

CAPITAL MARKETS REPORT

A Special Report On Legal Developments Affecting:
Securitization • Mortgage and Asset Finance • Financial Products

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SEC Issues MD&A Guidance

By Joan A. Stumpf

Citing a need to improve the quality of information provided by public companies, the Securities and Exchange Commission recently issued guidance on disclosures that a registered issuer should consider making in the Management's Discussion and Analysis of Financial Condition and Results of Operations section of its financial statement.

The MD&A guidance came in response to a petition made by the Big Five accounting firms. It addresses disclosures in three specific areas: (i) liquidity and capital resources, including off-balance sheet arrangements with "structured finance or special purpose entities;" (ii) certain trading activity that includes non-exchange traded contracts accounted for at fair value; and (iii) effects of transactions with related and certain other parties.

The SEC said that its guidance neither "create[s] new legal requirements" nor "modif[ies] existing" ones; rather, its purpose "is to suggest steps that issuers should consider in meeting their current disclosure obligations." Moreover, the SEC reminded issuers that disclosure must be "both useful and understandable" in language and in a format that investors can be expected to understand. This should be presented in a single location, rather than in a "fragmented manner" throughout the financial statement.

Liquidity and Capital Resources

The SEC observed that disclosures about liquidity and capital resources "are likely to be affected by many of the same facts and circumstances," and that "off-balance sheet financing arrangements often are integral to both." Accordingly, the SEC stated that management should consider all of these items together, as well as individually, when drafting MD&A disclosures.

Off-Balance Sheet Arrangements. The SEC stated that registrants should consider the need to provide disclosures concerning transactions, arrangements and other relationships with unconsolidated "structured finance or special purpose entities" or other entities that are reasonably likely to affect materially liquidity or the availability of or requirements for capital resources.

According to the SEC, "the extent of the registrant's reliance on off-balance sheet arrangements should be described fully and clearly where those entities provide financing, liquidity, or market or credit risk support for the registrant; engage in leasing, hedging, research and development services with the registrant; or expose the registrant to liability that is not reflected on the face of the financial statements." Further, the SEC stated that issuers must disclose any uncertainties resulting from contingencies inherent in the arrangements that are reasonably likely to affect the continued availability of a material histori-

Cadwalader Again Tops Annual Rankings of MBS Counsel

The firm took first place in *Commercial Mortgage Alert's* 2001 annual rankings of law firms used by CMBS issuers when ranking deals both by number and value. We tied as the top-ranked firm used by underwriters based on the number of deals, and placed second among underwriters' counsel based on deal value.

In separate rankings, *Asset-Backed Alert*, which tracks asset-backed securitizations, named Cadwalader as the number four counsel for both underwriters and issuers.

Cadwalader also placed first in terms of proceeds in *Asset Securitization Report's* 2001 rankings of legal advisers to MBS issuers and second among MBS managers' legal advisers. These rankings were exclusive of CMBS and agency issuances.

Cadwalader Tops ISR List of North American Firms

On January 30, the firm was honored as the *International Securitisation Report's* (ISR) "Best Law Firm for North America" for 2001 at ISR's Annual Awards Dinner at the Dorchester Hotel in London. Winners of the fifth annual awards were determined by surveys of the legal, business and financial communities. *International Securitisation Report*, a Thomson Financial Publication, is a leading source of authoritative and independent news and analysis on the issuance of, and investment in, asset-backed securities and mortgage-backed securities around the world.

cal source of liquidity and finance.

In making their MD&A disclosures, the SEC said that companies should consider the need to include information about off-balance sheet arrangements, such as: their business purposes and activities; their economic substance; the key terms and conditions of any commitments; the initial and ongoing relationships with the company and its affiliates; and the company's potential risk exposures resulting from its contractual or other commitments involving the off-balance sheet arrangements.

For example, the SEC noted, a registrant may be "economically or legally required or reasonably likely to fund losses of an unconsolidated, limited purpose entity, provide it with additional funding, issue securities pursuant to a call option held by that entity, purchase the entity's capital stock or assets, or the registrant otherwise may be financially affected by the performance or non-performance of an entity or counterparty to a transaction or arrangement." In such circumstances, the SEC opined that the registrant may need to include information about the arrangements and exposures resulting from contractual or other commitments "to provide investors with a clear understanding of the registrant's business

activities, financial arrangements, and financial statements."

The SEC further noted that issuers should consider the following disclosures to explain the effects and risks of off-balance sheet arrangements:

- total amount of assets and obligations of the off-balance sheet entity, with a description of the nature of its assets and obligations, and identification of the class and amount of any debt or equity securities issued by the registrant;
- the effects of the entity's termination if it has a finite life or it is reasonably likely that the registrant's arrangements with the entity may be discontinued in the foreseeable future;
- amounts receivable or payable, and revenues, expenses and cash flows resulting from the arrangements;
- extended payment terms of receivables, loans, and debt securities resulting from the arrangements, and any uncertainties as to realization, including repayment that is contingent upon the future operations or performance of any party;

- the amounts and key terms and conditions of purchase and sale agreements between the registrant and the counterparties in any such arrangements; and
- the amounts of any guarantees, lines of credit, standby letters of credit or commitments or take-or-pay contracts, throughput contracts or other similar types of arrangements, including tolling, capacity or leasing arrangements, that could require the registrant to provide funding of any obligations under the arrangements, including guarantees of repayment of obligors of parties to the arrangements, make-whole agreements, or value guarantees.

Although disclosure regarding similar arrangements can be aggregated, the SEC cautioned that important distinctions in terms and effects should not be lost in that process. The relative significance to the issuer's financial position and results of the arrangements with structured finance entities "should be clear from the disclosures to the extent material."

Moreover, while legal opinions regarding "true sale" issues or other issues relating to whether a company has contingent, residual or other liability may play an important role in transactions with structured finance entities, the SEC warned that they "do not obviate the need for the registrant to consider whether disclosure is required."

Finally, the SEC counseled that disclosure "should not consist merely of recitation of the transactions' legal terms or the relationships between the parties or similar boilerplate." Rather, the disclosure "should be clear and individually tailored" to describe the risks to the registrant.

Liquidity Disclosures. With respect to liquidity, the SEC cautioned that disclosures should not be "overly general" and "boilerplate," but should be sufficiently detailed and tailored to the company's individual circumstances. Registrants must disclose circumstances that could materially affect liquidity if such circumstances are "reasonably likely" to occur, a disclosure threshold

that the SEC noted is lower than "more likely than not." As the SEC observed, market price changes, economic downturns, defaults on guarantees, or contractions of operations that have material consequences for the registrant's financial position or operating results can be reasonably likely to occur under some conditions.

The SEC stated that known trends, demands, commitments, events and uncertainties that are not reasonably likely to occur need not be disclosed. If management cannot determine that such events are not reasonably likely to occur, "it must evaluate objectively the consequences of [such an event] on the assumption that it will come to fruition. Disclosure is then required unless management determines that a material effect on the registrant's financial condition or results of operations is not reasonably likely to occur," the SEC explained. To identify known trends, demands, commitments, events and uncertainties that require disclosure, the SEC said that management should consider the following:

- provisions in financial guarantees or commitments, debt or lease agreements or other arrangements that could trigger a requirement for an early payment, additional collateral support, changes in terms, acceleration of maturity, or the creation of an additional financial obligation, such as adverse changes in the registrant's credit rating, financial ratios, earnings, cash flows, or stock price, or changes in the value of underlying, linked or indexed assets;
- circumstances that could impair the registrant's ability to continue to engage in transactions that have been integral to historical operations or are financially or operationally essential, or that could render that activity commercially impracticable, such as the inability to maintain a specified investment grade credit rating, level of earnings, earnings per share, financial ratios, or collateral;
- factors specific to the issuer and its markets that it expects will be given significant weight in the determination of its credit rating or will otherwise affect its ability to raise short-term and long-term financing;

- guarantees of debt or other commitments to third parties; and
- written options on non-financial assets (for example, real estate puts).

Disclosures about Contractual Obligations and Commercial Commitments. The SEC said that it would be beneficial to investors if registrants aggregated information about contractual obligations and commercial commitments in a single location in financial statements “so that a total picture of obligations would be readily available.” The SEC provided a “schedule” that could be used by registrants to convey such information, noting that it could be tailored to the needs of the particular registrant and “accompanied by footnotes to describe provisions that create, increase or accelerate liabilities, or other pertinent data.”

Certain Trading Activities Accounted for at Fair Value

The SEC expressed concern that there may be “a lack of transparency and clarity with respect to disclosure of trading activities involving commodity contracts that are accounted for at fair value but for which a lack of market price quotations necessitates the use of fair value estimation techniques.” The SEC stated that companies engaged “to a material extent” in such trading activities should consider providing MD&A disclosures that supplement those required in the financial statements by applicable accounting standards, such as “additional statistical and other information about these business activities and transactions, including derivatives contracts involving the same commodities that are part of those trading activities.”

The SEC also reminded issuers that accounting standards require disclosures in financial statements of “material energy trading and risk management activities.” Discussion in MD&A of material trends and uncertainties arising from those activities is also required, the SEC noted. “Information about these trading activities, contracts and modeling methodologies, assumptions, variables and inputs, along with explanations of the different outcomes reasonably likely under different circumstances or mea-

surement methods, should be considered for inclusion in management’s discussion of how the activities affect reported results for the latest annual period and subsequent interim period and how its financial position is affected as of the latest balance sheet date,” the SEC advised.

Consistent with its “cautionary advice” on disclosing “critical accounting policies” in MD&A, the SEC stated that registrants should consider the need to furnish information, quantified to the extent practicable, that does the following:

- disaggregates realized and unrealized changes in fair value;
- identifies changes in fair value attributable to changes in valuation techniques;
- disaggregates estimated fair values at the latest balance sheet date based on whether fair values are determined directly from quoted market prices or are estimated; and
- indicates the maturities of contracts at the latest balance sheet date (*e.g.*, within one year, within years one through three, within years four and five, and after five years).

For illustrative purposes, the SEC provided a schedule in which such disclosures could be made.

In addition, the SEC stated that issuers should consider the need to disclose the fair value of net claims against counterparties that are reported as assets at the most recent balance sheet date, based on the credit quality of the contract counterparty (*e.g.*, investment grade; noninvestment grade; and no external ratings). The SEC further stated that registrants should consider whether they should provide fuller disclosure regarding the management of risks related to such trading activities, “including changes in credit quality or market fluctuations of underlying, linked or indexed assets or liabilities, especially where such assets are illiquid or susceptible to material uncertainties in valuation.”

Effects of Transactions With Related and Certain Other Parties

The SEC noted that transactions with related

parties “cannot be presumed to be carried out on an arm’s length basis, as the requisite conditions of competitive, free-market dealings may not exist.” Thus, the SEC stated that MD&A should include discussion of material related-party transactions to the extent necessary for an understanding of the company’s current and prospective financial position and operating results, “with clear discussion of arrangements that may involve transaction terms or other aspects that differ from those which would likely be negotiated with clearly independent parties.” According to the SEC, registrants should consider describing the elements of the transactions that are necessary for an understanding of the transactions’ business purpose and economic substance, their effects on the financial statements, and the special risks or contingencies arising from these transactions. In this respect, the SEC stated that it may be necessary to discuss:

- the business purpose of the arrangement;
- identification of the related parties transacting business with the registrant;

- how transaction prices were determined by the parties;
- if disclosures represent that transactions have been evaluated for fairness, a description of how the evaluation was made; and
- any ongoing contractual or other commitments as a result of the arrangement.

The SEC further advised registrants to consider the need to disclose material transactions with parties that fall outside the definition of “related parties,” but with whom the registrant or its related parties have a relationship “that enables negotiation of terms that may not be available from other, more clearly independent, parties on an arm’s-length basis.” By way of example, the SEC cited transactions with companies owned or operated by current or former senior management of a registrant. As the SEC noted, investors may be unable to understand the registrant’s reported results of operations without a clear explanation of these arrangements and relationships. □

Enron’s Wake Wipes Out ABS Safe Harbor; Netting Stays Afloat

By Michael S. Himmel

In the wake of the Enron collapse, Congressional negotiators have stricken the proposed safe harbor for asset-backed securitization, which had been included in omnibus bankruptcy reform legislation passed by both the House and the Senate. Conversely, Enron appears to have improved the prospects for passage of the “netting” provisions in the legislation.

Under the ABS safe harbor, financial assets transferred by a company before its bankruptcy to a special purpose entity to back investment grade ABS generally would have been excluded from the bankruptcy estate and therefore beyond the reach of the company’s creditors in bankruptcy. The safe harbor would have treated the financial assets as “transferred” if the debtor had represented and warranted in writing that it had sold, contributed or otherwise conveyed them

with the intention of removing them from the debtor’s estate. This treatment would have applied regardless of (1) whether the debtor directly or indirectly obtained or held an interest in the issuer or in any securities issued by the issuer; (2) whether the debtor had an obligation to repurchase or to service or supervise the servicing of all or any portion of the assets; or (3) the characterization of the conveyance for tax, accounting, regulatory reporting or other purposes.

Under current securitization practice, counsel to the issuer is ordinarily required to render a reasoned “true sale” opinion, concluding that transferred assets would not be included in the debtor’s bankruptcy estate, and the factors in clauses (1), (2) and (3) of the preceding paragraph are often material to this analysis. Under current

law, creditors may challenge the characterization of such a transfer if the debtor continues to have some level of involvement with the transferred assets.

The bond industry, other participants in the ABS market and Congressional Republicans promoted the ABS safe harbor. However, Congressional Democrats and other opponents of the provision, including a group of law school bankruptcy professors, were of the view that it would facilitate many of the abuses that contributed to the Enron collapse. In a widely circulated letter, the professors concluded that the safe harbor “would encourage more companies to recast liabilities so that they no longer appeared on the balance sheet, much to the detriment of the investing public and other creditors of the business” and that it “would institutionalize and encourage one of the practices that has led to Enron’s failure and its harsh consequences.”

Enron also highlighted the risk to partici-

pants in derivatives transactions arising from the insolvency of a significant party to outstanding transactions. The netting provisions would broaden the scope of transactions currently subject to various safe harbors under the Bankruptcy Code, and would allow counterparties to settle outstanding derivatives contracts quickly in the event of an insolvency. Counterparties would be permitted to close out outstanding derivatives contracts with bankrupt trading partners by netting all the losses and gains of individual contracts into one deal. Although the netting provisions are strongly supported by Federal Reserve Chairman Alan Greenspan, as well as by Wall Street institutions that are subject to substantial exposure in the derivatives markets, they are bogged down in the current political wrangling over the pending omnibus legislation. It is unclear whether the netting provisions will have to await passage of comprehensive bankruptcy reform legislation, or whether they might be passed in a separate bill. □

SFAS No. 94 and the CDO Market

By Richard Schetman and Neil Weidner

For the last several years the collateralized debt obligation (CDO) sector of the securitization market has grown significantly. However, recent Financial Accounting Standards Board discussions regarding Statement of Financial Accounting Standards No. 94 and Accounting Research Bulletin No. 51 raise questions about the structure and accounting treatment of existing and future CDOs.

Unlike many securitization vehicles, CDOs are not typically qualifying special purpose entities, or QSPEs. Structured to be “brain dead,” QSPEs do not allow the active management of assets that is common to many CDO transactions. Accordingly, under current practice, CDOs are generally viewed as non-consolidatable only if the CDO has a minimum of 3% equity as a percentage of the total capital structure sold to third parties. Although CDOs often have more equity – based on the structure, the type and credit quality of the underlying assets and the ratings

requirements of the transaction – equity usually stays below 10%. For example, a high yield CDO is typically structured with 8% to 10% equity, and an ABS or investment grade corporate CDO generally requires much less equity (typically 4% to 5%).

Proposed changes to SFAS 94/ARB 51 would raise the minimum equity requirement from 3% to 10%. Unless existing CDOs are grandfathered (an alternative not currently proposed) a “primary beneficiary” would need to be identified. This primary beneficiary would be required to put the entire CDO on its balance sheet. In many cases the primary beneficiary would be the collateral manager, who often owns a portion of the equity or subordinated tranches, receives incentive compensation and may have transferred assets to the vehicle. Thus the proposed interpretation raises two concerns: that existing CDO structures would need to be consolidated with the collateral manager or similar party; and that future CDO

structures would have difficulty achieving the 10% non-consolidation threshold because this level of equity is generally not consistent with the economics of the structure.

However, discussion at a FASB meeting on April 3 indicated possible flexibility in applying the 10% threshold. According to Marty Rosenblatt of Deloitte & Touche LLP:

- If an entity held a significant portion of the “variable interests” (such as preferred shares and, possibly, non-investment grade notes) and that holding was significantly more than the holdings of others, that entity would be the primary beneficiary. If no entity met these conditions because holdings of the variable interests were sufficiently dispersed, no primary beneficiary would be identified.
- A contract to provide services to a special purpose entity, or SPE, in return for market-based fees, including incentive fees, would not be considered a variable interest. The ability to replace the collateral manager without cause would be an indicator that the fees

are market-based.

- If equity capital is 10% or more, a presumption would exist that an SPE would have the ability to finance itself without the assistance of or reliance on a primary beneficiary. However, even without 10% equity capital, if it is determined, based on relevant facts and circumstances, that the SPE had independent economic substance, there would not need to be a primary beneficiary.

Although tentative in its conclusions, the April 3 discussion offers a scenario whereby SFAS 94/ARB 51 would acknowledge and accommodate the difference between CDO structures and structures with “hidden recourse” to third party investors or counterparties. The expected timetable for FASB is that a draft will be ready for submission to members of the Emerging Issues Task Force for review, followed by a draft to the Board to be discussed at a public meeting by the end of April. An exposure draft for public comment is unlikely to be available before May. □

CWT Meets With U.S. Treasury Department Officials Regarding Treatment of Credit Derivatives for Tax Purposes

By David S. Miller

On March 21, CWT partners David Miller, Richard Schetman and Neil Weidner met with officials at the U.S. Treasury Department to seek clarification of the treatment of credit derivatives and “credit-portfolio” collateralized debt obligation (CDO) vehicles for U.S. federal tax purposes.

Credit Derivatives

Credit derivatives are financial contracts under which one party (the “credit protector”) assumes certain default, bankruptcy and similar risks with respect to specified “reference obligors” from a counterparty (the “protected party”) in exchange for cash consideration. Credit derivatives permit a protected party that owns bonds or loans of a reference obligor, or that has entered into other positions with respect to the reference

obligor, to hedge its “credit risk” that the reference obligor will default on its obligations.

Credit derivatives permit a credit protector to assume the isolated credit-risk of a reference obligor’s debt without assuming the interest-rate, currency or prepayment risk inherent in that debt, or making the investment necessary to actually acquire the debt. Credit derivatives can also be used by a credit protector to acquire a synthetic position in bonds, loans or other debt instruments on a highly leveraged basis without incurring the administrative costs of actually acquiring the debt instruments, some of which may be illiquid, not transferable or unavailable.

Credit derivatives are generally documented on ISDA Master Agreements which incorporate

the 1999 ISDA Credit Derivative Definitions. These definitions contemplate a number of different variables in the terms of the credit derivatives, including a number of different specified "Credit Events" with respect to the reference obligors that trigger a payment by the credit protector, and the means of settlement (cash or physical).

Credit-Portfolio CDO Transactions

In recent transactions, CDO vehicles have used credit derivatives as the exclusive means to gain economic exposure to corporate issuers of bonds or borrowers under loan agreements. These CDO vehicles are referred to as "credit-portfolio" or "credit-default" CDOs. In a typical credit-portfolio CDO transaction, the vehicle will issue notes and equity to investors. The proceeds will be invested in U.S. Treasury bonds or other very high-grade debt instruments. In addition, the vehicle will serve as the credit protector under one or more credit derivatives: In exchange for cash consideration, the CDO will assume the risk that a Credit Event will occur with respect to one or more reference obligors.

In a "managed" credit-portfolio CDO transaction, the credit derivatives entered into by the CDO vehicle may be actively managed by a "credit risk manager" who will have the ability, within certain parameters established by the credit rating agencies as a condition to their rating of the vehicle's notes, to enter into, assign, terminate or offset the credit derivatives it enters into on behalf of the vehicle.

The Tax Uncertainty Surrounding Credit Derivatives

Although credit derivatives are documented on ISDA Master Agreements, are treated generally as financial instruments (much like interest-rate and currency swaps) and are not treated as insurance for state law purposes or any other purpose, the question has arisen whether they could be treated as insurance contracts for U.S. federal tax purposes. This question arises primarily because there is no statutory or regulatory definition of insurance for tax purposes; instead, in 1941, in *Helvering v. Le Gierse*, the U.S. Supreme Court established a very broad definition of insurance

for tax purposes, which credit derivatives arguably could satisfy. Treatment of credit derivatives as insurance for U.S. federal tax purposes could have significant adverse tax consequences for both credit protectors and protected parties.

For example, although foreign CDO vehicles and other foreign corporations that merely trade in stocks and securities and enter into "derivative" transactions are not subject to U.S. corporate income tax under a safe harbor in the Internal Revenue Code, even if they have a U.S. collateral manager, if a foreign CDO vehicle with a U.S. collateral manager were treated as issuing insurance, it could be subject to U.S. corporate income tax. In addition, although there is no U.S. withholding tax or other U.S. tax on most derivative payments made by U.S. persons to foreign CDO vehicles or other foreign corporations, if a credit derivative is treated as insurance, an excise tax could be imposed on the payments made by or paid to the foreign insurer.

These legal uncertainties have chilled the markets, causing many sponsors of credit-portfolio CDO vehicles to negotiate and close their transactions offshore, and to use only foreign collateral managers in managed credit-portfolio CDO transactions. These restrictions avoid the possibility of a U.S. corporate income tax even if the credit derivatives are treated as insurance.

Meeting with the U.S. Treasury Department

David Miller, Richard Schetman and Neil Weidner were invited by officials at the Treasury Department to speak to them in Washington about credit derivatives generally, including the reasons why parties enter into them, their mechanics, and the tax policy issues surrounding them and credit-portfolio CDO transactions. Credit derivatives have achieved greater prominence following recent articles in the popular press regarding their use by financial institutions holding Enron debt. Increasingly, U.S. Treasury officials have been asked to consider the federal tax issues associated with their use.

Messrs. Miller, Schetman and Weidner gave a presentation on credit derivatives and engaged in a discussion with the Treasury officials regarding

the tax policy issues raised by credit derivatives. They requested that the Treasury and IRS confirm in regulations that credit derivatives are treated as financial instruments (and not insurance) for purposes of the safe harbor that protects foreign CDO vehicles generally from U.S. corporate

income tax. They also asked that more generalized guidance be issued in a Revenue Ruling to the effect that credit derivatives are not treated as insurance for federal tax purposes. The Treasury officials encouraged a formal written letter to be submitted requesting this guidance. □

Financing Mortgage Loans Under the Revised UCC

By Karen B. Gelernt and Lech Kalembka

A prudent secured lender will want to know that its security interest is perfected and has first-priority status. If perfected, the lender is assured that its interest in the collateral is in most cases superior to any interest that may be claimed by other creditors of the borrower and, most importantly, that its interest will survive the borrower's bankruptcy.¹

Having first-priority further assures the lender that it will come out ahead of any other creditor that perfected a security interest in the same collateral.

The Uniform Commercial Code (the "UCC"), which has recently been revised (as revised, the "Revised UCC"), is the comprehensive body of state law that governs the validity, perfection, priority and enforcement of security interests in almost all forms of personal property. At first glance, the reader may find a discussion of mortgage loans under the UCC incongruous, since the UCC generally excludes interests in real estate from its coverage.² Nevertheless, the UCC also provides that property, such as a mortgage note, is not excluded from coverage merely because the obligation it represents is secured by property that is excluded, such as a mortgage.³

Traditionally, Article 9 of the UCC has provided for only two methods of perfecting a security interest in mortgage notes (and other "instruments"⁴). The first method involves taking physical possession of the note, either directly⁵ or "constructively" through a third party bailee unaffiliated with the borrower.⁶ The second perfection method is automatic, without any further mechanical step, where the security inter-

est is given for "new value" under a written agreement;⁷ this automatic perfection, however, lapses after 20 days.⁸ A parallel 20-day automatic perfection rule protects a lender that releases mortgage notes to the borrower for limited purposes, such as making collections from the underlying borrower.⁹

Accordingly, filing a financing statement with respect to mortgage notes (and other instruments) has, until recently, been ineffective to perfect a security interest in such property. While this limited the parties' perfection options, the lender was relieved from the burden, often time-consuming and always painstaking, of reviewing UCC search reports to ensure that no prior creditor of the borrower had previously filed a financing lien that would cause the lender to stand second in line under the UCC's "first-to-file-or-perfect" rule.¹⁰

This fairly uncomplicated legal landscape has been changed in the Revised UCC, which went into effect in most states in July 2001 and is now in effect in every state. Most fundamentally, the Revised UCC permits lenders to perfect a security interest in mortgage notes (and other instruments) by filing a financing statement.¹¹ The Revised UCC also provides that the sale of "promissory notes"¹² (which is a subset of instruments) is automatically perfected upon conveyance¹³ and codifies the "mortgage-follows-the-note" doctrine.¹⁴

In the case of perfection by filing, the financing statement must be filed with the central filing office of the state in which the borrower is "located."¹⁵ The Revised UCC includes detailed rules

for determining a debtor's location.¹⁶ A "registered organization,"¹⁷ such as a corporation, limited liability company or limited partnership, is located in the state under whose law it is organized.¹⁸

Permitting perfection by filing will surely have many salutary effects, not the least of which will be to protect the lender's perfection in cases in which the borrower or its affiliate retains possession of the mortgage note beyond the period of temporary automatic perfection.

At the same time, enhanced flexibility raises certain risks to secured lenders. Not surprisingly, under the Revised UCC, a security interest in mortgage notes perfected by possession will, except in limited circumstances, have priority over a security interest perfected by filing,¹⁹ even if the possessory security interest is subsequent to the security interest perfected by the filing.²⁰

Less obvious risks emanate from UCC filings that may have been previously made by other creditors of the borrower.

Although a UCC filing was ineffective under the prior version of the UCC (the "Prior UCC") to perfect a security interest in mortgage notes, creditors not infrequently made UCC filings covering mortgage notes anyway, either in anticipation of the Revised UCC (which has retroactive effect)²¹ or as an additional precaution. In some cases, these filings also had the immediate effect of perfecting the creditor's security interest in intangible property related to the financed mortgage loans, such as servicing receivables or rights under hedge agreements covering the mortgage loans.

Depending on the predilections of the creditor and its counsel, UCC filings may describe the collateral with great precision, referring, for example, to mortgage notes (and, if applicable, contract rights and other general intangibles) related to mortgage loans listed specifically on an identified schedule. Such a circumscribed description would make it fairly easy for a subsequent lender to determine whether the prior lender had a perfected security interest in mortgage notes or related intangible assets of the bor-

rower that the new lender intends to finance.

At the opposite extreme, filings may describe the collateral as "all of the borrower's mortgage notes, instruments, contract rights and general intangibles."

Frequently, collateral descriptions fall into a gray intermediate zone, referring to mortgage loans "in respect of which an advance has been made" or "transferred to the secured party" under a specified agreement.

The practical ramifications of the differences among these collateral descriptions are enormous. First, even if the subsequent lender has possession of the mortgage notes, it could find its security interest in any intangible assets related to the mortgage loans (although normally not in the mortgage notes) subordinate in priority to an earlier "blanket" filer. This risk, incidentally, already existed under the Prior UCC.

An even more draconian outcome, unique to the Revised UCC, could befall a lender who relies on filing or automatic perfection in the mortgage notes. In this case, the priority of this lender's security interest in the notes themselves could be jeopardized under the "first-to-file-or-perfect" principle²² by a prior filing that referred, for example, to "mortgage loans," "mortgage notes," "promissory notes" or "instruments," without appropriate limiting language.

The risk is significant in particular for lenders that finance "wet-ink" mortgage loans (mortgage loans financed at origination where the lender does not yet have physical possession of the notes). Because a wet-ink lender will rely on the temporary perfection rules, its security interest could well be subordinate to a prior blanket filer until the wet lender obtains possession.

The moral of this story is that a lender financing mortgage loans must now carefully scrutinize UCC searches – especially, although not exclusively, if the lender is not taking possession of the mortgage notes. Of course, the first step is to determine the filing office or offices in which to search. Naturally, the lender must search in the jurisdiction in which the borrower is located

under the Revised UCC, such as the borrower’s jurisdiction of organization in the case of a registered organization. In addition, because of the “grandfather” provisions of the Revised UCC that preserve the effectiveness of filings made prior to its effective date in the proper jurisdiction under the Prior UCC even if that jurisdiction is different from the one specified by the Revised UCC²³ (for example, a filing made in New Jersey in 1998 against a Delaware corporation headquartered in New Jersey), the prudent lender will sometimes be constrained to undertake multiple searches (in New Jersey and Delaware in this example).

As noted, reviewing UCC searches can be a laborious undertaking. The hypothetical collateral descriptions illustrated above do not capture the complexity — not to mention the imprecision — of real-world filings that searches typically reveal. This process permits no substitute for vigilance, care and exacting attention to detail.

Moreover, identifying a troublesome filing is usually less than half the battle. First, the problem must be explained to the secured party in whose favor the filing was made, who may lack any practical incentive to cooperate with the new lender.

Next, corrective action acceptable to all interested parties, which typically involves the amendment of the problematic filing to enhance

its precision or the filing of a partial release to limit its scope, must be agreed upon and implemented.

The new filing rules are not the only noteworthy changes affecting mortgage loan financing under the Revised UCC. In particular, the statute provides that the sale of a “promissory note” is automatically perfected, that is, without the need for filing or possession. Literally, this rule provides the purchaser with permanent automatic perfection in mortgage notes acquired in, for instance, a repurchase transaction.

Nevertheless, given the uncertain characterization of a repo as a “true sale” or disguised financing,²⁴ mortgage note purchasers may wish to take the steps necessary to perfect their security interests to mitigate the consequences of a judicial recharacterization.

Finally, the Revised UCC codifies the “mortgage-follows-the-note” doctrine,²⁵ under which the perfection of a security interest in a mortgage note automatically perfects a security interest in the related mortgage.

While this rule does not cause the secured party to become the mortgagee of record, the rule ensures that the secured party’s rights regarding the mortgage will be senior to a subsequent lien creditor of the mortgager, including a bankruptcy trustee.²⁶ □

Endnotes

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| <p>1. See 11 U.S.C. § 544(a).</p> <p>2. Revised UCC § 9-109(d)(11).</p> <p>3. Revised UCC § 9-109(b).</p> <p>4. Defined in Revised UCC § 9-102(a)(47).</p> <p>5. Revised UCC § 9-313(a).</p> <p>6. Revised UCC § 9-313(c).</p> <p>7. See Revised UCC § 9-312; see also Revised UCC § 9-309(4) and text below.</p> <p>8. Revised UCC § 9-312(e).</p> <p>9. Revised UCC § 9-312(g). Note that the period of temporary automatic perfection has been reduced from 21 days to 20 days under Section 9-312 of the Revised UCC.</p> <p>10. Revised UCC § 9-322(a)(1).</p> <p>11. Revised UCC § 9-312(a).</p> | <p>12. Defined in Revised UCC § 9-102(a)(65).</p> <p>13. Revised UCC § 9-309(4).</p> <p>14. Revised UCC §§ 9-203(g), 9-308(e).</p> <p>15. Revised UCC §§ 9-301(1), 9-501(a)(2).</p> <p>16. Revised UCC § 9-307.</p> <p>17. Defined in Revised UCC § 9-102(a)(70).</p> <p>18. Revised UCC § 9-307(e).</p> <p>19. Revised UCC § 9-330(d). The possessory security interest will not have priority, however, if the secured party in possession did not give value to the borrower, did not act in good faith, or had knowledge that its acquisition of the security interest “violates the rights” of the original secured party.</p> <p>Merely filing a financing statement</p> | <p>describing mortgage notes does not constitute notice to the subsequent creditor in possession that its acquisition of a security interest violates the rights of the prior lender. Cf. Off. Cmt. 7, Revised UCC § 9-330.</p> <p>20. The rules for “instruments,” such as mortgage notes, are consistent with the rules that have traditionally applied to chattel paper.</p> <p>21. Revised UCC § 9-702(a).</p> <p>22. Revised UCC § 322(a)(1).</p> <p>23. Revised UCC § 9-705(c).</p> <p>24. See Off. Cmt. 4, Revised UCC § 9-109.</p> <p>25. Revised UCC §§ 9-203(g), 9-308(e).</p> <p>26. Off. Cmt. 6, Revised UCC § 9-308.</p> |
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Capital Markets Report

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