

ABSTRACT

TESTING THE REACH OF UCC ARTICLE 9: THE QUESTION OF TAX CREDIT COLLATERAL AS THE FUTURE OF SECURED FINANCING

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INTRODUCTION

Whether you are a small, start-up business taking out your first loan or a large and sophisticated commercial borrower looking to engage in a complex and potentially high yielding transaction, most all borrowers can expect that they will be required to post a certain level of security to the lender for its loan.¹ While many lenders may be more willing to advance funds to borrowers who have valuable assets and large amounts of liquid capital than they would a start-up company with few assets and little to no profits, each borrower will nonetheless be required to provide some level of collateral to secure its borrowed funds.² The prudent lender wants to reduce the risk that the borrower will default and fail to repay the loan.³ In the event the borrower defaults, the lender wants to know that something of value—preferably equal to or greater than the value of the loan itself—can be quickly converted into cash to satisfy the debt.⁴ Thus, the availability of credit, and the ability to post collateral, have gone hand in hand since lending's most early origins.⁵ In the financing world, what you get depends, in great part, on what you can give.

As the history of secured financing goes, the most traditional form of collateral was real property.⁶ The borrower would receive the funds and, in exchange, would grant a security interest in his land.⁷ This would typically come in the form of a conventional mortgage.⁸ Alternatively, or along with the mortgage, some lenders would also require that the borrower grant a security interest in goods or other personal property as well.⁹

¹ See Robert L. Jordan, William D. Warren, & Steven D. Walt, *Secured Transactions in Personal Property*

² Sandra Schnitzer, *Structuring Commercial Loan Agreements*, Para. 5 (2d ed. 1990).

³ George G. Triantis, *Secured Debt Under Conditions of Imperfect Information*, 21 *J. Legal Stud.* 225, 235–36 (1992); Carl S. Bjerre, *Secured Transactions Inside Out: Negative Pledge Covenants, Property, and Perfection*, 84 *Cornell L. Rev.* 305 (1999).

⁴ See generally Lucian A. Bebchuk & Jesse M. Fried, *The Uneasy Case for the Priority of Secured Claims in Bankruptcy*, 105 *Yale L.J.* 857, 879 (1996); Clifford W. Smith & Jerold B. Warner, *On Financing Contracting: An Analysis of Bond Covenants*, 7 *J. Fin. Econ.* 117 (1979).

⁵ See George Lee Flint, Jr., *Secured Transactions History: The Fraudulent Myth*, 29 *N.M.L. Rev.* 363 (1999); see also Douglas G. Baird & Thomas H. Jackson, *Possession and Ownership: An Examination of the Scope of Article 9*, 35 *Stan. L. Rev.* 175, 178 (1983); Richard E. Speidel, et al., *Secured Transactions, Teaching Materials* 49 (5th ed. 1993); H.F. Jolowicz, *Historical Introduction to the Study of Roman Law* 162, 313-17 (1952); Roger J. Goebel, *Reconstructing the Roman Law of Real Security*, 36 *Tul. L. Rev.* 29, 32 (1961).

⁶ See Coke, Edward. *Commentaries on the Laws of England*. ("[I]f he doth not pay, then the Land which is put in pledge upon condition for the payment of the money, is taken from him for ever, and so dead to him upon condition, . . . and if he doth pay the money, then the pledge is dead as to the Tenant.")

⁷ See generally *id.*

⁸ *Id.* See also Robert M. Lloyd, *Secured Transactions* (Matthew Bender 1988).

⁹ See 1 Grant Gilmore, *Security Interests in Personal Property* 24 (1965).

This category of collateral could include anything from farm equipment and cattle, to cars, boats, and planes.¹⁰ These more “movable” types of collateral were usually secured by a chattel mortgage and, in more recent times, a security interest pursuant to article 9 of the Uniform Commercial Code.¹¹

But as time has progressed, business parties have become more sophisticated in their transactions.¹² Deals—which before involved merely the lending of capital and the repayment of principal plus interest, all secured by personal and real property—have been surpassed by business imagination and innovation.¹³ No longer do individuals merely expect to make cash profits from their investments; they can also expect to receive other forms of value as well.¹⁴ Specifically in recent years, individuals can expect to make investments, not only for a return of the loan plus interest, but also for the receipt of valuable tax credits.¹⁵

The granting of tax credits to encourage individuals to engage in certain activities is a classic hallmark of tax policy in the United States.¹⁶ Individuals and companies with heavy tax liabilities can use tax credits in order to reduce the amount they owe the

¹⁰ See generally Douglas G. Baird & Thomas H. Jackson, Cases, Problems, and Materials on Security Interests in Personal Property xxv (1987).

¹¹ See Robert L. Jordan, William D. Warren, & Steven D. Walt, Secured Transactions in Personal Property 12–13 (Foundation Press 2000).

¹² See Christopher K. Odet, Towards a Convention for the International Sale of Real Property: Challenges, Commonalities, and Possibilities, 29 Quinnipiac L. Rev. 383, ___ (2011).

¹³ See, e.g., Ken Belson & Jeff C. Klein, Ownership of Maple Leafs and Raptors May Change Hands, N.Y. Times, Dec. 9, 2011, at D4; Evelyn M. Rusli, Thoma Bravo Acquires Blue Coat Systems for \$1.3 Billion, N.Y. Times, Dec. 9, 2011; Vinod Sreeharsha, Accel Invests in Brazilian Review and Search Site, Dec. 1, 2011; Julie Satow, Visions of a Development Rising From the Sea, N.Y. Times, Nov. 22, 2011; C.J. Hughes, The Tricky Task of Renovating a Building Without Altering Its Landmark Insides, N.Y. Times, Nov. 22, 2011; Julie Satow, Study Clarifies the Energy Savings in Retrofitted Buildings, N.Y. Times, Nov. 8, 2011; Evelyn M. Rusli, I.B.M. to Buy DemandTec for \$440 Million, N.Y. Times, Dec. 8, 2011; Evelyn M. Rusli & Michael J. de la Merced, LivingSocial Set to Raise About \$200 Million, Nov. 18, 2011; Evelyn M. Rusli, Gym, Tan, Raise Venture Capital?, Nov. 18, 2011.

¹⁴ SC. county approves incentives for Amazon, San Francisco Chronicle, Dec. 9, 2011; Gary Glancy, Commissioners to discuss economic incentives, BlueRidgeNow, Dec. 8, 2011; Emily Schettler, IRL developer defends VOn Maur incentives, Bolkom says larger TIF discussion is needed, Press-Citizen.com, Dec. 7, 2011; Scott Sloan, State incentives approved for expanding companies, Herald-Leader, Dec. 10, 2011; Kirsten Valle Pittman & Tim Funk McClatchy, In scramble for new jobs, states bid up incentives, Knoxvillebiz.com, Dec. 7, 2011; Lauren Pack, Retail developer seek millions in incentives from county, Middleton Journal, Dec. 8, 2011.

¹⁵ See generally Lily L. Batchelder, Fred T. Goldberg Jr. & Peter R. Orszag, Efficiency and Tax Incentives: The Case for Refundable Tax Credits, 59 Stanford L. Rev. 23 (2006); Michael S. Knoll, International Competitiveness, Tax Incentives, and a New Argument for Tax Sparing: Preventing Double Taxation by Crediting Implicit Taxes, U of Penn, Inst for Law & Econ Research Paper No. 08-21 (2008); Kirk J. Stark & Daniel J. Wilson, What Do We Know About the Interstate Economic Effects of State Tax Incentives?, 4 Georgetown Journal of Law & Public Policy (2005); Thomas Karier, Business Tax Incentives and Investment, Jerome Levy Economics Institute Working Paper No. 103 (1998); Roberta F. Mann and Mona L. Hymel, Moonshine to Motorfuel: Tax Incentives for Fuel Ethanol, 19 Duke Environmental Law & Policy Forum 43 (2008); Jacques P. Morisset & Nede Pirmia, How Tax Policy and Incentives Affect Foreign Direct Investment: A Review, World Bank Policy Research Working Paper No. 2509 (2005).

¹⁶ See Wendy C. Gerzog, On Public Policy Grounds, a Limited Tax Credit for Child Support and Alimony, 11 The American Journal of Tax Policy, 321 (1994); David T. Ellwood, The Impact of the Earned Income Tax Credit and Social Policy Reforms on Work, Marriage, and Living Arrangements, 53 National Tax Journal 4 (2000).

government. Moreover, tax credits have become even more valuable as commercial lending and government policy has evolved to include programs that heavily incentivize certain activities and industries. Tax credits have become a way of not only reducing one's tax liability, but also as a way to make a profit. An investor who loans money into a project which qualifies for certain tax credits can then take those tax credits, and sell them on the market to a willing buyer. Those investors use the credits as relief from their high-tax-bracketed liabilities, and will often pay a premium. The ability for highly taxed groups to obtain relief, sometimes substantial, from their tax liabilities makes the holder of tax credits a powerful economic player on the commercial scene. Government policymakers know the value of tax credits and, in turn, have created many different incentive programs whereby investors advance funds for certain projects which are deemed to be in the public good.¹⁷ In return, the investors receive valuable tax credits that can be traded and sold for a high price such that the investor can recoup his investment and also receive a return. Tax credit programs in the United States are as varied and diverse as the American commercial landscape itself. There are credits for purchasers of electric cars¹⁸ and hybrid vehicles,¹⁹ for producers of clean-fuels,²⁰ new enhanced oil recovery projects,²¹ and oil and gas from marginal wells,²² refiners of low sulfur diesel fuel²³ and fuel from nonconventional sources,²⁴ inventors of energy efficient appliances,²⁵ energy-producing equipment,²⁶ and technology to produce electricity and synthetic gases from coal,²⁷ biomass,²⁸ and petroleum,²⁹ as well as investors in low-income housing³⁰ and projects in low-income communities.³¹ Whatever may be the government policy *de jour*, one can expect to see a tax credit produced to help push that policy along by giving an incentive to investors to choose to put their money in *this* project, as opposed to another.³² And as long as individuals are looking for ways to reduce their tax burden, tax credits will only become more and more valuable.³³ With legislative bodies at both at the state and local levels continuously producing large quantities of tax credits in order to further their policies, the cash-flushed investor has a

¹⁷ Daniel Shaviro, The Minimum Wage, the Earned Income Tax Credit, and Optimal Subsidy Policy, University of Chicago Law Review (1997); Miki Malul & Israel Luski, The Optimal Policy Combination of the Minimum Wage and the Earned Income Tax Credit, 9 The B.E. Journal of Economic Analysis & Policy 1 (2009).

¹⁸ IRC § 30 (2011).

¹⁹ IRC § 30B (2011).

²⁰ IRC § 30C (2011).

²¹ IRC § 43 (2011).

²² IRC § 45I (2011).

²³ IRC § 45H (2011).

²⁴ IRC § 45K (2011).

²⁵ IRC § 45M (2011).

²⁶ IRC § 48 (2011).

²⁷ IRC § 48A (2011).

²⁸ *Id.*

²⁹ *Id.*

³⁰ IRC § 42 (2011).

³¹ IRC § 45D (2011).

³² See generally C. Eugene Steuerle, Contemporary U.S. Tax Policy (The Urban Institute Press 2d ed. 2008); see also Christopher Howard, The Hidden Welfare State: Tax Expenditures and Social Policy in the United States (Princeton University Press 1997).

³³ C. Eugene Steuerle, Contemporary U.S. Tax Policy 42–45 (The Urban Institute Press 2d ed. 2008).

myriad of options to pick from when determining which project is worth the investment (and which will produce the most credits).³⁴

Lenders are also wise to the rush by individuals and corporations toward tax credit investments.³⁵ An investor might borrow money from a financial institution in order to make an investment in a certain business that intends to undertake a project that qualifies to receive substantial tax credits. The business will receive profits from the success of the project, and, in turn will transfer the tax credits it receives to the investor as repayment. Traditionally the financial institution would require that typical collateral be posted to secure the loan.³⁶ This could include real property, the goods and equipment of the investor if applicable, and the investor's deposit accounts and accounts receivable.³⁷ However, as lenders have become aware that the true value in the hands of the investor and his business partners is the tax credits, the sufficiency of more traditional forms of collateral has been called into question.³⁸ More and more lenders want a security interest in the tax credits as a way to secure the loan. While traditional forms of collateral may, if foreclosed upon, help make the lender whole, the potential proceeds from the sale of the tax credits can, in some circumstances, be a more reliable form of security. The prudent lender, in determining the level of collateral required in order to advance the funds, will assess the entirety of the borrower's assets and revenue streams.³⁹ The substantial economic value of tax credits produced from certain investments are ripe for the picking in terms of providing the lender with the security that it needs to substantiate the lending of the funds. Moreover, some borrowers—who might not necessarily have the requisite level of traditional collateral to entice a lending institution to advance funds—can use the allure of a tax credit allocation to persuade lenders that tax credit collateral will more than secure the loan and provide protections to reduce the bank's risk.

While tax credit financing may be all the rave in the world of secured transactions, there remains an undercurrent of uncertainty regarding its legal efficacy. The exotic and economically profitable nature of the tax credit as collateral is both what makes them attractive to lenders, but also uncertain to lawyers. Tax credits do not fit neatly into the traditional categories of collateral under the UCC's article 9. While they may seem to fit into the UCC's category of "general intangibles" because of their amorphous and unique qualities, courts have struggled with how to properly label these rights.⁴⁰ General intangibles have been held to include copyrights, patents, trademarks,

³⁴ See Christopher Howard, *The Hidden Welfare State: Tax Expenditures and Social Policy in the United States* (Princeton University Press 1997).

³⁵ See Vanessa Houlder, Megan Murphy, Financial Times, & Jeff Gerth, Tax wars: A fight worth billions, Sept. 2011, Financial Times.

³⁶ See Killian N. Betrowe, *Bank Lending, Banking and Financial Developments* (Nova Science Publishers, Inc. 2011).

³⁷ See William D. Warren & Steven D. Walt, *Secured Transactions in Personal Property* (Foundation Press 2010).

³⁸ An example of the shift by lenders to require more unconventional forms of collateral, see Claire Philpott & Susan Jahnke, Intellectual property: A new form of collateral, Mar. 6, 2005, Puget Sound Business Journal.

³⁹ See Thomas J Pinkowish, *Residential Mortgage Lending: Principles and Practices* (Cengage Learning 2011); see also James W. Kolari and Benton E. Gup, *Commercial Banking: The Management of Risk* (John Wiley & Sons, Inc. 2005).

⁴⁰ See Part IV and accompanying discussion.

and intellectual property.⁴¹ However, whether tax credits fall neatly into this category has yet to be determined. Some courts have avoided making an affirmative determination, others have engaged in confusing legal acrobatics to affirm them, and in some cases, courts have denied their use as collateral at all.⁴² Moreover, cases on the issue are incredibly sparse.⁴³ Very little judicial guidance exists in the way of tax credit financing, despite the fact that more and more security agreements are being drafted to include tax credits as a part of the collateral. In substantial transactions where a great deal of capital is at stake and a large portion of the security is bound up in tax credit allocations, the prospect of a court invalidating the security should give more than just a moment's pause to lawyer and businessperson alike. Tax credit financing is an emerging trend in today's business world, but how solid is its foundations?

This Article attempts to lay that foundation by analyzing the theoretical underpinnings of the UCC's category for general intangibles and showing how classification as a general intangible can and should comport with the legal substance of tax credits as a form of secured financing. Part I investigates the theory and nature that forms the basis of tax credits and their economic value, as well as provides some background and analysis of the UCC's collateral category for general intangibles. Part II gives an overview of the relatively meager amount of case law on tax credit financing and explains how courts have struggled with this new concept. Part III analyzes how courts have treated other types of general intangible assets; a treatment, which may help in forming the basis of the jurisprudential analysis for tax credit financing. Taking these theories and background a step further, Part IV makes several recommendations on how courts can theoretically approach cases involving tax credits used as collateral in secured transactions. The Article concludes that tax credits should be treated as permissible collateral under article 9 and that courts should adopt a flexible and broad view when confronted with these and other types of emerging and nontraditional security.

⁴¹ See Lars S. Smith, General Intangible or Commercial Tort: Moral Rights and State Based Intellectual Property as Collateral Under Ucc Revised Article 9, 22 Emory Bankruptcy Developments Journal 95 (2005).

⁴² See Part IV and accompanying discussion.

⁴³ *Id.*