

PUBLICATION

Resting Comfortably - Four Paths to Perfection

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The last edition of Dispatches from the Trenches discussed the Article 9 concept of attachment. Once a security interest has attached and is enforceable by a lender, lessor or other person who has been granted a security interest (each, a "Secured Party") against the borrower, lessee or other person who grants such an interest (each, a "Debtor"), the question arises as to whether it is enforceable against other creditors of the Debtor.

The process of "perfecting" a security interest is what provides a Secured Party with rights in the collateral which are superior to certain other creditors. Basically, a "perfected" security interest prevails over any other creditor who uses judicial process to obtain a lien on collateral. Since a trustee in bankruptcy is given status of a lien creditor under §544(a) of the bankruptcy code, a perfected security interest will "beat" a bankruptcy trustee whose job it is to free up collateral for the unsecured parties.

Depending upon the method and timing of perfection, a perfected security party may also have a "priority" position over one or more other creditors. The Secured Party with the best priority position has a "first priority" security interest. It sometimes helps to view creditors of a Debtor as standing in a long line waiting their turn to start grabbing collateral (like people standing in one of those annoying roped lines at a bank waiting to withdraw money, although I'm sure those who do collection work wish it were as easy as giving a bank teller a withdrawal slip). The person first in line has a first priority interest, the next person a second priority interest and so on.

There are four primary ways in which an attached security interest may be perfected—filing, possession, control and automatic perfection.

The most common method of perfecting a security interest is filing a financing statement. Section 9-310 of the UCC provides the general rule that filing is the only manner in which to perfect security interests unless otherwise specified. It then lists the types of transactions where filing is not required.

Some of these exemptions exist because public notice of the security interest is governed by another statute, like a Certificate of Title Act. Other exceptions relate to situations where perfection is accomplished by "possession" of the collateral (under the theory that a Secured Party's possession should be sufficient notice of its interest).

Other exceptions relate to control, which is a concept similar to possession and is discussed below. Lastly, some security interests are automatically perfected because the drafters decided that other parties would not be misled by the lack of public notice or that the costs of filing were not worth the advantages it would provide (such as purchase money security interests in Consumer Goods).

A. Filing.

Article 9 of the UCC provides a sample uniform financing statement that must be accepted by the local filing offices.^[1] There is no requirement that a filer use the uniform financing statement, but all financing statements

must contain the following information and, in order to avoid a massive headache, should be on a form familiar to the local filing office:

1. Name of Debtor (must be accurate). Financing Statements are indexed under the name of the Debtor.^[2] As such, and it is crucial that the name of the Debtor listed on the financing be accurate. Prudent Secured Parties filing under Article 9 should obtain certified copies of any and all of the Debtor's formation documents (and amendments) that may be necessary to determine the exact name of the Debtor. Failure to include the exact name could render the financing statement ineffective.

This result stems from the fact that a failure to provide the correct name of the debtor is a "seriously misleading" error unless "a search of the filing office under the debtor's correct name, using the filing office's standard search logic, if any, would disclose a financing statement that fails to sufficiently provide the debtor's name."^[3] It is worth noting that "standard search logic" can vary widely amongst the different states.

2. Name of Secured Party (or Representative). The financing statement may name either the Secured Party or its representative and need not indicate the representative capacity. The name of the Secured Party is not used for indexing and therefore receives less scrutiny.

There are at least three different circumstances addressed under Article 9 in which a financing statement is effective even though it lists a different name for the Secured Party.

First, the financing statement can have the name of a "representative" of the Secured Party and need not even disclose the representative capacity. In particular, the UCC provides that states "[f]ailure to indicate the representative capacity of a secured party or a representative of a secured party does not affect the sufficiency of a financing statement."^[4]

Second, a secured party may assign its security interest to a third party and the financing statement will remain effective even if no amendment is filed to reflect the transfer of the security interest.^[5]

Third, errors in the name of the secured party do not necessarily cause a financing statement to be ineffective. In particular, the comments to §9-506 provide as follows:

Inasmuch as searches are not conducted under the secured party's name, and no filing is needed to continue the perfected status of security interest after it is assigned, an error in the name of the secured party or its representative will not be seriously misleading. However, in an appropriate case, an error of this kind may give rise to an estoppel in favor of a particular holder of a conflicting claim to the collateral.^[6]

It is worth noting generally that the Secured Party designated on the financing statement is the party with the power to amend it, terminate it or otherwise deal with it. In the event multiple Secured Parties are listed on a financing statement, each Secured Party may file amendments and termination statements with respect to its interest or may authorize another party to do so.

3. Collateral. All that is technically required is that the collateral be described by "any method, if the identity of the collateral is objectively determinable".^[7] A super-generic description (such as "all assets of the Debtor now owned or hereafter acquired or arising") is sufficient on a financing statement.^[8]
4. Debtor Signature not Required BUT Authorization Is. Neither the financing statement nor any amendment thereto requires the signature of the Debtor. All that is required is the "authorization" of the Debtor. The grant of a security interest in collateral constitutes an automatic authorization to file a

financing statement covering that collateral. However, prudent Secured Parties will often obtain separate authorization in the security agreement, particularly if the description on the filing is arguably broader than that in the security agreement. Consider, for example a financing statement containing the supergeneric description of "all assets" or "all personal property."

Those engaged in equipment leasing should also obtain express authorization to file a precautionary financing statement with respect to true lease transactions.

A special type of filing, usually called a "Fixture Filing", can be made with respect to fixtures, timber to be cut and as-extracted collateral. It is indexed in the real property records where mortgages and other interests in real property are recorded. In order to allow such indexing, Article 9 requires Fixture Filings to contain additional information not required for other filings.

Some differences relating to fixture filings rules and procedures include the fact that a financing statement filed as a fixture filing must: (a) indicate that it covers the applicable type of collateral—such as fixtures or as-extracted collateral; (b) indicate that it is to be filed for record in the real property records; (c) provide a description of the real property to which the collateral is related which is sufficient for the financing statement to fit into the real-property search system; and (d) provide the name of the record owner of the property if the Debtor is not the record owner.^[9] A record of mortgage can sometimes double as a fixture filing as well.^[10]

B. Possession.

Certain types of collateral may or must be perfected by possession. Money, for example, **must** be perfected by possession of the Secured Party.^[11]

A security interest in instruments, certificated securities, chattel paper, goods and negotiable documents **may** be perfected by possession.^[12] It should also be noted that, although a UCC Financing Statement is an effective method of perfecting a security interest in this collateral, possession provides certain priority rights. Those readers involved in the assignment of equipment leases are familiar with super-priority associated with possession of the sole original counterpart of the leases (which are chattel paper under Article 9).

C. Control

The concept of control is similar to the concept of possession. A security interest in investment property (including certificated securities), deposit accounts, letter of credit rights, electronic chattel paper or electronic documents may be perfected by obtaining "control" of the collateral.^[13] Control is the only method of perfection of Deposit Accounts.

Control over investment property and deposit accounts basically requires the issuer or depository institution to enter into a control agreement or other writing acknowledging that it will honor the instructions of the Secured Party without further consent of the Debtor.

Control of electronic chattel paper is a complex item intended to facilitate syndication of electronic transactions and is beyond the scope of these issue of Dispatches from the Trenches. It involves the blend of legal standards expressed in Article 9 as well as the technology necessary to meet those standards.

D. Automatic Perfection

Certain security interests are automatically perfected upon attachment. Many of these are not relevant to traditional commercial lenders such as: (1) a purchase money security interest in Consumer Goods; (2) security interests in investment property created by a securities intermediary or a commodities intermediary; and (3) an assignment of health insurance receivables to a health insurance provider.

One important security interest which benefits from automatic perfection is that of a Supporting Obligation. A "Supporting Obligation" means "a letter-of-credit right or secondary obligation [like a guaranty] that supports the payment or performance of an account, chattel paper, a document, a general intangible, an instrument, or investment property."^[14] Article 9 provides for automatic *attachment* of the Supporting Obligation and automatic *perfection* once the security interest in the obligation which it supports is perfected. In other words, a lender who takes assignment of chattel paper or an instrument which is guaranteed will automatically have a security interest in the rights under the associated guaranty. Once it perfects in the chattel paper or instrument, it will be deemed automatically perfected in the rights under the guaranty as well. Care should be taken not to confuse this automatic perfection of an interest in the Guaranty with steps necessary to perfect an interest in any collateral that the guarantor pledges, as debtor, as security for its obligations under the Guaranty.

Security interests in proceeds of original collateral are automatically perfected if the interest in the original collateral was perfected.^[15] However, the benefit of this perfection can be complicated and is beyond this scope of this issue of Dispatches from the Trenches.

[1] U.C.C. §9-521.

[2] U.C.C. § 9-519(c)(1).

[3] See U.C.C. § 9-506(a) ("A financing statement substantially satisfying the requirements of this part is effective, even if it has minor errors or omissions, unless the errors or omissions make the financing statement seriously misleading.") and U.C.C. §9-506(b) and (c) (indicating when the wrong name of the Debtor renders the financing statement seriously misleading).

[4] U.C.C. §9-503(d).

[5] U.C.C. §9-310(c)

[6] U.C.C. §9-506, Official Comment No. 2.

[7] U.C.C. §9-504(1) and 9-108(b)(6).

[8] U.C.C. §9-504(1)

[9] U.C.C. §9-502(b) and Official Comment No. 5.

[10] U.C.C. §9-502(c).

[11] U.C.C. §9-312(b)(3).

[12] See U.C.C. §9-313.

[13] See U.C.C. §9-314.

[14] U.C.C. §9-102(a)(77).

[15] U.C.C. §9-315(c).