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WHAT YOU MUST KNOW ABOUT THE NEW ARTICLE 9

Perfecting your security interests under Article 9 of the Uniform Commercial Code (UCC) in accounts receivable, inventory, equipment and other personal property is extraordinarily important in the event a borrower defaults. Surprisingly, when we examine security documents after a default in preparation for a foreclosure or a bankruptcy filing, we often find fatal mistakes. These mistakes include: (1) failing to properly describe the collateral in both the security agreement and the financing statement; (2) failing to correctly spell or otherwise identify the name of the borrower; (3) failing to timely file financing statements ensuring first lien status; (4) failing to file financing statements in the proper jurisdiction; (5) failing to notify existing lien holders of purchase money security interests in inventory or consignments; and (6) failing to obtain possession or control of collateral when that is necessary for perfection. The catastrophic result of the failure to properly perfect is to render the lender's security interest void and convert it into an unsecured creditor equal with vendors, employees and most bond debt. The results of perfecting a security interest, but not doing so on a timely basis are twofold.

First, another secured creditor may slip in front. Second, in the event of bankruptcy, an untimely lien may be set aside as a preferential transfer.

Another area where lenders often get stung is in the process of enforcing a security interest by foreclosure. In other words, did the lender hold a commercially reasonable sale? Did the lender notify the proper parties? Or, if the lender held off selling the collateral because of a poor market, is it deemed to have accepted the collateral in full satisfaction of the debt and waived the

potential for recovering a deficiency against the obligor or the guarantor?

Article 9 has been substantially revised to address a myriad of concerns. The purpose of this paper is to set out as succinctly as possible what lenders must know to properly perfect and enforce their security interests under the new Article 9. This legislation goes into effect in states where it has been adopted on July 1, 2001, and all security interests created thereafter must comply therewith. In order to alleviate some of the expense of conforming security interests existing prior to July 1, 2001, the new Article 9 contains a series of key transition rules lenders must know particularly when it comes time to renew existing filings. This paper is not meant to be an exhaustive legal discussion of the changes. Rather, it is intended to explain the practical effect the new Article 9 will have on a lender's every day business.

Perfection by Filing UCC-1 Financing Statements

The UCC-1 financing statement contains only a few important elements, all of which have given lenders numerous headaches while enriching my brother litigators. The new Article 9 simplifies these elements and thereby should reduce lender maladies and provide other more interesting work for lawyers. These basic elements are: (1) filing in the proper jurisdiction; (2) the borrower's name and signature; and (3) an adequate description of the collateral. As discussed below, the new Article 9 simplifies all of these elements.

Filing Location

Have you ever loaned money to a company that does business in multiple states? Have you ever wondered where a UCC-1 should be filed if the company was incorporated in Delaware, its headquarters are in California, and the collateral is located in Texas? You are not alone. Under the old Article 9, the solution to this vexing problem depended on the nature of the collateral. Good lending attorneys probably advised their clients to file in all three places. Moreover, if the borrower's business was national in scope, lenders often filed UCC-1 financing statements in all 50 states. New Section 9-307(e) states that if the borrower is an organization which is registered in a state, then the location of the business is the state of registration. In other words, if you are making a loan to a corporation which was incorporated in Delaware, the only place you have to file a UCC-1 is in Delaware. This not only saves the lending community from having to either make a judgement call

about where to file or otherwise file all over the place, it means that before lenders make a loan, they will only have to check one location to ensure priority.¹ If you take a security interest in assets owned by a company organized abroad, the UCC-1 need only be filed in Washington, D.C.

Name

Under the old Article 9, many parties (i.e. borrowers or competing lien holders) alleged that a lender's security interest was not perfected due to a minor misspelling. There are many cases going in many different directions which discuss the nature of a minor misspelling. New Section 9-506(c) provides a rule which should alleviate this litigation. Essentially, it states that if an electronic search of the correct name turns up the UCC-1, then the error will be considered minor and the lender will not lose its perfection. Since many electronic searches can pick up spelling variations, a lender should not lose perfection by a minor misspelling. On the other hand if the misspelling is so bad that an electronic search will not pick up the UCC-1, then the lender will lose perfection. Since the issue is judged by the electronic search logic used in the office where the UCC-1 was filed, there is nothing for a court of law to interpret and litigation expenses on this issue should be reduced or eliminated.

Borrower's Signature

Under the old Article 9, the borrower had to sign the financing statement. This element is eliminated under new Section 9-502. Moreover, new Section 9-509 states that any person authorized by the Borrower may file the financing statement and contemplates that this authority will be granted in the security agreement. Thus, lender's will no longer have to obtain the borrower's signature. Although this was not difficult at the loan closing, it is more difficult down the road when, for example, new collateral or a new name needs to be added. The lender will not have to negotiate with the borrower to obtain a signature. Moreover, this rule will facilitate electronic filing where that service is available.

¹ This statement, however, will technically only be true after expiration the transition period, which is more fully discussed below.

Description of Collateral

Under the old Article 9, many parties (i.e. borrowers or competing lien holders) alleged that a lender's security interest was not perfected in particular items of collateral because they were not properly described in the UCC-1. Moreover, many state courts do not accept a generic description such as *All assets.* This led to the rather inefficient practice of attaching lengthy lists of collateral to UCC-1 financing statements. New Section 9-504(2) specifically states that listing *All assets* or *All personal property* in the UCC-1 **is** sufficient for purposes of perfection. Please note, however, that a description by category (e.g. accounts, inventory, equipment, etc.) is still required in the security agreement. This change should make a UCC-1 the one page document it was originally intended to be and should efficiently facilitate electronic filing.

Purchase Money Security Interests and Consignments

The rules for purchase money security interests have not changed significantly, except that consignments are now treated as if they are purchase money security interests. In order to perfect a purchase money security interest, lenders must file their UCC-1 financing statements within 20 days after the debtor receives delivery of collateral other than inventory. Where inventory is involved, the lender must also notify any prior existing lienholders.

Perfection Other Than By Filing

In several major instances, the old Article 9 provided for perfection by means other than the filing of a UCC-1 financing statement. The new Article 9 significantly changes these rules. The first one is where the collateral is being held by a third party such as a bank with respect to money. This change has major implications for asset based lenders that are not banks. The second one involves situations where third parties such as bailees are in possession of inventory or other personal property. The last one involves security interests in negotiable instruments. These changes are discussed below.

Bank Accounts

If the lender is a bank it automatically holds a security interest under common law in all deposit accounts held at the bank. This is why credit agreements often require debtors to maintain

their deposit accounts at the lending bank. Non-bank asset based lenders, however, are at a disadvantage since they do not have deposit accounts. Therefore, asset based lenders must ordinarily rely on the cumbersome lock box device. This disadvantage is erased by new Section 9-104. It grants non-bank lenders the ability to perfect liens on deposit accounts by having all three parties (i.e. the secured party, the bank and the debtor) execute an authenticated record authorizing the bank to comply with the instructions of the secured party directing disposition of the funds. Moreover, the fact that the debtor also has the right to direct disposition of funds in the account does not destroy perfection. Essentially, this provides asset based lenders with a tool whereby the debtor has unfettered access to the account so long as no default exists. But, in the event of default, the asset based lender can instruct the bank on disposition of funds. Incidentally, this is the same way lenders can perfect security interests in certificated securities under Article 8. Perfection by similar methods of control can also be utilized in the case of letters of credit and electronic chattel paper.

Negotiable Instruments

Under the old UCC, the only way to perfect liens on negotiable instruments (i.e. promissory notes, chattel paper, etc.) is to obtain possession of the original documents. New Section 9-312(a), however, permits perfection in instruments by filing. The priority obtained from perfection by filing only exists to the extent the instruments remain in the hands of the debtor. Thus, perfection by filing will be superior to creditors with judgment liens and bankruptcy trustees. However, under new Section 9-330(d), a purchaser for value of the instrument from the debtor without notice of the filing will defeat perfection by filing. Section 9-330(f), however, provides some protection against this type of an occurrence by providing that if the instrument itself indicates that it was assigned, the purchaser will be deemed to have notice. This is extremely valuable in situations where you might be lending money to a finance company that has pledged promissory notes as collateral for the debt, but which needs to retain the original notes in order to effectuate collection. By simply requiring the debtor to place a legend on the notes stating that they have been assigned, a potential purchaser cannot take priority. This is an easy way to stop the rare practice of a debtor pledging or selling notes to multiple parties.

Bailees

Under old Article 9, the method for perfecting security interests in personal property held by third parties such as bailees was simply to give notice to the third party. Under new Section 9-313(c), the lender must obtain an authenticated acknowledgment from the third party in possession of the collateral. This governs assets that are not subject of negotiable documents of title such as bills of lading.

Enforcement of Your Security Interests

How does a lender enforce its security interest? Traditionally, the answer is that it must hold a commercially reasonable foreclosure sale of the collateral. There has been much litigation over the meaning of the phrase *commercially reasonable* and this will likewise continue under the new Article 9.

Adjustment of Sale Price

Under new Section 9-626(a)(3), if a court finds that the sale was not commercially reasonable, then it can adjust the deficiency amount to reflect what should have been recovered. In situations where the secured party bids the collateral in, Sections 9-615(f) and 9-626(a)(5) provide that if the obligor proves the bid received at the sale was significantly below the range of prices that would have been realized in a competitive bid to a third party, then the court can once again adjust the deficiency. Further, if the lender decides to sell the collateral on credit, new Section 9-615(c) does not require it to credit the entire purchase price against the debt at the time of sale. Rather, the lender can credit the debt as payments are received from the foreclosure purchaser. This effectively enables the lender to pursue other assets of the debtor or secondary obligors such as guarantors for larger amounts.

Notification

Under the old Article 9, many states differed on the type of notice a lender had to give to effectuate a foreclosure. New Section 9-611(c) requires reasonable notice to all guarantors or other parties liable on the debt and to all other secured creditors. Thus, lenders will have to obtain a UCC search to determine the identity of other secured creditors entitled to notice. As under the old Article 9, unsecured creditors need not be notified of the foreclosure sale. Under new Section 9-612, a ten

day notice of sale is *per se* reasonable. Of course, ten days will not be required if the collateral is perishable.

Temporary Retention of Collateral

Under both old and new Article 9, a lender can propose to retain collateral in full satisfaction of the debt. Sometimes lenders elect to delay selling collateral into a poor market. Under old Article 9, such a delay led some courts to hold that the lender was deemed to have retained the collateral in full satisfaction and could not pursue a deficiency against the debtor or guarantors. New Section 9-620(b) overrules these cases. Therefore, lenders no longer need to conduct distress sales of collateral, and can conduct private sales designed to maximize value over a much longer period of time.

Transition

What happens to existing security interests when the new Article 9 takes affect? The answer lies in the transition rules contained in Part 7. The general rule is that a security interest that is perfected under the old Article 9 will remain perfected for a period of one year or until July 1, 2002. The purpose of this rule is to give lenders this amount of time to comply with any new perfection requirements . However, if the procedure for obtaining perfection remains the same, the lender need do nothing further. Moreover, the rules depend to a large extent on whether the existing security interest was perfected by the filing of a UCC-1 financing statement, unperfected or perfected by possession. The easiest way to understand these rules is to review the examples discussed below.

Security Interest Perfected by UCC-1 Filing

The most common situation involves security interests which were perfected prior to July 1, 2001 by the filing of a proper UCC-1 financing statement. Fortunately, under these circumstances, the one year rule does not apply and lenders need do nothing until the filing lapses. Typically, a UCC-1 financing statement lasts for five years. If the security interest remains in effect at the end of five years, the lender must to file a continuation statement. Assuming the lender's existing UCC-1 will lapse sometime after July 1, 2001, it will have to file a continuation statement, but it may be in a different place. As discussed above, the correct place to file a UCC-1 under the new Article 9 is the state where the debtor is incorporated. If the original UCC-1 was filed in the state of

incorporation, under new Section 9-705, the lender can file a continuation statement in the same state. However, if the state of incorporation is different (which may very well be the case because so many borrowers are incorporated in Delaware or Nevada), under new Section 9-706, the lender must file an initial UCC-1 in the state of incorporation. Even though the document is denominated as an initial UCC-1, the priority will relate back to the original filing.

Unperfected Security Interests

Suppose the lender holds a security interest in an asset, but the interest has not been perfected by July 1, 2001. Under these circumstances the lender must perfect under the rules of new Article 9. One way this might happen (other than simply forgetting to file the UCC-1 in the first place) is if the collateral description contained in the UCC-1 is insufficient. For example, as discussed above, under old Article 9 a description such as **A**ll personal property[®] may not be sufficient, while such a description is sufficient under the new Article 9. If the UCC-1 was filed in the state of incorporation, it will automatically become effective on July 1, 2001. If it is not filed in the correct state, then the lender file another one in the correct state.

Instruments

Another example is perfection of a security interest in instruments. Under the old Article 9, a lender had to have possession of instruments in order to be perfected. As discussed above, under the new Article 9, the lender can perfect a lien on instruments against all parties except bona fide purchasers by filing a UCC-1. If the lender already has a UCC-1 on file in the state of incorporation that lists instruments as collateral, it will become automatically perfected on July 1, 2001. Again, if it is not filed in the correct state, the lender simply needs file it in the appropriate state. On the other hand, if the lender has possession of the instruments, then it need do nothing since that is a sufficient means of perfection under both the new and old Article 9.

Collateral Held by Third Parties

Another important transition rules involves situations where the collateral is in the hands of a third party such as a bailee. As discussed above, new Article 9 requires lenders to obtain an authenticated acknowledgment from the bailee in order to perfect.

In these circumstances, the transition rules give lenders with existing liens one year period, or until July 1, 2002, to obtain such an acknowledgment from the bailee.

Conclusion

The basic general concepts contained in the old Article 9 are retained in the new version. In this writer's opinion, the primary purpose of the newer version is to simplify the filing process, enable electronic filing and eliminate a few issues which promote litigation. It should achieve these goals. If you have any questions regarding the new Article 9, please give me a call at (713) 961-9045.