Protecting Yourself as a Secured Creditor

New Developments: 2010 Proposed Amendments to Article 9

By Cynthia G. Fischer

The Uniform Commercial Code (“UCC”) was drafted by two independent commissions (the Uniform Law Commission and the American Law Institute). It was recommended for adoption to all fifty states in the U.S. in an effort to harmonize the law of sales and other commercial transactions in the United States. The UCC is comprised of nine articles. With certain state specific revisions, Article 9 of the UCC, governing secured transactions, has been enacted in all fifty states and the District of Columbia. While there are state variations in Article 9 as adopted, the substantive content is largely similar. In 2010, to address issues that have arisen in practice, these two commissions proposed amendments to Article 9 with a recommended effective date of July 1, 2013.

This article discusses how creditors can better protect themselves by obtaining a security interest in certain assets of their debtors in accordance with Article 9. It is a simple and inexpensive procedure but failure to do so can have a significant impact on a creditor’s business interests. In addition, this article will review the 2010 proposed amendments to Article 9 and how they can provide additional protections to the secured creditor.

The Current Law

The faltering economy has caused, and will continue to cause, financial distress to businesses across all sectors, resulting in many credit defaults. A properly created security interest, perfected in accordance with Article 9, can offer a significant benefit to creditors; however, many creditors do not take advantage of the extra protection offered by the relatively simple procedures detailed under that article. Article 9 allows lenders, suppliers of goods and consignors of goods to establish a security interest in the assets of a debtor, which become collateral. Collateral can include personal property such as inventory, accounts receivable, intangibles and fixtures as well as the proceeds of certain collateral.

A security interest in any or all of a debtor’s property provides the creditor with an added level of protection if the debtor is later unwilling or unable to repay the creditor. Having a position as a secured creditor can be crucial in the event of a debtor’s financial distress, insolvency or bankruptcy.

Obtaining a Security Interest

To obtain a security interest under Article 9, the debtor must execute a security agreement granting a security interest in favor of the creditor. It can be a separate agreement between the parties or a section or provision contained in a broader document governing the creditor-debtor relationship, such as the terms and conditions of sale, so long as the document is executed by the debtor. A security interest exists, and “attaches” to the collateral, as soon as the security agreement is executed by the debtor, value is given, and the debtor has rights in the collateral.

Once a security interest has been created, a creditor should also be aware of the rules under Article 9 which establish priority among competing security interests. The specific priority rules in Article 9 make the secured party’s priority dependent on “perfection” of the security interest, and depending on the type of collateral, there are different ways to “perfect” and establish priority. Filing a UCC-1 financing statement (“UCC-1”) is the most common, and in some cases, the exclusive method of perfection. Among other things, the UCC-1 describes the collateral subject to the security interest and identifies the debtor and the secured creditor.
The filing of the UCC-1 “perfects” the security interest and establishes priority against subsequent filers, lien creditors and the debtor’s trustee in bankruptcy. It can be filed before the security agreement is signed, but should definitely be filed as soon as possible after the security agreement is signed. In the case of a “purchase-money security interest” (“PMSI”) which is discussed below, filing should occur before goods are shipped or delivered. It should be noted that there are limited types of collateral for which the filing of a UCC-1 is not effective to perfect a security interest.

The Mechanics

Before filing a UCC-1, a creditor should perform a UCC lien search to determine if other creditors have already perfected security interests in the collateral. Even if a previous creditor has already filed a UCC-1 against the collateral, a subsequent creditor should still file a UCC-1 to protect its interests. Earlier filers will have priority and will be paid first in the event of debtor’s bankruptcy. However, suppliers of goods or property who have a PMSI may be able to obtain a special priority and go to the head of the line. Such suppliers can obtain priority over previous filers, with respect to collateral (and, in most cases, its proceeds) supplied by them. In this case, a search is essential because of the prior notice required, as discussed below.

A completed UCC-1 financing statement is then filed, with all necessary filing fees, with the Secretary of State in the state where the debtor is located. In the case of a registered organization such as a corporation, this would be the state in which it is organized. In the case of an individual, it is the state of the debtor’s principal residence, for both personal and business assets. Filing against fixtures should be made where the assets are located. Filing fees are reasonable. For example, in New York, the fee is $40 for a paper and $20 for an electronic filing. For an additional nominal fee, it is advisable to request a confirmation copy of the filing, date-stamped to indicate its receipt and filing.

UCC-1 financing statements are valid for up to five years, but they may be renewed for additional five year periods by filing a continuation statement within the six month period before the end of the current five year period. Conversely, when the debtor repays its debt to the creditor, and the security agreement is terminated, a “termination statement” (“UCC-3”) discharging the security interest should be filed. Both of these forms are filed in the same manner and in the same jurisdiction as the original UCC-1.

Purchase-Money Security Interest

A purchase-money security interest — or “PMSI” — is available to a creditor who supplies goods or property to the debtor. The primary difference between a PMSI and an ordinary security interest is that a PMSI can only secure an interest in property that the creditor sells to the debtor or delivers to the debtor on consignment.

An enormous advantage of a PMSI is that, if properly perfected, it can achieve priority over previous filings. Because the debtor would not have been able to acquire the property that is the subject of the PMSI without the creditor’s assistance, the PMSI creditor is granted priority over other security interest holders with respect to the property supplied as well as to certain of its products and proceeds. It is rare that a business has no bank credit lines, financing or other secured debt already in place, and thus, a PMSI can be a critical tool for eligible creditors.

To perfect a PMSI, two additional steps must be taken: a) creditors who hold conflicting interests must be notified in writing of the conflict, and that the PMSI creditor will file a UCC-1 financing statement to secure a PMSI debt; and b) the UCC-1 financing statement must be filed before any goods are shipped or transferred to the debtor. It is not necessary to make separate filings each time collateral is provided.
Foreign Creditors and Debtors
Creditors located outside of the U.S. may avail themselves of the benefits of Article 9 in the same way as a domestic creditor. Likewise, security interests can be obtained in the collateral of non-U.S. debtors doing business in the U.S. A foreign corporation does not qualify as a “registered organization.” The general rule for choice of law purposes is that the debtor’s jurisdiction will govern perfection. However, if the law of the foreign jurisdiction affords no public notice or registration system of non-possessory security interests, the UCC steps in and, absent certain special situations, the debtor is deemed to be located in the District of Columbia.

An Essential Protection
Obtaining a security interest is an important step for any creditor to protect its rights in the collateral and it is a relatively simple and inexpensive procedure. Yet, it can be of enormous importance in collecting debts from debtors in financial difficulty. In addition to achieving priority in the event of bankruptcy, a secured creditor may also have greater leverage in negotiating payment from a debtor experiencing financial difficulties.

Whether providing goods, financing, or offering goods on consignment, every creditor should take advantage of this tool provided by the UCC. It is impossible to predict who will have problems in the future and, therefore, it is in every creditor’s best interest to adopt this procedure with all of its clients and customers.

2010 Amendments to UCC Article 9
Amendments to UCC Article 9 - Secured Transactions were proposed by the Uniform Law Commission and the American Law Institute in 2010. The amendments are designed to go into effect on July 1, 2013. As of January 1, 2012, nine states have adopted these amendments.

The amendments are designed to correct ambiguities in the current law and address issues that have arisen in practice. This includes issues that are the result of non-uniform language adopted by various states and inconsistencies that have been raised by judicial decisions. The amendments provide greater protection to the secured creditor and streamline the process. The most notable changes are the amendments regarding the correct name of the debtor, treatment of after acquired collateral in the event of debtor’s relocation or merger into a new entity, and the new opportunity for secured creditors to file “information statements.” The issue of the correct name of the debtor is the most significant of the amendments as it addresses those situations where, because of an error in the name of the debtor, a secured creditor’s seemingly perfected security interest is in fact found to be unperfected, leaving the security interest subordinate to the rights of a lien creditor or other filers and affecting the secured creditor’s priority in the case of debtor’s bankruptcy.

In addition, there are a number of “technical amendments” including those dealing with the content of the UCC-1 financing statement and accommodation of collateral in an electronic form, as well as the transfer and disposition of electronic collateral. Finally, there is additional commentary to Article 9 which addresses among other issues, certain judicial decisions criticized by UCC scholars and practitioners.

The Debtor’s Name: Individuals and Registered Organizations. Probably of most practical significance to the secured creditor are the amendments that provide greater guidance as to the name to be provided on a financing statement for an individual debtor. Financing statements are effective to perfect most security interests provided that the financing statement complies with the requirements of Article 9, such as providing the debtor’s name. Currently, with respect to individual debtors, Article 9 instructs the filer to
use the “individual name” of the debtor. The 2010 amendments provide States with two alternative solutions. Alternative A requires a filer to provide the name on the debtor’s unexpired driver’s license. If the debtor does not have a driver’s license, the filer must use either the “individual name” of the debtor (i.e. the debtor’s name as required under current law) or the debtor’s surname and first personal name. Alternative B leaves intact the current requirement to use the debtor’s “individual name” but also provides that either the name on the debtor’s driver’s license or the debtor’s surname and first personal name will be sufficient as well. Further, the majority of the nine states which have adopted the 2010 amendments have added identification cards as alternatives to the driver’s license under Alternative A. This clarification is of paramount importance as failure to perfect under the correct name can result in loss of priority. So long as the debtor has a driver’s license, which in most cases will be true, use of the name on the license is available under either alternative and gives the secured creditor some certainty.

With respect to registered organizations, (which includes most business entities) the filer currently must provide the name of the debtor indicated on the public record of the debtor’s jurisdiction of organization which shows the debtor to have been organized. Under the 2010 amendments, the filer must use the name of the registered organization on the “public organic record” most recently filed with or issued by the registered organization’s jurisdiction of organization. “Public organic record” has been added as a new definition which clarifies the records to use in determining the proper name for a registered organization. Also, the term “registered organization” has been clarified to confirm that it includes corporations, limited partnerships, limited liability companies and statutory trusts.

After Acquired Property. Under current law if a debtor relocates to a new state, the security interest in the assets of the debtor at the time of relocation continues perfected for four months after the change. So long as the secured creditor files in the new jurisdiction within the four month grace period, it will maintain perfection and priority in such assets. Oftentimes, a debtor will also grant to a secured creditor a security interest in “after-acquired property,” which is property the debtor does not yet have rights in, such as future inventory or accounts. The security interest in collateral acquired by a debtor after relocating is unperfected until the secured lender files in the new state. Similarly, in the case of a new debtor which acquires collateral subject to a security interest of another debtor, located in a different state, typically through a merger or consolidation, the secured creditor has a one year grace period to file in the new state. However, again, the security interest in after acquired collateral is unperfected until there is a new filing. The 2010 amendments change this by providing that security interests in after-acquired property arising within four months after a debtor relocates or assumes collateral are perfected, and will remain perfected provided a filing is made in the new jurisdiction within the four month grace period.

Information Statements. Article 9 currently provides that a debtor may file a “correction statement” providing notice to third parties that a filed financing statement or other record is inaccurate. The 2010 amendments change the term to “information statement” and now also afford the secured party the right to file an “information statement” in the event it believes that a filing, such as a termination statement, has been wrongfully filed. As before, the filing of an information statement does not affect the effectiveness of the initial financing statement or other record. It does, however, put third parties on notice that there is a disputed filing.

Technical Amendments. A number of amendments which have been characterized as “technical” nonetheless have a significant impact on procedures and definitions. A few of them are outlined below:
a. **Financing Statements.** Certain information currently required on financing statements such as the type of organization, jurisdiction of organization and organizational identification number of a debtor, will no longer be necessary. There is also clarification as to the proper information to be contained on a financing statement when the collateral is held in a statutory or common-law trust or in a decedent’s estate.

b. **Sale of Payment Intangibles and Promissory Notes.** The amendments clarify that while, as a general rule, the override to contractual restrictions on security interests found in Section 9-406 (d) does not apply to the sale of a payment intangible or promissory note, it does apply to the enforcement of a security interest through the sale or strict foreclosure of payment intangibles and promissory notes due to debtor’s default.

c. **Electronic Forms and Dispositions.** Several amendments deal with issues raised by collateral in an electronic form and electronic filings and dispositions of collateral. For example, the general rule for perfection of electronic chattel paper has been made consistent with the Uniform Electronic Transactions Act. Likewise, clarification is given with respect to treatment of certificates of title where the certificates of title are, in whole or in part, in electronic form. The definition of “certificate of title” will now encompass electronic records where such records are maintained by states in lieu of issuing certificates of title. Additionally, further guidance is given with respect to the notice requirements applicable to electronic dispositions of collateral (specifically, time and “electronic location” of on-line auctions) when a security interest is enforced by sale or other disposition of the collateral.

d. **Commentary.** In addition to new commentary explaining the various proposed amendments, Comment 3 to Section 9-307 adds that an additional requirement for deeming a non-U.S. debtor to be located in the District of Columbia is that none of the special rules applicable to registered organizations organized under state or federal law, foreign banks or foreign air carriers apply.

**Status**
As of October 1, 2011, nine states (list) have adopted the 2010 proposed amendments. The legislation is currently pending in five other states, the District of Columbia and Puerto Rico. It is hoped that all fifty states, the District of Columbia and relevant U.S. territories will adopt the amendments uniformly, including the recommended effective date of July 1, 2013, so as to avoid any confusion in interstate transactions.

This document is a basic summary of legal issues. It should not be relied upon as an authoritative statement of the law. You should obtain detailed legal advice before taking legal action.

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