement in a bankruptcy case to the same extent that the agreement is enforceable under nonbankruptcy law, if a nonconsensual plan meets all of the §1129(a) and (b) requirements, the court shall confirm the plan. The phrase "'[n]otwithstanding section 510(a) of this title' removes section 510(a) from the scope of 1129(b)(1) …."); *see also TCI2 Holdings, LLC*, 428 B.R. at 158 (same).

[39] *See In re Chrysler LLC*, 405 B.R. 84, 102-03 (Bankr. S.D.N.Y. 2009) (holding that administrative agent had the exclusive authority, at direction of "required lenders," to direct the collateral trustee's exercise of the first lien lenders' remedies with respect to the first lien collateral); *In re Metaldyne Corp.*, 409 B.R. 671, 678 (Bankr. S.D.N.Y. 2009) (affirming an agent's right to affect a credit bid of entire facility at direction of majority of lenders, finding that the agent was authorized under the applicable credit documents to take such action); *In re GWLS Holdings, Inc.*, 2009 WL 453110 (Bankr. D. Del. Feb. 23, 2009) (upholding agent's authority to credit bid senior lenders' claims at behest of majority lenders over objection of dissenting first lien lender); *Beal Savings Bank v. Sommer*, 8 N.Y.3d 318, 328-29 (Ct. Appeal NY 2007) (holding that dissenting lender had no standing to sue agent to enforce "keep well" provision of agreement after "requisite lenders" directed agent to forbear from exercising remedies).

[40] *See Banque Arabe et Internationale D'investissement v. Maryland National Bank*, 57 F.3d 146, 158 (2d Cir. 1995) ("Generally, banking relationships are not viewed as special relationships giving rise to a heightened duty of care."); *Banco Espanol de Credito v. Security Pacific National Bank*, 973 F.2d 51, 56 (2d Cir. 1992) (holding that "an arms length transaction between sophisticated financial institutions" creates no independent duty to disclose information that could have been discovered by the other party); *First Citizens Federal Savings and*

Loan Association v. Worthen Bank and Trust Co., N.A., 919 F.2d 510, 514 (9th Cir. 1990) ("Banks and savings institutions engaged in commercial transactions normally deal with one another at arm's length and not as fiduciaries.").

Municipal Bankruptcies: An Overview and Recent History of Chapter 9 of the Bankruptcy Code

KENNETH E. NOBLE AND KEVIN M. BAUM

This article provides an overview and history of Chapter 9 of the Bankruptcy Code, beginning with a discussion of the various substantive provisions that govern (i) Chapter 9's eligibility requirements, (ii) case administration issues that arise in Chapter 9 cases and (iii) the requirements for confirming a Chapter 9 plan of adjustment. The article also discusses significant Chapter 9 cases since the Orange County bankruptcy case in 1994 — the largest municipal bankruptcy at the time. Finally, since many municipal bonds are insured, the article provides an update on the major monoline insurance companies.

Recently, the City of Detroit filed for protection under Chapter 9 of the Bankruptcy Code,[1] becoming the largest municipality to ever file for bankruptcy. Detroit's bankruptcy filing presents numerous complicated issues, which will be resolved over the course of the case.

This article provides an overview and history of Chapter 9 of the Bankruptcy Code, beginning with a discussion of the various substantive provisions that govern (i) Chapter 9's eligibility requirements, (ii) case administration issues that arise in Chapter 9 cases and (iii) the requirements for confirming

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a Chapter 9 plan of adjustment. Next, the article discusses significant Chapter 9 cases since the Orange County bankruptcy case in 1994 — the largest municipal bankruptcy at the time. Finally, since many municipal bonds are insured, the article provides an update on the major monoline insurance companies — most of which have been placed into rehabilitation proceedings due to their own financial challenges. At the end of this article is a chart that compares the key provisions of Chapter 9 to counterparts of Chapter 11.

CHAPTER 9 CASE ISSUES

Eligibility Requirements (§ 109(c))

Section 109(c) of the Bankruptcy Code sets forth the requirements to be eligible to file as a Chapter 9 debtor. Specifically, a debtor must establish that it (i) is a municipality, (ii) has specific authorization to file, (iii) is insolvent, (iv) wants to adjust its debts through a plan and (v) meets one of four creditor-negotiation requirements.[2]

Authorization to File (§ 109(c)(2))

Section 109(c)(2) of the Bankruptcy Code provides that in order to be a Chapter 9 debtor a municipality must be "specifically authorized, in its capacity as a municipality or by name, to be a debtor under such chapter by State law, or by a governmental officer or organization empowered by State law to authorize such entity to be a debtor under such chapter."

The degree to which state laws permit Chapter 9 filings varies from state to state.[3] Twelve states specifically authorize Chapter 9 filings, while 12 others permit bankruptcy filings given a further action to be taken by a state, official or other entity.[4] In addition, three other states authorize a limited subset of municipalities to file for bankruptcy. The remaining 23 states do not authorize municipal bankruptcy filings.

Negotiation with Creditors (§ 109(c)(5)(A)-(D))

Section 109(c)(5) of the Bankruptcy Code provides that Chapter 9 eligibility requires some element of pre-petition negotiation with creditors, which can be satisfied by complying with one of four alternative provisions. The first alternative is that the Chapter 9 debtor "obtained the agreement of creditors holding at least a majority in amount of the claims of each class, that [the debtor] intends to impair under a plan in a case under [Chapter 9]."[5] Significantly, in order to satisfy this requirement, the Chapter 9 debtor must obtain the creditors' consent to the actual plan as filed, and, thus, the debtor cannot simultaneously file an amended plan of adjustment and satisfy the first alternative.[6]

The second alternative is that the Chapter 9 debtor "has negotiated in good faith with creditors and has failed to obtain the agreement of creditors holding at least a majority in amount of the claims of each class that [the debtor] intends to impair."[7] In *In re Sullivan County Regional Refuse Disposal District*,[8] the bankruptcy court interpreted this provision to require that the debtor present to creditors a comprehensive, but not formal, workout plan that the debtor can implement in its Chapter 9 case.[9] The negotiations must also "revolve around the negotiating of the terms of a plan that could be effectuated if resort is required to [c]hapter 9."[10] Chapter 9 debtors do not have to show that they have fully levied taxes to the maximum allowed by law.[11] However, bankruptcy courts have found that municipal debtors have not acted in good faith where the debtors never exercised their assessment powers prior to initiating proceedings in bankruptcy court.[12]

The third alternative is that the Chapter 9 debtor demonstrate that it "is unable to negotiate with creditors because such negotiation is impracticable."[13] This alternative was inserted in the statute to deal with the problems created by major municipalities, whose bonds are numerous and are frequently in bearer form. Under such circumstances, negotiation is difficult at best, because of the difficulty in identifying the creditors with whom the municipality must negotiate.

The fourth alternative is that the debtor "reasonably believes that a creditor may attempt to obtain a preference."[14] As discussed below, pursuant to Section 926(b) of the Bankruptcy Code it is important to note that payments on account of a bond or a note may not be avoided as a preference under Section 547 of the Bankruptcy Code. Accordingly, a Chapter 9 debtor cannot avoid entering into negotiations with its bondholders on the basis that the bondholders are attempting to obtain a preference.

CHAPTER 9 CASE ADMINISTRATION

Automatic Stay of Enforcement of Claims Against the Debtor (§ 922)

Section 922(a) of the Bankruptcy Code provides for a stay of actions against entities other than the debtor itself. The additional stay is meant to supplement, and not replace, the automatic stay granted under Section 362 of the Bankruptcy Code.

The additional stay prohibits a creditor from taking actions against an officer or inhabitant of the city. Accordingly, a creditor cannot bring a *mandamus* action against an officer on account of the creditor's claims against the debtor, nor can a creditor seek to collect its debt by commencing an action against an inhabitant of the debtor for collection of taxes that are owed to the municipality. Similarly, any attempt by a creditor to enforce a lien on taxes owed to the municipality is also stayed under Section 922(a) of the Bankruptcy Code.

Section 922(d) of the Bankruptcy Code provides an exception to the additional stay for pledged funds. Specifically, under Section 922, if an indenture trustee or paying agent is in possession of pledged funds from special revenue bonds, the trustee or agent may apply the pledged funds to payments as they come due and/or distribute the funds to the bondholders. In addition, a Chapter 9 debtor's voluntary payment of such funds to an indenture trustee or paying agent on account of the special revenue bonds, and the application thereof, does not violate the stay and does not require court approval. In *Jefferson County*, however, the bankruptcy court allowed Jefferson County to withhold payment (at least on an interim basis) of special revenues pending determination of the scope of the county's interest in the special revenues and the county's actions in connection with its restructuring efforts.

Avoidance Powers

Section 901 of the Bankruptcy Code provides, among other things, that a Chapter 9 debtor has most of the avoidance powers granted to a Chapter 11 debtor, including the ability to avoid preferences and fraudulent transfers.[15] Further, Section 926(a) of the Bankruptcy Code provides that "[i]f the debtor refuses to pursue a cause of action under section 544, 545, 547, 548, 549(a), or 550 of [the Bankruptcy Code], then on request of a creditor, the court may appoint a trustee to pursue such cause of action." Notwithstanding a Chapter 9 debtor's ability to commence an avoidance action, Section 926(b) provides that transfer on account of a bond or a note may not be avoided as a preference under Section 547 of the Bankruptcy Code.

Bankruptcy Judge (§ 921(b))

Pursuant to Section 921(b) of the Bankruptcy Code, "[t]he chief judge of the court of appeals for the circuit embracing the district in which the case is commenced shall designate the bankruptcy judge to conduct the case." The provision is designed to remove politics from the case of a major municipality and to ensure that the case is presided over by a competent judge.[16] The provision also gives the chief judge the flexibility to appoint a retired judge or a judge who sits in a district other than the one where the case is pending, which allows the chief judge to manage the flow of judicial business in the various parts of the circuit.[17]

Collective Bargaining Agreements (§ 365)

Like a Chapter 11 debtor, a Chapter 9 debtor has the power to assume and reject contracts under Section 365 of the Bankruptcy Code. In Chapter 11, if a debtor wishes to reject a collective bargaining agreement, the debtor must comply with the requirements of Section 1113 of the Bankruptcy Code, which affords various protections to the union that is the counterparty to the collective bargaining agreement. Section 1113, however, does not apply in a Chapter 9 case. Instead, Section 365, as informed by the Supreme Court's decision in *NLRB v. Bildisco & Bildisco*,[18] applies when determining whether a Chapter 9 debtor may reject or modify a union contract. *Bildisco*, which was decided prior to the enactment of Section 1113, held that under Section 365, a debtor could unilaterally reject or modify a collective bargaining agreement without complying with applicable state law.

Two California bankruptcy courts have clarified the ramifications of Congress's decision not to incorporate Section 1113 in Chapter 9 cases. In

Orange County,[19] a coalition of county employee organizations brought an action against the debtor to enforce their various labor agreements.[20] In connection with their action, the coalition also sought an emergency injunction enjoining the debtor from permanently laying off county employees represented by the various organizations composing the coalition.[21] Although the *Orange County* court held that the standard articulated in *Bildisco* was applicable to the rejection of the labor agreements in Chapter 9, the court also agreed with the coalition that the debtor should also be required to satisfy the standards of California law "if not as a legal matter, certainly from an equitable standpoint."[22] Accordingly, the *Orange County* court concluded that even under *Bildisco*, municipalities may only modify their labor contracts as a matter of last resort.

In *City of Vallejo*,[23] the debtor moved to reject its collective bargaining agreements ("CBAs") less than a month into the case. Agreeing with *Orange County* court, the *Vallejo* court held that Section 1113 is inapplicable to a Chapter 9 debtor's motion to reject a CBA and that the correct standard is the one set forth in *Bildisco*.[24] The *Vallejo* court, however, was far less deferential to California state labor law than the *Orange County* court had been. The court emphasized that under Section 903 of the Bankruptcy Code, states "act as gatekeepers to their municipalities' access to relief under the Bankruptcy Code."[25] Accordingly, the court reasoned that when a state authorizes its municipalities to file Chapter 9 petitions, "it declares that benefits of chapter 9 are more important than state control over its municipalities" and, therefore, "must accept chapter 9 in its totality."[26] Thus, if a state authorizes a municipality to file under Chapter 9, the municipality "is entitled to fully utilize [Section] 365 [of the Bankruptcy Code] to accept or reject its executory contracts."[27] While the California law allowing Vallejo to file for bankruptcy purported to require that municipalities comply with state law while in bankruptcy, the bankruptcy court held that that portion of the law was preempted by the Bankruptcy Code.[28] Ultimately, the bankruptcy court did not grant Vallejo's motion.[29] Instead, the court encouraged the parties to reach a settlement, which they did approximately five months later.

Ultimately, bankruptcy courts have consistently held that Section 1113 does not apply in a Chapter 9 case. Instead, Section 365 of the Bankruptcy Code, as such section is applied in *Bildisco*, governs the rejection of CBAs in

Chapter 9. These courts, however, have issued inconsistent opinions as to whether the Chapter 9 debtor must comply with state law when seeking to reject or modify a CBA.

Official Committees (§ 901(a))

Section 901(a) of the Bankruptcy Code provides that Section 1102 applies in a Chapter 9 case. Accordingly, official committees can be formed in a Chapter 9 case. As discussed below, however, a Chapter 9 debtor is not technically obligated to pay for the fees and expenses of an official committee through the debtor's plan of adjustment.

PLAN OF ADJUSTMENT REQUIREMENTS

Confirmation Requirements (§ 943)

A Chapter 9 plan of adjustment is simply the document that provides for the treatment of the various classes of creditors' claims against the municipal debtor. Similar to a Chapter 11 debtor, a Chapter 9 debtor submits a disclosure statement that describes the plan and related matters, and the disclosure statement is sent with a ballot to each impaired creditor with an opportunity to vote on the plan. Similar to a Chapter 11 plan of reorganization, in order to be confirmed, the plan of adjustment must be accepted by a majority and two thirds in amount of each class of claims that is impaired under the plan.

In addition to the voting requirements, the Bankruptcy Code contains several other requirements that a plan of adjustment must meet to be confirmed by the bankruptcy court. The requirements include the following: (i) the Chapter 9 debtor must not be prohibited by law from taking any action necessary to carry out the plan; (ii) all post-petition administrative expense claims must be paid in full; (iii) the Chapter 9 debtor must have obtained all of the regulatory and electoral approvals necessary to consummate the plan; and (iv) the plan must be feasible. Importantly, the plan of adjustment must also be in the best interest of creditors. Since a Chapter 9 debtor is ineligible to be a debtor in a Chapter 7 liquidation, however, this test has been interpreted to mean that a plan of adjustment need only be "better than alternatives," such as the dismissal of the Chapter 9 case.

If an impaired class of creditors votes against a Chapter 9 debtor's plan of adjustment, the bankruptcy court can still confirm the plan through a "cram down" of the dissenting class (or classes) if the plan meets all of the other confirmation requirements set forth in Section 943 of the Bankruptcy Code. In order to accomplish such a cram down, the debtor must show that at least one impaired class has accepted the plan and that the plan is fair and equitable and does not discriminate unfairly among creditors. In Chapter 11, the fair and equitable requirement, often referred to as the "absolute priority rule," requires that the debtor establish that no junior class of creditors is receiving any distribution under the plan of reorganization on account of its claims unless all senior classes of claims are paid in full. In Chapter 9, however, a plan of adjustment is considered "fair and equitable" if the amount to be received by the dissenting class is "all they can reasonably expect to receive under the circumstances."

If a plan of adjustment is not approved, the bankruptcy court may dismiss the Chapter 9 case, thereby stripping the municipality of the protections of the Bankruptcy Code. A bankruptcy court may also dismiss a Chapter 9 case for a variety of other reasons, such as the failure of a debtor to prosecute the case, unreasonable delay, the non-acceptance of a plan by creditors or a material default or termination of a plan.

Professional Fees (§ 943(b)(3))

Section 943(b)(3) of the Bankruptcy Code requires that "all amounts to be paid by the debtor or by any person for services or expenses in the case or incident to the plan have been fully disclosed and are reasonable." As such, a Chapter 9 debtor must disclose any and all fees and expenses being paid to professionals. Section 943(b)(3) of the Bankruptcy Code, however, does not require the municipality to pay the fees and expenses of committee professionals. "Absent the debtor's consent, there is nothing in chapter 9 that automatically requires a debtor to pay the fees and costs of an official committee, professionals employed by the committee or professionals employed by members of an official committee."[30]

NOTEWORTHY CHAPTER 9 BANKRUPTCY CASES

Municipal bonds are traditionally viewed as safe investments because defaults are rare. From 1970 to 2012, only 71 rated municipal bond defaults occurred, and only five of those were by general purpose municipalities (*i.e.*, cities, villages, towns or counties).[31] In fact, 78 percent of all municipal bond defaults came from health care- and housing-related projects issued by special entities.[32]

Given this low default rate, it is hardly a surprise that municipal bankruptcies are also rare. Only 636 municipal bankruptcy cases have been filed since such cases were first authorized by Congress in 1937.[33] Moreover, only approximately 250 municipalities have filed under Chapter 9 of the Bankruptcy Code,[34] as compared to the approximately 1.2 million individuals who filed personal bankruptcy proceedings in 2012 alone.[35] Only 17.5 percent of Chapter 9 filings between 1980 and 2007 were by general purpose municipalities.[36] Approximately 61.8 percent of Chapter 9 cases involved utilities and special purpose districts.[37] The remaining 20.7 percent of Chapter 9 cases mainly involved schools, public hospitals and transportation authorities.[38]

Historically, bondholders have fared well in Chapter 9 cases, experiencing, at worst, some payment delays or relatively minor haircuts. Recently, however, the assumption that bondholders will be paid in full (or at least the vast majority of their claims) in a bankruptcy case has been called into question.[39] Below is a discussion of the major municipal bankruptcies from the past 20 years.

Orange County, California (1994)

In 1994, Orange County, California, was the fifth-largest county in the United States with an operating budget in excess of $3.7 billion. Increasing demand for high-quality public services strained the county's finances since the California Constitution restricted the ability of local governments, including Orange County, to raise tax revenue. The County Treasurer tried to solve Orange County's financial problems by pooling the county's money with funds from nearly 200 local public agencies through an entity known as the Orange County Investment Pool ("OCIP") and investing those funds. In particular, the OCIP used the pooled funds to borrow more money (the

OCIP borrowed $2 for every $1 on deposit) to invest in derivatives and high-yield, long-term bonds. As a result of adverse market conditions, the OCIP lost $1.64 billion by November 1994.[40]

In December 1994, Orange County and the OCIP both filed for Chapter 9 after many Wall Street investment firms commenced legal actions to seize their collateral. The bankruptcy court dismissed the OCIP's case after determining that such an entity did not qualify as a "municipality" under the Bankruptcy Code and, therefore, was ineligible to be a Chapter 9 debtor. Although the dismissal allowed the creditors to continue their actions against the OCIP, the bankruptcy court enjoined such creditors from enforcing against the OCIP's funds, thereby preventing severe financial stress from being placed on Orange County (and the other local agencies that had invested in the fund).[41] Orange County initially submitted a plan of adjustment that called for a sales tax increase of one half of one percent, which would require voter approval under California law. As such, the voters of Orange County would effectively be voting on the plan. After the voters rejected the tax increase, it became apparent that the debtor's initial plan would not be confirmed. The bondholders, who risked having the debtor default on its principal payment obligation, agreed to rollover the county's debt for another year in exchange for increased interest payments. The county then developed another plan under which (i) the county would divert tax funds from other county agencies and use those funds to pay bondholders; (ii) the local governments that lost money would agree to wait for full payment until the county won the lawsuits it filed against Wall Street firms alleging that such firms were culpable as a result of their actions surrounding the bankruptcy; and (iii) the county would issue $880 million in 30-year bonds that were insured by a municipal bond insurer to pay the debt on existing bonds, refinance other debt and pay for bankruptcy litigation and other expenses.[42]

Orange County emerged from bankruptcy 18 months after it filed. From a fiscal perspective, the county's bankruptcy was very successful in that it reduced the county's debt to an affordable level. Indeed, Orange County was able to access the lending markets a mere two years after its bankruptcy. Seven years after the filing, Orange County had a AA bond rating.[43]

Prichard, Alabama (1999 and 2009)

Prichard, Alabama, which experienced a population decline of approximately 50 percent over the past 50 years, filed for bankruptcy in 1999 after it was unable to pay approximately $3.9 million in delinquent bills. In addition to the unpaid bills, Prichard also admitted to not making payments to its employees' pension funds and, even though the city had withheld taxes from employees' paychecks, the city failed to submit such withholdings to the state and federal governments.[44]

During the bankruptcy case, Prichard was able to make some progress enhancing social, financial and technological growth, as well as economic development. Its 2001 budget predicted a four percent increase in revenue over its 2000 budget, and the city exited from bankruptcy in 2001.[45]

While in bankruptcy, the city successfully revised its budget so that it no longer operated at a deficit. However, Prichard was still unable to meet its pension obligations. In 2009, Prichard filed for bankruptcy for the second time in order to stay a pending suit brought by its pensioners after it failed to make pension payments for six months. In its Chapter 9 petition, the city claimed that during the previous year it had operated a $600,000 deficit on its $10.7 million budget. Further, Prichard had failed to make a $16.5 million payment to its pension fund under its previous plan of adjustment.[46]

In August 2010, the bankruptcy court dismissed Prichard's Chapter 9 case because the court held that the city was ineligible to be a Chapter 9 debtor. In particular, the bankruptcy court determined that the Alabama statute authorizing Chapter 9 filings only enabled permitted municipalities with bonded debt to file. Since Prichard did not have bond debt, the bankruptcy court found that it was ineligible to file.[47] Prichard appealed the bankruptcy court's decision to the district court, which in turn certified the eligibility question to the Alabama Supreme Court.[48] In April 2012, the Alabama Supreme Court ruled that municipalities did not need bond debt in order to file. The district court therefore reversed the bankruptcy court's decision and remanded the case.[49] The Alabama Supreme Court's decision has been viewed as opening the door for Jefferson County's bankruptcy case — which is discussed below in greater depth — because Jefferson County's debt was in the form of warrants, not bonds.[50]

City of Vallejo, California (2008)

The City of Vallejo, with 120,000 residents, filed for bankruptcy in May 2008. Unlike most general purpose municipalities that file for bankruptcy, Vallejo's financial distress was not caused by excessive debt. Rather, the city's financial problems resulted from a budget issue. Vallejo's finances had a long-term structural imbalance resulting from a declining tax base, decreasing revenues from property and sales taxes, state funding cuts and satisfying its expensive labor contracts. The city's tax revenues decreased by $20 million between 2007 and 2011 as a result of the recession and decreasing home values that caused property taxes to decrease. Vallejo's largest debt resulted from the city's pension liabilities and financial obligations under its various labor contracts. Prior to filing for bankruptcy, Vallejo attempted to negotiate with several of its labor unions, but the parties were unable to reach an agreement.[51]

Shortly after Vallejo filed for bankruptcy, the city filed a plan of adjustment that it thought was feasible at the time and sought to adjust its labor contracts. As discussed below, the labor unions objected to the plan on the ground that it impermissibly abrogated the unions' collective bargaining agreements. The bankruptcy court held that the labor agreements could be rejected under Section 365 of the Bankruptcy Code. At the court's encouragement, the parties negotiated new labor agreements. However, Vallejo's finances continued to deteriorate during the Chapter 9 case, causing the original plan of adjustment to no longer be feasible.[52]

Three years and five months after Vallejo filed its bankruptcy petition, the bankruptcy court approved the city's new plan of adjustment. As part of the confirmed plan, the city closed fire stations, reduced public services, cut staffing requirements, laid off city workers, required new city workers to contribute more to their pensions and all employees to contribute more for their health insurance and sought new revenue.[53]

It was noteworthy that during the bankruptcy proceedings, Vallejo continued to make all payments on its bond debt, which totaled approximately $62 million, on time and in full. Likewise, the city's plan of adjustment did not adjust the city's bond debt. Under the plan, general unsecured claims received between 5 and 20 percent of their claims over a period of two years.[54]

Westfall, Pennsylvania (2009)

Westfall, Pennsylvania, a small town with a population of 2,400 and a $1.5 million operating budget in 2009, filed for bankruptcy in April 2009. The impetus for the bankruptcy filing was a $20 million civil rights judgment obtained by a property developer against the town. Westfall and the developer entered into negotiations to settle the developer's claim, which proved unsuccessful.[55]

The bankruptcy court ultimately approved Westfall's plan of adjustment, which reduced the developer's claim to $6 million and provided that the claim would be paid over 20 years without interest. In order to pay for the settlement, the town raised the property tax rate by 48 percent (the property tax would gradually decrease each year over the 20-year period).[56]

It is likely that the developer ultimately agreed to the plan of adjustment because he was concerned that the bankruptcy court would approve a less favorable plan. Specifically, the developer was aware that one class of the town's creditors would vote to confirm the plan, which would allow the debtor to cram down the plan over the developer's objection.[57]

Jefferson County, Alabama (2011)

Jefferson County, the second-largest county in Alabama, filed for Chapter 9 in November 2011, which at the time was the largest municipal bankruptcy case in US history, in order to resolve the indebtedness of the county's sewer system (a special purpose vehicle). In 1994, Jefferson County began a sewer restoration and rehabilitation program. Although the project was originally estimated to cost $1 billion, the costs eventually ballooned to $3.2 billion. In order to service its debt, the county increased sewer rates by 400 percent. In addition, the county lowered the costs of its debt service by entering into swap agreements under which the county would swap long-term fixed higher interest rate debt into short-term variable rate debt. The 2008 financial crisis destabilized the market for such swap agreements, which caused the county's debt service to increase. In 2008, Jefferson County defaulted on its debt obligations, which resulted in the acceleration of the debt.[58]

Over the next several years, Jefferson County considered a Chapter 9 filing. The county opted, however, to enter into a forbearance agreement in

2009, which allowed the county to negotiate with its creditors. The parties' negotiations revolved around (i) the creditors forgiving a portion of the sewer debt, (ii) the parties restructuring the remaining debt at fixed rates and (iii) the county limiting sewer rate increases to the rate of inflation.[59]

In June 2013, Jefferson County reached an agreement on a plan of adjustment, which still needs to be approved by the bankruptcy court, under which the county will pay its creditors $1.84 billion, or 60 percent of what they are owed. JPMorgan Chase & Co., seven hedge funds and a group of bond insurers, which together hold $2.4 billion, or approximately 78 percent, of the sewer debt, agreed to support the plan. Under the plan, JPMorgan, which holds $1.22 billion of debt, will forgive $842 million. Taken together with a previous settlement, the bank will have agreed to pay the county and waived sewer obligations totaling $1.57 billion. Under the plan, the county will increase sewer rates by 7.4 percent annually for four years. The plan provides that Jefferson County will exit bankruptcy by the end of the year.[60]

Harrisburg, Pennsylvania (2011)

The city of Harrisburg, Pennsylvania, the state capital, guaranteed debt issued by a special purpose vehicle that was formed in order to finance the construction of an incinerator plant. The construction and operation of the plant went over budget, and the original forecasts of the revenues that would be generated from the plant proved to be overly optimistic. Consequently, the special purpose vehicle defaulted triggering the city's guaranty of the bond debt. In 2010, Harrisburg owed $68 million in interest payments — an amount that was $3 million in excess of the city's yearly operating budget.[61]

Harrisburg sought a forbearance agreement with its creditors, which would permit the parties to negotiate a settlement. During this time, the city also began considering a Chapter 9 filing in the face of the city mayor's resistance to such a filing. Notwithstanding the ongoing negotiations, in October 2011, the Harrisburg city council authorized the city to file for bankruptcy. The filing was met with disagreement from the mayor, the dissenting city council members and elected state officials.[62]

In November 2011, the bankruptcy court dismissed the Chapter 11 petition, holding that the city was not properly authorized to file under Chapter

9 of the Bankruptcy Code and, therefore, was ineligible to be a Chapter 9 debtor. Following the dismissal, Pennsylvania's governor commenced an action in state court seeking to have a receiver appointed for the city pursuant to the state intervention procedures for municipalities in fiscal distress.[63]

Stockton, California (2012)

The City of Stockton, a city of 296,000 residents, filed for bankruptcy in June 2012, which at the time was the largest city ever to file for bankruptcy. Stockton was hard hit by the 2008 financial crisis. The collapse of the real estate market resulted in significant declines to the city's property and sales tax revenues. In addition, the city experienced budgetary stress as 75 percent of Stockton's general fund was used for the public safety payroll and to service debt, and satisfying pension obligations accounted for nearly 13 percent of the city's overall spending. These budgetary problems were exacerbated by Stockton's inability to generate new tax revenue, which was limited by California law. Stockton could not raise property taxes, and if the city wanted to levy a sales tax, like Orange County, it would need two-thirds voter approval in a special election.

At the time Stockton filed, the city stopped making debt service payments on its appropriation and pension obligation bonds. These bonds were, and still are, unsecured general fund obligations and have no specified tax revenues pledged for debt service. Stockton, however, has no general obligation bonds, which typically have better protections for bondholders.

Stockton has proposed to significantly reduce its bond debt while leaving its pension obligation owed to the California Public Employees' Retirement System ("CalPERS"), the pension fund for public workers in California, unimpaired. While bondholders have suffered minor losses or delayed payments in previous Chapter 9 cases, if Stockton's case proceeds as planned, it would mark the first time that a municipality significantly impaired its obligations to bondholders.

Facing large losses, Assured Guaranty Corp., the monoline insurance company that insured Stockton's bonds, and other capital market creditors objected to Stockton's bankruptcy filing, arguing that Stockton had not negotiated with them in good faith. Specifically, the monoline argued that

Stockton's demands fell "short of the fairness requirements of chapter 9." The bankruptcy court, however, overruled the objection, finding that the capital market creditors, not Stockton, had not negotiated in good faith prior to the bankruptcy filings when they "chose to take a we-have-nothing-to-talk-about position once the City indicated that it was not proposing to impair its obligations to CalPERS."[64] Stockton's bankruptcy case remains ongoing.

San Bernardino, California (2012)

San Bernardino, a city of 210,000 residents, filed for bankruptcy in July 2012 because of a $48.5 million budget deficit that threatened the city's ability to make payroll. Prior to filing, the city obtained $10 million in concessions from city employees and slashed its workforce by 20 percent over four years. Notwithstanding these efforts, San Bernardino's fiscal problems that resulted from a variety of issues including accounting errors, deficit spending, lack of revenue growth and increases in pension and debt costs, remained unresolved. In addition, following the 2008 economic crisis, San Bernardino's tax revenues declined by as much as $16 million annually, primarily because of drops in sales and property taxes. At the time of filing, 73 percent of the city's general fund was being used to pay for public safety services.

In October 2012, CalPERS preliminarily objected to San Bernardino's bankruptcy filing, arguing the city could not demonstrate that it was eligible to be a Chapter 9 debtor. In particular, the pension fund argued that San Bernardino could not demonstrate that it (i) desired to effectuate a plan of adjustment, or (ii) negotiated with its creditors in good faith prior to the bankruptcy filing. The bankruptcy court ordered the parties to conduct discovery in respect of the eligibility issue. A hearing on the eligibility issue is scheduled for August 2013.

After filing for bankruptcy, San Bernardino, unlike Stockton, ceased making payments to CalPERS on account of the city's pension obligations. San Bernardino submitted a pendency plan, which would defer $35 million of payments to CalPERS, which is necessary in light of the city's budget deficit. San Bernardino has indicated that it intends to resume making payments. Such payments, however, will not include any payments on account of the $33 million owed to CalPERS in respect of the city's unpaid post-petition obligations.

MONOLINE MUNICIPAL BOND INSURERS

In 2007, there were six AAA monolines that insured municipal bond debt. These companies, however, experienced various degrees of financial distress as a result of their structured finance obligations. Below is a brief summary of the current financial status of each company.

Ambac Assurance Corporation ("Ambac")

As of November 2007, Ambac had $556 billion of insured obligations outstanding. In 2008, Ambac's financial condition began to be adversely affected by the effects of problems arising from mortgage lending practices in the United States because Ambac underwrote (i) direct financial guaranties of RMBS obligations and (ii) CDS on collateralized debt obligations backed primarily by RMBS. On March 24, 2010, at the request of the Wisconsin Office of the Commissioner of Insurance, Ambac formed a segregated account, which is a separate insurer from Ambac, and filed a petition for rehabilitation that limited the rehabilitation to only the segregated account, while leaving most policies in the general account with Ambac. Ambac's municipal bond obligations remained in the general account and, therefore, were not affected by the rehabilitation proceeding.

CIFG Guaranty ("CIFG")

As of November 2007, CIFG had $85 billion of insured obligations outstanding. Like Ambac, CIFG experienced financial strains as a result of the company guaranteeing large amounts of RMBS. On January 22, 2009, the New York Insurance Department approved two transactions meant to keep CIFG out of a rehabilitation proceeding. The transactions involved a commutation of approximately $12 billion in troubled credit default swaps and reinsurance of $13 billion of municipal bonds. As part of the transaction, Assured Guaranty Corp. (AGC) acquired the investment grade portion of now-defunct CIFG's municipal exposure through a reinsurance agreement. Most former CIFG bonds now carry the Aa3/AA+ ratings of AGC.

Financial Guaranty Insurance Company ("FGIC")

As of November 2007, FGIC had $315 billion of insured obligations outstanding. On June 28, 2012, the court signed a rehabilitation order appointing the Superintendent of Financial Services of the State of New York as rehabilitator of FGIC. On June 11, 2013, the New York state court entered an order approving FGIC's plan of rehabilitation. Under the plan of rehabilitation, FGIC will make an initial payment of 17.5 percent on allowed claims, and make later payments totaling 40 percent of the allowed claims. While the court confirmed the plan of rehabilitation, the plan has not yet become effective and will not do so until mid-August 2013, at the earliest.

Assured Guaranty Corp. (f/k/a Financial Security Assurance) ("AGC")

As of November 2007, AGC had $414 billion of insured obligations outstanding. In 2009, AGC's parent Assured Guaranty Ltd. acquired Financial Security Assurance and subsequently renamed it Assured Guaranty Municipal (AGM), thus combining under the same ownership the two most highly rated bond insurers at that time. Both monolines were rated AAA at the time of the acquisition, but were subsequently downgraded to AA in 2010. As a result of the real estate market deterioration, the RMBS portion of AGC's consolidated exposure was hit with significant claims in recent years. However, on a percentage basis the exposure was not as large as that of other insurers such as MBIA and Ambac, and fewer claims have resulted. As such AGM and AGC have retained their high investment grade ratings. The addition of the insured book of CIFG has increased the percentage of exposure accounted for by municipal bonds.

MBIA Insurance Corporation ("MBIA")

As of November 2007, MBIA had $652 billion of insured obligations outstanding. Like many of the other monolines, MBIA's credit rating was downgraded because of its RMBS exposure. Recently, however, the company's bond rating was upgraded from B- to BBB. More importantly, MBIA's municipal debt guaranty business unit, National Public Finance Guarantee

Corp. ("NPFGC"), was upgraded from BBB to A. While MBIA retained Weil Gotshal & Manges LLP as restructuring counsel in April 2013,[65] such reports indicate that the firm's retention was part of an effort to avoid a possible rehabilitation of MBIA's structured finance unit, and not the municipal bond unit. There is no indication that a rehabilitation proceeding will be commenced against NPFGC.

Syncora Guarantee Inc. (f/k/a XL Capital Assurance) ("XLCA")

As of November 2007, Syncora, then known as XLCA, had $143 billion of insured obligations outstanding. Unlike many of the other monoline insurers, Syncora has remained solvent. Syncora, however, is not underwriting any new policies.

COMPARING CHAPTER 9 AND CHAPTER 11

Bankruptcy Code/Rules Provision	**Chapter 9**	**Chapter 11**
Commencing a Case (§§ 301 and 303)	A Chapter 9 case can only be commenced by filing of a voluntary petition.	A Chapter 11 case can be commenced by the filing of a voluntary or involuntary petition.
Eligibility to be a Debtor (§ 109)	A Chapter 9 debtor must demonstrate that it is eligible to be a Chapter 9 debtor by establishing that it: • is a municipality; • has specific authorization to file; • is insolvent; • wants to adjust its debts through a plan; and • meets one of four creditor-negotiation requirements. A group of creditors often object to a Chapter 9 debtor's petition on the grounds that the debtor is not eligible to file.	Generally, any individual, corporation, partnership or LLC is eligible to be a Chapter 11 debtor. Exceptions include: • insurance companies; • insured banks; • stockbrokers; • commodity brokers; and • municipalities. It is rare for a group of creditors to challenge an entity's eligibility to be a Chapter 11 debtor.

Automatic Stay and Additional Stay (§§ 362 and 922(a))	The automatic stay applies in a Chapter 9 case and stays all actions filed against the debtor. Section 922(a) of the Bankruptcy Code also stay actions against officers and inhabitants of the Chapter 9 debtor if such action is seeking to enforce a claim against the debtor.	The automatic stay only acts to stay actions against the Chapter 11 debtor. Generally, actions against non-debtors are not stayed as a result of a bankruptcy filing.
Schedules and Statements (§§ 501, 924 and 925; Bankruptcy Rule 1007)	A Chapter 9 debtor does not need to file any schedules of assets and liabilities or a statement of financial affairs. However, a Chapter 9 debtor is required to file a list of the creditors holding the 20-largest unsecured claims. A Chapter 9 debtor also must file a list of all of its creditors. Any claim listed on the list of creditors is a proof of claim deemed filed under § 501, unless filed as contingent, disputed or unliquidated.	A Chapter 11 must file schedules and a statement of financial affairs.
Retention of Professionals (§ 327)	A Chapter 9 debtor does not need bankruptcy court approval in order to retain professionals.	A Chapter 11 debtor does need bankruptcy court approval in order to retain professionals.

Professionals' Compensation (§§ 327–330, 901(a) and 943)	A Chapter 9 debtor is not required to pay for the professionals employed by an official committee or the costs of the committee.	In a Chapter 11 case, Sections 328 through 331 provide the statutory basis for allowing administrative claims for professionals, including those retained by creditors committees.
Use, Sale or Lease of Property (§ 363)	A Chapter 9 debtor can use, sell or lease its property without bankruptcy court approval or oversight.	A Chapter 11 debtor cannot use, sell or lease property outside of the ordinary course without bankruptcy court approval.
Rejecting Collective Bargaining Agreements (§§ 365 and 1113)	Section 1113 of the Bankruptcy Code does not apply in a Chapter 9 case. The rejection of collective bargaining agreements is governed by Section 365 of the Bankruptcy Code, as informed by *NLRB v. Bildisco & Bildisco.*	Section 1113 of the Bankruptcy Code limits a Chapter 11 debtor's ability to unilaterally reject a collective bargaining agreement.
Retiree Benefits (§ 1114)	Section 1114 of the Bankruptcy Code does not apply in a Chapter 9 case. A Chapter 9 debtor may unilaterally stop paying for or otherwise modify retiree benefits.	A Chapter 11 debtor must timely pay retiree benefits or satisfy various requirements in order to modify such benefits.
Preference Actions (§§ 547 and 926(b))	While a Chapter 9 debtor may generally avoid preferential transfers, there is an exception for payments or transfers of property to bondholders.	A Chapter 11 debtor may avoid preferential transfers made to bondholders.

Post-Petition Effect of Security Interest (§ 552)	A pre-petition pledge (or security interest) in special revenue bonds continues to attach to revenue acquired post-petition.	Generally, property acquired after the commencement of a case is not subject to any lien resulting from a pre-petition security agreement.
Nonrecourse Claims (§§ 927 and 1111)	Section 1111(b) of the Bankruptcy Code does not apply in Chapter 9 cases. Special revenue bondholders do not have recourse against Chapter 9 debtors and, therefore, will not have allowed claims.	A nonrecourse claim secured by a lien on property of the estate is allowed or disallowed pursuant to Section 502 of the Bankruptcy Code regardless of whether the holder of such claim had recourse against the debtor unless the holder of such claim makes an 1111(b) election.
Priority Wage Claims (§ 502(a)(4))	Section 502(a)(4) of the Bankruptcy Code does not apply in Chapter 9 cases. Claims for unpaid wages are not entitled to priority in a Chapter 9 case.	Claims for up to $11,275 in unpaid wages, salaries or commissions, including severance, are entitled to priority.
Exclusivity (§§ 941 and 1121)	Only a Chapter 9 debtor may file a plan of adjustment. There is no deadline for filing a plan of adjustment unless the bankruptcy court orders one.	A Chapter 11 debtor has the exclusive right to file a plan of reorganization during the first 120 days of the case. The Chapter 11 debtor's exclusivity period may be extended or terminated for cause.
Plan Requirements (§§ 943 and 1129)	A Chapter 9 debtor can only adjust its debts through a plan. A municipality cannot liquidate in Chapter 9.	A Chapter 11 debtor may either reorganize or liquidate through a plan.

NOTES

[1] The bankruptcy court docket for Detroit, including copies all documents filed in the case, is available without charge to the public at http://www.kccllc.net/Detroit.

[2] *See* 1 *Collier on Bankruptcy*, ¶109.04[1] (16th ed.).

[3] Mike Maciag, "How Rare Are Municipal Bankruptcies?" Governing, Jan. 24, 2013.

[4] Michigan is one of the states that conditionally authorizes Chapter 9 filings. Specifically, MCL 141.1558 authorizes a local government for which an emergency manager has been appointed to become a Chapter 9 debtor if the governor approves the emergency manager's recommendation that the local government commence a Chapter 9 case. The statute further provides that "[t]he governor may place contingencies on a local government in order to proceed under chapter 9." *Id.*

[5] 6 *Collier on Bankruptcy* ¶ 900.02[2][e][i] (16th ed.).

[6] *Id.* ("In *New Smyrna-DeLand Drainage District v. Thomas*, in which the debtor filed an 'amended plan,' but relied on prior consents to the original plan, the court of appeals upheld the dismissal of the petition on the grounds that the plan was a plan new, and that the prior consents to one plan could not be counted toward the new plan.").

[7] *Id.* ¶ 900.02[2][e][ii].

[8] 165 B.R. 60 (Bankr. D.N.H. 1994).

[9] *Id.* at 78.

[10] *Id.* (citing *In re Cottonwood Water & Sanitation Dist.*, 138 B.R. 973, 974, 979 (Bankr. D. Colo. 1992).

[11] *Id.*; *In re Villages at Castle Rock Metropolitan Dist. No. 4*, 145 B.R. 76, 84 (Bankr. D. Colo. 1990); 4 *Collier on Bankruptcy* ¶ 900.03.

[12] *Sullivan County*, 165 B.R. at 78.

[13] 6 *Collier on Bankruptcy* ¶ 900.02[2][e][iii] (16th ed.).

[14] *Id.* ¶ 900.02[2][e][iv].

[15] Specifically, Sections 544, 545, 546, 547, 548, 549(a), 549(c), 549(d), 550, 551, 552, 553, 555, 556, 557, 559, 560, 561, 562 of the Bankruptcy Code apply in a Chapter 9 case.

[16] 6 *Collier on Bankruptcy* ¶ 921.03 (16th ed.) (citing S. Rep. No. 94–458, 94th Cong., 1st Sess. 15 (1975)).

[17] *Id.* (citing H.R. Rep. No. 94–686, 94th Cong., 1st Sess. 2 (1975)).

[18] 465 U.S. 513 (1984). The three-part test articulated in *Bildisco* requires a debtor to establish that (a) the labor agreement burdens the estate; (b) after careful scrutiny, the equities balance in favor of contract rejection; and (c) "reasonable efforts to negotiate a voluntary modification have been made, and are not likely to produce a prompt and satisfactory solution." *Bildisco*, 465 U.S. at 526.
[19] *In re County of Orange*, 179 B.R. 177 (Bankr. C.D. Cal. 1995).
[20] *Id.* at 179.
[21] *Id.*
[22] *Id.* at 184.
[23] 403 B.R. 72 (Bankr. E.D. Cal. 2009).
[24] *Id.* at 78.
[25] *Id.* at 76.
[26] *Id.*
[27] *Id.*
[28] *Id.* at 76–77.
[29] *Id.* at 78.
[30] 6 *Collier on Bankruptcy* ¶ 901.04[13][c] (16th ed.).
[31] *National Governors' Association et al., Facts You Should Know: State and Local Bankruptcy, Municipal Bonds, State and Local Pensions* 2 (2013).
[32] *National Governors' Association et al., Facts You Should Know: State and Local Bankruptcy, Municipal Bonds, State and Local Pensions* 2 (2011).
[33] Michael De Angelis & Xiaowei Tian, "United States: Chapter 9 Municipal Bankruptcy — Utilization, Avoidance, and Impact" 323 (2011).
[34] *Id.* at 321.
[35] *See* American Bankruptcy Institute, Quarterly Non-business Filings by Chapter (1994–2012).
[36] *Id.* at 321–22.
[37] *Id.* at 322.
[38] *Id.*
[39] *See* Steven Church, "Stockton Threatens to Be First City to Stiff Bondholders," Bloomberg, June 30, 2012.
[40] *See* De Angelis & Tian, *supra* note 33 at 324.
[41] *See id.* at 325.
[42] *See id.* at 325–26.
[43] *See id.* at 326.
[44] *See id.* at 331.
[45] *See id.*

[46] *See id.*
[47] *See id.*
[48] *See* Katherine Sayre, "Alabama Supreme Court Ruling Allows Prichard Bankruptcy to Move Forward," April 20, 2012.
[49] *See id.*
[50] *See id.*
[51] *See* De Angelis & Tian, *supra* note 33 at 326–27.
[52] *See id.* at 327.
[53] *See id.* at 327–28.
[54] *See id.*
[55] *See id.* at 330.
[56] *See id.*
[57] *See id.* at 330–31.
[58] *See id.* at 328.
[59] *See id.* at 328–29.
[60] *See* Steven Church, Margaret Newkirk and Kathleen Edwards, "Jefferson County, Creditors Reach Deal to End Bankruptcy," Bloomberg, June 5, 2013.
[61] *See* De Angelis & Tian, *supra* note 33 at 329.
[62] *See id.* at 329–30.
[63] *See id.* at 330.
[64] *In re City of Stockton*, Slip-Op Case No. 12-32118-C-9 (Bankr. E.D. Cal. June 12, 2013).
[65] *See, e.g.*, Shayndi Raice, "MBIA Hires Law Firm," *The Wall Street Journal,* April 27, 2013, at B2.

Cross-Defaulted Leases in Bankruptcy: Integrated or Severable Agreements?

RICK D. THOMAS

In this article, the author addresses the risks that bankruptcy poses to the security provided to a lessor by cross-default and other similar provisions, and then suggests means by which lessors and their attorneys might be able to avoid these risks at the drafting stage.

In commercial leasing transactions, it is not uncommon for portfolios of distinct and independently operated properties to be leased by their owner (or a group of affiliated owners) to a single tenant (or a group of affiliated tenants). For example, during the recent economic downturn, many businesses sought to improve their balance sheets and acquire certain tax benefits via "portfolio sale-leaseback" transactions. To oversimplify, a portfolio sale-leaseback involves a property owner that sells a portfolio of real properties upon which it operates its business to an investor and as part of the same transaction, leases the properties from that investor. The sale-leaseback structure provides significant benefits to the seller-lessee; for example, the seller-lessee:

- is able to retain the property necessary to run its business;
- receive a significant influx of cash from the sale and/or eliminate debt from its balance sheet; and

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- begin deducting its future rental payments, in full, when calculating its taxable income, whereas only the portion of its prior mortgage payment that was attributable to interest was previously deductible.[1]

One concern for a lessor when leasing a portfolio of properties, however, is how it can ensure cash flow from the portfolio of properties in the aggregate. Indeed, it is very possible that the lessee will breach the leases for nonprofitable properties and then only perform for those that are profitable. In such a situation, the lessor is exposed to the downside risk for nonperforming assets and simultaneously benefits in less upside return.

Furthermore, if a lessor financed the purchase of the properties via debt, such a situation negatively affects its credit worthiness. To address this concern, lessors typically negotiate and structure the deal to shift the economic incentives for the lessee to perform with respect to the entire portfolio. For example, many lessors use cross-default provisions in each of the individual leases by which a default under one individual lease is deemed a default of the entire portfolio. The lessor thereby shifts the economic incentives of the lessee to perform. That is, in the absence of a cross-default provision, it may be beneficial to the lessee to breach a lease for a nonperforming asset because there are no external ramifications to the lessee (other than the damage to its relationship with the lessor). If the leases within the portfolio are cross-defaulted, however, it is only efficient for the seller-lessee to breach an individual lease if it is also efficient to breach each and every lease in the portfolio. The cross-default provision, in this context, "unifies" or "bundles" the leased properties. By cross-defaulting and bundling the portfolio, the lessor acquires greater leverage over the lessee concerning future performance, which in turn serves as a credit enhancement for the lessor who finances such transactions with debt.

Cross-default and other similar provisions are common and are routinely enforced under state-contract-law doctrines. Notwithstanding this fact, however, lessees can frequently avoid the effect and purpose of cross-default and other similar provisions by filing for relief under the Bankruptcy Code.[2] The purpose of this article is two-fold: first, this article addresses the risks that bankruptcy poses to the security provided to a lessor by cross-default and other similar provisions; second, this article provides the means by which lessors and their attorneys might be able to avoid these risks at the drafting stage.

Immediately below readers will find a discussion of:

- the treatment of commercial leases under the Bankruptcy Code (the purpose of which is to provide a limited background and understanding for readers that are unfamiliar with bankruptcy concepts and terminology);
- the treatment of cross-default and other such provisions in bankruptcy as they relate to portfolios of leased properties; and
- a discussion of methods for crafting commercial leases in such a fashion so as to preserve the effect of cross-default and other similar provisions in bankruptcy for the benefit of lessors.

TREATMENT OF COMMERCIAL LEASES IN BANKRUPTCY

The Bankruptcy Estate and the Automatic Stay

Pursuant to § 541 of the Bankruptcy Code, all of a debtor's property becomes the property of the bankruptcy estate on that debtor's petition date.[3] If the debtor is a tenant under any unexpired leases that were not terminated prior to the bankruptcy petition date, then said leases will be included among the property of the estate.[4] If the debtor or another party to a lease terminates their lease prior to the bankruptcy petition date, however, there is no property interest that could become part of the debtor's estate.[5]

Whether the lease is property of the estate is significant for several reasons. Chief among them is that non-debtors are prohibited under federal law from taking any action against the debtor or the property of the estate outside the context of the bankruptcy proceedings — this blanket prohibition is known as the automatic stay.[6] Parties that ignore the automatic stay and take action against either the debtor or the property of the estate outside of the bankruptcy risk the wrath of the bankruptcy court and its ability to impose severe civil sanctions[7] under its nationwide jurisdictional reach.[8]

Assumption and Rejection of Unexpired Leases

A debtor-lessee has two options regarding treatment of leases that are property of the bankruptcy estate. First, the debtor may "assume" the lease (i.e., maintain its obligations and rights under the lease). If there has been a default of the lease, the debtor may not assume a lease unless at the time of assumption it has cured its defaults under the lease,[9] compensates or provides adequate assurance that the debtor will promptly compensate its landlord for any actual pecuniary loss, and provides adequate assurance of future performance.[10] Further, if the debtor elects to assume a lease, it must assume all of the terms thereto and cannot pick and choose terms that will remain in effect. As a general exception to this rule, however, bankruptcy courts will not enforce provisions designed solely to impair the debtor's ability to assume a lease — these provisions are commonly referred to as "anti-assignment provisions."[11] Second, the debtor has the right to "reject" the lease. To reject is, in simpler terms, to elect to default under the lease. The debtor must then surrender possession of the leased premises and its landlord may file a claim for damages against the debtor's estate.[12]

The debtor's ability to assume or reject unexpired leases is one of the most basic and fundamental tools that Congress has made available to assist debtors to reorganize. As explained by the U.S. Supreme Court, "[T]he authority to reject an [unexpired lease] is vital to the basic purpose [of] a Chapter 11 reorganization, because it can release the debtor's estate from burdensome obligations that can impede a successful reorganization."[13] Accordingly, by allowing the debtor to reject some executory contracts and unexpired leases, and assume others, the debtor "can shed disadvantageous contracts but keep the beneficial ones."[14]

Now, recall the purpose and effect of cross-default, and other similar, provisions as discussed above. The lessor employs cross-default provisions to ensure that its lessee performs under the *entire portfolio of leases* rather than simply under the leases for properties where it is beneficial. Thus, the purpose of a debtor's ability to assume some leases while rejecting others is in direct conflict with the lessor's purpose and intent in cross-defaulting a portfolio of leases.

This conflict has led to divergent case law in which bankruptcy courts have both (1) enforced cross-default provisions as fundamental aspects of the debtor-lessee and creditor-lessor's bargain[15] and (2) refused to enforce cross-default provisions as anti-assignment provisions.[16] Unfortunately, the only certainty provided by this line of cases is that attorneys and their clients can never be sure as to whether cross-default and other similar provisions will be upheld in bankruptcy court. Nonetheless, the purpose of this article is to identify the risks that bankruptcy poses to the lessor, and to set forth what, if anything, can be done at the drafting stage to preserve lessors' interests.

TREATMENT OF PORTFOLIOS OF LEASES IN BANKRUPTCY: ONE AGREEMENT OR SEVERAL?

As discussed above, outside of bankruptcy, cross-default provisions effectively bundle and integrate portfolios of leases. In the bankruptcy context, however, it is well settled that cross-default provisions do not integrate unexpired leases that are otherwise separate and severable.[17] Thus, the focus in bankruptcy litigation is whether the portfolio of leases are an economically integrated agreement, or, on the other hand, divisible and severable agreements. In the prior instance, bankruptcy courts will uphold cross-default provisions and thereby preclude the piecemeal assumption of some, and rejection of other, leases from within the portfolio; in the latter instance, the debtor will be free to assume some of the leases and reject others, notwithstanding the fact that the leases within the portfolio are cross-defaulted. Complicating matters, bankruptcy courts do not apply a federal standard, but instead interpret the state law which applies to the lease agreement.[18]

Immediately below are summaries of recent cases involving portfolios of cross-defaulted leases, and the determination of the bankruptcy courts in each case with respect to the severability of the leases at issue.

Decisions Finding Agreements to be Severable

In re Convenience USA, Inc., 2002 WL 230772 (Bank. M.D.N.C. 2002)

In *Convenience USA*, the bankruptcy court held that a single document that provided the terms for the debtor leasing 27 gas station properties from six affiliated landlords, was severable and, accordingly, the debtor was permitted to reject the lease with respect to six non-performing properties.[19]

In reaching its holding, the bankruptcy court applied Texas law. The important factors in concluding that the lease was severable are as follows:

- *One Document*: The court held that the "mere fact that agreements are embraced in one instrument will not make the writing entire and indivisible."[20] Accordingly, the fact that the 27 properties were leased by a single document was not determinative, though the court did not indicate whether it was inconsequential.[21]
- *Provisions for the Transfer of Leased Properties:* The court held that the landlord's unfettered right to transfer the leased properties at any time during the lease term, and thereby sever it from the lease without affecting the other properties subject to the lease, was indicative of the parties' intent to create a severable agreement.[22] Therefore, the court concluded, this provision weighed in favor of finding the lease to be severable.
- *Apportionment of Rent for Sale, Casualty, and/or Condemnation:* While the lease called for a lump sum rent payment, it included a mechanism for apportionment of rent among the 27 properties in the event of sale, casualty, and/or condemnation of one or more of the properties. The court held that such a provision was indicative of the intent of the parties to enter into a severable agreement because, under Texas law, a "circumstance that weighs heavily in finding that a contract is divisible is if the part of the contact to be performed by one party consists of several separate items and the price to be paid by the other party is apportioned to each item."[23]
- *Several, Rather than Joint and Several, Obligations of Landlords:* The bankruptcy court noted that while the landlords argued that the lease was an interdependent agreement, the landlords' obligations under the lease were several, rather than joint-and-several;[24] that is, the properties were not cross-defaulted with respect to the landlords' obligations, which the court concluded weighed in favor of severability.
- *Cross-Default Provisions:* On the other hand, the court noted that while the properties being cross-defaulted with respect to the lessees' obligations weighed in favor of finding an interdependent agreement, such provisions were "insufficient to outweigh the other provisions of the lease which [weighed] more heavily in favor of or a finding of an intent that the lease be divisible."[25]

In re Cafeteria Operators, L.P., 299 B.R. 384 (Bankr. N.D. Tex. 2003)

In *Cafeteria Operators*, the bankruptcy court held that 43 subleases for cafeteria space in K Mart stores were severable and distinct agreements, which allowed the debtor-sub-lessees, to reject some and assume others, notwithstanding the fact that the subleases were contained in a single document and a default at one location, would be deemed a default at all of the locations.[26]

In *Cafeteria Operators*, K Mart Corporation occupied various retail outlets located on properties across the country which it leased from two different owners.[27] The debtors subleased a portion of these properties from K Mart pursuant to a single master sublease agreement which contained the terms for the subleasing of 43 independently operated cafeteria/restaurant sites.[28] Upon the debtors filing for bankruptcy, they sought to reject the master lease agreement with respect to some, but not all, of the cafeteria locations.[29]

In holding that the master sublease agreement was severable into 43 distinct leases, and thereby allowing the Debtors to reject some but not all of the subleases, the bankruptcy court interpreted Michigan law regarding the severability of contracts, which, according to the bankruptcy court, provides that "[d]etermination of the issue depends primarily on the intention of the parties, the subject matter of the agreement, and the conduct of the parties."[30]

The factors that weighed in favor of the bankruptcy court holding that the subleases were severable, are as follows:

- *Apportionment of Rent by Location*: The bankruptcy court held that the allocation of rent among the different cafeteria properties weighed in favor of severability, despite the debtors' practice of making lump sum rent payments for each of the properties[31] because apportionment permits the leases to be easily divided from the master lease agreement.[32]
- *Rent Reduction Provisions*: The bankruptcy court held that the inclusion of rent reduction provisions for condemnation and noneconomic use with respect to the individual properties weighed in favor of severability.[33]
- *Different Terms for Individual Properties*: The bankruptcy court held that the fact that the term under the individual leases varied by property and the fact that the master sublease agreement required the debtors to surrender possession of the properties when its respective term was expired

(notwithstanding the fact that the master lease agreement was still in effect) weighed in favor of severability.[34]

- *No Requirement to Enforce the Master Lease Agreement in its Entirety*: The bankruptcy court also noted that the master lease agreement allowed the landlord to terminate, re-enter, repossess and/or relet all *or part* of the properties in the event of default. Further the master lease agreement contained an integration clause which specifically allowed the landlord to enforce the master lease agreement with respect to individual properties, but not necessarily with respect to all of the properties.[35] The bankruptcy court reasoned that the ability of landlord to enforce the master agreement against some of the properties, without a requirement that it enforce it with respect to all of the properties, indicated that the parties intended the subleases to be severable.[36]
- *Provision Allowing Debtors to Sublet the Properties*: Also, a provision allowing the debtors to sublease a particular location, and sever it from the master lease agreement, merely by delivering a new sublease that is satisfactory to the landlord and a letter of credit securing the performance of sublessee's payment obligations, evidenced that the subleases were divisible.[37]
- *Subject Matter of the Agreement*: Finally, the bankruptcy court held that "this type of agreement, which addresses numerous independently operated restaurant facilities scattered across multiple states, inherently leads itself to being divisible."[38]

In re Wolflin Oil, L.L.C., 318 B.R. 392 (Bankr. N.D. Tex. 2004)

In *Wolflin Oil*, the bankruptcy court held that six leases for properties used by businesses "providing and specializing in automotive lubrication services" (i.e., oil changes), could be assumed or rejected, in part, notwithstanding the fact that the leases were cross-defaulted.[39] The bankruptcy court applied Texas law, which requires an analysis of the intent of the parties, the subject matter of the agreement, and the conduct of the parties.[40]

- *Subject Matter of the Agreement*: The Court held that the subject matter of the leases weighed in favor of severability because each lease covered a separate building and the debtor operated each store independently from the others.[41]

- *Apportionment of Rent by Location*: Further, the fact that the debtor paid rent under each lease separately and the rent was calculated differently for each location, weighed in favor of severability.[42]
- *No Reference to Other Leases*: Also, the fact that not one lease made reference to the other leases weighed in favor of severability.[43]
- *Merger Clause*: In addition, the fact that each lease provided a merger clause providing that "this Lease…is the entire agreement or the parties, and there are no oral representations, warranties, agreements, or promises pertaining to this Lease…not incorporated in writing in this Lease," weighed in favor or severing the leases.[44]
- *Lack of Evidence that Cross-Default Provisions Were a Material Inducement to Lessor*: Finally, though the cross-default provisions evidenced that the leases were part of an integrated agreement, the court was unconvinced that the landlord would not have entered into the leases absent the cross-default provisions. Indeed, the bankruptcy court explained that "where a non-debtor party would have been willing, absent the existence of the cross-default agreement, to enter into a contract that the debtor wishes to assume, the cross default provision should not be refused where to do so would thwart the benefit of the non-debtor party's bargain."[45] The bankruptcy court however, acting as the finder of fact, refused to give weight to the landlord's "self-serving" testimony that he would not have entered into the agreement "had [the cross-default] provisions not been present in the executed leases" — despite the landlord also testifying that the rental payments from the properties were his sole income in retirement.[46]

In re FFP Operating Partners, LP, 2004 WL 3007079 (Bankr. N.D. Tex. Dec. 27, 2004)

In *FFP Operating Partners*, the bankruptcy court held that a single sublease agreement, by which a landlord leased 22 distinct convenience store properties to a sublessee was severable into 22 distinct sublease agreements.[47] The bankruptcy court's decision allowed the sublessee-debtor to assume the sublease agreement with respect to 12 properties, and reject it with respect to 10 properties.[48] In reaching its decision, the bankruptcy court applied Texas law and considered the following:

- *Right to Sell Properties Subject to Lease*: The court held that a provision allowing the landlord to sell any of the properties covered by the lease without terminating the lease with respect to the remaining properties, weighed in favor of severability.
- *Rent Reduction Upon Condemnation/Destruction*: The court held that a provision providing for the reduction of the aggregate rent for the properties upon the condemnation or destruction of an individual property, was indicative of the intent of the parties to enter into a severable agreement because, under Texas law, a "circumstance that weighs heavily in finding that a contract is divisible is if the part of the contact to be performed by one party consists of several separate items and the price to be paid by the other party is apportioned to each item."[49]
- *Apportionment of Rent*: As seen in the cases above, the bankruptcy court concluded that while a lump sum rental payment was due each month with respect to the portfolio of properties, the apportionment of that price to each property, included in the lease as an exhibit, weighed in favor of severing the leases.[50]
- *Cross-Default Provision*: As seen in the cases above, the bankruptcy court concluded that while cross-default provisions are indicative of the intent to create an interdependent and unified agreement, their presence alone is not dispositive.[51]
- *Language Suggesting One Agreement:* Important to note, the landlord made an interesting argument regarding the language used in the lease; that is, the landlord argued that the use of the word "lease" throughout the document, rather than "leases" weighed in favor of finding the agreement to be interdependent.[52] While the court rejected this argument, it did so based on other language in the document that provided that the use of a noun in the singular should be construed, where appropriate, as being in the plural (i.e., a "use of words" provision).[53] The court's logic, by negative implication, suggests that the absence of such a "use

of words" provision, or the inclusion of other language clarifying that the word "lease" should always be interpreted in the singular, may have weighed in favor of finding for the landlord.

Decisions Finding Agreements to be Interdependent

In re Buffets Holdings, Inc., 387 B.R. 115 (Bankr. D. De. 2008)

In *Buffet Holdings*, the bankruptcy court held that subleases for 21 restaurant properties in at least eight different states were part of a single indivisible master lease agreement, and thus, a group of affiliated debtors could not assume some of the subleases, and reject others.[54]

The deal structure in *Buffet Holdings* was as follows. Prior to bankruptcy, the debtor sought to recapitalize and issue a dividend to shareholders.[55] To accomplish this goal, the debtors entered into a sale-leaseback transaction with the lessor.[56] The initial benefit to the debtors was the $35 million in cash it received pursuant to the sale and the removal of the restaurant properties from their balance sheets.[57] This, in turn, allowed the debtors to refinance their remaining secured debt at more reasonable rates and to issue a dividend to shareholders.[58]

The leaseback at issue in the bankruptcy was structured as two master-leases, each with two tenants, that respectively covered 10 and 11 restaurant properties scattered across at least eight different states.[59] The restaurant properties were then subleased by the two tenants to the master leases to the affiliated debtor entities which operated the restaurants thereon independently.[60] Total rent due under the master-leases was wired by the debtors to the lessor as a lump sum payment, but was allocated by, and apportioned among, the underlying restaurant properties.[61] As a preliminary matter, it should be noted that the apportionment of rent allocable for each property weighed in favor of severing the subleases from the master-leases; that being said, the bankruptcy court also stated that this factor alone is not determinative, and, thus, still held that the subleases were independent and integrated agreements for the reasons set forth below.[62]

In holding that the subleases were indivisible from the master leases, the bankruptcy court applied Illinois law as to the issue of severability, which requires courts to determine the intent of the parties to the agreement by first examining its terms, and then, only if its terms are ambiguous, looking to factors outside the four corners of the agreement.[63] The bankruptcy court noted several express terms of the contract that weighed in favor of the lessor's argument that the debtors should be required to assume or reject the subleases *en toto*, rather than be allowed to "cherry pick" the leases for profitable locations while rejecting the remaining leases:

- *Joint and Several Liability for Rent*: First, all rent would remain due even if the debtors were unable to use one or more of the properties because of condemnation, destruction, or termination of the ground lease.
- *Extension Provisions*: Second, at the expiration of their terms, the Master Leases could only be extended if the subleases were extended.
- *Cross-Defaults*: Third, all of the subleases were cross-defaulted which weighed in favor of finding the agreement economically interdependent. Furthermore, the court noted that the cross-default provisions, which allowed the lessors upon default of one of the individual leases to elect to either declare the master lease in default, or to treat only the individual lease in default, did not weigh against finding the agreement to be economically interdependent. The Court explained that contracts are frequently drafted "to give a party flexibility in exercising its remedies on default, allowing it to exercise some remedies without waiving any other remedy it may have at law."[64] The *Buffet Holdings* court's interpretation of this provision conflicts with the analysis of a similar provision in Cafeteria Operators.[65]
- *Identification of Instances where Subleases were Severable*: Also, the inclusion of provisions specifically identifying certain circumstances when the subleases could be severed from the rest of the agreement due to the landlord selling the property or condemnation of the property, weighed against severability.[66] As with the court's analysis of the landlord's remedies under the cross-default provisions, the analysis of these provisions conflicts with that of the courts in *Convenience USA* and *FPP Operating Partners* that dealt with similar provisions. Indeed, the court in *Convenience USA* specifically rejected the argument that provisions of these

type are merely included to specify instances in which an otherwise economically interdependent agreement is severable.[67]

- *No Rent Adjustment for Condemnation/Casualty/Termination:* The court held that the fact that the total rent for the properties would remain due notwithstanding one of the lessees being unable to use its property due to condemnation, destruction, or termination of the lease weighed in favor of finding an economically interdependent agreement.[68]

Further, the bankruptcy court looked outside the four corners of the relevant documents evidencing the agreement and, in dicta, stated that the very fact that the lessor had negotiated for the master lease, and the testimony from the lessor that it "would never have done the deal as individual leases" evidenced that the subleases were integrated and interdependent.[69] The key, in the words of the bankruptcy court, was that "the Debtors entered into the sale/leaseback agreement whereby the leases were bundled in exchange for one obligation. [Lessor] agreed to pay the Debtors a substantial sum of money in exchange, inter alia, for the right to bundle the leases…. and restrict the exercise rights by the individual tenants."[70]

Other Cases Enforcing Cross-Default Provisions as Material to the Bargain

There are numerous other cases that enforce cross-default provisions but that are distinguishable from the above because they do not concern portfolios of cross-defaulted leases. That said, each case stands for a similar proposition and the logic behind such can be applied to cross-defaulted lease portfolios; while cross-default provisions are inherently suspect, they are not *per se* unenforceable in bankruptcy and a bankruptcy court should not refuse to enforce a cross-default provision where to do so would thwart the non-debtor lessor's benefit of the bargain. Indeed, this is the overriding theme that is present throughout the *Buffet Holdings* decision discussed above.

For example, in *In re Liljeberg Enterprises Inc.*, the debtor (a group of consolidated affiliates) entered into a lease with a hospital operator which provided development financing (the payments under the debtor's notes were equal to the rent payment required under the lease, and resulted in accounting entries for each while no actual money changed hands) and also a pharmaceutical agreement whereby the debtor was the sole provider of pharmaceutical services at the hospital.[71] The pharmaceutical agreement was cross-defaulted with the lease.[72] In finding that the pharmacy agreement and the lease were interrelated and not severable, the Fifth Circuit placed great emphasis on the fact that the parties, in a pre-trial order, agreed that the hospital operator would not have entered into the lease with the debtor if the debtor had not entered into the pharmacy agreement and vice versa.[73] Accordingly, the court noted that the above was "all a part of the overall transaction to finance the building of the hospital" and therefore, the debtor was unable to assume the pharmacy agreement without also assuming the lease.[74]

Further, as explained by the Bankruptcy Court for the District of Minnesota, defaults under cross-defaulted agreement should not be subject to cure upon assumption of a lease except where (1) the lessor furnished special consideration in connection with the provisions or (2) the lessor's lease bargain would be prejudiced by non-performance.[75] Now, it is unclear what "special consideration" is exactly, but those bankruptcy courts that have enforced cross-default provisions and required the lessor to cure each default among the bundle of contracts prior to assumption have done so based on the need, or the policy, of upholding the bargain between the two parties.[76]

DRAFTING LEASES TO MAXIMIZE THE SECURITY OF LESSORS

As seen above, the analysis of the law of severability, and thus the enforceability of cross-default provisions in bankruptcy, is highly dependent on facts. The most significant factual inquiry made by a bankruptcy court is with respect to the contents of the relevant documents. Also important, but less so, are the facts relating to the conduct of the parties in negotiating and performing under the documents. With this in mind, attorneys that structure portfolio lease transactions have the unique ability to craft the facts that a bankruptcy court would analyze in such a fashion so as to make it more likely that a bankruptcy court will enforce the cross-default and other similar provisions contained therein.

As discussed above, cross-default provisions will be upheld where the facts demonstrate that the lessor and lessee intended to enter into a unified agreement rather than severable and distinct agreements. Below is list of factors which the courts found persuasive in reaching their respective determinations and a brief discussion regarding how attorneys can use this knowledge to their benefit in drafting a portfolio of cross-defaulted commercial leases.

Language Indicating Specific Intent to Enter into an Economically Interdependent Agreement

As the intent of the parties to the agreement is the key factor in determining whether it is severable or economically integrated, it may therefore be obvious that the lessor should include language indicating that the intent of the parties is to enter into an economically integrated agreement within each of the relevant documents. Indeed, including language to this effect will be much more persuasive than post-hoc testimony from the landlords — for example, while the court in *Buffet Holdings* found the testimony from the landlord that the "bundling" of the leases was a material inducement to enter into the deal, the court in *Wolflin Oil* considered similar testimony of the landlord therein and rejected/ignored it in reaching its conclusion that the agreement therein was severable. In each of these instances, the testimony of the respective landlord would have been unnecessary (or been provided merely for additional support) if the relevant documents expressly provide that the parties intended the leases to be economically interdependent.

The Use of Master Leases

As discussed above, master lease agreements were used in both *Cafeteria Operators* and *Buffet Holdings*. The respective courts, however, reached opposite conclusions regarding severability. Of note, however, is the discussion of the different purposes for using a master lease agreement. In *Buffet Holdings*, in which the court found the various subleases to be interdependent, it is suggested that the use of a master lease was part of the consideration received by the lessor for doing the deal: "[Lessor] had no real interest in each specific lease; its interest was in the total package. This conclusion is supported by the terms of the Master Lease… To allow Debtors to reject one of the leases without continuing to pay the total rent would be to destroy the essence of [the] bargain."[77] In *Cafeteria Operators*, where the master lease agreement was held to be severable, the reason for structuring the agreement as a master lease was not discussed at length and the court suggests that it was used only for convenience: "The Master Lease Agreement, in essence, establishes common terms for 43 individual leases."[78] Accordingly, where possible, counsel for the lessor in such transactions should include language indicating the importance of the master lease agreement to the lessor (i.e., it is not merely for the convenience of the parties in drafting, but an integral part of the consideration paid to lessor for doing the deal). Including language to this effect is imperative and demonstrates the quid pro quo between lessor and lessee in creating an economically interdependent agreement.

Choice of Law

As discussed above, bankruptcy courts apply state law to determine the issue of severability. Notwithstanding state-by-state variance with respect to contract legal doctrine, bankruptcy courts routinely rely on the intent of the parties and their course of dealings in determining whether an agreement is severable. Important to note, however, the application of Michigan law in *Cafeteria Operators*, and Texas law in *Convenience USA*, *Wolflin Oil*, and *FFP Partners* caused the court therein to analyze and discuss the "subject matter" of the agreement. The application of Illinois law in, *Buffet Holdings*, on the other hand, did not require such an analysis. The distinction may not have been determinative in any of the cases discussed above, but in structuring a portfolio lease transaction, it would be best to avoid choosing a state's law for application to the agreement that includes an analysis of the subject matter of the agreement. As the Court noted in *Cafeteria Operators*, the type of agreement "that addresses numerous independently operated restaurant facilities scattered across multiple states, inherently leads itself to being divisible,"[79] which is precisely the nature of portfolio lease transactions. Accordingly, counsel for a would-be purchaser/lessor in a portfolio sale-leaseback is well advised to research the law of severability of contracts for any state law that is to be applied to the agreement. Indeed, it may be wise to choose Illinois law for the purposes of determining severability given that the bankruptcy court for the District of Delaware decided *Buffet Holdings*

— an authoritative court across bankruptcy jurisdictions. On the other hand, it would be unwise for a lessor to advocate the use of Texas law to interpret an agreement given that the courts in three cases discussed above — *Convenience USA*, *Wolflin Oil*, and *FFP Operating Partners* — all interpreted Texas law and found the respective leases at issue to be severable.

Apportionment of Rent

The apportionment of total rent for the portfolio or leased properties will weigh in favor of severability. Indeed, even if a lump sum payment is due for the portfolio of properties, any apportionment of rent by property may negate this fact. As indicated by *Buffet Holdings*, however, the apportionment of rents is not dispositive. Accordingly, it would be most persuasive if the net rents across the portfolio were not apportioned by property. That being said, given the nature of portfolio lease transactions, the apportionment of rent among the various properties may not be avoidable as certain contingencies such the sale, condemnation, and/or destruction of one of the properties would require a rent reduction. In such a situation, the best practice would be to require a lump-sum payment from the lessors for the total rent due — the lessor should understand, however, that this set of facts will, at best, neutralize the effect that the apportionment of rent in an analysis of whether the subject leases are interdependent or severable.

One Document

The use of one document appears to be insignificant, to bankruptcy courts when determining whether an agreement is severable. As discussed above, the mere fact that agreements are embraced in one instrument will not make the writing entire and indivisible. Indeed, in three of the cases discussed above which found the agreements to be severable — *Cafeteria Operators*, *Convenience USA*, and *FPP Operating Partners* — the relevant agreement was evidenced by a single document. On the other hand, in *Buffet Holdings*, in which the bankruptcy court found the agreement to be indivisible, the specific terms with respect to each sublease under the master lease agreements were contained in separate documents.

That being said, this factor should not be overlooked. In all instances of litigation where courts will be applying a rule which requires a balancing of various factors, it is helpful to have as many facts on your side as possible. Accordingly, if the contemplated deal structure allows it, then the lessor should negotiate to have the terms of the agreement contained within a single document — the lessor should understand, however, this is no panacea, but merely one factor of many that a court will analyze.

Merger Clauses

Merger clauses should be drafted with particular attention to detail in portfolio lease transactions. As demonstrated by *Wolflin Oil*, the use of a generic merger clause that makes no reference to the other lease agreements in a portfolio could weigh against a court finding an interdependent agreement and the enforcement of cross-default provisions. Accordingly, drafters should be reminded to look at their form language and reconsider it in light of the above. While many attorneys may believe that the inclusion of a cross-default provision is sufficient to integrate leases within a portfolio, and changes to a merger clause are therefore unnecessary, this assumption is only correct insofar as the agreement is interpreted outside of bankruptcy court.

Joint & Several Obligations for Rent

If properties within the portfolio are leased to various affiliated entities, then the rent obligations of all the entities should be joint and several as was the case in *Buffet Holdings*. By doing so, the parties would demonstrate their intent to make the portfolio of leases economically interdependent by making each individual tenant liable for the aggregate rent, and not merely the rent for the property which they respectively occupy. Furthermore, such a provision functionally eliminates the legal separateness of each tenant with respect to rent. Though not discussed by the court in *Buffet Holdings*, such a provision also evidences the “benefit” which the landlord “bargained” for; that is, the landlord bargained for a single rent payment, payable by any of the parties to the agreement irrespective of the fact that the obligated party occupies only a portion of the aggregate leased premises.

Joint & Several Obligations of Landlord(s)

As indicated in *Convenience USA*, joint and several obligations of various landlords to a pool of leases will weigh in favor of finding the agreements to be interdependent. This is sensible as it is the equivalent of cross-defaulting the obligations of the landlords. That being said, a landlord with leverage in negotiations will need to weigh the benefit of including such an obligation because (i) there is no indication that this factor alone is determinative; and (ii) even if it is determinative, the risk associated with such a provision may outweigh its potential benefits as bankruptcy is a tenant's last resort and, as such, somewhat rare.

Rent Reduction Provisions

As can be discerned from the above, the inclusion of rent reduction provisions in case of condemnation, casualty, or other disposition of a property, or a portion thereof, that is subject to the pool of leases will only weigh in favor of severability. A provision providing for no apportionment of rent upon condemnation or casualty, on the other hand, will weigh in favor of finding the leases to be interdependent. This is a drastic interpretation by bankruptcy courts and is nonsensical; that is, commercial leases almost always include provisions for the reduction of rent upon condemnation or casualty of part of the leased premises — why the reduction of aggregate rent for a pool of leased properties being decreased weighs in favor of severability, while such a provision for a single property would be negligible, makes no sense. Indeed, such provisions simply apportion risk for certain events that are beyond the control of either party to the agreement. In this sense, rent reduction shifts the risk of condemnation and casualty to the lessor. That said, by reaching such holdings, bankruptcy courts will cause lessors to negotiate for there being no adjustment for condemnation and/or casualty, which will shift the risk of such to lessees (i.e., debtors, for the purposes of this article).

Do the Agreements have the Same Duration

As evidenced by *Cafeteria Operators*, if the leases within the portfolio have different durations, it will weigh in favor of a bankruptcy court finding severability. By negative implication, if each lease within the portfolio has the same duration, it will weigh in favor of finding an economically interdependent agreement. Furthermore, the terms for extension should be identical and interdependent (i.e., as was the case in Buffet Holdings where the individual leases could only be extended if the entire master lease agreement was extended).

Contemporaneous Execution by the Same Parties

Though not discussed in the above cases dealing with portfolio lease transactions, other bankruptcy courts have recognized, as a general rule, that instruments executed at substantially the same time, by the same parties, and relating to the same subject matter "are to be read and interpreted together as one instrument."[80] Furthermore, contemporaneous execution of the relevant documents by the same party lends itself to a finding that the parties intended to enter into an economically interdependent and integrated agreement.[81] Accordingly, the lessor should require contemporaneous execution by the same party when entering into multiple leases to affiliated entities.

Do the Agreements Contain Cross-Default Provisions

The inclusion of cross-default provisions is evidence of parties' intentions to make the subject leases an indivisible agreement; provided, however, the inclusion of cross-default provisions is not dispositive.[82] As discussed above, the inclusion of a cross-default provision is not sufficient by itself to integrate the agreements. Notwithstanding this fact, it is difficult to imagine a bankruptcy court finding that a portfolio of leases are economically interdependent in the absence of cross-default provisions. As such, the inclusion of cross-default provisions should be deemed necessary, but understood to be insufficient, to integrate a portfolio of leases.

Whether Termination of One Lease Constitutes Termination of Them All

Nearly each case above finding the leases to be severable commented that some right to terminate one of the leases within its respective pool of leases, without terminating each other, weighed in favor of severability. In *Buffet Holdings*, on the other hand, the court held that such provisions weigh in favor of finding the leases to be interdependent because they specifically identify instances in which the leases are severable as opposed to interdependent. The latter approach is more reasonable; that is, in light of the detail included in these types of provisions (i.e., the specificity regarding the factual events leading to the termination of the respective lease and the effect thereof) it follows that these specific instances of severability are part of the bargained for exchange between the parties. Furthermore, by negative implication, the inclusion within a lease of the specific instances when one agreement is severable from the whole agreement to the exclusion of other instances, indicates the parties' intent to make these the sole and only instances in which an individual lease can be separated from the pool. To find that such a provision weighs in favor of severing the leases is contrary to the intent of the parties to the agreement and contrary to most doctrines of contractual interpretation. The only cue that lessors can take from the above is to be careful in crafting such provisions and in doing so expressly state that the enumerated instances are the exception to the rule that the agreement is integrated and indivisible.

CONCLUSION

The state of the law regarding the indivisibility of agreements, and thus the enforcement of cross-default provisions in bankruptcy, is anything but clear. Indeed, much of the case law is contradictory. That being said, lessors can take certain actions to preserve the security provided by cross-default provisions in bankruptcy by:

(1) including language in the operative documents indicating that it is the parties' intention to create an integrated and unified agreement (indeed, this is the most significant step that a lessor can take toward ensuring enforcement of cross-default provisions in bankruptcy);

(2) using a master lease structure;

(3) selecting a forum's law that is favorable to finding the leases to be integrated;

(4) using one operative document, or at least referencing each document in the various operative documents;

(5) making the lessees' obligations for rent joint and several;

(6) making the lessor's obligations under the leases joint and several;

(7) requiring the lessee to pay the same amount of rent notwithstanding a condemnation or other taking of a property;

(8) causing each lease to have the same duration and requiring an extension to the term be exercised with respect to all of the properties;

(9) requiring contemporaneous execution by the same representative for related tenants; and

(10) always including cross-default provisions if multiple operative documents are to be used.

While no one factor will be determinative, nor will a lessor be able to employ all of these strategies, a lessor would be well advised to structure a portfolio lease transaction with the above in mind.

NOTES

[1] Stephen G. Tomlinson, Sale Leaseback Offers Compelling Alternative, www.kirkland.com/sitecontent.cfm?contentid+223&Itemid=2500.

[2] 11 U.S.C. § 101, *et seq.*

[3] 11 U.S.C. § 541(a)(1).

[4] *Id*. at § 541(a)(1).

[5] *In re Tiny's Cafe, Inc*., 322 B.R. 224, 226 (Bankr. D. Mass. 2005) ("Under Sections 362 and 541 of the Bankruptcy Code, a lease that has been terminated for non-payment prior to the filing of bankruptcy is not property of the estate, and is thus not protected by the automatic stay."); *In re Gromyko*, 142 B.R. 20 (Bankr. D. R.I. 1992) (granting relief from stay as landlord terminated lease prepetition).

[6] 11 U.S.C. § 362.

[7] Creditors violating the automatic stay may be held in contempt by the bankruptcy court in addition to being held liable for actual damages, punitive damages, and attorneys' fees and costs. *See* 11 U.S.C. § 362(k).

[8] *In re Rimsat, LTD*, 98 F.3d 956 (7[th] Cir. 1996) (explaining that the scope of the automatic stay provision: "[the stay violator] is a U.S. Citizen, incontestably within the jurisdiction of the Congress of the United States, which can by statute (the automatic stay) forbid him to conduct proceedings anywhere in the world that would affect the debtor's property.")

[9] Note that no default related to the following needs to be cured for the Debtor-Lessor to assume the Lease: insolvency, commencement of a bankruptcy case or similar proceeding, appointment or taking possession by a trustee, or the satisfaction of any penalty rate or penalty provision relating to a default arising from any failure by the debtor to perform nonmonetary obligations under the Lease. 11 U.S.C. § 365(b)(2)(A)-(D).

[10] 11 U.S.C. § 365(b)(1)(A)-(C).

[11] 11 U.S.C. § 365(f)()

[12] 11 U.S.C. § 365(h)(1)(A)(i).

[13] *NLRB v. Bildisco & Bildisco*, 465 U.S. 513, 528 (1984).

[14] *In re Bankvest Capital Corp.*, 360 F.3d 291, 296 (1[st] Cir. 2004).

[15] *United Air Lines*, 346 B.R. at 470 (noting that the "critical feature" of decisions which do not invalidate cross-default provisions is "that the agreements linked by a cross-default clause were economically interdependent: the consideration for one agreement supported by the other.")

[16] *In re Convenience, USA, Inc.*, ("[c]ross-default provisions are unenforceable in bankruptcy where they would restrict the debtor's ability to fully utilize the provisions of § 365…. Thus, where a debtor is a party to a number of unexpired leases, cross-default clauses that would serve to prevent the debtor from assuming some of the leases without assuming the others at the same time are unenforceable under § 365(f)"); *In re Plitt Amusement Co. of Washington, Inc.*, 233 B.R. 837, 847 (Bankr. C.D. Cal. 1999) ("It is well-settled that, in the bankruptcy context, cross-default provisions do not integrate otherwise separate transactions or leases.… The cross-default provisions must be disregarded in the bankruptcy law analysis, because they are impermissible restrictions on assumption and assignment.").

[17] *In re Plitt Amusement Co. of Washington, Inc.*, 233 B.R. 837, 847 (Bankr. C.D. Cal. 1989).

[18] *In re T & H Diner, Inc.,* 108 B.R. 448, 453 (D.N.J.1989) ("The question of divisibility is a matter of state law.").

[19] *In re Convenience USA, Inc.*, 2002 WL 230772 (Bank. M.D.N.C. 2002).

[20] *Id.* at *3 (*citing Click v. Seale*, 519 S.W.2d 913, 918 (Tex. Civ. App. 1975)).

[21] *Id.*

[22] *Id.* at *4.
[23] *Id.*
[24] *Id.* at *5.
[25] *Id.*
[26] *See generally In re Cafeteria Operators, L.P.,* 299 B.R. 384 (Bankr. N.D. Tex. 2003).
[27] *Id.* at 387.
[28] *Id.*
[29] *Id,* at 388.
[30] *Id.* at 389.
[31] *Id.* at 389-90.
[32] *Id.* at 392.
[33] *Id.*
[34] *Id.*
[35] *Id*. at 390 (the master lease agreement provided: "Integrated Sublease. Sublessor and Sublessee acknowledge and agree for themselves, their stockholders, successors, and assigns, that his Sublease is an integrated and single Sublease, enforceable with respect to all *or any* of the Premises in accordance with its terms, *notwithstanding that multiple properties are covered hereby*. Enforcement of the terms hereof by Sublessor *with respect to any one or more of the Premises shall not affect Sublessor's ability to enforce this Sublease from time to time with respect to the remainder of the premises*.").
[36] *Id.* at 392.
[37] *Id.*
[38] *Id.*
[39] *See generally In re Wolflin Oil, L.L.C.*, 318 B.R. 392 (Bankr. N.D. Tex. 2004).
[40] *Id.* at 396.
[41] *Id,* at 397.
[42] *Id.* at 398.
[43] *Id.*
[44] *Id.*
[45] *Id*. (*quoting In re Liljeberg Enterprises, Inc.,* 304 F.3d 410, 445 (5th Cir.2002))
[46] *Id.* at 399.
[47] *In re FFP Operating Partners, LP*, 2004 WL 3007079 (Bankr. N.D. Tex. Dec. 27, 2004).
[48] Id. at *1.
[49] *Id.* at *4 (citing Convenience USA at *5).

[50] *Id.*
[51] *Id.*
[52] *Id.*
[53] *Id.*
[54] *See generally In re Buffets Holdings, Inc.,* 387 B.R. 115 (Bankr. D. De. 2008).
[55] *Id.* at 118.
[56] *Id.*
[57] *Id.*
[58] *Id.*
[59] *Id.*
[60] *Id. at 119.*
[61] *Id.*
[62] *Id.*
[63] *Id.*
[64] *Id.* at 124.
[65] *See supra* discussion regarding *Cafeteria Operators*.
[66] *In re Buffets Holdings, Inc., 387 B.R.* at 123 ("The fact that the Master Leases could in certain circumstances be severed by their terms does not mean that the parties intended them to be separate agreements for all purposes. In fact, it demonstrates the opposite: that the parties intended each Mater Lease to ne an integrated agreement except for certain specifically identified circumstances.").
[67] *Id.* at 124.
[68] *Id.*
[69] *Id.*
[70] *Id.* at 126.
[71] *In re Liljeberg Enterprises Inc.*, 304 F.3d 410, 419 (5th Cir. 2002).
[72] *Id.*
[73] *Id.* at 445.
[74] *Id.*
[75] *In re Madison's Partner Group, Inc.*, 67 B.R. 633, 635 (Bankr.D.Minn.1986).
[76] *Matter of East Hampton Sand & Gravel Co., Inc.* 25 B.R. 193, 198 (Bkrtcy N.Y. 1982) ("equity will not countenance the debtor's exercise of § 365 to relieve itself of conditions which are clearly vested by the contracting parties as an essential part of their bargain and which do not contravene overriding (sic) federal policy.").
[77] *Id.* at 124.
[78] *In re Cafeteria Operators, L.P.,* 299 B.R at 390.
[79] *Id.* at 392.

[80] *In re Eastern Systems, Inc.* 105 B.R. 219, 228 (Bkrtcy. S.D.N.Y. 1989).

[81] *See, e.g.*, *Bistrian v. Easthampton Sand & Gravel Co., Inc*. (*In re Easthampton Sand & Gravel Co., Inc*.), 25 B.R. 193, 198–99 (Bankr.E.D.N.Y.1982); (lease of concrete business and promissory note interpreted together since both documents arose from same transaction and were conditionally dependent upon each other. Default on note could be considered default on lease since note was major consideration in effectuating lease of premises.); *BWA Corp. v. Alltrans Express U.S.A., Inc.*, 112 A.D.2d 850, 493 N.Y.S.2d 1, 3 (1st Dept.1985) (letter agreement executed contemporaneously with commercial lease read as one agreement); *Riverview Apartment Co. v. Golos*, 97 A.D.2d 917, 470 N.Y.S.2d 758, 760 (3d Dept.1983) (lease and management agreement interpreted together); *North Shore Mart v. Grand Union Company*, 58 Misc.2d 640, 296 N.Y.S.2d 855, 858 (Dist.Ct.Nassau Co.1968) (lease and "supplemental agreement" providing that landlord could acquire ownership of land found to be one transaction).

[82] *In re Convenience USA*, 2002 WL 230772 at *7; *In re FFP Operating Partnership*, 2004 WL 3007079 at *4.

Recent Changes to Article 9

ANDREW L. TURSCAK, JR., JAMES HENDERSON, AND DAVID NAFTZINGER

This article examines recent amendments to Uniform Commercial Code Article 9.

In 2010, the Uniform Law Commission promulgated several amendments (the "Amendments") to Article 9 of the Uniform Commercial Code ("Article 9") designed to address problems that have arisen since revised Article 9 went into effect in 2001. Most, but not all, of the Amendments address the proper way to reflect debtor names on financing statements.

TIMING AND ENACTMENT

To promote uniformity, the drafters proposed a national enactment date of July 1, 2013. As of June 26, 2013, 40 states and the District of Columbia had passed the Amendments.[1] In the majority of these jurisdictions, the enactment date was July 1, 2013.

WHAT'S CHANGING?

The Amendments clarify what is deemed to constitute the correct debtor name for purposes of a financing statement. There also are changes to the

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rules on perfection with respect to after-acquired property where a debtor changes its location for filing purposes or a new debtor becomes bound by a security agreement. Finally, there are changes to the form of financing statement and the provisions regarding correction statements, which are now referred to as "information statements."[2]

ORGANIZATION NAMES

Pre-amendment Article 9 provided that the correct name for a registered organization (*e.g.*, corporations and limited liability companies) was that stated in the "public record." This led to confusion when the public record contained different names for the registered organization. Section 9-503(a)(1) has been amended to address this concern, directing filers to look to "the name of the debtor indicated on the *public organic record* most recently filed with or issued or enacted by the registered organization's jurisdiction of organization."

A new definition describing what qualifies as a "Public Organic Record" has been introduced to Article 9.[3] Generally, records filed by the organization with the organizing authority will meet the definition, whereas documents generated by the governmental authority will not.[4]

Despite the drafters' efforts to make clear what record should be used to determine the correct name of an organization, there likely will be instances where there are uncertainties as to whether a given record is a public organic record. In these instances, the safest course is to file multiple financing statements for each name that may be applicable.

INDIVIDUAL NAME

With respect to individual debtors, the drafters put forward two alternatives, one of which relies primarily on the debtor's most recent unexpired driver's license ("Alternative A"). The other adopts a more lenient standard under which the "individual name" of the debtor, the "surname and first personal name" of the debtor, or the name reflected on the debtor's most recent unexpired driver's license will be deemed correct ("Alternative B").[5]

The most important difference between the two approaches is that in those jurisdictions opting for Alterative A, if the debtor has a driver's license that has not expired, the name shown on the license must be used. By contrast, under Alternative B, the filer may use the name shown on the debtor's most recent unexpired license, or it may use the debtor's individual name, or the debtor's surname and first personal name.

The Amendments and comments also address expected issues with the new individual name rules. First, the drafters suggested that in some jurisdictions it may be appropriate to expand the phrase "driver's license" to include other forms of identification, such as state issued identification cards. Additionally, Section 9-503(g) provides that if a debtor has multiple licenses a filer should use the most recent license. Finally, according to the official comments to the Amendments, a financing statement does not "provide the name of the individual…unless the name it provides is the same as the name indicated on the license. This is the case even if the name indicated…contains an error."

Despite these attempts to anticipate and eliminate potential areas of confusion, several questions remain. For example, how does a secured party verify whether a debtor has provided it with the correct driver's license or, for that matter, whether the debtor has a license —particularly in those states where the Department of Motor Vehicles Web site does not maintain a searchable database? Additionally, according to the comments, a filer should not "mechanically" follow a driver's license when completing the financing statement. Rather, regardless of the order of the names shown on the license, it is the responsibility of the filer to ensure that the surname of the debtor is placed in the correct box on the financing statement. Finally, must the name on the financing statement precisely match the name on the driver's license? For example, what would be the effect of a filer leaving out a middle initial or a suffix? The comments appear to suggest this would result in a failure to state the correct debtor name.

IMPACT OF DEBTOR'S CHANGE IN LOCATION ON AFTER-ACQUIRED PROPERTY

The Amendments create a new four month grace period for perfection on property acquired after a debtor "changes" location. Previously, if a debtor changed its location to a different jurisdiction, a secured party remained perfected for only four months on property acquired prior to the change of location. The Amendments expand the grace period to cover after-acquired property. However, as before, if the secured party does not file a new financing statement, or otherwise perfect its interest, within four months of the change of the debtor's location, the secured party will become unperfected.[6] This change is good news for a secured party of a debtor whose location (*i.e.*, jurisdiction governing perfection by filing under Article 9) changes, but the burden of gaining timely knowledge of the change still rests with the secured party.

NEW DEBTOR WHO ASSUMES OLD DEBTOR'S SECURITY AGREEMENT

Under the previous rules, when a "new debtor" became bound by an existing security agreement — such as after a merger between the original debtor and a new debtor where the new debtor was the surviving entity — a secured party would remain secured for one year on property acquired by the old debtor prior to the merger. Notably, this did not protect property acquired after the merger. The Amendments change this, providing that the secured party will be seamlessly perfected on after-acquired collateral, but only if it acts to perfect with respect to the new debtor within four months of the time the new debtor becomes bound by the security agreement.[7]

As with the amendment to the change of jurisdiction rule, secured parties must be vigilant to ensure that the transaction resulting in a new debtor does not adversely affect their priority over the debtor's property.

CHANGES TO FINANCING STATEMENT

Some information that was previously required on the financing statement form will no longer be included. Specifically, financing statements will no longer require a filer to list the debtor's type of organization, jurisdiction, or identification number. The goal in making these changes was to streamline the financing statement and eliminate unnecessary information.

INFORMATION STATEMENTS

The drafters also updated the documents previously known as "correction statements." These statements will now be referred to as "information statements." Secured parties, as well as debtors, may file these statements. Like the former correction statements, information statements have no legal effect on perfection or priority.

CONCLUSION

The newly adopted Amendments call for renewed attention and revisions to the process of determining the critical information and taking the necessary actions to assure the effectiveness of security agreements and the perfection of security interests.

NOTES

[1] The Amendments have been introduced in the legislatures of most of the remaining states, including New York, where the Amendments were very recently introduced in the State Senate.

[2] The Amendments contain several other minor clarifications and changes including, for example, to the definition of Registered Organization, which has been amended to expressly include business trusts. *See* § 9-102(71).

[3] *See* § 9-102(a)(68).

[4] The comments make clear that a certificate of good standing does not count as a public organic record.

[5] *See* UCC § 9-503(a).

[6] *See* § 9-316(h).

[7] *See* § 9-316(i).

The Cooperative Bank's Restructuring: Will This Be a Case of Lessons Learned?

STEPHEN PHILLIPS, STUART WILLEY, MICHAEL DORAN, AND WILL STONER

After discussing similar transactions, the authors review how the restructuring of the United Kingdom's Co-operative Bank is likely to be implemented and focus on what inducements, negative and positive, there will be for the holders to participate in the proposed exchange offer.

The United Kingdom's bank regulatory and insolvency law structures were unprepared for the global financial crisis. As a result, the U.K. government's response to intense bank stress in the immediate aftermath of the crunch led to a number of somewhat unsatisfactory ad hoc solutions ranging from nationalizations to encouraging otherwise healthy institutions to take over weaker banks. Generally speaking, there was a criticism, fairly made perhaps, that profits were privatized and losses had been socialized. In common with other European nations, the U.K. has striven hard to improve its insolvency laws so that a bank requiring a restructuring is able to contemplate a "bail in" (a "debt haircut," in old parlance) of its subordinated bondholders to contribute to the restructuring. In recent days, the Cooperative Bank (the "Bank") has announced that it requires additional capital to satisfy regulatory requirements. The Bank needs additional aggregate Common Equity Tier 1 capital of £1.5 billion by 2015, comprising:

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- £1 billion to be contributed in 2013; and
- £500 million to be contributed in 2014.

The Bank announced that it expects at least £1 billion will be generated in 2013 from an exchange offer with its subordinated bonds into shares and an unspecified fixed income instrument. Much of the crucial detail remains unclear; in particular the exchange ratio, the nature of the new fixed income instrument and how the new securities will be divided up between the different tranches of the subordinated bonds. The Bank currently expects that the launch of the Exchange Offer will be in October 2013. The Bank announced that it expects the remaining balance to be sourced from proceeds of the disposals of insurance assets owned by the group, savings on coupon payments tendered in the exchange offer and certain planned management actions.

The restructuring is bound to be controversial. Although this has been reported as being the first U.K. bank restructuring which involves a contribution by the subordinated bonds, in 2009, the West Bromwich Building Society's fixed rate subordinated bonds were exchanged into a new type of equity called "profit participating deferred shares" or "PPDS" to increase its Tier 1 capital. The Bank stated that "[t]he Exchange Offer is designed to ensure the Group and investors in the Bank's subordinated capital securities make a joint contribution to the recapitalization of Co-operative Bank and share in the upside of the Bank's transformation under the strengthened management team."

This article discusses the experience of other bail-ins, particularly in Ireland, where we see close parallels. It also reviews how the Bank's restructuring is likely to be implemented and focus on what inducements, negative and positive, there will be for the holders to participate in the proposed exchange offer.

THE IRISH EXPERIENCE

The regulators and the management of the Bank are likely to draw upon the Irish experience of bondholder bail-ins, particularly as the Irish banks had considerable success "bailing in" their bonds, many of which were English law governed. A number of Irish banks launched similar offers to noteholders inviting them to tender their notes for new securities or cash at a discount to face value. Holders were asked to appoint a proxy to vote in favor of an extraordinary resolution to include in the notes a call option allowing the bank to redeem for nominal consideration all notes which had not been tendered for exchange.

In at least one case, involving Anglo Irish Bank, after a successful offer, the bank purported to redeem the remaining notes as it believed it had obtained the requisite noteholder approval. However, in respect of some English law-governed bonds, the High Court subsequently held that the resolution was not validly passed because the terms of the notes prevented Anglo Irish from voting notes in which it held a beneficial interest. In *Assenagon Asset Management S.A. v Irish Bank Resolution Corporation (formerly Anglo Irish Bank Corporation Ltd)*,[1] Briggs J held that Anglo had acquired a beneficial interest in notes when they were tendered for exchange. Briggs J also considered the requirement for the "exit consent" from participating noteholders to be an unlawful "coercive threat." He held that "this form of coercion is in my judgment entirely at variance with the purpose for which majorities in a class are given power to bind minorities" and added that "oppression of a minority is of the essence of exit consent of this kind, and it is precisely that at which the principles restraining the abusive exercise of powers to bind minorities are aimed." Following *Assenagon*, it seems highly unlikely that the Bank will launch an offer on a similarly aggressive basis.

INDUCEMENTS

It is, however, likely that the Bank will consider another recent consent solicitation case which showed issuers how to incentivize a consent solicitation without falling into the same trap as Anglo Irish. In *Azevedo and Another v Importacao, Exportaacao E Industria De Oleos Ltda and others*,[2] Hamblen J found that it is lawful for a company to offer the 'carrot' of an additional payment to bondholders who vote in favor of an amendment where that additional payment is not made to those that do not vote or vote against the proposal. The claimants had argued that (i) a class of noteholders must be treated on a pari passu basis; and (ii) consent payments made only to those noteholders who vote in favor of an amendment should be characterized as an unlawful "bribe. These arguments were rejected.

Accordingly, experience suggests that the Bank may offer a small additional payment, perhaps for responding early—a so called "early bird fee" for voting for the proposal by a certain deadline, and it is unlikely this will be challenged.

THE INSOLVENCY INFRASTRUCTURE FOR BANKS IN THE U.K.

The Bank will be discussing a "Plan B" with its advisers in case an insufficient amount of capital is raised to fill the regulatory gap. One key feature of the bonds is that they include collective action clauses, which means they can be compromised if an Extraordinary Resolution is passed, and accordingly, minority holders can be subject to a "haircut" against their will. We assume that the threshold for an Extraordinary Resolution is 75 percent, but this information is contained in the bond trust deeds rather than the public debt documentation and is therefore not currently available to us.

As discussed above in the Anglo Irish Bank restructuring, the exchange offer was accompanied by a form of resolution which we now think the court would find unlawful if replicated and so the Bank may decide not to accompany its exchange offer with a vote, or if it does, it will need to think very carefully about the impact of the *Assenagon* decision. We suspect that holders will be sufficiently wary not to rely solely on the case law, however, and no doubt some holders may see a need to obtain stakes in relevant tranches to block a resolution in case the deal offered is not sufficiently attractive to them.

Assuming the take up on the exchange offer is insufficient to fill the regulatory gap, and that the Bank does not find a way to cram down the holders using the collective action clauses, the Bank and the authorities will need another way to "close the gap." Accordingly, in the exchange offer documents, we would expect that the Bank will make reference to the powers of the Bank of England in respect of failing banks. The Banking Act 2009 (the "Act") brought in the "Special Resolution Regime" (the "SRR") for deposit-taking institutions. The SRR gives the U.K. authorities the power to transfer parts of a bank to another institution, or to a publicly-owned "bridge bank" (these types of transfers being referred to as partial property transfers, or "PPTs") until a private purchaser is found, or place a failing bank in temporary public ownership. The stabilization options are exercised through the stabilization powers, which are the powers to effect the transfer of shares and other securities or property, rights and liabilities, by operation of law.

There is a relatively high threshold test for the use of these powers. Broadly, the power to effect a PPT can only be exercised where necessary to protect the public interest, having regard to the stability of U.K. financial systems, public confidence in U.K. banks and the aim of depositor protection. A transfer to temporary public ownership will only be possible where necessary to resolve or reduce serious threats to: the stability of the U.K. financial systems, or where the Treasury has already provided financial assistance to the same end.

There are a number of creditor safeguards in place in the case of use of the SRR/PPTs, including that:

- secured creditors' claims cannot be separated from the assets securing the liabilities in a PPT;
- the normal priority ranking of creditors is not altered; and
- creditors left behind upon transfer pursuant to a PPT will be compensated so that they are no worse off than they would have been in an insolvency of the whole bank.

It is obvious that the Bank's management and the U.K. authorities will want the Bank to be restructured privately without the use of any of the powers granted under the SRR. Leaving aside the dire public relations, cost and damage to the business which would result from the use of such powers, it is quite likely that holders will seek to use the protections inherent in the Act to challenge any such intervention.

The nationalization of Northern Rock saw several hedge funds contest the lack of compensation for shareholders and it is likely that any use of the Act would lead to a number of legal challenges.

BONDHOLDERS' REACTIONS

Many bondholders are customers of the Bank and there will be a large number of retail holders who are unlikely to welcome the loss of the attractive coupon attached to the subordinated debt instruments. It is reported that 5,000 investors hold Co-op preference shares, many of whom are likely to have bought these instruments at their local branches. If recent experience is anything to go by, we may see the emergence of a campaign which mimics the small investor group which faced losses in Bank of Ireland's attempted coercive exchange of its permanent interest bearing shares ("PIBS"), which had been issued by Bristol & West prior to a takeover. Holders of £75 million in PIBS managed to avoid an exchange by a combination of a vigorous PR campaign and legal threats.

A larger institutional base also held out and did not take part in the distressed exchange offer.

Over the past few months a number of hedge fund investors have purchased subordinated bonds at distressed prices, hoping to take advantage of the current uncertainty. A large amount of debt is likely to be in their hands. Such investors may not necessarily reject an exchange, as they may well have bought the subordinated debt at a level where they may see an upside in owning shares or an instrument, the pay out of which may be based on the future profits of the Bank, rather than a fixed interest rate. Ultimately their decision will be driven by the ratio of new equity to debt at which the exchange is offered.

Of some concern for the Bank's management is an editorial in the *Financial Times* on June 17, 2013 which suggested that "[i]t is, however, a mystery how the Prudential Regulation Authority could sign off on a restructuring that seems to upend the established ranking of investors. As a shareholder, the Bank's parent (the mutual Co-operative Group) would be the last to see a return on its investment in an insolvency, but the proposed restructuring would have it retain almost complete control at the expense of the junior bondholders. The Bank's argument might be that by virtue of selling certain assets the shareholder is 'buying back' its stake in the Bank. Bondholders may be looking for some certainty of commitment that, if they agree to the exchange, the further capital needed to plug the regulatory hole will be made available by the shareholder.

CONCLUSION

The next few months will prove fascinating and may involve brinkmanship on both sides before an agreement is reached. The Bank will soon need to decide whether to engage constructively with the holders in a negotiation, or simply launch an offer and see how many accept. Whether, in the absence of agreement, the U.K. authorities are prepared (and indeed, empowered) to step in to use any of their powers under the Act is an interesting question.

NOTES

1 [2012] EWHC 2090 (Ch).
2 [2012] EWHC 1849 (Comm).

LSTA's Revised Trading Documents Allow Revolver Loan Investors to Protect Their Posted Collateral — But Only If They Ask

LAWRENCE V. GELBER, DAVID J. KARP, AND ERIK SCHNEIDER

The authors review changes made by the Loan Syndications and Trading Association to its Collateral Annex for Loan Participations and LSTA Par and Distressed Trade Confirmations.

On June 28, 2013, the Loan Syndications and Trading Association ("LSTA") announced that the revised Collateral Annex for Loan Participations and revised LSTA Par and Distressed Trade Confirmations became effective. The revisions to the LSTA's suite of documents has improved the ability of investors in revolver loan participations to protect themselves against the lender of records' insolvency risk. Investors face this risk when they are required to post collateral with the lender of record to support their obligations to fund the borrower's future draws on the revolving loan under the participation agreement. The revisions to the LSTA's documents include, among several other changes:

- a check-the-box option that allows collateral to be segregated with the seller or a third-party custodian;

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- a revised formula to calculate the amount of collateral required; and
- more frequent triggers for the seller to return any excess collateral.

These revisions make it even more important for investors in revolver loans to negotiate these points at the time of the trade. If investors later have to settle a revolver loan trade by participation instead of by assignment, they may lack the leverage to negotiate the appropriate protections for their collateral. In addition, buy-side funds that frequently invest in revolvers may want to consider negotiating account control agreements with third-party custodians and each of their most frequent sell-side counterparties, if they are concerned about their sellers' credit risk.

THE LSTA COLLATERAL ANNEX IN PRACTICE — BUYERS FACE ADDITIONAL CREDIT RISK DUE TO COMINGLING OF COLLATERAL

The LSTA Collateral Annex is generally used when a trade for a revolving loan or commitment settles by participation instead of by assignment because the borrower did not consent to the assignment. Borrowers often have the right to consent to assignments of their revolver loans, even if they do not have consent rights with respect to assignments of term loans. Historically, borrowers have been reluctant to consent to an assignment of a revolving facility to investment funds because they (justified or not) are concerned with an investment fund's ability to fund their draws as reliably as a banking or similar financial institution. When a trade settles as a participation, the revolver lender remains obligated to the borrower to fund any future draws; however, under the participation agreement, the buyer is required to pay its share of any of the borrower's future draws to the revolver lender. On account of that same concern, revolver lenders that participate a piece of their revolver loans to an investment fund have typically required investment funds to post collateral with the revolver lender to secure their funding obligation under the participation agreement.

The LSTA's prior version of the Collateral Annex provided that the buyer would post its collateral into a comingled account with the seller and permitted the seller to freely transfer, assign, invest, commingle, hypothecate, pledge or otherwise dispose of the buyer's collateral. As a result, if the seller were to become subject to a bankruptcy case or other insolvency proceeding (e.g., under SIPA or as part of an FDIC receivership), the buyer would not have any security interest or any other property right in the specific collateral it posted with the seller, even though the collateral was the buyer's property (unless and until the buyer defaults on its obligations). Effectively, the buyer's posted collateral would have dissipated into the seller's bankruptcy or receivership estate, and the buyer would only have an unsecured claim for the posted collateral against the seller's estate. Adding insult to injury, if there was a draw after the seller's insolvency, the buyer would remain obligated to fund the full amount — irrespective of the collateral it had posted.

LSTA'S REVISED COLLATERAL ANNEX

The LSTA's prior version of the Collateral Annex was published in 2008 and was due for an update in light of the Lehman Brothers and MF Global bankruptcies and increasing global regulatory focus on collateralization of derivative transactions, which has resulted in a number of new initiatives, including Dodd-Frank's provisions requiring collateral segregation (in the case of bilateral, unsecured swaps) and increased margin requirements. After close to a year of negotiations in the LSTA's Trade Practices and Forms Committee, the revised Collateral Annex, Par Trade Confirmation and Distressed Trade Confirmation include the following changes:

- Trade Confirmations
  - Includes: (i) a check-the-box option for segregation of collateral if the collateral account is established with the seller; and (ii) a further option to establish the collateral account with a third-party custodian.
    - Note that if neither of these options is *agreed to at the time of trade*, the default is for the collateral to be posted with the seller in a comingled account.
- Collateral Annex

- Allows for segregation of collateral with the seller, or with a third-party custodian (depending on what was agreed to in the trade confirmation).
- Two alternative formulas to calculate any collateral shortfall or collateral excess:
  - Option one is based on a percentage of the amount of unfunded commitments; and
  - Option two differs from option one by also taking into account the market value of the participation (subject to a haircut).
- Increased frequency of refunding excess collateral — changed from quarterly upon buyer's demand, to monthly, after revolver pay-downs and after draws, subject to the buyer and the seller negotiating the exact timing of payments.
- If the seller maintains the collateral account, it must provide monthly statements.

THE LSTA COLLATERAL ANNEX IN FUTURE PRACTICE

With these revisions, the LSTA has taken steps in bringing its suite of documents up to date given the current regulatory environment and credit-risk-conscious market. However, far from defaulting to options protecting buyers' rights in its collateral, the LSTA's revised Collateral Annex and the related check-the-box options in the trade confirmations merely give buyers the option to negotiate these terms with their seller. As a result, it is now even more important for buyers to educate their trading and operation personnel on these options so that these can be dealt with upfront at the time of trade. Neglecting to negotiate these points early in the life of a trade may result in sellers refusing to entertain any discussions of collateral segregation when these issues become pertinent.

Additionally, the LSTA's revised Par and Distressed Trade Confirmations contain a cautionary footnote that effectively discourage parties from opting for establishing a segregated collateral account with a third-party custodian if there is no agreed-upon control agreement in place. This footnote's language arguably allows sellers to refuse to agree to any third-party custody arrangement until they have agreed to a control agreement. As a result, prudent buyers that are concerned about minimizing their exposure to counterparty credit risk under the LSTA's Collateral Annex should take immediate steps to negotiate a control agreement and be better positioned to segregate collateral with a third-party custodian for their revolver trades, if they so choose.

Where Credit is Due: Foreclosure Without the Note is a Remedy Without a Right

NATHAN T. JUSTER

Can a party without the right to collect a secured debt nonetheless seize the collateral securing it? This article asserts that it may not, and that in residential real estate finance, foreclosure of a property requires the right to collect the underlying secured debt.

The two pillars of a mortgage are the promissory note and the security instrument. The promissory note evidences the debt and the security instrument secures the debt by conveying a security interest in the real property of the mortgagor. When the two instruments are held by different parties, it raises the question of whether the party that holds the security interest may foreclose upon it after a breach of the promissory note. This question was recently before the Georgia Supreme Court, and is now being litigated across the country.

This article demonstrates that the party holding the security interest cannot foreclose for the debt underlying the promissory note. The remedy of foreclosure is granted for the purpose of securing repayment of the debt to the party entitled to collect it in the first place — a security interest cannot create a remedy where there is no right.

Much has been written about the economic causes and effects of the subprime mortgage crisis,[1] specifically about the inflation of the housing bubble, predatory lending ,[2] deregulation,[3] poor rating agency practices,[4] and neglectful Wall Street transactions.[5] The effects of the subprime mortgage crisis on Americans can be seen all over the United States. Atlanta is one city that has been particularly affected by resulting foreclosures.[6] The Atlanta Division of the U.S. District Court for the Northern District of Georgia alone contains Fulton, Cobb, DeKalb, Gwinnett, and Clayton Counties, the five counties with the highest number of pending foreclosure sales in the State of Georgia in the month of September, 2012.[7] The total number of foreclosure advertisements in those counties that month was 3,457, compared to a total 7,691 in the State of Georgia as a whole.[8] Georgia ranked sixth overall in the United States in total foreclosures that month.[9] Such statistics are likely aided by the fact that foreclosure proceedings in Georgia are among the fastest in the nation.[10] For these reasons, Georgia is prime example for exploring mortgage law issues that have been developing both within Georgia and nationwide.

On June 3, 2009, Izell and Raven Reese became one of the many families in Georgia to have foreclosure proceedings brought against them, in their case by Provident Funding Associates ("Provident").[11] In its notice of foreclosure to the Reeses, Provident identified itself as the holder of the security deed and the promissory note signed by the Reeses.[12] There was one major problem with Provident's notice of foreclosure — it was neither the holder of the security deed nor the holder of the promissory note.[13] In fact, the security deed and the promissory note were separately held by two entirely different parties[14] — a result of the secondary mortgage market where mortgage instruments are bundled and traded as commodities.[15] In *Reese v. Provident Funding Associates, LLP*, the Georgia Court of Appeals set aside Provident's foreclosure sale because the Reeses had "a right to know which entity has the authority to foreclose" on their home.[16]

At first glance, this decision appears to be about inadequate disclosures, but underlying this decision is a question that remains unanswered in Georgia law — if Provident was not "the entity with authority to foreclose,"[17] who holds such authority? Because Provident held neither the security deed nor the promissory note, and because each of these instruments was in different

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hands, the *Reese* decision left open the question of whether one or both of these instruments would be sufficient to create authority to foreclose. When both are in the hands of the same party, it is clear that such party can foreclose upon default. [18] However, when the instruments are in the hands of different parties, as occurred in *Reese*, significant questions arise.[19] Can either party foreclose? If neither party can foreclose, lenders may have inadvertently become holders of unsecured promissory notes. Is holding a security deed (or other security instrument) alone is enough to foreclose? If so, borrowers may face the potential for a foreclosure from one entity and a lawsuit from another for the same debt.

The Georgia Supreme Court recently ruled on these issues, but these same questions are being grappled with by courts nationwide. [20] Though such issues may also arise in commercial real estate, due to the volume of residential mortgages, their securitization into complex pools, and the nature of residential mortgage servicing, these questions arise mainly in the context of residential real estate. In Georgia, the security interest is evidenced by a security deed and the obligation is evidenced by a promissory note.[21]

This article contends that the proper approach is that a party that possesses a security instrument but does not possess the promissory note should not be able to foreclose after a breach of the promissory note. A party must possess both instruments in order to foreclose after a breach of the promissory note based on two general propositions. First, a security interest is given for the purpose of securing performance of an obligation by the obligor and to the obligee. Second, enforcement of the security interest is predicated on a failure to perform the secured obligation (a default) by the obligor to the obligee. Based on these two premises, only the obligee can enforce the security interest because only the obligee is owed performance of the obligation — a security interest in the hands of anyone other than the obligee is unenforceable.

Applied to the context of a residential mortgage transaction, the secured obligation is "the repayment of the [debt evidenced by the promissory note] [22] [to the holder of the security instrument], [23]" as well as "the performance of Borrower's covenants and agreements under [the] Security Instrument…."[24] The "debt" evidenced by the note is only repayable to the holder of the promissory note.[25] If the holder of the security instrument is not the holder of the promissory note, there is no debt evidenced by that promissory note that is repayable to the holder of the security instrument. Therefore, the holder of the security instrument cannot enforce the security interest on the basis of a failure to perform the obligation under the promissory note.

This article begins by providing background on the structure of a mortgage and the parts of a residential real estate finance transaction from origination to sale on the secondary mortgage market, concluding with an explanation the remedy of foreclosure both judicially and by power of sale. It then explores two approaches to authority to foreclose issues that developed in the U.S. District Court for the Northern District of Georgia,[26] one emphasizing entitlement to the underlying obligation, and the other emphasizing contractual rights, concluding with an analysis of the Georgia Supreme Court's adoption of one approach. This article then prescriptively analyzes the two approaches and concludes that the "underlying obligation" approach is the more sound of the two, leading to the conclusion that "[a] mortgage may be enforced only by, or in behalf of, a person who is entitled to enforce the obligation the mortgage secures."[27] Next, this article examines the implications of the Georgia Supreme Court's adoption of the contractual rights approach, and compares the implications to those of adopting the underlying obligation approach.

THE STRUCTURE AND FORECLOSURE OF A MORTGAGE

The issues raised by division of the mortgage instruments necessitate a close examination of the fundamental elements of a mortgage. "A mortgage is a conveyance or retention of an interest in real property as security for performance of an obligation."[28] In its most basic form a mortgage is between two parties, a debtor (mortgagor) and a creditor (mortgagee), with respect to real property.[29] The creditor holds an obligation, the debtor's promise, as well as an instrument conveying to the creditor a security interest in real property .[30] Upon default on the obligation by the debtor, the creditor may sue upon the obligation itself, or use the security interest to foreclose upon and sell the property to satisfy part of or the entire obligation.[31] The obligation generally is evidenced by a promissory note and the property interest is evidenced by a security instrument.

The Obligation — The Promissory Note

A mortgage can secure any obligation — it is not necessary that the obligation be a promise to pay a specific amount of money at a specific time, only that the obligation can itself be reduced to a monetary amount. [32] In the majority of residential mortgage transactions, the obligation is created by a promissory note, which is the instrument that constitutes the obligation.[33] The promissory note commonly takes the form of a negotiable instrument.[34] A negotiable instrument is "an unconditional promise or order to pay a fixed amount of money…[that] is payable to bearer or to order [and]…is payable on demand or at a definite time."[35] A negotiable instrument must contain an unqualified promise, which leads to promissory notes intended to be negotiable only containing terms regarding when and how to pay the principal and interest due. [36] Negotiable instruments are used to facilitate transfer of the right to receive payment from the original lender to another party through a process known as negotiation, instrumental to the frequent changing of hands of the promissory note in the secondary mortgage market.[37] Payment of the sums due satisfies the promissory note.[38] A mortgage relationship secures the promise to pay that the promissory note creates by granting the lender a security interest in real property.

The Security Interest — The Security Instrument

The type of interest in real property that the secured party possesses varies from state to state,[39] as does the instrument that conveys it.[40] The instrument, as a document containing covenants and conveying an interest in property has characteristics of both a deed and of a contract. [41] As a deed, it transfers an interest in property as security for a debt, and as a contract it defines the rights and responsibilities of the parties.[42] Because it contains covenants, it is possible to be in default under the security instrument and not the underlying loan.[43] When the promissory note and security instrument are held by the same party, "acceleration is not only permitted for failure to pay the mortgage debt promptly, but also for defaults in mortgage covenants to pay taxes, to maintain insurance, to keep buildings intact, to maintain an adequate financial condition, to avoid the commission of waste, and the like."[44] In addition, the holder of the security instrument can make advancements for payments made on behalf of the borrower, and secure those sums with the security interest.[45]

Under state law, payment in full of the secured debt[46] terminates the property interest, and the grantee or the holder of the instrument is required to record the cancellation of the security instrument.[47]

Transfer of Mortgages by the Mortgagee

A mortgagee may transfer a mortgage without notice to or consent of the mortgagor.[48] Most residential mortgages are transferred at least once; few lenders retain a portfolio of mortgages.[49] A mortgage is composed of a promissory note and a security instrument, and different laws govern the transfer of the constituent parts.[50] If the promissory note is a negotiable instrument, to the extent that the state has adopted it, the Uniform Commercial Code ("U.C.C.") Article 3 prescribes the method of negotiation from one holder to another.[51] If not, contract law for assignment applies.[52] On the other hand, the security interest is an interest in real property, and is governed by state law for the transfer of property.[53] Because of the potential for problems that these differences could create if one of the instruments is mistakenly not transferred with the other, the Restatement (Third) of Property (Mortgages) (the "Restatement") provides that "[a] transfer of an obligation secured by a mortgage also transfers the mortgage…[and] [e]xcept as otherwise required by the Uniform Commercial Code, a transfer of a mortgage also transfers the obligation the mortgage secures."[54] In either case the parties may agree otherwise, meaning such provisions only govern cases where the parties did not intend for the instruments to be separated.[55]

The U.C.C. provision that the Restatement drafters refer to as "[requiring] otherwise" is U.C.C. section 3-203.[56] That section provides that "[a]n instrument is transferred when it is delivered by a person other than its issuer for the purpose of giving to the person receiving delivery the right to enforce the instrument."[57] To transfer possession, or "negotiate" a negotiable promissory note, the promissory note must be physically delivered to the transferee.[58] This negotiation vests in the transferee the status of "holder in due course."[59] A holder in due course is immune to nearly all contract defenses to enforcement, with the exception of a few listed under U.C.C. Article 3.[60]

This status is part of what makes the secondary mortgage market possible, as a transferee of a negotiated promissory note takes without worry of unenforceability due to satisfaction, lack of consideration, or any other contract defense other than the ones listed under U.C.C. Article 3.[61]

Procedural steps for these transfers are not simple formalities; failure to follow them can result in foreclosures being set aside.[62] The importance of properly transferring both the promissory notes and the security instruments is critical to a functioning secondary mortgage market.

Mortgages as Structured Finance — The Secondary Mortgage Market

The secondary mortgage market developed as a way of maintaining liquidity for mortgage lenders, allowing the loan originators to continue making loans and preventing them from being saddled with illiquid, long term mortgages.[63] Mortgages are sold by the originating lenders and bundled into mortgage backed securities, which are "asset-backed securit[ies] or debt obligation[s] that represent[] a claim on the cash flows from mortgage loans, most commonly — but by no means solely — loans on residential property."[64] Mortgages are bundled in a variety of ways, from the simple "pass-through" to the more complex "tranch" arrangements.[65]

Securitization involves several transfers of the mortgage. First, the originating lenders, or "sponsors" assemble a pool of mortgage loans. [66] Next, the sponsors sell the loans to a special-purpose subsidiary known as a "depositor" that has no assets or liabilities other than the bundle of mortgages, in order to separate the loans from the assets and liabilities of the sponsor.[67] Then, the depositor conveys the loans to a special kind of trust known as a single-purpose vehicle ("SPV") which issues certificated securities.[68] In theory, the trustee of the SPV conveys the physical promissory notes and security instruments to a document custodian, and a loan servicer is brought in to manage the mortgages.[69] This results in an interesting division of legal title to the loans themselves, with the legal title being held by the trustee of the SPV, and the beneficial title being held by the trust.[70] Investors are creditors of the trust, not beneficiaries or legal owners of the trust assets.[71]

The entire process and the operation of the trust are governed by a Pooling and Servicing Agreement ("PSA").[72] The PSA contains a Master Loan Schedule, which courts deciding foreclosures can use to determine if the mortgage in question was ever transferred to the trust.[73]

The securitization process involves several transfers of the mortgage, and in many states transfers of security instruments must be recorded.[74] This generally requires the transferee to "deliver a copy of the document in question (often executed in the presence of witnesses or a notary public) to a county clerk that time stamps, indexes, and files the document…[and pay] a fee, ranging from $25 to $50…."[75] A group of mortgage industry participants conceived of a more convenient electronic system which would not require the recording of assignments, later incorporated as the Mortgage Electronic Registration System ("MERS").[76] MERS originally operated by having the lender "list[] itself as the payee on the promissory note and as the mortgagee on the security instrument."[77] The lender would then assign the loan to a sponsor for securitization, but would record an assignment of the security instrument to MERS in the county records.[78] Later, MERS determined that it could further reduce transaction costs by having the original security instrument list MERS as the mortgagee.[79] MERS claims that it holds legal title to the mortgage as a "nominee" for the holder of the promissory note.[80] As a result of being the mortgagee of record, courts have required MERS to be the plaintiff in foreclosures, a result that MERS initially accepted by allowing servicers to bring actions in MERS's name.[81]

MERS's status as mortgagee of record and "nominee" for the lender makes it unclear whether MERS holds legal title to the security interest.[82] If it does, it results in separate ownership of the security instrument and the promissory note.[83] If it does not, then it should not be able to bring foreclosures in its own name, nor assign the security deed to a servicer to do so.[84] Due to these issues, MERS no longer authorizes foreclosures in its own name.[85]

The existence of the secondary market poses issues of mortgage ownership and authority by dividing ownership of the constituent parts of a mortgage, and foreclosing securitized mortgages presents further difficulties of proving authority to enforce the security interest.

Foreclosure of a Mortgage

Foreclosure is the process of extinguishing the mortgagor's equity of redemption and transferring the title of the property either to the mortgagee in a strict foreclosure or to the highest bidder at a foreclosure sale.[86] Judicial foreclosures are proceedings to foreclose in court with all of the procedure and formality of any lawsuit. [87] By contrast, a nonjudicial foreclosure, or power of sale foreclosure, is a contractual remedy with little or no court supervision.[88]

As both types of foreclosures are remedies, the requisite to a foreclosure is a default, or nonperformance of the secured obligation.[89] The security interest creates the foreclosure remedy through which a judicial cause of action arises or grants a nonjudicial power of sale,[90] while a breach under the promissory note[91] or the security instrument[92] may create the default. Authority to foreclose may also be limited by statutory law.[93]

Requirements of authority to conduct foreclosures differ in judicial and nonjudicial contexts. If a judicial foreclosure is brought in a federal court, the foreclosing plaintiff must comply with the federal doctrine of standing, which requires injury-in-fact, causation and redressability.[94] Many state courts have similar requirements.[95] Some courts have held that MERS lacks standing because as a non-lender, it has not suffered a default and therefore cannot demonstrate injury-in-fact.[96]

In nonjudicial foreclosure states, the borrower appoints either the lender or a trustee as agent to conduct a foreclosure sale on the borrower's behalf upon default.[97] Any transfer of this right by the lender or trustee must be with all of the formalities of the original security deed,[98] or any subsequent sale is subject to being set aside.[99]

In both types of jurisdictions, when pursuing a foreclosure due to a default on the promissory note, some courts have held that the foreclosing party must be able to demonstrate that the indebtedness exists and that it is entitled to enforcement. [100] The easiest way to do so is to produce the original promissory note.[101] However, if the note was lost, the foreclosing party may file a lost note affidavit pursuant to the U.C.C. [102]

A significant problem arises if the party seeking the foreclosure based on a default of the promissory note is not entitled to performance under the note. Some courts have held that if a foreclosing party is not the holder of the promissory note, it cannot foreclose a property on those grounds, even if there has been a default under the promissory note and the foreclosing party holds title to the security interest in the subject property.[103] Others have held that the fact that indebtedness exists coupled with default and proper assignment of the security interest is sufficient for a party to bring foreclosure.[104] The question is whether a party that is not entitled to recover a debt may nonetheless foreclose based on a failure to pay that debt.

AUTHORITY TO FORECLOSE — THE "UNDERLYING DEBT" AND "CONTRACT RIGHTS" THEORIES

A mortgage is given to secure an obligation, and foreclosure of a mortgage requires a default in that obligation.[105] If the party holds the security instrument but not the promissory note, it must be able to demonstrate that it has suffered a default in the obligation despite being unable to enforce the obligation.[106] The drafters of the Restatement saw the issue presented by separating the note from the security interest, and attempted to settle the issue by indicating that "[a] [security instrument] may be enforced only by, or in behalf of, a person who is entitled to enforce the obligation the [security instrument] secures."[107]

However, this approach has not been universally followed.[108] The result is that "a substantial question of what entity has the right to foreclose when the borrower defaults on the loan" arises.[109] That question hinges on whether a party that possesses a security instrument but does not possess the promissory note may foreclose upon the security instrument after a default under the promissory note. Until recently, federal courts in Georgia grappled with this issue with little clear guidance from Georgia state courts.[110] This has produced two divergent lines of cases,[111] which can be described as the "underlying debt theory" and the "contract rights" theory respectively. The contract rights theory holds that contractual agreement is sufficient to allow the holder of the security deed to exercise the remedy of foreclosure upon default under the note.[112] The underlying debt theory holds that if the holder of the security interest and the holder of the promissory note are not the same person, the holder of the security interest lacks authority to foreclose based on default of the underlying debt.[113] This part of the article will descriptively analyze the two approaches as well as the approach that the Georgia Supreme Court ultimately adopted, and the next part of this article will contend that other states facing the choice between these approaches should adopt the underlying debt theory.

The Underlying Debt Theory — The *Morgan* Approach

The underlying debt theory is the most in line with the Restatement approach. The theory was first explored by federal district court Judge Totenberg in *Morgan v. Ocwen Loan Servicing, LLC*.[114] In *Morgan*, the court was presented with the question of "whether an assignment of a security deed [to a loan servicer] empowers [it] to foreclose when [it] does not hold the note."[115] The court noted that "Georgia law authorizes the secured creditor, the holder of the obligation, to exercise a power of sale," and that the right to foreclose lies with the party that holds the indebtedness. [116] It held that because the loan servicer did not hold the indebtedness, the loan servicer wrongfully foreclosed upon the homeowner. [117]

The *Morgan* court was faced with a similar question in *Stubbs v. Bank of America*.[118] There, the court struggled with the definition of "secured creditor" as used in the Georgia Code.[119] Finding no express definition of the term "secured creditor" within Georgia statutes, the court gave the term its plain meaning.[120] "Thus, according to the plain language of the statute, the secured creditor — the entity to whom the debt is owed — is authorized to foreclose pursuant to Georgia's nonjudicial foreclosure statute."[121] To bolster its interpretation of the law, the court cited to the legislative amendments to the Georgia foreclosure laws of 2008,[122] which it reasoned were adopted to "mak[e] transparent both the identity of the secured creditor with authority to foreclose and the identity (and contact information) of the party with authority to agree to a loan modification."[123] It rejected the interpretation that "secured creditor" referred narrowly and solely to a "beneficiary or assignee of the security deed," noting that "such a definition would render the 2008 amendment of section 162 meaningless, for whatever entity is the grantee of record of the security deed would have authority to foreclose, just as it did prior to the amendment." [124] The court explained that "[s]ecured creditor must have a fixed definition in order for the amendment to have meaning, and [the] Court is bound to apply the presumption that the legislature did not intend to 'enact meaningless language.'"[125] It further held that foreclosure notices must contain the identity of the secured creditor because of "its bearing on the entity with authority to modify the loan." [126] It noted that "[m]isidentifying the secured creditor creates confusion and doubt regarding the identification of the entity with authority to modify."[127]

Though the *Stubbs* court struggled with state law statutory interpretation, the importance of defining "secured creditor" as the holder of the promissory note goes directly to the heart of the underlying debt theory. *Stubbs* stood for the proposition that if the holder of the security instrument does not have authority to enforce the secured obligation, the holder of the security instrument does not have authority to foreclose.[128] However, other Northern District of Georgia cases took the position that "secured creditor" refers to the holder of the security instrument when the two mortgage instruments are held by different parties, and thus reached a contrary conclusion.

The Contract Rights Theory — The *LaCosta* Approach

LaCosta v. McCalla Raymer[129] and *Chae Yi You v. JPMorgan Chase Bank, N.A.*,[130] were two Northern District of Georgia cases that expounded the "contract rights" theory.[131] This theory focuses on the fact that a security instrument is a contract, and that the mortgagor grants the right to foreclose to the holder of the security instrument in the contract, regardless of where the underlying debt resides.[132] The *LaCosta* court held that in the absence of case law proving otherwise, nothing prevented MERS, the record holder of the security deed, from foreclosing without holding the promissory note.[133] The court emphasized the terms of the contract as controlling, noting that "[i]t is clear that a security deed which includes a power of sale is a contract and its provisions are controlling as to the rights of the parties thereto and their privies."[134] Additionally it held that as a contract, security deeds are "to be construed…to effectuate the intent of the parties." [135] The court held that this required it to construe the contract in favor of allowing the exercise of the power of sale.[136]

The district court in *You* expanded this contractual argument, citing approval by the Eleventh Circuit.[137] It noted that case law in Georgia supports the proposition that the security deed "stands alone" and may be enforced even when an action on the underlying note is statutorily barred,[138] and therefore by analogy may be enforced when the security deed holder does not have any beneficial interest in the note.[139] In response to the underlying debt theory, the court noted that because a Georgia statute provides that "transfers of deeds to secure debt…shall be sufficient to transfer the property therein described and the indebtedness therein secured, whether the indebtedness in evidenced by a note or other instrument,"[140] when the security deed is transferred, "a sufficient interest in the underlying debt follows the deed to permit foreclosure by the deed holder."[141]

Reese — The Georgia Court of Appeals Weighs In

The conflict highlighted by *LaCosta* and *Morgan* remained primarily in federal court until the Georgia Court of Appeals confronted the issue in *Reese v. Provident Funding Associates.*[142] In that case, the homeowners executed a promissory note to a loan originator secured by a security deed conveying "an interest in the property and a power of sale in the event of a default."[143] However, the security deed designated its grantee as "Mortgage Electronic Registration Systems, Inc. ('MERS'), acting solely as the nominee for [the loan originator] and its successors and assigns…."[144] After the loan originator funded the loan, it sold the promissory note, but continued to service the loan.[145] At some point, the owners defaulted on the loan, and the loan originator sent a notice to the owners that it was initiating foreclosure proceedings after the owners failed to cure the default.[146] Notably, the loan originator "was not the holder of the Note, and the record reflects that MERS…[and not the loan originator] was the grantee of the Security Deed until [almost a month later]."[147] The owners brought suit for wrongful foreclosure, and argued that the loan servicer's notice did not comply with Georgia notice law.[148] They argued that the loan originator, who held neither the promissory note nor the security deed, was not the "secured creditor" that must send notice as required by state law.[149] The owners further argued that the notice was deficient because it never identified the secured creditor.[150] The trial court held that the loan originator's notice complied with the statute.[151] It adopted the reasoning in *LaCosta*, that "notice…provided by the secured creditor directly, or by its agent, is of no consequence."[152]

The Georgia Court of Appeals reversed the trial court. [153] It did not disagree that a "loan servicer may be permitted to send the notice on behalf of the secured creditor,"[154] but it agreed with the owners, that notices must contain the identity of the secured creditor.[155] In doing so, it expressly agreed with the *Stubbs* decision, that the thrust of the 2008 statutory amendments was to increase transparency in the foreclosure process.[156] The court explained that while the statute was facially unambiguous, it was ambiguous as applied to the facts of the case, "where a notice is sent by a third party other than the secured creditor and that third party misrepresents the identity of the true secured creditor." [157] The court noted that on those facts, it is ambiguous as to "whether the plain language of OCGA § 44–14–162.2(a) requires the notice to reflect both the identity of the secured creditor…[and] the person…with the full authority to negotiate, amend, and modify the mortgage.[158] Based on this statutory interpretation, it concluded that the statute requires notices of foreclosure to include the identity of the secured creditor to further the intention of transparency.[159] It explained that "a debtor has a right to know which entity has the authority to foreclose, and there should be no confusion about the identity of that entity."[160] Because the loan originator in *Reese* was not the secured creditor, the foreclosure notice identifying the loan servicer was not in compliance with Georgia law.[161]

While the *Reese* court would seem to have settled the dispute by adopting the *Morgan* line of cases, the decision actually created further questions about authority to foreclose. It was clear that the loan originator was not the secured creditor, as the loan originator held neither the promissory note nor the security instrument.[162] As noted in the *You* certified question order, "[a]lthough the opinion appeared to assume that the note holder would be deemed to be the secured creditor the court was not required to decide whether the deed holder could also fit that description, as the servicing agent clearly filled neither role."[163] The terminology changed, but the question remained: Who can foreclose when a mortgagor defaults on his loan?

You Revisited — The Georgia Supreme Court Adopts Contract Rights

In the *You* district court case, discussed above, Chief Judge Carnes certified three questions to the Georgia Supreme Court:[164]

(1) Can the holder of a security deed be considered a secured creditor, such that the deed holder can initiate foreclosure proceedings on residential property even if it does not also hold the note or otherwise have any beneficial interest in the debt obligation underlying the deed?

(2) Does OCGA § 44–14–162.2(a) require that the secured creditor be identified in the notice described by that statute?

(3) If the answer to the preceding question is "yes," (a) will substantial compliance with this requirement suffice, and (b) did defendant Chase substantially comply in the notice it provided in this case?[165]

The Georgia Supreme Court answered "yes" to the first question, and "no" to the second, rendering the third question moot.[166] The court began by explaining that "[t]he scant statutory law that does exist in this area has evolved as a means of providing limited consumer protection while preserving in large measure the traditional freedom of the contracting parties to negotiate the terms of their arrangement."[167] It noted that while the argument that a "secured creditor" must hold both the security deed (to be secured) and the promissory note (to be a creditor) has "superficial appeal," ultimately the language and intent of the Georgia statute required that it hold otherwise.[168] The court explained that it "has continued to recognize the stand-alone enforceability of the deed, apart from the note, thus reinforcing the ability of a deed holder to exercise its rights under the deed, independent of the note," referring to cases where the promissory note was unenforceable but enforcement of the security deed was allowed.[169] The court noted that "Georgia law governing the transfer of security deeds expressly provides that '[t]ransfers of deeds to secure debt…shall be sufficient to transfer the property therein described *and the indebtedness therein secured.*'"[170] The court expressly broke with the Restatement, holding that in Georgia a mortgage can be enforced by one who is not entitled to enforce the underlying obligation.[171] The court briefly addressed the possibility that double liability could result from two separate entities holding two separate remedies of enforcement for the same indebtedness, but in dicta noted that cases in Georgia have held that there is some equitable interest in the security held by the note holder which would prevent this.[172] Finally, the court held that the foreclosure statute does not require identifying the "secured creditor" in a foreclosure notice, overruling *Reese*.[173] The court explained that the statute only requires "the name, address, and telephone number of the individual or entity who shall have full authority to negotiate, amend, and modify all terms of the mortgage with the debtor" and that that person could be the security deed holder, the note holder, or "someone other than the deed holder or the note holder, such as an attorney or servicing agent."[174]

The Supreme Court of Georgia thus adopted the contract rights approach. Other courts are now facing this same issue,[175] and remainder of this article will contrast the Georgia approach (contract rights) with the Restatement approach (underlying debt) and examine the implications of adopting one approach or the other.

WHO HAS THE AUTHORITY TO FORECLOSE?

The Supreme Court of Georgia has ruled in favor of the contract rights approach, but this part of the article will explain why other jurisdictions should adopt the underlying debt approach. Because only a party holding the promissory note is entitled to repayment of the secured debt evidenced by the note, a party not holding the note cannot foreclose based on a breach of the promissory note. The underlying debt theory supports this conclusion. This part of the article will explore the shortcomings of the contract rights theory, and demonstrate why the underlying debt theory is the more sound theory.

Contract Rights Theory

A term in a contract cannot overcome the necessity that the holder of a security instrument has authority to enforce the promissory note in order to foreclose upon breach of the note. As an initial matter, "contract rights" is in some ways a misnomer, as a security instrument such as a security deed is a contract entered into for the purpose of securing a loan:

> This Security Instrument *secures to Lender*: (i) the repayment of the Loan, and all renewals, extensions and modifications of the Note; and (ii) the performance of Borrower's covenants and agreements under this Security Instrument and the Note. *For this purpose***,** Borrower does hereby grant and convey to Lender and Lender's successors and assigns, with power of sale, the following described property. . . .[176]

As a secondary matter, foreclosure is a remedy to allow for collection of the underlying debt, not a potential punishment to encourage cooperation by the borrower. The holder of the security instrument is no worse off after a breach of the promissory note than before, as in either case such an entity was not entitled to any of the money under the promissory note. A contract term cannot accomplish default on the obligation by specifying that holder will accelerate the promissory note and foreclose on the balance if the borrower misses payments — absent a defined agency relationship,[177] the holder of the security instrument does not have any legal rights to the promissory note, or to the debt evidenced by the note.[178]

Allowing the holder of one instrument to potentially affect the rights of the holder of the other may implicate the U.C.C. The Georgia Supreme Court identified two Georgia code sections that involve transfers of one of the instruments. The first was that "transfers of deeds to secure debt…shall be sufficient to transfer the property therein described and the indebtedness therein secured."[179] The court explained that this section "further supports the conclusion" that in Georgia, one may enforce the security without the underlying promissory note.[180] The second identified section was "'[t]he transfer of notes secured by a mortgage or otherwise conveys to the transferee the benefit of the security.'"[181] The court explained in dicta that this may prevent the holder of the note from suing on the note after the holder of the security instrument has foreclosed, due to an equitable interest in the security held by the note holder.[182]

Taken together, these seem to imply that the holder of each of the separated instruments has some sort of interest in the underlying interest created by the other instrument (the indebtedness and the security). This means that the indebtedness evidenced by a promissory note can be transferred or satisfied by someone other than the holder.

However, Georgia has adopted the U.C.C., which states that with regards to negotiable instruments, "[a]n instrument is transferred when it is delivered by a person other than its issuer for the purpose of giving to the person receiving delivery the right to enforce the instrument."[183] So, to the extent that the promissory note is a negotiable instrument,[184] the U.C.C. prevents transfers of the promissory note by such an operation of law. As to a note's potential satisfaction by the holder of the security deed, if the note is held subject to the possibility of satisfaction by nonjudicial foreclosure, it would no longer be an unqualified promise to pay as required of negotiable instruments by the U.C.C.,[185] as it would be "subject to or governed by another writing,"[186] namely the security deed. Rendering promissory notes non-negotiable was not likely the intent of the Georgia Supreme Court, as doing such would frustrate the purpose of adopting the U.C.C.[187] and potentially expose holders of notes to defenses from loan origination.[188]

Outside of Georgia, the position that transfers of the underlying obligation by operation of law are restricted by the U.C.C. is also embraced by the Restatement, which notes that "[e]xcept as otherwise required by the Uniform Commercial Code, a transfer of a mortgage also transfers the obligation the mortgage secures unless the parties to the transfer agree otherwise."[189] This provision can be read as only applying in cases of mistake where one instrument was not transferred, and as grounds to compel the transferor of one of the instruments to transfer the other.[190]

The contract rights theory also overlooks the fact that the sole purpose of the interest in land is to secure performance of an obligation.[191] The contractual terms simply dictate the particulars of the relationship. The terms of the contract cannot waive the rights to notice,[192] to the equity of redemption,[193] and to a foreclosure sale.[194] A foreclosure can be enforced only upon default, and a party only holding the security "can never suffer a default" on the loan.[195]

Underlying Debt Theory

The underlying debt theory emphasizes that a breach of the promissory note gives rise to a foreclosure only if the promissory note and security instrument are held by the same entity. One reason for adopting the underlying debt theory is that default of the promissory note gives rise to rights independent of the security instrument. The holder of the promissory note can proceed with an action upon the note independent of any action for foreclosure, and such an action is unavailable to the holder of the separated security instrument.[196]

In addition, the holder of the promissory note has certain rights independent of foreclosure that control the rights of the holder of the security instrument. The holder of the promissory note has the authority to mark a debt as satisfied,[197] and the duty to accept timely redemption.[198] In each case, the security interest is extinguished.[199] On the other hand, a foreclosure by a party holding only the security instrument may have no effect at all on the rights of a party holding the promissory note.[200]

There are significant policy reasons for adopting the underlying debt theory. The holder of the promissory note is in the best position to prove the existence of the debt, to prove the existence of a default in repayment of the debt, to accept repayment in full of the debt, and to negotiate a refinancing or modification of the debt.[201] A holder of security instrument lacks the authority to do any of these. In addition, there is a significant risk to the borrower if the holder of the security instrument does not deliver the proceeds of a foreclosure sale to the holder of the promissory note, an issue ultimately left unresolved by the Georgia Supreme Court.[202] The holder of the promissory note could attempt to collect on the full loan balance, a position that would be strengthened if the holder of the promissory note was a holder in due course as the result of a negotiation. [203] Such a transferee takes without worry of unenforceability due to partial or complete satisfaction under U.C.C. Article 3.[204] Anti-deficiency legislation may also not prevent such a result. Under Georgia law, the requirement of a confirmation may not bar a second action by the holder of the promissory note, as courts have held that in order for "a foreclosure sale…[to preclude] a judgment for the full amount of the note, the proceeds of the sale must have been transferred…to the creditor."[205]

It is arguable that only the holder of the underlying debt can suffer a default on the debt. An argument that a term in the contract can create sufficient rights to foreclose *for the balance due on the promissory note*, regardless of who holds the note disregards the purpose of the contract created by the security instrument. As shown by the terms of the security instrument itself, the purpose of the transfer of the interest in the borrower's real property is to secure repayment of the underlying debt to the holder of the security instrument.[206] If the holder of the security instrument is not entitled to this debt, the contract's purpose is not accomplished by allowing the holder to foreclose. However, this does not mean that a security interest can never be foreclosed if it is separated from a promissory note, only that the two instruments must be conveyed to a single entity first.

IMPLICATIONS

An entity holding the security instrument separated from a promissory note faces issues of enforceability in an underlying debt jurisdiction. Such issues may weigh on a court's decision of which theory to adopt. This final part of the article examines consequences of Georgia adopting the contract right's theory, as well as any impact of a jurisdiction adopting the underlying debt theory.

Issues Unresolved by *You*

The Georgia Supreme Court admittedly did not resolve the potential for double liability under the contract rights theory, as it was not present in that case.[207] Many borrowers now face uncertainty as to whether their debt has been satisfied, partially or fully, by foreclosure. Ensuring that foreclosures take place by entities who hold both the right to the security interest and to the underlying debt resolves these issues finally, conclusively proves the existence of the debt, and prevents double payouts for borrowers.

The court also granted certiorari to, vacated, and remanded *Reese*.[208] However, the servicer in that case held neither the security deed nor the note when it sent out the foreclosure notice,[209] yet only identified itself, as the lender, on the notice.[210] *You* held that the statute only requires "the name, address, and telephone number of the individual or entity who shall have full authority to negotiate, amend, and modify all terms of the mortgage with the debtor" and that that person could be the security deed holder, the note holder, or "someone other than the deed holder or the note holder, such as an attorney or servicing agent."[211] The Georgia Court of Appeals will thus have to decide on remand whether Provident held "full authority to negotiate, amend, and modify all terms of the mortgage" with the Reeses despite holding neither the security deed nor the promissory note.

The Implications of Adopting the Underlying Debt Theory

Georgia has adopted the contract rights theory to foreclosure enforcement, but other states such as Massachusetts have adopted the underlying debt theory,[212] and the question may spread to other jurisdictions.[213] Adopting the underlying debt theory poses its own issues. The effect that adopting the underlying debt theory will have on foreclosures brought by parties who cannot demonstrate a right to the underlying debt will differ in judicial and nonjudicial foreclosure states, but in both types of jurisdictions it should be a curable error. In judicial foreclosure states, where part of the foreclosing plaintiff's *prima facie* case is proving ownership of the loan, commentators have argued that courts should require the original note or transfer documents,[214] and that failure to prove assignment, or bringing foreclosures on behalf of unknown third parties should result in dismissal with leave to amend.[215] One such commentator has noted that "when the foreclosing financial institution could not prove it received a legal or authorized assignment [of the promissory note]…[courts] have unanimously stated that such foreclosures are improper and should be prevented from going forward,"[216] but cautioned that courts "should hesitate before giving too much credence to the neglected-assignment foreclosure defense as a tool to completely erase debt…[and] should always [dismiss] inadequate foreclosure filings, and proofs of claims [in bankruptcy], without prejudice and with leave to amend."[217]

In nonjudicial foreclosure states, the mortgagor must bring an action to enjoin or to set aside the foreclosure.[218] If the foreclosure sale has already proceeded, it will be defective. Defective powers of sale foreclosures fall into two categories — void and voidable.[219] Voidable sales pass bare legal title subject to redemption, while void sales pass no title "to the sale purchaser or subsequent grantee."[220] In situations "where the person foreclosing [does] not own the note," some courts outside of Georgia have held that the foreclosure is void, and can be set aside even against a bona fide purchaser.[221] In these cases, the foreclosure sale would have to be re–noticed, re–advertised, and re–conducted.

Contract Formalism Versus Fairness in Mortgages

Separation of the promissory note and the security instrument pose issues that are confined to a specific set of facts, but in a broader sense relate to a dispute between contract formalism and fairness in mortgages. The *LaCosta* court supplied a rule of construction that under Georgia law, security deeds are "to be construed [] to effectuate the intent of the parties," meaning in favor of allowing the exercise of the power of sale.[222] However, a countervailing statutory rule of construction is codified in Georgia law, which provides that "[p]owers of sale in deeds of trust, mortgages, and other instruments shall be strictly construed and shall be fairly exercised."[223] Such a rule of construction exists in other jurisdictions as well.[224] Courts in Georgia are challenged to enforce security instruments as written, while at the same time ensuring that powers of sale are "strictly construed and [] fairly exercised."[225] The end result is a balancing act where courts are told to ensure fairness while not interfering with the intent of the parties.[226]

Over the history of this country, mortgage lenders have developed ways to improve their position contractually, courts have either struck down or enforced these provisions,[227] and legislators have attempted to keep up by passing legislation such as requiring additional notice.[228] There are, however, certain aspects of a mortgage that simply cannot be avoided by contract.[229] Allowing foreclosure without proof of possessing the underlying obligation — the central object of the mortgage, must be one of them.[230]

CONCLUSION

The first Tuesday of this month, and of every month after that, between the hours of 10:00 A.M. and 4:00 P.M,[231] by public outcry on the steps of the one of the many Georgia courthouses, one out of every approximately four-hundred houses in the state of Georgia will be foreclosed upon.[232] Chief Justice Hunstein explained in *You* that the Georgia Supreme Court "is not blind to the plight of distressed borrowers, many of whom have suffered devastating losses brought on by the burst of the housing bubble and ensuing recession" and that "the continued ease with which foreclosures may proceed in this State gives [the court] pause, in light of the grave consequences foreclosures pose for individuals, families, neighborhoods, and society in general.[233] While the Reeses' story isn't over yet, [234] the *You* case was a major setback for homeowners like them, one that potentially only the Georgia General Assembly can resolve now.

The best way to protect the rights of homeowners is to require that if the holder of the security instrument is not the holder of the promissory note, the holder of the security instrument cannot enforce the security interest on the basis of a failure to perform the obligation under the note. Foreclosure is a remedy for an injury, and not a punishment for failure to keep up with payments. A party not holding the promissory note is not harmed when the note is breached. Without an injury to remedy, there are no grounds on which to justify the foreclosure.

The holder of the note has authority to negotiate the terms of the loan, and clearly identifying such a party may enable more distressed mortgagors to refinance rather than be foreclosed on.[235] Most importantly, the holder of the note is best able to prove that a debt exists. In cases where the holder of the note cannot be identified, allowing a foreclosure to take place prevents negotiations and perpetuates clouds on title.[236] The only way to avoid these problems is to prevent foreclosures conducted by mortgagees not entitled to the subject debt. The alternative is a remedy where there is no right.

NOTES

[1] Dan Immergluck, Foreclosed: High-Risk Lending, Deregulation, and the Undermining of America's Mortgage Market (2009); Michael Lewis, The Big Short: Inside the Doomsday Machine (2010).

[2] Patricia A. McCoy, *A Behavioral Analysis of Predatory Lending*, 38 Akron L. Rev. 725 (2005) [hereinafter "McCoy, *Behavioral Analysis*"]; Patricia A. McCoy et. al., *Systemic Risk Through Securitization: The Result of Deregulation and Regulatory Failure*, 41 Conn. L. Rev. 1327, 1335 (2009) [hereinafter "McCoy, *Systemic Risk*"]; Roy D. Oppenheim & Jacquelyn K. Trask-Rahn, *Deconstructing the Black Magic of Securitized Trusts: How the Mortgage-Backed Securitization Process Is Hurting the Banking Industry's Ability to Foreclose and Proving the Best Offense for A Foreclosure Defense*, 41 Stetson L. Rev. 745, 748–49 (2012).

[3] McCoy, *Systemic Risk*, *supra* note 2 at 1335.
[4] *Id.*
[5] David R. Greenberg, *Neglected Formalities in the Mortgage Assignment Process and the Resulting Effects on Residential Foreclosures*, 83 Temp. L. Rev. 253 (2010).
[6] Christopher Quinn, *Georgia fifth in completed foreclosures*, Atlanta J.-Const. (Jun. 29, 2012), http://www.ajc.com/news/business/georgia-fifth-in-completed-foreclosures/nQWs4/.
[7] 28 U.S.C. § 90 (2006); *Georgia Local Foreclosure Trends and Foreclosure Information*, RealtyTrac, http://www.realtytrac.com/trendcenter/ga-trend.html (last visited Sept. 26, 2012).
[8] *Georgia Local Foreclosure Trends and Foreclosure Information*, RealtyTrac, *supra* note 7.
[9] *U.S. Foreclosure Trends and Foreclosure Market Statistics*, RealtyTrac, http://www.realtytrac.com/trendcenter/trend.html (last visited Sept. 26, 2012).
[10] J. Scott Trubey, *Georgia's no-trial foreclosures mask problems, critics say* (Oct. 27, 2012), Atlanta J.-Const. http://www.ajc.com/news/business/georgias-no-trial-foreclosures-mask-problems-criti/nQmSQ/ ("In Georgia, lenders can foreclose in as few as 37 days, which is among the fastest in the nation. Industry officials say that figure is misleading, and that foreclosures take 241 days on average in Georgia from the date of last payment. The national average is 355 days.").
[11] *Reese v. Provident Funding Associates, LLP*, 730 S.E.2d 551, 552 (Ga. Ct. App. 2012), *vacated*, No. S12C2028 (Ga. May 20, 2013).
[12] *Id.* at 552–53.
[13] *Id.* ("Here, it is undisputed that at the time Provident sent the June 3, 2009, notice of the foreclosure sale, it was not the secured creditor.").
[14] *Id.* at 553 ("Provident admitted that it was not the holder of the Note, and the record reflects that MERS, and not Provident, was the grantee of the Security Deed until June 24, 2009. Rather, RFC was the secured creditor, i.e., owner of the loan, and Provident was merely the loan servicer.").
[15] *See infra*.
[16] *Reese*, 730 S.E.2d at 555.
[17] *Id.*
[18] Frank S. Alexander, Ga. Real Estate Finance and Foreclosure Law § 3:7 (2012-2013 ed.).
[19] *Id.* § 5:3.
[20] Elizabeth Renuart, *Property Title Trouble in Non-Judicial Foreclosure States: The Ibanez Time Bomb?*, 4 Wm. & Mary Bus. L. Rev. 111 (2013); Dale A. Whitman

& Drew Milner, *Foreclosing on Nothing: The Curious Problem of the Deed of Trust Foreclosure Without Entitlement to Enforce the Note*, 66 Ark. L. Rev. 21 (2013).

[21] ALEXANDER, *supra* note 18 § 3:7.

[22] *Single Family Security Deed*, FANNIEMAE.COM 2, https://www.fanniemae.com/content/legal_form/3011w.doc (last visited Jan. 21, 2013). The secured obligation can also include repayment of sums due under the security instrument. Such sums can arise due to advances by the holder of the security instrument, waste against the collateral, or failure of the homeowner to pay property taxes. *See* RESTATEMENT (THIRD) OF PROPERTY (MORTGAGES) §§ 2.1, 2.3 (1997). This article focuses on failures to repay of the debt evidenced by the promissory note, and does not challenge the authority of the holder of the security instrument to enforce the security interest based on a failure to repay debts arising under the security instrument, as addressed *infra*.

[23] The standard form security instruments refer to the party who receives a security interest as the "grantee" of the security instrument. This article will use the term "holder" instead of "grantee" or "assignee" to emphasize the fact that both the security instrument and the promissory note can and do change hands on multiple occasions, and that the rights the instruments create follow the holder of the respective instrument. *See infra*.

[24] *Single Family Security Deed*, FANNIEMAE.COM, *supra* note 22, at 2.

This Security Instrument secures to Lender: (i) the repayment of the Loan, and all renewals, extensions and modifications of the Note; and (ii) the performance of Borrower's covenants and agreements under this Security Instrument and the Note. For this purpose, Borrower does hereby grant and convey to Lender and Lender's successors and assigns, with power of sale, the following described property.… *Id.* at 2–3.

'Lender' is the grantee under this Security Instrument.

'Borrower' is the grantor under this Security Instrument.

'Loan' means the debt evidenced by the Note, plus interest, any prepayment charges and late charges due under the Note, and all sums due under this Security Instrument, plus interest. *Id.* at 1.

[25] U.C.C. § 3-104 (2002) ("negotiable instrument" means an unconditional promise or order to pay a fixed amount of money, with or without interest or other charges described in the promise or order, if it: (1) is payable to bearer or to order…."); *see also* RESTATEMENT (SECOND) OF CONTRACTS § 317 (1981) ("An assignment of a right is a manifestation of the assignor's intention to transfer it by virtue of which the assignor's right to performance by the obligor is extinguished

in whole or in part and the assignee acquires a right to such performance.").

[26] *See* text accompanying footnotes 7–9, *supra*.

[27] RESTATEMENT (THIRD) OF PROPERTY (MORTGAGES) § 5.4 (1997).

[28] *Id.* § 1.1. In this article, a "mortgage" refers to the promissory note and security instrument together, and not to any specific form of security instrument or interest in real property. For a discussion of some of the different types of security interests creditors may take in property in the historical context of Georgia law, see ALEXANDER, *supra* note 18 §§ 1:3–1:5, 2:4.

[29] RESTATEMENT (THIRD) OF PROPERTY (MORTGAGES) § 1.1 introductory cmt. (1997) ("In most cases the mortgage takes the form of a conveyance executed by the owner of the real estate to the secured party.").

[30] Frequently, the creditor has loaned the debtor the money to purchase the property in exchange for the debtor's promise to repay the loan, secured by the interest in the property. *See id.* § 7.2 ("In real estate transactions, it is common for a vendor of real estate to convey title to the purchaser, receive part of the purchase price in cash, and take back a mortgage on the real estate to secure a promissory note for the balance of the purchase price. Such a mortgage is frequently referred to as a 'vendor purchase money mortgage.'").

[31] *Id.* § 8.2.

[32] GRANT NELSON & DALE WHITMAN, REAL ESTATE FINANCE LAW § 2.2 (5th ed. 2007).

[33] *Id.* § 1.1.

[34] *Id.* § 5.28.

[35] U.C.C. § 3-104 (2002).

[36] U.C.C. § 3-106. *See, e.g.*, *Multistate Fixed Rate Note*, FREDDIEMAC.COM, http://www.freddiemac.com/uniform/doc/3200-MultistateFRNote.doc (last visited Jan. 21, 2013).

[37] U.C.C. § 3-203. *See infra*.

[38] U.C.C. § 3-603; RESTATEMENT (SECOND) OF CONTRACTS § 235 (1981).

[39] *See* ALEXANDER, *supra* note 18 § 1:1 ("[M]ost states during the nineteenth century developed either a "lien theory" or "title theory" approach to mortgages, with mortgages viewed either simply as liens or as involving the actual passage of legal title to the property….").

[40] *See id.* § 1:5 (discussing some of the different forms of transactional structures for real estate finance, and the fact that Georgia statutory law recognizes most of them).

[41] *See* BAXTER DUNAWAY, THE LAW OF DISTRESSED REAL ESTATE § 15:7 (2010 ed.);

see also, e.g. Single Family Security Deed, FANNIEMAE.COM, *supra* note 22.
[42] *See, e.g. Single Family Security Deed*, FANNIEMAE.COM, *supra* note 22.
[43] ALEXANDER, *supra* note 18 § 4:1 ("[B]reach of any contractual obligation may give rise to acceleration and foreclosure if the security documents specify the availability of such remedy").
[44] RESTATEMENT (THIRD) OF PROPERTY (MORTGAGES) § 8.1 (1997).
[45] *See id.* §§ 2.1, 2.3.
[46] This includes sums due under the security instrument. *See* RESTATEMENT (THIRD) OF PROPERTY (MORTGAGES) § 8.1.
[47] *E.g.* GA. CODE ANN. § 44-14-67 (2012); RESTATEMENT (THIRD) OF PROPERTY (MORTGAGES) § 6.4, *Statutory Table Mortgage Discharge Penalties* (listing state statutes that indicate "the event that initiates the grace period allowed for the mortgagee to provide or record a satisfaction, the duration of the period, and the penalty that attaches if the mortgagee fails to comply."); *see also* ALEXANDER, *supra* note 18 § 6:4.
[48] *See* NELSON AND WHITMAN, *supra* note 32 §§ 5.27, 5.33.
[49] *See id.* §5.34 ("During the past several decades it has become increasingly common for a mortgage loan to be transferred on the secondary market, not just once, but perhaps several times during its lifetime.").
[50] ALEXANDER, *supra* note 18 § 5:3.
[51] U.C.C. § 3-203 (2002).
[52] *See* RESTATEMENT (SECOND) OF CONTRACTS § 317 (1981).
[53] *See* U.C.C. § 9-109(d) (2000) (noting inapplicability of U.C.C. Article 9 (secured transactions) to "the creation or transfer of an interest in or lien on real property.").
[54] RESTATEMENT (THIRD) OF PROPERTY (MORTGAGES) § 5.4 (1997).
[55] *Id*; *see infra*.
[56] RESTATEMENT (THIRD) OF PROPERTY (MORTGAGES) § 5.4 (1997) cmt. c ("If the mortgage obligation is a negotiable note, Uniform Commercial Code § 3-203 (1995) is generally understood to make the right of enforcement of the note transferrable only by delivery of the instrument itself to the transferee.").
[57] U.C.C. § 3-203 (2002).
[58] *Id.* § 3-201 ("[N]egotiation requires transfer of possession of the instrument and its indorsement by the holder.").
[59] *Id.* § 3-302.
[60] *Id.* § 3-305(b).
[61] *Id.* § 3-305(b) (listing "(i) infancy…, (ii) duress, lack of legal capacity, or

illegality of the transaction…, (iii) fraud…, or (iv) discharge of the obligor in insolvency proceedings").

[62] *See* Greenberg, *supra* note 5, at 254; Renuart, *supra* note 20.

[63] LEMKE, ET AL., MORTGAGE-BACKED SECURITIES § 1:1 (2012 ed.).

[64] *Id.*

[65] *Id.* This article will not go into depth explaining the different varieties of mortgage backed securities. For more background, see generally *id.* (providing "an overview of some of the key concepts and other background information" behind mortgage backed securities); Oppenheim & Trask-Rahn, *supra* note 2, at 748–49 (critiquing the mortgage backed securitization process).

[66] Adam J. Levitin & Tara Twomey, *Mortgage Servicing*, 28 YALE J. ON REG. 1, 13 (2011).

[67] *Id.*

[68] *Id.* at 14. The SPV, in the case of private-label securitizations, is generally a real estate mortgage investment conduit ("REMIC") for tax purposes. Adam J. Levitin & Tara Twomey, *Mortgage Servicing*, 28 YALE J. ON REG. 1, 14 n.35 (2011). Securities may be divided into "tranches" based on the level of risk the bundled mortgages present, and credit-rating agencies assign different credit ratings to the different tranches. *See generally* Roy D. Oppenheim & Jacquelyn K. Trask-Rahn, *Deconstructing the Black Magic of Securitized Trusts: How the Mortgage-Backed Securitization Process Is Hurting the Banking Industry's Ability to Foreclose and Proving the Best Offense for A Foreclosure Defense*, 41 STETSON L. REV. 745, 754–55 (2012) (outlining the process by which mortgages are rated based on risk and assigned credit ratings, and critiquing the process based on the uncertainty of measuring the quality and value of mortgages).

[69] Levitin & Twomey, *supra* note 66, at 14 n.35.

[70] *Id.* at 16.

[71] *Id.*

[72] Oppenheim & Trask-Rahn, *supra* note 2, 756–57 (2012) (*citing* Levitin & Twomey, *supra* note 66, at 31–32).

[73] *Id.* at 757.

[74] *E.g.* GA. CODE ANN. § 44-14-64 (2012).

[75] Christopher L. Peterson, Foreclosure, *Subprime Mortgage Lending, and the Mortgage Electronic Registration System*, 78 U. CIN. L. REV. 1359, 1365 (2010).

[76] *Id.* at 1368–69.

[77] *Id.* at 1370.

[78] *Id.*

[79] *Id.* at 1371 ("By eliminating the reference to an actual mortgagee or the actual assignee, MERS estimated it would save the originator an average of $22.00 per loan.").
[80] *Id.* at 1374–75 (2010). *See also* ALEXANDER, *supra* note 18 § 5:4 ("MERS litigation throughout the country reveals widespread disagreement over what type of authority is conferred as a result of MERS' self-imposed title of 'nominee.'").
[81] Peterson, *supra* note 75, at 1372. *But see* ALEXANDER, *supra* note 18 § 5:4 ("Fannie Mae has expressly directed that foreclosures not be brought in the name of MERS in any mortgage held by Fannie Mae or in a pool securitized by Fannie Mae.").
[82] Peterson, *supra* note 75, at 1374–75.
[83] *Id.* at 1379.
[84] *Id.* at 1385.
[85] *Cf. MERS® System Process Internal Controls and Quality Assurance Plan General Members*, MERS, INC. 20, http://www.mersinc.org/component/docman/doc_download/200-qa-plan-general-template-v2-1-final-secured ("For foreclosures initiated in the name of MERS, (allowed prior to July 22, 2011)….") (last visited Feb. 17, 2013).
[86] RESTATEMENT (THIRD) OF PROPERTY (MORTGAGES) §§ 6.4 cmt. a, 8.2 (1997); NELSON & WHITMAN, *supra* note 32 § 7.9. A successful foreclosure also cuts off rights of parties having junior interests in the land. DUNAWAY, *supra* note 41 § 15:2.
[87] *See* ALEXANDER, *supra* note 18 § 7:2.
[88] *Id.* § 8:1.
[89] RESTATEMENT (THIRD) OF PROPERTY (MORTGAGES) § 8.2 (1997); *see also* Remedy, BLACK'S LAW DICTIONARY (9th ed. 2009). ("The means of enforcing a right or preventing or redressing a wrong; legal or equitable relief.").
[90] RESTATEMENT (THIRD) OF PROPERTY (MORTGAGES) § 8.2 (1997). Certain state laws require the lender to pursue the foreclosure first. *See id* Reporters' Note.
[91] *E.g. Multistate Fixed Rate Note*, FREDDIEMAC.COM, *supra* note 36, at 2 ("If I do not pay the full amount of each monthly payment on the date it is due, I will be in default.").
[92] *See* DUNAWAY, *supra* note 41 § 15:7 ("[F]or example, the agreement to pay taxes, to insure, and to keep the property in good condition and repair."). If the same entity holds the promissory note and security instrument, a default under the promissory note is also default under the security instrument. *E.g. Multistate Fixed Rate Note*, FREDDIEMAC.COM, *supra* note 36, at 3. In addition, security

instruments often contain cross-default and due on sale provisions. *Single Family Security Deed*, FANNIEMAE.COM, *supra* note 22 at 12-13.
[93] RESTATEMENT (THIRD) OF PROPERTY (MORTGAGES) § 8.1 (1997).
[94] Peterson, *supra* note 75, at 1381.
[95] *See, e.g.*, GA. CODE ANN. § 9-11-17(a) (2012).
[96] *See, e.g.*, *In re Foreclosure Cases*, 521 F. Supp. 2d 650 (N.D. Ohio 2007); *but see, e.g.*, *Trent v. Mortgage Electronic Registration Systems, Inc.*, 288 Fed. Appx. 571 (11th Cir. 2008).
[97] *See* NELSON & WHITMAN, *supra* note 32 § 7.19. Under Georgia law, "[u]nless the instrument creating the power specifically provides to the contrary, a personal representative, heir, heirs, legatee, devisee, or successor of the grantee, or an assignee" may exercise a power of sale on behalf of the lender. GA. CODE ANN. § 23-2-114.
[98] *Williams v. Joel*, 79 S.E.2d 401, 405 (1953).
[99] *See* ALEXANDER, *supra* note 18 § 5:3 (*citing In re Cummings*, 173 B.R. 959 (Bankr. N.D. Ga. 1994), *Cary v. Guiragossian*, 270 Ga. 192, 508 S.E.2d 403 (1998) & *Jackman v. Hasty*, 2011 WL 854878 (N.D. Ga. 2011)).
[100] *See* Alan M. White, *Losing the Paper — Mortgage Assignments, Note Transfers and Consumer Protection*, 24 LOY. CONSUMER L. REV. 468, 503 (2012) (*citing Wells Fargo Bank, N.A. v. Marchione*, 69 A.D.3d 204, 887 N.Y.S.2d 615 (App. Div., 2009), *Wells Fargo Bank, N.A. v. Byrd*, 897 N.E.2d 722 (Ohio Ct. App. 2008) & *Morgan v. HSBC Bank, USA, NA*, No. 2009-CA-000597-MR, 2011 WL 3207776 (Ky. Ct. App. July 29, 2011)).
[101] *See* White, *supra* note 100, at 503.
[102] U.C.C. § 3-312. The abuse of these affidavits in situations where the affiant had no actual knowledge of whether the original note existed or was assigned came to be known as "robosigning." Anita Lynn Lapidus, *What Really Happened: Ibanez and the Case for Using the Actual Transfer Documents*, 41 STETSON L. REV. 817, 818 (2012). Forty-nine state attorneys general recently reached a settlement with five large mortgage servicers over the practice. Todd J. Zywicki, *The "Robo-Signing" Settlement: Seeds of Recovery, Or Chaos?* FORBES.COM (9:37 PM Feb. 2, 2012) http://www.forbes.com/sites/realspin/2012/02/20/the-robo-signing-settlement-seeds-of-recovery-or-chaos/.
[103] *See* NELSON & WHITMAN *supra* note 32 § 5.27 (*citing 5-Star Management, Inc. v. Rogers*, 940 F.Supp. 512 (E.D.N.Y.1996), *Matter of Ascot Mortg., Inc.*, 153 B.R. 1002 (Bankr.N.D.Ga.1993), *Associates of Selma, Inc. v. Whetstone*, 628 So.2d 578 (Ala.1993) & *South Carolina Nat'l Bank v. Halter*, 293 S.C. 121, 359 S.E.2d 74

(App.1987)).
104 *You v. JP Morgan Chase Bank, N.A., et al.*, No. S13Q0040, 2013 WL 2152562 (Ga. May 20, 2013)
105 Restatement (Third) of Property (Mortgages) § 8.1 (1997).
106 *But see* Restatement (Third) of Property (Mortgages) § 5.4 ("Since the obligation is not enforceable by [the holder of the security instrument], [such entity] can never suffer a default and hence cannot foreclose the mortgage.").
107 Restatement (Third) of Property (Mortgages) § 5.4.
108 *Chae Yi You v. JPMorgan Chase Bank, N.A.*, No. 1:12-CV-202-JEC-AJB, 2012 WL 3904363, at *6 (N.D. Ga. Sept. 7, 2012), *certifying questions to* No. S13Q0040 (Ga. May 20, 2013) ("[A] split of authority has developed as to whether a deed holder who does not also possess the note can validly institute foreclosure proceedings under Georgia law."); *You v. JP Morgan Chase Bank, N.A., et al.*, No. S13Q0040, 2013 WL 2152562 (Ga. May 20, 2013) (answer to certified questions).
109 *Morgan v. Ocwen Loan Servicing, LLC*, 795 F. Supp. 2d 1370, 1375 (N.D. Ga. 2011).
110 *See, e.g.*, *You*, No. 1:12-CV-202-JEC-AJB, 2012 WL 3904363 ("[T]he remaining two arguments raise important and unsettled questions of state law"); Ashby Kent Fox, *et al.*, *Foreclosure Law in the Wake of Recent Decisions on Residential Mortgage Loans: The Situation In Georgia*, Pratt's J. Bankr. L. 2013.03-2 (Feb./Mar. 2013).
111 *Id.* at *6 (N.D. Ga. Sept. 7, 2012) ("[A] split of authority has developed as to whether a deed holder who does not also possess the note can validly institute foreclosure proceedings under Georgia law.").
112 *LaCosta v. McCalla Raymer, LLC*, No. 110-CV-1171-RWS, 2011 WL 166902 (N.D. Ga. Jan. 18, 2011) (unreported). The "underlying debt" cases do not deny the rights of parties to contract freely, however the terminology "contract rights" was selected based on the rationale the cases used. *See, e.g.*, *id.*
113 *See Morgan v. Ocwen Loan Servicing, LLC*, 795 F. Supp. 2d 1370, 1376 (N.D. Ga. 2011).
114 795 F. Supp. 2d 1370, 1376 (N.D. Ga. 2011) (Totenberg, J.).
115 *Id.*
116 *Id.* (*citing Weems v. Coker*, 70 Ga. 746, 749 (1883); *In re Truitt*, 11 B.R. 15 (Bankr.N.D.Ga.1981); *Bowen*, 438 S.E.2d at 122; *Boaz*, 580 S.E.2d at 578; *Cummings v. Anderson*, 173 B.R. 959, 963 (Bankr.N.D.Ga.1994) & *Weston v. Towson*, No. 5:04–CV–416, 2006 WL 2246206, at *6 (M.D.Ga. Aug. 4, 2006)).

[117] *Id.* Interestingly, the foreclosure had not actually occurred yet, but the court held that a wrongful attempted foreclosure was sufficient to grant the relief requested, which was injunctive relief against the loan servicer. *Morgan v. Ocwen Loan Servicing, LLC*, 795 F. Supp. 2d 1370, 1377 (N.D. Ga. 2011).
[118] 844 F. Supp. 2d 1267, 1270 (N.D. Ga. 2012).
[119] GA.CODE ANN. § 44-14-162.3 (2012).
[120] *Stubbs v. Bank of Am.*, 844 F. Supp. 2d 1267, 1270 (N.D. Ga. 2012).
[121] *Id.*
[122] *Id.* (*citing* GA. CODE ANN. § 44-14-162.3(c) (2012); 2008 Georgia Laws Act 576 (S.B. 531)).
[123] *Id.*
[124] *Id.* at 1272 (*citing Osborne Bonding & Surety Co. v. Georgia*, 481 S.E.2d 578, 579 (Ga. Ct. App. 1997)).
[125] *Id.* (*citing Osborne*, 481 S.E.2d at 579).
[126] *Stubbs*, 844 F. Supp. 2d at 1272.
[127] *Id.*
[128] *Id.* (defining "secured creditor" with authority to foreclose as the holder of the promissory note).
[129] No. 110-CV-1171-RWS, 2011 WL 166902 (N.D. Ga. Jan. 18, 2011) (unreported).
[130] No. 1:12-CV-202-JEC-AJB, 2012 WL 3904363 (N.D. Ga. Sept. 7, 2012).
[131] *You* did not hold for one approach or another, but rather certified a question to the Georgia Supreme Court to resolve the dispute. *See You*, No. 1:12-CV-202-JEC-AJB, 2012 WL 3904363. *You* was certified after *Reese*, *infra*, but is examined first because it summarized the development of the contract rights line of cases from *LaCosta* to *Reese*.
[132] *LaCosta v. McCalla Raymer, LLC*, No. 110-CV-1171-RWS, 2011 WL 166902 (N.D. Ga. Jan. 18, 2011) ("Plaintiff unequivocally granted MERS the power to sell the Property if she were not able to comply with the terms of the Note.").
[133] *Id.* at *4–5.
[134] *Id.* (*citing Gordon v. S. Cent. Farm Credit, ACA*, 446 S.E.2d 514, 515 (Ga. Ct. App.1994).
[135] *Id.* at *5 (*citing Kennedy v. Gwinnett Commercial Bank*, 270 S.E.2d 867 (Ga. Ct. App. 1980)).
[136] *Id.* (*citing Kennedy*, 270 S.E.2d at 867).
[137] *Chae Yi You v. JPMorgan Chase Bank, N.A.*, No. 1:12-CV-202-JEC-AJB, 2012 WL 3904363 (N.D. Ga. Sept. 7, 2012) , at *5. *certifying questions to* No.

S13Q0040 (Ga. May 20, 2013) (*citing Smith v. Saxon Mortg*., 446 F. App'x 239 (11th Cir. 2011)).
[138] *Id.* (*citing Brinson v. McMillan*, 263 Ga. 802, 440 S.E.2d 22 (1994)).
[139] *Id.*
[140] GA.CODE ANN. 44-14-64(b) (2012).
[141] *You*, No. 1:12-CV-202-JEC-AJB, 2012 WL 3904363 (*citing Kabir v. Statebridge Co., LLC*, No. 1:11–cv–2747–WSD, 2011 WL 4500050, at *5 (N.D.Ga.2011) (unpublished); *In re Corley*, 447 B.R. 375, 383 (S.D.Ga.2011)).
[142] 730 S.E.2d 551 (Ga. Ct. App. 2012).
[143] *Reese*, 730 S.E.2d, at 551.
[144] *Id.* at 551–552.
[145] *Id.* at 552.
[146] *Id.*
[147] *Id.* at 553.
[148] *Id.* at 552 (*citing* GA. CODE ANN § 44-14-162.2 (2012)). Section 44-14-162.2 provides that "[n]otice of the initiation of proceedings to exercise a power of sale in a mortgage, security deed, or other lien contract shall be given to the debtor by the secured creditor no later than 30 days before the date of the proposed foreclosure."
[149] *Id.*
[150] *Id.*
[151] *Reese v. Provident Funding Associates, LLP*, No. 09-1-7378-34 (Ga. Super. Ct. Cobb County Aug. 16, 2011), *rev'd by* 730 S.E.2d 551 (Ga. Ct. App. 2012).
[152] *Id.* slip op. at 4 (*quoting LaCosta v. McCalla Raymer, LLC*, No. 110-CV-1171-RWS, 2011 WL 166902 (N.D. Ga. Jan. 18, 2011) (unreported)).
[153] *Reese*, 730 S.E.2d at 554.
[154] *Id.*
[155] *Id.*
[156] *Id.* (*citing Stubbs v. Bank of Am*., 844 F. Supp. 2d 1267, 1270–71 (N.D. Ga. 2012); Ga. L. 2008, Act 576).
[157] *Id.* at 553.
[158] *Id.*
[159] *Id.*
[160] *Id.*
[161] *Id.*
[162] *Id.*
[163] *Chae Yi You v. JPMorgan Chase Bank, N.A.*, No. 1:12-CV-202-JEC-AJB, 2012

WL 3904363 (N.D. Ga. Sept. 7, 2012), *certifying questions to* No. S13Q0040 (Ga. May 20, 2013) (*citing Reese*, 730 S.E.2d at 553) (footnotes omitted).
[164] *You*, No. 1:12-CV-202-JEC-AJB, 2012 WL 3904363, *certifying questions to* No. S13Q0040 (Ga. May 20, 2013).
[165] *You v. JP Morgan Chase Bank*, No. S13Q0040, 2013 WL 2152562 (Ga. May 20, 2013).
[166] *Id.* slip op. at *1–2.
[167] *Id.* at *2.
[168] *Id.*
[169] *Id.* at *3 (*citing Decatur Federal Sav. and Loan v. Gibson,* 489 S.E.2d 820 (1997) for unenforceable notes and *Brinson v. McMillan,* 440 S.E.2d 22 (1994) for statute barred notes).
[170] *Id.* at *5 (*citing* GA. CODE. ANN. § 44–14–64(b) (2012)) (emphasis in original).
[171] *Id.*
[172] *Id.*
[173] *Id.* at *6.
[174] *Id.* (*citing* GA. STAT. § 44–14–162.2(a))
[175] Renuart, *supra* note 20; Whitman & Milner, *supra* note 20.
[176] *Single Family Security Deed*, FANNIEMAE.COM, *supra* note 22.
[177] *Cf.* RESTATEMENT (THIRD) OF PROPERTY (MORTGAGES) § 5.4 (1997).
[178] RESTATEMENT (THIRD) OF PROPERTY (MORTGAGES) § 5.4 (1997).
[179] *You*, No. S13Q0040, 2013 WL 2152562, at *5 (*citing* GA. CODE ANN. 44-14-64(b) (2012)).
[180] *Id.*
[181] *Id.* (*citing* GA. CODE. ANN. § 10–3–1).
[182] *Id.*
[183] GA. CODE ANN. § 11-3-203 (2012). *See also* GA. CODE ANN. § 11-3-201 ("[I]f an instrument is payable to an identified person, negotiation requires transfer of possession of the instrument and its indorsement by the holder.").
[184] *See* ALEXANDER, *supra* note 18, § 5:3 ("[A] note is a contractual obligation most commonly in the form of a negotiable instrument….") (internal parentheses omitted).
[185] Ga. Code Ann. § 11-3-104 (2012) ("'[N]egotiable instrument' means an unconditional promise or order to pay a fixed amount of money….").
[186] GA. CODE ANN. § 11-3-106 (2012).
[187] *See* U.C.C. § 1-103 (2011) ("[The Uniform Commercial Code] must be liberally construed and applied to promote its underlying purposes and policies…

[including] to make uniform the law among the various jurisdictions.”).
[188] *See supra*.
[189] RESTATEMENT (THIRD) OF PROPERTY (MORTGAGES) § 5.4.
[190] *See* ALEXANDER, *supra* note 18, § 5:3 (“The thrust of these provisions is to permit a transferee of one instrument to compel the transfer of the other instrument in the absence of evidence that the intention of the parties was contrary.”) (*citing* RESTATEMENT (THIRD) OF PROPERTY (MORTGAGES) § 5.4).
[191] “The note is the cow and the mortgage the tail. The cow can survive without a tail, but the tail cannot survive without the cow.” RESTATEMENT (THIRD) OF PROPERTY (MORTGAGES) § 5.4 reporter’s n. (*citing Best Fertilizers of Arizona, Inc. v. Burns*, 571 P.2d 675, 676 (Ariz.Ct.App.1977)).
[192] GA. CODE ANN. § 44-14-162.3 (2012).
[193] ALEXANDER, *supra* note 18, § 6:1 n.3 (2012-2013 ed.) (“In general any provision in the mortgage at its inception which takes away the right of the mortgagor to exercise his equity of redemption is void.”) (*citing Bromley v. Bromley*, 127 S.E.2d 836, 840 (Ga. App. 1962), *Lewis Broadcasting Corp. v. Phoenix Broadcasting Partners*, 502 S.E.2d 254 (Ga. App. 1998)).
[194] ALEXANDER, *supra* note 18, § 6:1 n.4 (“For all practical purposes, Georgia has never recognized and does not permit strict foreclosure.”) (*citing Hodsdon v. Whitworth*, 266 S.E.2d 561 (Ga. App. 1980)).
[195] *See* RESTATEMENT (THIRD) OF PROPERTY (MORTGAGES) § 5.4 cmt e.
[196] *Id.* § 8.2. *See also* ALEXANDER, *supra* note 18, § 3:7.
[197] *See* DUNAWAY, *supra* note 41, § 3B:8 (short sales).
[198] RESTATEMENT (THIRD) OF PROPERTY (MORTGAGES) § 6.4 (1997).
[199] *Id.*
[200] *See* GA. CODE ANN. § 11-3-305 (2012) (listing defenses against a holder in due course).
[201] *See Stubbs v. Bank of Am.*, 844 F. Supp. 2d 1267, 1271-72 (N.D. Ga. 2012) (“The identity of the secured creditor is material because of its bearing on the entity with authority to modify the loan. Misidentifying the secured creditor creates confusion and doubt regarding the identification of the entity with authority to modify.”)
[202] *You v. JP Morgan Chase Bank*, No. S13Q0040, 2013 WL 2152562, at *5 (Ga. May 20, 2013) (“Appellants contend that if [the holder of the security instrument] is permitted to exercise the power of sale, Appellants will be at risk of double liability because the note holder will still have the right to sue for default under the note. We do not believe the law necessarily allows such a result….

Because this issue is not directly presented here, however, we need not resolve it.").

[203] U.C.C. § 3-302 (2002).

[204] U.C.C. § 3-305(b) (listing "(i) infancy…, (ii) duress, lack of legal capacity, or illegality of the transaction…, (iii) fraud…, or (iv) discharge of the obligor in insolvency proceedings" as the only valid defenses against a holder in due course).

[205] *Fed. Deposit Ins. Corp. v. Dye*, 642 F.2d 837, 843 (5th Cir. Unit B Apr. 1981).

[206] *See supra*.

[207] *See supra*.

[208] *Provident Funding Associates, LLP v. Reese*, No. S12C2028 (Ga. May 20, 2013).

[209] *Reese v. Provident Funding Associates, LLP*, 730 S.E.2d 551, 552–53. (Ga. Ct. App. 2012), *vacated*, No. S12C2028 (Ga. May 20, 2013). ("Here, it is undisputed that at the time Provident sent the June 3, 2009, notice of the foreclosure sale, it was not the secured creditor.…Provident admitted that it was not the holder of the Note, and the record reflects that MERS, and not Provident, was the grantee of the Security Deed until June 24, 2009. Rather, RFC was the secured creditor, i.e., owner of the loan, and Provident was merely the loan servicer.").

[210] *Id.* at 553 ("[T]he notice misidentified Provident as the holder of the Note and the Security Deed…[and] the notice misidentified Provident as the "Lender," rather than as the loan servicer. Indeed, the notice made no mention whatsoever of RFC, the secured creditor, resulting in a complete failure to properly reflect that the notice was sent by, or on behalf of, the proper secured creditor.").

[211] *Id.* (*citing* GA. STAT. § 44–14–162.2(a))

[212] *See U.S. Bank Nat. Ass'n v. Ibanez*, 458 Mass. 637, 647, 941 N.E.2d 40, 50 (2011) ("One of the terms of the power of sale that must be strictly adhered to is the restriction on who is entitled to foreclose.").

[213] Whitman & Milner, *supra* note 20.

[214] Lapidus, *supra* note 102.

[215] *See* Greenberg, *supra* note 5.

[216] *Id.* at 278.

[217] *Id.* at 291.

[218] *See, e.g.* ALEXANDER, *supra* note 18, § 8:10.

[219] NELSON & WHITMAN, *supra* note 32, § 7.20.

[220] *Id.*

[221] *Id.* (*citing Williams v. Kimes*, 996 S.W.2d 43, 45 (Mo. 1999). *See also U.S. Bank Nat. Ass'n v. Ibanez*, 941 N.E.2d 40, 50 (Mass. 2011) ("Any effort to foreclose by a party lacking "jurisdiction and authority" to carry out a foreclosure…is

void."); *Bevilacqua v. Rodriguez*, 955 N.E.2d 884, 893 (Mass. 2011) (extending *Ibanez* and noting that "[b]y alleging that [the foreclosing party] was not the assignee of the mortgage at the time of the purported foreclosure, [the foreclosure sale purchaser] is necessarily asserting that the power of sale was not complied with, that the purported sale was invalid…."). *See generally* Renuart, *supra* note 20 (examining *Ibanez* and *Bevilacqua* and the potential for the rationale for the decisions to spread to other states).

[222] *LaCosta v. McCalla Raymer, LLC*, No. 110-CV-1171-RWS, 2011 WL 166902 (N.D. Ga. Jan. 18, 2011) (unreported), at *5 (*citing Kennedy v. Gwinnett Commercial Bank*, 270 S.E.2d 867 (Ga. Ct. App. 1980)).

[223] GA. CODE ANN., § 23-2-114.

[224] *See U.S. Bank Nat. Ass'n v. Ibanez*, 458 Mass. 637, 647, 941 N.E.2d 40, 50 (2011) ("One of the terms of the power of sale that must be strictly adhered to is the restriction on who is entitled to foreclose.").

[225] GA. CODE ANN., § 23-2-114.

[226] *See* ALEXANDER, *supra* note 18, § 8:1 ("Men have a right to do with their own as they will, and the law ought not to be concerned to limit that right, unless it be very plain.") (*quoting Calloway v. People's Bank of Bellefontaine*, 54 Ga. 441, 449, 1875 WL 3084 (1875) (internal quotations omitted).

[227] *Id.* § 1:3.

[228] *See, e.g.*, 2008 Georgia Laws Act 576 (S.B. 531).

[229] GA. CODE ANN. § 44-14-162.3 (notice); ALEXANDER, *supra* note 18, § 6:1 n.3 (equity of redemption); ALEXANDER, *supra* note 18, § 6:1 n.4 (foreclosure by sale).

[230] *See* RESTATEMENT (THIRD) OF PROPERTY (MORTGAGES) § 5.4 cmt e. (1997).

[231] GA. CODE ANN. § 9-13-161.

[232] *Georgia Local Foreclosure Trends and Foreclosure Information*, REALTYTRAC, *supra* note 7 (based on the number of foreclosure filings, not the number of completed foreclosures).

[233] *You v. JP Morgan Chase Bank*, No. S13Q0040, 2013 WL 2152562, at *6 (Ga. May 20, 2013).

[234] *See supra*.

[235] *See Reese v. Provident Funding Associates, LLP*, 730 S.E.2d 551, *vacated*, No. S12C2028 (Ga. May 20, 2013).

[236] *See* Renuart, *supra* note 20.

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