

News & Types: Commercial, Competition & Trade Update

Lessons for Secured Creditors in Recent Decision

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A recent Seventh Circuit decision authored by Judge Posner offers several lessons for secured creditors competing over the same collateral. (*Caterpillar Financial Services Corporation v. Peoples National Bank, N.A.*, 7th Circuit Court of Appeals, No. 12-2854, March 4, 2013)

The two secured creditors in this case are both well-known and presumably sophisticated financial companies. While the transaction at issue had some complex elements, in the end, the losing party lost on a very basic point and its failure highlights lessons from which the rest of us can learn.

In 2006 a coal-mining company in southern Illinois named S Coal borrowed around \$7 million from Caterpillar, secured by the coal company's mining equipment. S Coal was also indebted to Peabody Energy Corporation for an earlier loan secured by the same mining equipment. Two years later, in 2008, Peoples loaned S Coal \$1.8 million secured by the same mining equipment. This meant that the same mining equipment was security for three different loans – Peabody, Caterpillar, and Peoples. Peoples was not content with third position. It wanted to be first. So Peoples and Peabody negotiated a subordination agreement under which Peabody subordinated its claim to the claim of Peoples. The court noted that Peoples did not obtain a copy of the security agreement between S Coal and Peabody.

Sure enough, S Coal defaulted resulting in a battle over priority in the mining equipment as collateral. Peoples obtained possession of the mining equipment and sold it for \$2.5 million. It kept \$1.4 million to cover S Coals' debt to Peoples. It sent a check for the remaining \$1.1 million to Caterpillar, which neither cashed nor returned the check.

Judge Posner began his analysis with the basic statement that priority of conflicting security interests in the same collateral is based on time of filing. Applying this rule, Peabody filed first, followed by Caterpillar, and then Peoples. But, of course, the resolution of the dispute was not so simple. Judge Posner's analysis gives us at least three important lessons for secured creditors.

3. Lesson Number Three – Know the Effects of Subordination.

Peoples claim of priority over Caterpillar clearly rested on Peoples subordination agreement with Peabody. Here Judge Posner had an interesting and informative analysis of subordination agreements in general. According to Judge Posner, courts have disagreed on the effect of a subordination agreement on priorities among creditors. Some cases choose "complete subordination", dropping the subordinating creditor to the bottom of the "priority ladder." But the majority approach is "partial subordination", in which the parties to the

subordination agreement simply swap priorities. Under this approach, the priorities among the creditors would be Peoples, Caterpillar and then Peabody.

"The "partial" in "partial subordination" denotes the fact that the parties to a subordination agreement swap places in the priority ladder only to the extent of the smaller of the swapping parties' loans. If, for example, Peabody had been owed \$1 million by S Coal, the subordination agreement would have given the bank [Peoples] first priority only with respect to the first \$1 million of the bank's \$1.8 million loan. The order of priority would then be bank (\$1 million), Caterpillar (\$7 million), bank (\$.8 million), Peabody (\$1 million). The amount subordinated is limited to the amount that the creditor having priority over the nonparty was owed before he swapped places with a junior creditor. In the real as distinct from the hypothetical case, S Coal owed Peabody at least \$4 million, which was much more than the bank's loan, and so the bank was able to move into first place for its entire loan without hurting Caterpillar."

So, Peoples benefited from Judge Posner's first lesson. By stepping into the shoes of Peabody, whose loan to S Coal was greater than Peoples' loan, Peoples obtained priority over Caterpillar by the first to file rule. Caterpillar was not in a worse position, since it would have been lower than Peabody anyway.

2. Lesson Number Two – Know the Definition of a Purchase Money Security Interest

Caterpillar was not done. Caterpillar argued that its 2006 loan was a purchase money loan and, therefore, Caterpillar was entitled to purchase money security interest priority. If a security interest is a purchase money security interest, then it enjoys priority even over other security interests in the same collateral.

But Caterpillar lost on this also. The mining equipment financed in 2006 was not newly purchase equipment. According to the court, S Coal had obtained leases that entitled S Coal to purchase the equipment for a "nominal sum" after completing specified payments. So the transaction was actually a disguised security interest with the "lessors" functioning as lenders. For the original lessors / lenders, it didn't matter. They were protected either way.

But the distinction was critical to Caterpillar. It could not use the "nominal sum" to piggyback on the original lessors' purchase money status. Caterpillar was neither the original lessor nor the original seller. Rather, Caterpillar stepped in to finance the "nominal sum" required for the purchase price. Caterpillar's 2006 loan was not the "enabling loan" that enabled S Coal to acquire the mining equipment. (UCC Section 9-103(a)(2)) So Caterpillar's 2006 loan was not a purchase money loan.

The court indicates that Caterpillar could have maintained purchase money security interest by refinancing the original lessor's loans and obtaining an assignment of the original lessor's security interest. But this is not what Caterpillar did. Rather, it acted as a new lender loaning money against mining equipment that S Coal already had. So Caterpillar lost on its purchase money priority argument also. But the most important lesson remained.

1. Lesson Number One – Document, Document, Document!

At this point, it looked grim for Caterpillar. But all was not lost. As Judge Posner put it, "So far we have seen Caterpillar's arguments for priority over the bank falling like ninepins. But the bank's argument for priority encounters a greater obstacle – in fact an insurmountable one."

Remember the fact referenced above that Peoples failed to obtain a copy of the security agreement between S Coal and Peabody? This critical failure torpedoed Peoples claim for priority. A security interest is not enforceable unless "the debtor has authenticated a security agreement that provides a description of the collateral." (citing UCC Section 9-203(b)(3)(A)). Peoples failed to show that S Coal authenticated a security agreement for Peabody.

Judge Posner acknowledged, "It is of course possible, and in fact very likely, that Peabody had such an agreement with S Coal; its financing statement says so." But the court could not assume this and, even if there was a security agreement, it could not assume that the collateral described in the security agreement included the specific mining equipment that was at issue.

Peoples invoked a "composite document theory" to assert the existence of an authenticated security agreement. Peoples cited cases that utilized the composite document theory to show the existence and content of a security agreement. In one case, in particular, the creditor had filed a financing statement and used a resolution signed by the debtor's board of directors that stated the debtor was conveying a security interest in the assets described in the financing statement. Unfortunately for Peoples, it had no document comparable to the board resolution.

Since Peoples' security interest priority derived from Peabody's, based on the subordination agreement, Peoples stepped into the shoes of Peabody. Since Peabody (or Peoples) could not produce an authenticated security agreement, its security interest failed and Peoples lost its claim for priority. Peoples had no right to the proceeds of sale. Rather, Caterpillar was the rightful recipient of the proceeds.

The *Caterpillar* case is full of lessons applicable to lending and secured transactions. Some of the lessons may seem basic and elementary. But when two sophisticated lenders are taught these lessons the "hard way", it's clear the lessons are worth repeating.