September 2018 Vol. 34, No. 9

CLARKS' SECURED TRANSACTIONS MONTHLY
Documentation • Bankruptcy • Regulation

PLEDGES OF EQUITY INTERESTS IN LLCS AND PARTNERSHIPS: CHANGES COMING

A movement is afoot to revise UCC Article 9 to exempt ownership interests in limited liability companies (LLCs), general partnerships and limited partnerships from the "anti-assignment" override provisions in UCC 9-406 and 9-408. Should secured lenders welcome these changes, or are they a trap for the unwary?

Many unincorporated entities – such as LLCs or partnerships – have provisions in their organizational documents that restrict transfers of ownership interests. The idea is that you, an existing equity owner, should be able to "pick your partner." LLC operating agreements, for example, often prohibit an existing member from either selling or pledging his or her equity interests – or require that either the LLC itself or certain other members must first approve any sale or pledge. Other restrictions may also apply, such as rights of first refusal in favor of existing owners.

When it comes to corporations, these types of transfer restrictions are generally enforceable. UCC 8-204, for example, provides that: "A restriction on transfer of a security imposed by the issuer, even if otherwise lawful, is ineffective against a person without knowledge of the restriction unless ... the security is certificated and the restriction is noted conspicuously on the security certificate." While UCC Article 8 itself doesn't determine whether a transfer restriction is enforceable ("other law" determines that, according to Official Comment No. 1 to UCC 8-204), UCC Article 8 clearly contemplates "legending" a stock certificate to put transferees on notice of a stock transfer restriction. In general, a transfer restriction noted conspicuously on a stock certificate will be upheld, unless the transfer restriction constitutes an "unreasonable restraint" on alienation.

Current UCC 9-406 and 9-408 transfer restriction overrides. Under current Article 9, the rules are different for ownership interests in unincorporated entities such as LLCs and partnerships, at least if the ownership interests qualify as a "general intangible" – as is usually the case. (Note: It's possible that an LLC or partnership interest itself could constitute a "security" rather than a "general intangible," or that the LLC or partnership could elect to "opt in" to UCC Article 8 and treat its ownership interests as a security. In those relatively rare "security" cases, the "general intangibles" analysis discussed below wouldn't apply.)

UCC 9-406 and 9-408 – which many practitioners find to be among the most opaque and confusing provisions of UCC Article 9 – render "ineffective" certain contractual or legal restrictions on assignments of general intangibles. UCC 9-408(a), for example, provides that a term in an agreement between an account debtor and the debtor (here the LLC operating agreement, with the account debtor being the LLC) which prohibits, restricts or requires the consent of the LLC to a transfer (including a pledge) of an LLC ownership interest is "ineffective" to the extent the term would "impair the creation, attachment or perfection of a security interest." UCC 9-406(d) goes one step further by providing that, in the case of a *payment intangible* (a type of general intangible where the account debtor's (the LLC's) primary obligation is a payment obligation), any such restriction is ineffective not only to the extent it would impair the "creation, attachment or perfection" but also to the extent it would impair the "enforcement" of a security interest.

Taken together, this means that, at a minimum, a transfer restriction in an LLC operating agreement on encumbering an LLC ownership interest wouldn't prevent a secured party from obtaining a perfected security interest in the ownership

Also in This Issue:

By:
Barkley Clark
Stinson Leonard Street LLP

Barbara Clark
Commercial Law Institute

LexisNexis®
An A.S. Pratt® Publication

interest. The extent to which the secured party can "enforce" that security interest is less clear. UCC 9-408(d) generally gives the LLC (the "account debtor") the right to ignore any collection or other enforcement actions. If, however, a pledged LLC ownership interest can be subdivided into a "payment intangible" – for example, only the right to receive LLC cash distributions as and when made – the secured party may be able to enforce its security interest in those payment rights against the LLC. Enforcement rights aside, the anti-assignment override provisions of UCC 9-406 and 9-408 at least give the secured party the ability to obtain a perfected security interest in an LLC ownership interest that would survive the pledgor's bankruptcy.

PEB proposes new changes. The Permanent Editorial Board for the Uniform Commercial Code (PEB), with the backing of the Uniform Law Commission and other groups, now proposes that the various states enact uniform amendments to UCC 9-406 and 9-408 that would exempt limited liability companies and partnerships from their coverage – meaning UCC 9-406 and 9-408 would *not* override transfer restrictions in an LLC operating agreement or a partnership agreement. The proposed amendments provide that either all or parts of UCC 9-406 and 9-408 "do not apply to a security interest in an ownership interest in a general partnership, limited partnership, or limited liability company."

Proposed Official Comment 10 to UCC 9-408 goes on to provide that: "...this section does not apply to an ownership interest in a limited liability company, limited partnership, or general partnership, regardless of the name of the interest and whether the interest: (i) pertains to economic rights, governance rights, or both; (ii) arises under: (a) an operating agreement, the applicable limited liability company act, or both; or (b) a partnership agreement, the applicable partnership act, or both; or (iii) is owned by: (a) a member of a company or transferee or assignee of a member; or (b) a partner or a transferee or assignee of a partner; or (iv) comprises contractual, property, other rights, or some combination thereof."

Gathering storm: entity lawyers vs. commercial lawyers. The PEB isn't the first to come up with the idea of exempting LLC and partnership ownership interests from UCC Article 9's transfer restriction overrides. A handful of states have already either revised UCC 9-406 and 9-408 or changed their LLC or partnership statutes to provide that those entity statutes, and not UCC Article 9, govern the enforceability of transfer restrictions on ownership interests in LLCs or partnerships. Delaware, most notably, has non-uniform provisions in its UCC 9-406 and 9-408 which provide that those sections don't apply to ownership interests in LLCs or partnerships. Other states, such as Texas, have amended their entity statutes to provide that UCC 9-406 and 9-408 don't override transfer restrictions permitted under those entity statutes. Colorado, Kentucky and Virginia likewise recognize transfer restrictions in operating and partnership agreements notwithstanding UCC 9-406 and 9-408.

The ideological struggle is one between "entity" lawyers – those who prepare entity documents and want to preserve the "pick your partner" concept – and "commercial" lawyers, who generally favor free assignability of property rights to facilitate secured financing. While the "free assignability" camp has generally prevailed when it comes to transfers of most payment rights, the "pick your partner" camp is gaining the upper hand in preserving transfer restrictions affecting entity ownership interests, particularly those pertaining to governance and information rights, including, most importantly, voting rights. The PEB, with the backing of the Joint Editorial Board on Uniform Unincorporated Organization Acts (*i.e.*, the "entity" lawyers), is now following the lead of states such as Delaware, Texas and others that have amended either UCC 9-406 and 9-408 or their state entity laws to uphold transfer restrictions affecting LLC and partnership ownership interests, and without regard to whether those transfer restrictions relate only to economic interests or more broadly to voting and other governance rights.

What's this mean? What effect will the PEB amendments have if they're adopted? Probably not that much – although, as discussed below, secured lenders could lose out if they're not careful.

As under current Article 9, lenders extending credit against equity interests (whether stocks or LLC or partnership ownership interests) will want to ensure there are no contractual restrictions on pledging those equity interests. Relatively few lenders "rely" on UCC 9-406 and 9-408 to override a contractual restriction on pledging an ownership interest in an LLC or partnership, at least if the ownership interest is important collateral. Besides, even if UCC 9-406 or 9-408 does override a contractual restriction, that doesn't necessarily mean the secured party can "enforce" its security interest in the pledged ownership interest – at least in terms of it or a foreclosure buyer becoming an "owner" of the voting or other governance rights that comprise an equity interest.

Moreover, UCC 9-406 and 9-408 only override transfer restrictions in an agreement between the "account debtor" (the LLC or partnership) and the pledgor. If, for example, there's a side agreement among only members of the LLC, such as a buy-sell agreement, or perhaps even if the LLC isn't a party to its own operating agreement, UCC 9-406 and 9-408 may not override any transfer restrictions in those agreements. Another danger in "relying" on UCC 9-406 and 9-408 transfer restriction overrides is that the overrides apply only to LLCs or partnerships that are "general intangibles." As noted above, an LLC could elect, long *after* its ownership interests have been pledged, to be treated as "security" under UCC Article 8. In that scenario, the transfer restriction

overrides in UCC 9-406 and 9-408 likely wouldn't benefit the secured party.

So, lenders relying on equity interests collateral today already *should* – and, if the PEB proposed amendments to UCC 9-406 and 9-408 are adopted by the various states – *must* carefully review any contractual transfer restrictions affecting pledged ownership interests. Lenders must then obtain any consents needed not only to obtain a security interest, but also to *enforce* the security interest, including, if needed, the power to exercise voting rights and to become a substitute owner.

Room for improvement. In a perfect world, could the "pick your partner" and "free transferability" camps fashion a grand compromise whereby the pure "economic rights" associated with an LLC ownership interest or partnership interest may be encumbered pursuant to a bona fide pledge, and without regard to any contractual transfer restrictions in the entity agreements or any separate shareholder agreements? This would give secured lenders the potential right to receive economic distributions only if and when paid by the entity, but not the right to exercise any voting, information sharing or other governance rights that would violate the "pick your partner" principle. If those voting and other "full ownership" rights are required by the lender as collateral, the lender would need to obtain any consents required of the entity itself or its other owners.

The "pick your partner" rationale has its limitations. What relevance does it have to a *single member* LLC? Should a transfer restriction in a single-member LLC's operating agreement override the member's subsequent agreement with a lender to pledge its ownership interests in the LLC? Perhaps the member would be "estopped" from raising any such objection, but what about a bankruptcy trustee? Also, consider the typical loan structure whereby a loan to a parent entity is secured by a pledge of the parent's ownership interests in its various wholly-owned subsidiaries, some of which are LLCs. If an ownership interest transfer restriction exists in an LLC operating agreement, the lender's security interest in the related LLC ownership interests wouldn't attach (or, therefore, be perfected) under the proposed PEB amendments. The PEB amendments could thus be a trap for the unwary, particularly where pledged LLC or partnership interests are taken as part of an "all assets" security interest and where subsidiary organizational documents aren't carefully reviewed for transfer restrictions.

Also, does it make sense to treat ownership interest transfer restrictions differently, depending on the type of issuer entity? Current Article 9 overrides certain transfer restrictions on ownership interests in LLCs and partnerships, but not those of corporations or other Article 8 securities, including closely held corporations whose entity documents may contain transfer restrictions. The proposed PEB amendments would at least achieve that goal, in the sense that UCC 9-406 and 9-408 override provisions would no longer apply to LLCs or partnerships.

A modest proposal. Still, unincorporated entities like LLCs and partnerships are more likely to have ownership interest transfer restrictions than corporations. Why not change the PEB amendments, and state law entity statutes, so that the "economic rights" of any ownership interest, regardless of underlying entity type, may be collaterally assigned and enforced, and without regard to any contractual restriction? Doing so would treat entity payment rights much like accounts receivable and similar payment rights that can be assigned without the account debtor's consent and notwithstanding a contractual prohibition. Allowing economic rights to be encumbered without regard to transfer restrictions would also be similar to a court serving a "charging order" on a partnership or similar entity that applies only to equity distributions if and when paid. The PEB amendments, however, would uphold transfer restrictions affecting both governance rights and economic rights. In that case, secured lenders who don't get transfer restriction waivers will be left holding the bag.

The preceding story was written by Mark Ovington, a commercial finance attorney at Stinson Leonard Street LLP. For further discussion of these issues, particularly as they relate to LLCs, see Mark's story in the April 2018 issue of this newsletter.

OCC READY TO CONSIDER FINTECH CHARTERS, BUT WILL WE EVER SEE ONE?

On July 31, 2018, the Office of the Comptroller of the Currency announced that it would begin accepting national bank charter applications from nondepository financial technology companies who participate in aspects of the business of banking. The decision to move forward with these special purpose national bank ("SPNB") charters brings to fruition an idea first proposed under former Comptroller Thomas Curry and which was far from guaranteed to be finalized under current Comptroller Joseph Otting. A Policy Statement and supplement to the *Comptroller's Licensing Manual*, "Considering Charter Applications From Financial Technology Companies" ("Fintech Supplement") accompanied the OCC's announcement.

Just hours before the OCC issued its statement, the Treasury Department issued its own report on Nonbank Financials, Fintech, and Innovation (the "Treasury Fintech Report"), which, among many other things, urged the OCC to move forward with SPNB charters.

SPNB chartering has been controversial, still faces significant legal hurdles, and may or may not attract much attention from financial fintechs, which have thrived even in the absence of a federal charter—the Treasury Fintech Report notes that 3,330 technology-based firms serving the financial services industry were founded between 2010 and late-2017 and that lending by fintechs now accounts for 36% of all personal loans, up from less than 1% in 2010.

Treasury pushes for fintech charters. The Treasury Fintech Report is the last of four reports issued by Treasury in response to President Trump's policy of regulating the financial system consistent with a set of Core Principles. The Core Principles are:

1. Empower Americans to make independent financial decisions and informed choices in the marketplace, save for retirement, and build individual wealth;
2. Prevent taxpayer-funded bailouts;
3. Foster economic growth and vibrant financial markets through more rigorous regulatory impact analysis that addresses systemic risk and market failures, such as moral hazard and information asymmetry;
4. Enable American companies to be competitive with foreign firms in domestic and foreign markets;
5. Advance American interests in international financial regulatory negotiations and meetings;
6. Make regulation efficient, effective, and appropriately tailored; and
7. Restore public accountability within federal financial regulatory agencies and rationalize the federal financial regulatory framework.

The Treasury Fintech Report proposes changes to the current financial regulatory framework in the hopes of better aligning that regulation with technological innovations in the financial services sector.

According to the Treasury Department, "Nonbank financial service providers generally operate within a largely state-based regulatory regime requiring compliance with a disparate set of standards across individual states and territories that can be cumbersome and produce conflicting guidance for entities operating on a national basis." Thus, Treasury views SPNB charters as one way to simplify regulatory obligations to better serve the needs of some fintech firms. Treasury also proposes modernizing the regulatory environment by increasing adoption of model laws (such as the Uniform Regulation of Virtual Currency Businesses Act and the Uniform Money Services Act), expanding the reach of the Nationwide Multistate Licensing System, and clarifying oversight requirements applicable to third-party service providers.

Treasury believes that marketplace lenders and payment companies are likely to be the most interested in SPNB charters: marketplace lenders presumably would find reduced licensing costs and consolidated supervision by a single primary regulator attractive, while payment companies could benefit from avoiding state-by-state money transmitter licenses and potentially easier access to payment services.

Striking the right balance. Ultimately, Treasury recommended that "the OCC move forward with prudent and carefully considered applications for special purpose national bank charters." In line with the Core Principle of avoiding taxpayer-funded bailouts, Treasury stated that SPNBs should not participate in FDIC deposit insurance, which should reduce taxpayer risk. Treasury deferred to the OCC whether and how to apply financial inclusion requirements to SPNBs. Similarly, Treasury notes that the Federal Reserve "should assess whether OCC special purpose national banks should receive access to federal payment services." Finally, Treasury cautioned that the OCC needs to maintain a level playing field and not advantage fintechs to the detriment of banks with full charters. Striking the right balance presents one of the biggest practical challenges to successful implementation of any special purpose charters.

The OCC's fintech policy and plan. As of July 31, 2018, "[i]t is the policy of the ... [OCC] to consider applications for national bank charters from companies conducting the business of banking, provided they meet the requirements and standards for obtaining a charter. This policy includes considering applications for special purpose national bank charters from financial technology (fintech) companies that are engaged in the business of banking but do not take deposits." The OCC believes that offering SPNB charters is one way the OCC can "support[] responsible innovation in the federal banking system." The OCC also explains that SPNB charters would allow fintechs to be subject to uniform standards with the robust supervision applicable to other nationally chartered institutions.

As with earlier OCC publications, neither the Policy Statement nor the Fintech Supplement ever precisely define "fintech." The closest the OCC comes to a definition is its statement that the Fintech Supplement covers "applications from fintech companies to charter a special purpose national bank that would engage in one or more of the core banking activities of paying checks or lending money, but would not take deposits" or be FDIC-insured. The advantage to the OCC's approach is flexibility: Any company taking advantage of technology to provide financial services, regardless of its business model or particular role, can make a case for treatment as a new kind of special purpose national bank. The OCC does not start off by preferring any particular type of company or service provided under the broad umbrella of "fintech." The drawback to the OCC's approach

is uncertainty, a point raised by many interested parties during the fintech chartering proposal public comment period. For example, the New York State Department of Financial Services ("NY DFS") chided the OCC for creating an "amorphous category of 'fintech'—an exceedingly broad and undefined term." It would not be surprising to see NY DFS try to make an issue out of this in future litigation. (More on anticipated litigation below.)

The OCC's SPNB charters will not give fintechs—in whatever form those fintechs may take—a free pass to the benefits of a national bank charter. Existing chartering standards and procedures set forth in the *Comptroller's Licensing Manual* will generally apply. And, '[a]s with all national banks, the OCC will consider whether a proposed bank has a reasonable chance of success, will be operated in a safe and sound manner, will provide fair access to financial services, will treat customers fairly, and will comply with applicable laws and regulations." Safety and soundness will be front and center, although the OCC promises to tailor standards and oversight "based on the bank's size, complexity, and risk profile," as is the case with traditionally chartered institutions. The Fintech Supplement, along with the rest of the *Comptroller's Licensing Manual*, provides a roadmap of the charter application process.

Financial inclusion requirements. Another key issue raised during public comment on the fintech chartering proposal was whether and how financial inclusion requirements would apply. Traditional banks are subject to financial inclusion requirements under the terms of the 1977 Community Reinvestment Act. But CRA, by its terms only applies to institutions that accept deposits—something fintech SPNBs will not do. The OCC's Policy Statement indicates that SPNBs will be subject to CRA-like expectations, but "[t]he nature of that commitment will depend on the company's business model and the types of products, services, and activities its plans to provide." While Appendix B to the Fintech Supplement provides details about how financial inclusion should be addressed in a charter application and explains that financial inclusion is an ongoing commitment that will be reviewed during the examination process, it is far less certain exactly how financial inclusion obligations will be enforced.

Does the OCC have the authority? Both the Policy Statement and the Treasury Fintech Report assert that the OCC has the authority to issue fintech SPNB charters. Yet, it is not entirely clear whether, absent specific Congressional approval, SPNB chartering authority exists. The National Bank Act authorizes the OCC to charter "associations for carrying on the business of banking." 12 U.S.C. §§ 21, 26–27. Traditionally, the three hallmarks of national banks and the business of banking have been the receipt of deposits, payments of checks, and lending of money. *See Warren v. Shook*, 91 U.S. 704 (1875) ("Having a place of business where deposits are received and paid out on checks, and where money is loaned upon security, is the substance of the business of a banker."); *Independent Bankers Ass'n of Am. v. Conover*, Case No. 84-1403-Civ-J-12, 1985 U.S. Dist. LEXIS 22529, at * 25 ("Courts have long recognized that the power to accept demand deposits and make commercial loans is at the core of the 'business of banking.'"). The question then arises whether the OCC has the authority to charter an SPNB that does not engage in one of these core functions—taking deposits.

In 2003, the OCC adopted a final rule that amended 12 C.F.R. § 5.20(e)(1) so that it now provides: "A special purpose bank that conducts activities other than fiduciary activities must conduct at least one of the following core banking functions: Receiving deposits; paying checks; or lending money." Whether the OCC's own interpretation of the NBA that is arguably in some tension with case law interpreting the term "business of banking" will withstand legal challenge remains to be seen. This issue could ultimately test whether the Supreme Court has any appetite for reexamining the contours of *Chevron* deference.

Challenging the OCC's authority. Both the NY DFS and the Conference of State Bank Supervisors ("CSBS") have vigorously opposed the OCC's plans to issue fintech SPNB charters, believing that state laws and regulations are sufficient and should not be preempted. In response to the OCC's Policy Statement, the CSBS had this to say: "An OCC fintech charter is a regulatory train wreck in the making. Such a move exceeds the current authority granted by Congress to the OCC. Fintech charter decisions would place the federal government in the business of picking winners and losers in the marketplace. And taxpayers would be exposed to a new risk: failed fintechs. ... On behalf of the citizens to whom we are accountable, state regulators are keeping all options open to stop this regulatory overreach." The NY DFS did not mince words either: "DFS believes that this endeavor, which is also wrongly supported by the Treasury Department, is clearly not authorized under the National Bank Act. ... [A] national fintech charter will impose an entirely unjustified federal regulatory scheme on an already fully functional and deeply rooted state regulatory landscape."

In response to OCC's issuance of its 2016 Whitepaper, *Exploring Special Purpose National Bank Charters for Fintech Companies*, which laid out the OCC's fintech chartering proposal, both the NY DFS and the CSBS sued the OCC, arguing that it lacked authority to issue fintech SPNB charters. Both cases were dismissed without prejudice for lack of standing and ripeness. *See Conference of State Bank Supervisors v. O.C.C.*, 2018 U.S. Dist. LEXIS 72048 (D.D.C. April 30, 2018); *Vullo v. O.C.C.*, 2017 U.S. Dist. LEXIS 205159 (S.D.N.Y. Dec. 12, 2017). While it's possible that the OCC's Policy Statement alone makes the

NYDFS and CSBS's grievances sufficiently concrete and imminent so that standing and ripeness now exist, *see Vullo* at *21 ("The alleged injuries will only become sufficiently imminent to confer standing once the OCC makes a final determination that it will issue SPNB charters to fintech companies."), renewed lawsuits may not be filed until after issuance of a fintech SPNB charter by the OCC. *See CSBS* at *18 ("The OCC's national bank chartering program does not conflict with state law until a charter has been issued."). To date, no fintech charter applications have appeared in the OCC's Weekly Bulletin, where notice of such applications is provided.

Will any fintechs apply? In May, the *American Banker* reported that Commissioner Otting had indicated that interest in fintech charters had dwindled since the OCC issued the Whitepaper. Being a nationally chartered bank is not cheap and it is not easy. It is unclear whether many or any fintechs will believe that the benefits of becoming a regulated national bank (primarily, preemption) outweigh the many compliance and oversight burdens. To date, partnering with traditional banks and seeking appropriate state licenses have served the industry well.

To make matters worse, the initial fintech SPNB applicant knows that it will be stepping into at least one lawsuit concerning the validity of the charter it's applying for. That's not a trivial disincentive.

Some parting thoughts:

- First, debates regarding the proper role of the states vs. federal government when it comes to the country's banking system are nothing new. As the Treasury Fintech Report explains: "The United States has a long and complex history of state and federal regulation in financial services." These days even fans of the "Hamilton" musical can tell you that national bank chartering has been controversial from the United States' earliest days. *See* Hamilton Original Broadway Cast Recording, "Cabinet Battle #1," Act 2, Track 2 (2015).

- Second, a couple more points from the Treasury Fintech Report deserve attention. First, Treasury has encouraged Congress to act to codify the "valid-when-made" rule ignored by the Second Circuit's *Madden v. Midland Funding* decision. Our hope is that in appropriate subsequent cases the valid-when-made rule will be vigorously argued and will carry the day, as it has since the 1800s. While congressional action would certainly resolve the issue, it may not ultimately be necessary.

- Third, the Treasury Fintech Report highlights the role that uniform laws can play in eliminating state-by-state differences in the law. We are certainly big fans of uniform law. For decades, the UCC has made good on its promise to streamline the law governing many aspects of banking practice. The smooth operation of the UCC has also arguably limited the need for regulatory intervention into the areas the Code covers. Moreover, there's good precedent for using uniform law to address technological changes. As the Official Comment to 4A-102 explains: "The funds transfer governed by Article 4A is in large part a product of recent and developing technological changes." If fintech charters are not the answer to challenges created by the rise of fintech, then perhaps uniform laws are.

The preceding story was written by Matthew D. Clark. Matthew is a commercial litigator with Faegre Baker Daniels LLP and a frequent contributor to this newsletter.

BONDHOLDERS FACE STORMY SEAS IN PUERTO RICO DEBT RESTRUCTURING

The facts of the Puerto Rico Bondholder litigation. In *The Financial Oversight and Management Board for Puerto Rico v. Altair Global Credit Opportunities Fund (A), LLC, et al.*, A.P. No. 17-213-LTS (D. P.R. 08/17/18), involving the financial restructuring proceedings of Puerto Rico, the Puerto Rico Employees Retirement System ("ERS"), by and through the Financial Oversight and Management Board (the "Oversight Board"), filed suit against bondholders of the ERS ("Bondholders"), which asserted validly perfected security interests in a range of ERS' assets. The ERS claims were to invalidate the asserted Bondholders' security interests.

The decision is a primer on the basics of secured transactions: debtor names, collateral descriptions, and retroactive avoidance powers of a trustee.

ERS was permitted by statute to issue debt secured by its assets. In 2008, ERS issued pension funding secured bonds to the Bondholders pursuant to a Resolution describing the collateral for the debt as including ERS revenues. The security agreement granted the Bondholders "a security interest in (i) the Pledged Property, and (ii) all proceeds thereof and all after-acquired property, subject to application as permitted by the Resolution." The security agreement did not define "Pledged Property," but provided that "[a]ll capitalized words defined herein shall have the meanings ascribed to them in the Resolution."

Problematic UCC filings. Financing statements ("the 2008 UCC-1s") were filed identifying the debtor as "Employees Retirement System of the Government of

the Commonwealth of Puerto Rico" and describing the collateral as "[t]he pledged property described in the Security Agreement attached as Exhibit A hereto and by this reference made a part hereof." The security agreement was attached to the financing statements, but the Resolution, which defined "Pledged Property," was not attached.

In 2013, the Puerto Rico legislature, by statute, changed the name of the pension system to "Retirement System for Employees of the Government of the Commonwealth of Puerto Rico" ("RSE"). In 2015 and 2016, amendments were filed to the 2008 UCC-1s which fully described the Pledged Property (the "Amendments"). However, the debtor's new name was not noted on any of the Amendments, identifying the debtor only insofar as the Exhibit to each amendment referred to the debtor as the "Employees Retirement System of the Government of the Commonwealth of Puerto Rico."

Deficiencies of the original 2008 filings. The Bondholders argued that the original 2008 UCC-1s were sufficient to perfect a security interest because a financing statement may incorporate a collateral description by reference, even if the referenced document is not publicly available. The Court distinguished cases in which an extrinsic collateral description was incorporated into security agreements, rather than a financing statement, noting that financing statements, as opposed to the contractual nature of a security agreement that may incorporate extrinsic evidence to reflect the parties' intent, "serve a public notice function and must disclose a minimum amount of information to interested third parties." By failing to provide the definition of "Pledged Property," the Court found that the 2008 UCC-1s failed to satisfy the threshold collateral description requirements of Article 9. The Court found it would "defeat the basic notice function of Article 9" to force searchers to scour publicly available records outside of relevant UCC records to ascertain the scope of a collateral description.

The Amendments were also defective. The Court dispatched the Bondholders' argument that the Amendments were sufficient to either cure the deficiencies with the 2008 UCC-1s or independently perfect the security interest. The ERS argued that the Amendments were defective, as they failed to include the Debtor's new official name. Applying 9-503 and 9-506, the Court found that a search of the UCC records using the RSE name would not reveal the Amendments, and the Amendments were thus seriously misleading. Although RSE had continued to sometimes refer to itself as ERS, the use of that name was deemed a "trade name" of RSE, rendering a filing under that name insufficient pursuant to 9-503(c).

The Effect of PROMESA and Bankruptcy Section 544. The Oversight Board, in its capacity as debtor representative in ERS's PROMESA debt adjustment case, further argued that the Bondholders' unperfected security interest be declared unenforceable pursuant to bankruptcy code Section 544 as the trustee has the status of a hypothetical lien creditor. PROMESA provides that the term "trustee," for purposes of Section 544, means the Oversight Board. Applying Puerto Rico law, as required to determine the rights available to a hypothetical lien creditor, the Court found that ERS was "sufficiently structured like a private business that its assets may be subject to provisional remedies, including liens." As such, Puerto Rico Civil Rule 56.1 would permit a court to order attachment of a lien against the property of ERS, meeting the non-bankruptcy law standard to provide lien rights to a judgment creditor.

Court approves retroactive invalidation of liens. The Bondholders raised federal constitutional concerns as grounds not to construe Section 544 in a manner to invalidate liens granted prior to the enactment of PROMESA. Retroactive application of Section 544, the Bondholders argued, would invalidate the security interest in violation of the Takings Clause contained in the Fifth Amendment. The Court noted that the Bankruptcy Code has been interpreted to be prospective only, but that the Court "cannot invoke the principle of constitutional avoidance to subvert the clear intention of Congress" as expressly provided in PROMESA, which was enacted specifically to enable Puerto Rico to address its debt crisis. To hold that Section 544 could apply only prospectively would render the avoidance powers contained in PROMESA unavailable and meaningless.

More to Come. This decision has been appealed to the United States Court of Appeals for the First Circuit.

Key points from the Puerto Rico decision

- We think the court correctly applied the collateral description requirements in finding that the 2008 UCC-1s were insufficient to provide notice to third parties. The court stressed the public policy of promoting commercial certainty for filers and searchers.
- Puerto Rico has adopted the UCC, and under Puerto Rico law the central filing office for financing statements is the secured transactions registry of the Department of State.
- The Opinion cites to Puerto Rico's enactment of UCC 9-110 as the controlling law on collateral description requirements for a financing statement. Under Rev. Article 9, this citation would be to 9-108. Puerto Rico did not adopt Rev. Article 9 until January 17, 2012, simultaneously with the 2010 Amendments, both with an effective date of January 17, 2013. As the financing statement was filed in 2008, the Court referred to Former UCC 9-110 as the governing statute.

- The Opinion applies Rev. Article 9 to the legal effect of the Amendments, as it was effective prior to the filing of the Amendments.
- As noted in the Opinion, UCC 9-503 does not speak specifically to identification of a governmental debtor. Governmental debtors are generally bound by Article 9, to the extent a statute of a state, foreign country, or government unit does not otherwise expressly govern the creation, perfection, priority, or enforcement of a security interest. See 9-109(c).
- In footnote 18, the Court correctly notes that under 9-507(c)(1) a financing statement that becomes insufficient due to a subsequent change in the debtor's name is nonetheless effective to perfect a security interest in collateral acquired by the debtor before, or within four months after, the financing statement becomes seriously misleading. That provision did not come to the rescue of the Bondholders, however, as the 2008 UCC-1s were insufficient to perfect the Bondholders' interest in the first place.
- The Puerto Rico Oversight, Management, and Economic Stability Act (PROMESA), 48 U.S.C. §§ 2161, *et seq.*, was enacted in 2016 to establish an oversight board and a procedure for the restructuring of debt in light of the Puerto Rico public-debt crisis.

The above story was written by Bradley Salyer, a creditors' rights attorney at Morgan Pottinger McGarvey.