LOEB & LOEB LLP

Finance

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It's All Fun and Games Until Someone Sues for Breach of Contract

Loans secured by stock are an important and popular product offered by many lenders to individuals and other borrowers. The ability of a lender to sell the stock held as collateral is very much dependent on the documentation governing the loan. When and to what extent a lender may realize upon (or liquidate) the stock to repay the indebtedness under the loan should be carefully and clearly set forth in the loan documents. A recent federal court case analyzed the ability of a lender to act upon stock pledged to secure a loan, and provides insight into valuable language to be included in the loan documentation.

In *Kinzel v. Merrill Lynch*, the Sixth Circuit affirmed the judgment of the district court in favor of Merrill Lynch, finding that the financial services company breached neither the contract nor its duty of good faith under the terms of the loan management account agreement between the parties, in selling amusement park stock held as collateral for an $8 million loan the financial services company advanced to purchase the shares.

Richard L. Kinzel, CEO of Cedar Fair Entertainment Company, entered into an agreement with Merrill Lynch in April 2008 to borrow approximately $8 million to exercise his stock options in Cedar Fair, a publicly traded company with the appropriate NYSE ticker symbol "FUN." The terms of the agreement incorporated 12 clauses that called for Merrill Lynch to liquidate collateral, one of which was "in its sole discretion and without prior notice," "if the value of the … collateral is in the sole judgment of [Merrill Lynch] insufficient."

With the recession and the slide in the stock market, the market value of the FUN stock declined precipitously and, in March 2009, fell to $6.99 per share from the acquired market value of $23.19 in 2008. On March 2, 2009, Merrill Lynch began to sell off shares of the FUN stock for repayment of the loan, and over the course of a day of trading, liquidated 167,900 shares at an average price of $6.38, applying proceeds of more than $1 million to pay down the loan balance.

Kinzel sued Merrill Lynch and Bank of America (which acquired Merrill Lynch in 2009) for breach of contract and breach of the covenant of good faith and fair dealing, claiming that he would still own an additional 167,900 shares of FUN stock if Merrill Lynch had not liquidated the loan collateral. On Sept. 27, 2010, when the suit was filed, the share price of FUN stock had rebounded to $12.63 per share.

The District Court for the Northern District of Ohio dismissed all of the counts in the second amended complaint except the good-faith claim, and denied Kinzel's motion for leave to file a third amended complaint, finding that plaintiffs could not state a breach of contract claim. After a bench trial, the court found for Merrill Lynch on the good-faith claim.

The Sixth Circuit affirmed the district court's decision, holding that the lower court had not abused its discretion in denying plaintiffs leave to amend their complaint: "Even if all the facts in the Kinzels' pleadings are true, the Kinzels cannot show that Merrill Lynch actually breached any term of the LMA when it liquidated the Kinzels' shares: the Kinzels had given 'ultimate control' and 'sole discretion' to Merrill Lynch to liquidate the collateral in the Securities Account when the stock market crashed, and Merrill Lynch acted accordingly."

The court rejected plaintiffs' argument that the Utah Uniform Commercial Code, § 70A-9a-611 — which requires that a secured party disposing of collateral after default must send a "reasonable authenticated notice of disposition" to the debtor — applied to invalidate the provision allowing Merrill Lynch to liquidate collateral upon the occurrence of any of the remedy events without first demanding repayment. Section § 70A-9a-611 applies only after a default — and no default occurred under the terms of the agreement governing the loan. The court also noted that § 70A-9a-611 does not apply "if the collateral is perishable or threatens to decline speedily in value or is of a type customarily sold on a recognized market," and that "it is undisputed that FUN shares are 'of a type customarily sold on' the New York Stock Exchange."

This case is an important reminder of the consequences of loan documentation and drafting and negotiation. Had the LMA provided (either in its original form or through negotiation with the borrower) that the shares could only be liquidated upon an event of default under the LMA (instead of "in Merrill Lynch's sole discretion if the value of the … collateral is in the sole judgment of [Merrill Lynch] insufficient"), the Uniform Commercial Code (and its requirements with respect to notices provided in connection with the sale of collateral) would have applied. In that case, Merrill Lynch would not have been able to sell the shares with such expediency or without notice, which could have further reduced the value of the collateral. In addition, had the loan documentation provided a threshold other than "sole discretion" or required a floor only below which the lender may liquidate the stock, Merrill Lynch would have been held to a different standard that may have altered the outcome.

The result of the case is an important reminder that lenders must be aware not only of how their form documents are drafted, but also of how modifications in response to borrower requests may affect the rights and remedies under those documents.

The business of amusement parks is fun, but as the U.S. Court of Appeals for the Sixth Circuit noted, litigation related to the financing of holdings in amusement parks? Not so much.

For more information, please contact Bryan Petkanics (bpetkanics@loeb.com or 212.407.4130), Anthony Pirraglia (apirraglia@loeb.com or 212.407.4146) or any member of the Loeb Finance Practice below.

Loeb & Loeb's Finance Practice

CURTIS W. BAJAK	CBAJAK@LOEB.COM	310.282.2024
DANIEL B. BESIKOF	DBESIKOF@LOEB.COM	212.407.4129
ROBERT CALDWELL	RCALDWELL@LOEB.COM	+852.3923.1115
MIRIAM L. COHEN	MCOHEN@LOEB.COM	212.407.4103
NICHOLE D. CORTESE	NCORTESE@LOEB.COM	212.407.4958
WALTER H. CURCHACK	WCURCHACK@LOEB.COM	212.407.4861
KEVIN M. EISENBERG	KEISENBERG@LOEB.COM	212.407.4123
RICHARD FACUNDO	RFACUNDO@LOEB.COM	212.407.4178
KENNETH D. FREEMAN	KFREEMAN@LOEB.COM	212.407.4086
JEFFREY S. FRIED	JFRIED@LOEB.COM	212.407.4987
SCOTT J. GIORDANO	SGIORDANO@LOEB.COM	212.407.4104
DOV GOODMAN	DGOODMAN@LOEB.COM	310.282.2238
WILLIAM M. HAWKINS	WHAWKINS@LOEB.COM	212.407.4126
NANCY S. JACOBSON	NJACOBSON@LOEB.COM	312.464.3160
STAN JOHNSON	SJOHNSON@LOEB.COM	212.407.4938
LANCE JURICH	LJURICH@LOEB.COM	310.282.2211
STEVEN M. KORNBLAU	SKORNBLAU@LOEB.COM	212.407.4217
DAVID B. KOSTMAN	DKOSTMAN@LOEB.COM	212.407.4196
CHERICE LANDERS	CLANDERS@LOEB.COM	212.407.4204
JADA SOYUN LEE	JSLEE@LOEB.COM	+852.3923.1150
JC LEE	JCLEE@LOEB.COM	+852.3923.1146
RICHARD A. NARDI	RNARDI@LOEB.COM	212.407.4009
JOHN J. OBERDORF, III	JOBERDORF@LOEB.COM	212.407.4190
BRYAN G. PETKANICS	BPETKANICS@LOEB.COM	212.407.4130
ANTHONY PIRRAGLIA	APIRRAGLIA@LOEB.COM	212.407.4146
EMILY RAKOWICZ	ERAKOWICZ@LOEB.COM	212.407.4867
DANA ROSENTHAL	DROSENTHAL@LOEB.COM	212.407.4156
P. GREGORY SCHWED	GSCHWED@LOEB.COM	212.407.4815
PETER G. SEIDEN	PSEIDEN@LOEB.COM	212.407.4070
PAUL W. A. SEVERIN	PSEVERIN@LOEB.COM	310.282.2059