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SECURED TRANSACTIONS

Common Exclusions From Blanket Liens

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When structuring secured loans, whether large syndicated credits or small single-lender asset-based facilities, lenders frequently say that their borrowers and any guarantors must grant a security interest in all of their assets to secure the debt. Term sheets for such financings often describe the collateral to be provided as being "all assets." Moreover, §9-504(2) of the Uniform Commercial Code (UCC) provides that a financing statement sufficiently indicates the collateral if it states that it covers "all assets." Despite their all-inclusive appearance, however, "all asset" security interests—commonly called "blanket liens"—are subject to various exclusions. Today, we examine some items that commonly are carved out of blanket liens, either by operation of law or by market practice.

Outside Article 9's Scope

Article 9 of the UCC generally governs consensual security interests only in personal property and fixtures.[1] Immediately outside Article 9's scope, therefore, are liens on real estate. Furthermore, Article 9 expressly does not apply to certain types of personal property, especially insurance, tort claims (other than commercial tort claims) and judgments as original collateral (i.e., not collateral that constitutes the proceeds of other collateral) as well as deposit accounts in consumer transactions. Thus, unless lenders take affirmative steps under non-UCC law (such as recording mortgages or deeds of trust covering real property or taking assignments of insurance policies, judgments or consumer deposit accounts in compliance with applicable common law or statutory requirements), any such property that a borrower may have is excluded from the blanket lien. Prudent lenders, of course, should perform diligence to ascertain the existence and value of any such assets, whereupon they and their borrowers can decide whether the effort and expense of obtaining a security interest in such collateral is warranted.

Although commercial tort claims can be included within an Article 9 security interest, creating a security interest in them requires special attention. They cannot be covered by the after-acquired property clauses that are used in blanket liens. This is because UCC §9-108(e) requires that commercial tort claims be described specifically, not merely by "type." Thus, an after-acquired commercial tort claim cannot fall within a preexisting blanket lien and will become collateral only if and when the borrower has granted a new lien on it after acquiring it. Lenders typically have the borrower covenant to give notice when it acquires commercial tort claims and, upon request, to execute and deliver a collateral supplement specifically describing and pledging the new claim.[2]

Many states have adopted non-uniform provisions that alter what Article 9 covers. New York, for instance, has adopted non-uniform provisions that bring within Article 9's scope security interests in that iconic New York form of real property, the cooperative apartment, but that exclude annuity contracts, which otherwise would constitute general intangibles covered by the UCC.[3] Where lenders require liens on such property, they may have to choose the law governing the security agreements accordingly. Thus, non-New York lenders seeking pledges of the shares of cooperative apartments would, if practicable, want New York law to govern the security arrangements while New York lenders who are taking liens on annuity contracts might select another jurisdiction whose UCC covers annuities and that has choice of law rules that will give effect to the selection.

Article 9 also does not apply to the extent it is preempted by a U.S. statute, regulation or treaty.[4] In practice, when federal laws preempt Article 9, they typically do so only regarding how and where a security interest is perfected, not how that security interest is created. Thus, for example, liens on registered copyrights and on certain vessels and aircraft must be recorded in registries created under federal law in order to be perfected,[5] but those liens are granted in the first place under the UCC. Accordingly, a blanket lien grant in an Article 9 security agreement that sufficiently describes such assets creates a security interest therein, but, notwithstanding the filing of an "all assets" financing statement, the lien on those assets is unperfected absent compliance with the recordation requirements of applicable federal law. Again, should a borrower have any such assets, it and its

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lenders have to evaluate the costs and benefits of complying with the federal recordation schemes.

Legal or Contractual Restrictions

We turn now to lien carve-outs that are common as matters of market practice rather than required by operation of law. Security agreements routinely exclude from an "all assets" grant the borrower's rights under any contract, permit or license if and to the extent the grant of a security interest therein (i) would cause a breach or default thereunder, (ii) is prohibited by any applicable law or regulation, or (iii) requires consent from a governmental authority. In addition to the general carve-out, one often sees a more narrowly tailored exception for patents, trademarks, copyrights or other intellectual property if the grant of a security interest therein constitutes or results in the impairment, abandonment, invalidation or rendering unenforceable of the borrower's right, title or interest therein. The rationale for these exclusions is self-evident: Borrowers want not to breach or risk forfeiture of their contracts, permits and licenses, and lenders want to avoid liability for tortious interference. Moreover, if granting a security interest in the property triggers the loss of its use or value, it would be self-defeating.

This general exception, however, is itself subject to three common exceptions. First, it typically does not apply to the extent that the restriction on pledging the relevant contract, permit or license rights is rendered ineffective pursuant to UCC §§9-406 through 409. Those sections override in an extraordinarily complex fashion certain contractual or statutory provisions that purport to prohibit a debtor from granting a security interest in certain accounts, contract rights, payment intangibles or other general intangibles.[6] Second, the exemption is moot if the applicable contract counterparties or governmental authorities consent to the borrower's encumbering its rights. If contract or license rights form a material portion of the borrower's collateral package, the lenders will want to consider requiring that the borrower obtain such consents as a condition to getting the loan. Often, counterparties and governmental authorities consent initially only to the grant of the security interest and reserve to the future the right to approve the lender's enforcement of its lien. Lenders thus need in each case to review the sufficiency of all consents they may require. Finally, well-drafted security agreements apply the carve-out only "for so long as" the breach, default or illegality condition exists. If the condition were to cease (e.g., by an amendment or repeal of the subject contract, permit, license, law or regulation), the borrower's rights under the contract, permit or license would thereupon be brought within the lien's coverage automatically.

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Recognizing the distinctions between types of assets that are and are not restricted is critical. For example, although encumbering governmental licenses is often prohibited by statute, recent case law has allowed a pre-bankruptcy lien on the *proceeds* of the sale of a Federal Communications Commission license to attach to the proceeds of the debtor's postpetition sale of such licenses out of bankruptcy.[7] Practitioners thus should take care to draft the "all assets" grant sufficiently broadly and the general carve-out no broader than necessary to accomplish their intended tasks.

Foreign Subsidiaries

Blanket liens, of course, generally cover the equity interests in a borrower's subsidiaries. Nevertheless, the security interest in the equity of foreign subsidiaries is often limited to 65 percent of the equity of the first tier of foreign subsidiaries, leaving the remaining 35 percent of first tier foreign subsidiaries and all of the equity at lower tiers unencumbered. This is done to avoid "deemed dividends" under §956 of the Internal Revenue Code. Corporate borrowers organized in the United States generally are not taxed on the earnings and profits of their controlled foreign corporation subsidiaries (CFCs) until, and then only to the extent, the CFCs repatriate the earnings and profits to their U.S. parent via dividends or other distributions. Under §956, however, a CFC is *deemed* to have dividended its accumulated earnings and profits to its U.S. parent for federal income tax purposes if (1) the CFC has guaranteed the U.S. parent's debt or pledged its assets to secure that debt, or (2) the U.S. parent has pledged 66⅔ percent or more of the CFC's voting stock and made one or more negative covenants restricting the CFC's ability to dispose of assets and incur additional liabilities outside the ordinary course of business. Once such a dividend is deemed to have been made, the U.S. parent must include in its U.S. taxable income the earnings of the CFC up to the amount of the loan obligations that benefit from the CFC's credit support, even though no cash has actually been distributed to the U.S. parent. Accordingly, borrowers with foreign subsidiaries typically resist pledging more than 65 percent[8] of the equity of their first tier CFCs and similarly resist giving upstream guaranties or asset pledges from any of their CFCs. Lenders ordinarily are sensitive to a borrower's needs on this issue. Credit requirements may nevertheless dictate 100 percent pledges in workouts or other distressed situations, however, especially if the CFCs have little or no earnings for U.S. tax purposes, such income can be sheltered by net operating losses or the CFC is already distributing its earnings to the U.S. parent. Even in the ordinary course, if a U.S. borrower's domestic assets are insufficient to generate adequate loan availability for its needs or to make the lender comfortable, the borrower's actual tax situation should be considered before it and the lender agree reflexively to the 65 percent cap. A detailed review by tax experts might, in fact, show that significant collateral value residing in offshore CFCs could be tapped without triggering excessive out-of-pocket U.S. tax liability.

Payroll Deposit Accounts

For liability and reputational reasons, lenders often exclude from blanket liens the deposit accounts that borrowers maintain exclusively for employee payroll and payroll withholding taxes. Monies credited to such accounts are functionally held in trust for the benefit of the employees and

taxing authorities. Using these funds to reduce the borrower's loan, thereby leaving the employees or taxing authorities unpaid, might expose the secured party to liability for conversion and would doubtless sully its image. The risks associated with foreclosing on deposit accounts reserved exclusively for employee-related purposes generally outweigh the benefits of including such deposits in the collateral package.[9]

Burdensome Collateral

The final broad category of collateral that regularly falls outside blanket liens embraces assets that are too expensive, time-consuming or burdensome to encumber. This exception usually applies only to types of property that can be included in the Article 9 blanket lien grant but that must be perfected against by means other than filing a financing statement.[10] For example, it is common in secured financings for lenders not to bother to perfect against equipment consisting of titled motor vehicles, which typically require notation of the lien on title certificates, when the vehicles have but modest value relative to the overall transaction. A different result applies, of course, when the borrower has a large fleet of vehicles that are valuable in its business. In acquisition financings, deal sponsors often now insist that lenders not perfect liens on deposit accounts with third-party banks as original collateral because the process of getting the necessary control agreements with such banks has become unduly laborious and frustrating. A workaround for this challenge is to require that all deposit accounts the lenders want as original collateral be maintained only with a bank that is a member of the lending syndicate.

Whatever the type of collateral the borrower asks not to pledge, a cost-benefit analysis has to be made on a case-by-case basis to determine whether or not the value of that collateral warrants incurring the costs and burdens of perfection or whether another device will provide a suitable alternative. Indeed, the agents in syndicated secured financings often reserve the right not to perfect against collateral whose value they determine is insufficient to justify the difficulty, time or expense of obtaining a perfected security interest therein. That way, they can avoid wasting resources on de minimis property without fear that a future syndicate member will attack them for failing to perfect against each and every item of collateral. Conversely, prudent lenders also reserve the right to perfect in the future against assets initially left unperfected if circumstances warrant, such as upon default.

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Conclusion and Valedictory

This article was written principally by Alan Christenfeld, and it truly marks a conclusion for me. Having served as a New York Law Journal columnist for nearly two decades, having published a triple-digit number of columns and having retired from full-time legal practice six years ago, the time has come for me to put down my pen. Performing this service for the profession has been a privilege, but I could not have done it alone. Along the way I have been blessed with three superb co-authors—Joseph Levie, the late Shephard Melzer, and, currently, Barbara Goodstein, in whose capable hands this column will continue. My partners at Clifford Chance and its predecessor, Rogers & Wells, have encouraged this endeavor, and many of them have contributed to it with their time and technical expertise. I am particularly grateful to Evan Cohen and Tom Schulte, who, since I retired, have performed the thankless task of wrangling associates to research topics and prepare first drafts. Many of the associates who assisted me have gone on to partnership or other senior positions, and I wish them continued success in their careers. The librarians at my firm, especially Fran Schoenfield, have undertaken cheerfully and successfully even my most arcane research inquiries. My secretary, Helen Eagleston, has worked with me since the beginning, and I credit her with saving me from publishing numerous embarrassing or bone-headed sentences. My wife, Bonnie Gale, has suffered far too many weekends during which I disappeared into black hole drafting sessions, and she ably edited many of the resulting drafts. And many readers have brought new cases or developments to my attention as topics for the column.

Finally, it is fitting that my final article appear on December 5. Today is the 104th birthday of my father, Paul Christenfeld, who died several years ago but who will always remain with me in spirit. Having graduated from law school during the Great Depression, when legal jobs were exceptionally scarce, my father became a business executive rather than a practicing lawyer. He never lost his interest in the law, however, and he experienced a legal career vicariously through my own. He particularly enjoyed reading my columns and discussing them with me, and that by itself provided motivation to continue writing them lo these many years. Here's to you, Dad. It has been fun

1. UCC §9-109(a)(1). Article 9 also covers agricultural liens and true sales of accounts and certain other assets, but a discussion of those matters is beyond the scope of this column.
2. See A. Christenfeld and B. Goodstein, "Protecting Liens on Debtors' Commercial Tort Claims," 247 NYLJ, No. 2, Feb. 2, 2012, at 5.
3. NYUCC §§9-109(a)(7), 9-109(c)(8).
4. UCC §§9-109(c)(1) and (d).
5. The federal regimes for recording liens on registered copyrights, most aircraft and related engines and equipment, and vessels that are documented with the Coast Guard are set forth at 17 U.S.C. §205, 49 U.S.C. §44107 and 46 U.S.C. §31321, respectively.
6. Sections 9-406 through 9-409 are among the most opaque and difficult to parse in the UCC, and a discussion of them is beyond the scope of this column. For a fuller discussion, see A. Christenfeld and S. Melzer, "How Revised Article 9 Affects Anti-Assignment Clauses," 227 NYLJ, No. 108, June 6, 2002, at 5.
7. See *In re Tracy Broadcasting*, 696 F.3d 1051 (10th Cir. 2012), and *In re TerreStar Networks*, 475 B.R. 254 (Bankr. S.D.N.Y. 2011). For a fuller discussion, see A. Christenfeld and B. Goodstein, "The Curious Case of Security Interests in FCC Licenses," 248 NYLJ, No. 109, Dec. 6, 2012, at 5.
8. The loan market has settled upon a 65 percent cap even though up to one share below 66⅔ percent of a CFCs voting equity could be pledged without triggering a deemed dividend.
9. The reasons for not taking liens on payroll-related deposit accounts are distinct from why lenders should never fund directly into accounts used exclusively to fund payroll. The latter results from IRC §3505(b), which makes lenders liable for payroll taxes that a borrower is required to withhold from its employees if (i) they supply funds to or for the borrower's account for the specific purpose of paying wages of the borrower's employees, (ii) they have actual knowledge or notice that the borrower does not intend or will be unable to make timely payments or deposits of such payroll taxes, and (iii) the borrower fails to pay the taxes. Although a lender's §3505(b) liability is limited to 25 percent of the amount loaned to the borrower, it is nevertheless a danger no lender wants to risk.
10. See UCC §9-310, entitled "When Filing Required to Perfect Security Interest or Agricultural Lien; Security Interests and Agricultural Liens to Which Filing Provisions Do Not Apply."

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