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Lesson to Warehouse Lenders On Collateral Arrangements

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Pennsylvania's Supreme Court recently held that a bank's right of setoff — the right to seize deposits to offset loan defaults — took priority over a warehouse lender's perfected security interest in the proceeds of collateral on deposit at that bank in the borrower's account.

Some claim this decision departs from existing law and undermines secured creditors' rights. In our view it affirms existing law as codified under revised Article 9 of the Uniform Commercial Code.

In any event, *Pioneer Commercial Funding Corp. v. American Financial Mortgage Corp.* is a stark reminder to warehouse lenders of the importance of properly structuring, implementing, and monitoring the wiring and other ministerial arrangements for the collateral against which they lend.

Pioneer agreed to act as a warehouse lender for RNG Mortgage Services Inc., a mortgage loan originator. After RNG filed for bankruptcy, American Financial decided to acquire RNG's portfolio of unfunded mortgage commitments.

Accordingly, RNG agreed to assign loans to American Financial, which would sell them in the secondary market. Both wanted funding from Pioneer for these transactions.

Pioneer delivered to American Financial notes evidencing loans it had financed for RNG, along with a bailee letter indicating Pioneer's security interest in the notes and their proceeds. Pioneer purported to retain title to the notes pending full payment.

American Financial was expected to pay Pioneer from the proceeds of sales of the loans.

WHAT WENT WRONG

Pioneer's first mistake was ceding control of the loan file and the bailee letter to American Financial. It should have sent the loan file and bailee letter to the intended purchaser from American Financial. Norwest Funding Inc. later bought a portfolio of loans from American Financial and made payment to an American Financial "settlement account" maintained with CoreStates Bank NA.

Another fundamental error was Pioneer's failure to require that such payment be made to an account that it owned or controlled and that was subject to standard documentation involving, most importantly, a waiver or subordination of its setoff rights against American Financial.

Though CoreStates forwarded the funds to Pioneer's account at Bank One Texas NA, Pioneer apparently became aware of its exposure arising from the initial transaction. Accordingly, Pioneer asked American Financial to tell Norwest to transmit proceeds from future sales directly to Pioneer's account at Bank One.

However, Pioneer did not itself furnish these instructions to Norwest. If it had, the ensuing debacle would probably have been avoided.

Without Pioneer's knowledge, CoreStates soon uncovered improper manipulation of accounts of corporations in which American Financial's principal, Thomas Flatley, had an interest, resulting in a substantial overdraft. CoreStates then imposed debit restraints on all Flatley company accounts, including American Financial's settlement account.

Without any of the parties to the first sale knowing it, a second sale between the same parties occurred shortly thereafter. Because Pioneer's request that sale proceeds be wired to its account at Bank One was not embodied in a bailee letter or security release to Norwest, Norwest wired the proceeds of this sale, per American Financial's instructions, to American Financial's settlement account.

When CoreStates froze the account and exercised its right of setoff to reduce the overdraft, Pioneer's collateral, now converted to proceeds, effectively disappeared.

THE COURTS SPEAK

In the ensuing litigation, a jury imposed liability, including consequential and punitive damages, on CoreStates. CoreStates appealed, and the intermediate appellate court awarded a retrial on the issue of punitive damages but affirmed as to liability.

CoreStates next appealed to the state Supreme Court, arguing that it had a right of setoff superior to Pioneer's security interest under applicable case law.

The Supreme Court held that commercial law, rather than tort principles, should guide the analysis. The court rejected Pioneer's argument that a "true bailment" existed with respect to the loans — a bailment that Pioneer said made the funds deposited in American Financial's account at CoreStates Pioneer property and immune to a bank setoff.

The court emphasized that the bailee letter was intended to preserve Pioneer's security interest in the notes, not to create a true bailment. It pointed to such evidence as an executed set of credit documents between Pioneer and American Financial.

Accordingly, notwithstanding Pioneer's perfected security interest, the funds in the settlement account remained American Financial's property and were therefore subject to CoreStates' superior right of setoff.

LESSONS FOR LENDERS

Though its facts are complex, Pioneer's lessons are plain. In order to maintain a perfected security interest in cash proceeds of collateral and ensure that such security interest is protected against the rights of the depository bank, a lender must take control of the operational details of the transaction.

- First, the lender should itself or through its agent prepare and send

bailee letters to the ultimate purchaser of the collateral. In no event should it rely on its borrower to complete this task.

- The lender must also pay close attention to wiring arrangements and require that proceeds are wired to a segregated account.

- Further, the bank holding the account must waive or at least subordinate its right of setoff (and related banker's lien and security interest) with respect to the account.

While avoiding the mistakes made by Pioneer, lenders should not overreact. For example, the case does not vitiate the effectiveness of bailee letters. To the contrary, the court said a bailee letter is a standard device used to maintain perfection of the lender's security interest.

Finally, lenders should not conclude that all mistakes regarding wiring instructions create a setoff risk. In the vast majority of cases where funds may be inadvertently wired to the wrong account, the lender suffers no loss. That is because ordinarily the error is promptly corrected, the account holder has no obligation to the bank subject to setoff, or the bank is legally prohibited from exercising setoff.

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