PITFALLS IN THE PERFECTION OF A SECURITY INTEREST

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Articles and Publications:

Priority and Dischargeability of Tax Claims, Collier on Bankruptcy Taxation, 2006, 2010-2011 (Assistant to Contributing Author)

In re Gulf Coast Oil: Difficulties Ahead For Prospective Debtors Looking to Sell Substantial Assets Under 363(b)?, June 2009 (Author)

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PITFALLS IN THE PERFECTION OF A SECURITY INTEREST

I. INTRODUCTION

The primary purpose of this paper is to: (i) present the numerous "bear-traps" that can befall a secured creditor looking to perfect its security interest in personal property via the filing of a financing statement; and (ii) provide advice as to how to avoid such traps and ensure the perfection of the secured creditor's interest in its collateral via the filing of a financing statement. From another perspective, this paper can also be utilized as a potential "target list" by a creditor residing in an inferior position (*e.g.*, a second lienholder or unsecured creditor) looking to "topple the giant" by busting a heretofore superior lien and gaining equal footing with a party previously thought to be superior in position.

II. PREFACE

Because this paper focuses on perfection of security interests in personal property, much of the discussion will revolve around Revised Article 9 ("Article 9") of the Uniform Commercial Code ("UCC"), which generally applies to any interest created by contract in personal property and which secures payment or other performance of an obligation. UCC § 9-109 (2013). This paper assumes a familiarity with the basic concepts of secured financing (*i.e.*, the concept of establishing a security interest in collateral that is effective against the debtor's property, the concept of perfecting a security interest that is effective as to other prospective secured parties, etc.), and will focus on how to achieve perfection as to the subject collateral while dodging the various mistakes a party desiring perfection can make during the process.

Prior to initiating a discussion on the ins-and-outs of perfection of a security interest via Article 9, it is important to note that while all 50 states have adopted the UCC in pertinent part, no state is bound to accept the UCC in its entirety and may opt out of or alter numerous provisions of the UCC via enactment of its own statutes. For example, while Article 9 contains numerous exceptions to its general rule that the state where the debtor is located is the proper jurisdiction for the filing of a financing statement on most forms of collateral (including exceptions for fixtures, as-extracted collateral, goods covered by certificate of title, deposit accounts, investment property, and letter-of credit rights) Louisiana law does away with these exceptions and provides that the filing of a financing statement in the state where the debtor is located is valid as to these excepted categories. UCC § 9-301, 9-303, 9-304, 9-305, 9-306 (2013); La. R.S. 10:9-301(1). As this paper cannot encompass the numerous individual state exceptions to Article 9 of the UCC, this paper will deal exclusively with "standard" Article 9. Readers should accordingly consult state law to ensure no state-law exceptions exist as to the portions of Article 9 they are utilizing when seeking to perfect a security interest.

In addition, although there are numerous methods by which a secured creditor may perfect its security interest in its collateral (*i.e.*, filing of a financing statement, possession of the collateral, control of the collateral), this paper will focus primarily upon the pitfalls that can befall a creditor who attempts to perfect its security interest in personal property through the filing of a financing statement. While this paper provides caution as to certain types of collateral as to which the filing of a financing statement is insufficient for perfection (*i.e.*, possession or control is required), the majority of discussion will revolve around perfection via the filing of a financing statement.

III. ATTACHMENT

In order to properly perfect a lien on its collateral, the creditor's lien must first "attach" to the collateral. Without initial attachment of the creditor's security interest, the security interest is not enforceable against the subject collateral at all. UCC § 9-203 (2013). In order for a security interest to attach to the collateral and be enforceable against the debtor: (i) value must be given by the creditor for the security interest; (ii) the debtor must have rights in the collateral which is the subject of the security agreement; (iii) the security interest must be evidenced by a security agreement authenticated by the debtor which sufficiently describes the collateral. UCC § 9-203(a)-(b) (2013).

A. Value Must be Given

A creditor must tender "value" to the borrower under Article 9 in order for attachment to occur. Article 9 defines "value" far more broadly than traditional concepts of consideration typically utilized in a contractual context, and includes both the giving of a security interest in total or partial satisfaction of a pre-existing debt and a binding commitment to extend credit within the ambit of "value." UCC § 9-203(b)(1) (2013).

B. Debtor Must Have Rights in the Collateral

The debtor must possess at least some rights in the collateral or the power to transfer rights in the collateral to a third party in order for a security interest to attach to the collateral. UCC § 9-203(b)(2) (2013). Outright ownership of the collateral is not required, but the debtor must possess at least some limited rights in the collateral. Concordantly, the debtor's right to encumber the collateral is limited to its rights in the collateral. The subject debtor may not necessarily be the primary obligor on the subject loan – rather, the debtor is the party possessing the rights in the collateral underlying the security interest. UCC § 9-102(28) (2013). For example, in a case where an LLC is the primary obligor

on a loan and a member of the LLC has actual ownership of the collateral, the member itself, and not the LLC, would constitute the "debtor" with rights in the collateral.

C. Security Interest Must be Evidenced by an Authenticated Security Agreement Which Sufficiently Describes the Collateral

i. No Explicit Requirements as to Form.

The security interest must be evidenced by an authenticated security agreement which sufficiently describes the collateral. UCC § 9-203(b)(3) (2013). Article 9 does not require that a security agreement take a specific form, so long as the instrument which is to serve as the security language contains clear language granting the security interest. State law is determinative as to what constitutes a security agreement, with the majority view holding that the intent of the parties to create a security agreement controls, and that multiple documents may be utilized to evidence such intent. *See, e.g., In re ProvideRx of Grapevine, LLC*, 507 B.R. 132 (Bankr. N.D. Tex. 2014) (primary concern is to give effect to the parties' intent as evidenced by the documents at hand – no formal wording is required, and no single document is required to evidence a security agreement); *In re Double G & T Dairy*, 2010 WL 9477481 (Bankr. E.D. Cal. July 28, 2010) (no special form is required to create a security interest - a security agreement can be derived by combining multiple documents, as long as the parties' intent is evidenced). In addition, the security agreement may often be contained within the loan agreement itself, a deed of trust, or a promissory note. However, a secured creditor should consult state law regarding required form for a security agreement, and it is generally advisable to have a "standalone" security agreement with clear language granting a security interest rather than a "patchworked" security agreement comprised of multiple documents which could be subject to challenge by the debtor or competing lienholders

ii. Sufficiency of Description of Collateral

Article 9 provides that a description of collateral within a security agreement is sufficient if it "reasonably identifies" the collateral, and does not require an explicit description of the collateral being secured (such as through serial numbers). UCC § 9-108 (2013). However, a security agreement that uses a hyper-generic description of collateral such as "all assets of debtor" or "all of debtor's personal property" does not reasonably identify collateral and lacks specificity. UCC § 9-108(c) (2013). A security agreement reasonably identifies collateral if it identifies the collateral by: (i) specific listing; (ii) category; (iii) a type of collateral defined within the UCC; (iv) quantity; (v) computational or allocational formula or procedure; or (vi) any other method, if the identity of the collateral is objectively determinable. UCC § 9-108(b) (2013).

Utilizing categories of collateral defined within Article 9 is probably the most common method of achieving specificity within a security agreement. Importantly, in many instances collateral may fall under more than one category. A comprehensive listing of collateral categories, along with references to their UCC definitions and recommendation as to their method of perfection, is attached to this paper as **Exhibit A**.

1. Special Instances

- Proceeds. Proceeds are generally defined as: (i) anything that is acquired upon the sale, lease, license, exchange, or other disposition of collateral; (ii) anything that is collected on, or distributed on account of, collateral; and (iii) any rights arising out of collateral. UCC §9-102(64) (2013). Article 9 explicitly provides that a security interest automatically attaches to any identifiable proceeds of collateral. UCC § 9-203(f) (2013). Accordingly, a failure to include proceeds within the description of the collateral is not fatal to the attachment of the security agreement to those proceeds.
- After-Acquired Property. There will be instances where the creditor desires a security interest in property which the debtor acquires subsequent to entrance into the security agreement. Article 9 permits such inclusion, but does not provide for automatic inclusion of after-acquired property unless the collateral description explicitly provides for said property. UCC § 9-204 (2013).

Perfection as to after-acquired property, even if properly included within the description of collateral, is subject to certain limitations:

- Purchase Money Security Interests. In the event that a third-party extends funds to a debtor explicitly earmarked for goods other than inventory, the third-party's purchase money security interest takes precedence over a conflicting security interest in the same goods if the third-party perfects its security interest in the goods within 20 days of receipt of possession of the new collateral by the debtor. UCC § 9-324 (2013).
- Buyer in the Ordinary Course of Business. A buyer from the debtor in the ordinary course of the debtor's business takes free of any pre-existing security interest. UCC § 9-320(a) (2013).

- Future Advances. Article 9 explicitly allows for a security interest to extend to future obligations owed by the debtor to the creditor, and it does not require an explicit description of the type of future advances contemplated by the parties at the time of entry into the security agreement. UCC § 9-204(c) (2013). However, if the collateral described within a security agreement is intended to cover future advances, the security agreement must include at least a general reference to future debts or obligations in the description of the collateral. Because Article 9 possesses such a broad scope with regard to future advances within a security agreement if future advances are included within the security agreement, debtors should attempt to limit such scope unless the debtor intends to pledge the entirety of its asset base under the security agreement.

Perfection as to future advances, even if properly included within the description of collateral, is subject to certain limitations. Specifically, future advances have priority over intervening liens only if the future advance is made within 45 days after the creditor making the future advance becomes a lien creditor as to the future advance, unless the future advance was made: (i) without knowledge of the intervening lien; or (ii) pursuant to a commitment entered into without knowledge of the lien. UCC § 9-323 (2013).

IV. PERFECTION

There are three primary methods for perfecting security interests in collateral under Article 9: (i) the filing of a financing statement; (ii) possession of the collateral; (iii) control of the collateral. UCC §§ 9-312, 9-313, 9-314 (2013). In certain instances, perfection will also be automatic upon attachment of the creditor's security interest to the collateral. The proper method(s) of perfection are entirely dependent upon the type of collateral the secured creditor is seeking to perfect a security interest in. These instances are outlined in **Exhibit A.**

A. Perfection by Filing

For most business assets, the filing of a financing statement (known as a UCC-1 form) is the appropriate method of perfection. The filing of a financing statement as to many types of tangible collateral such as investment property, negotiable documents, goods, and chattel paper is a sufficient, but not the sole, means of perfection as to these types of collateral. UCC § 9-312 (2013). Listed below are several integral components of a financing statement which, if not properly attended to, can prove fatal to the integrity of the financing statement – and thus, by extension, the perfection of the secured creditor's interest in the subject collateral.

i. Name of Debtor

Article 9 mandates proper inclusion of the debtor's name in a secured party's financing statement, and this requirement is one of the most integral aspects with regard to the validity of a financing statement. UCC § 9-503 (2013) Because the debtor's name is the basis for the indexing of filing records within the filing office's database, it is therefore an area in which a mistake can result in a fatal filing and an absence of perfection of the debtor's security interest. Generally, a secured creditor desiring perfection as to its lien should list the debtor's name in identical fashion to its listing on the underlying security agreement. Below are some guidelines to ensure the debtor's name is correctly ascertained and included in a filing:

1. Registered Organizations.

For registered organizations, such as corporations or LLC's, use the exact name of the organization. Perform a search of the secretary of state's website and use the name as indicated on the debtor's certificate of incorporation. Trade names and d/b/a's are generally considered insufficient for purposes of specificity. Moreover, the inclusion of d/b/a's in addition to the debtor's proper name can call into question the accuracy of the legal name of the debtor. In order to guard against the possibility of an erroneous naming of the debtor, if a debtor is doing business under more than one name, a secured creditor should make separate filings for each of the d/b/a's.

2. Unregistered Organizations.

If available, consult the creation document governing the unregistered entity, and utilize the name contained within the document when filling out the financing statement. If the unregistered organization does not have a name, utilize the exact legal names of the partners comprising the unregistered organization.

3. Trusts.

If the debtor is a trust, utilize the name of the trust as provided in the trust document. If the trust has no title, use the name of the settlor, and include any information which would serve to differentiate the trust from similar entities. Certain states provide that the trustee – as opposed to the trust itself – should be named as the debtor. Ideally, each of the trust, trustee, and settlor should be included as debtors if sufficient identifying information is available. State statutes should be consulted for clarity.

4. Individuals.

Article 9 provides extremely sparse qualifications as to what qualifies as the exact name of an individual. Accordingly, it is recommended that, to the extent name variations exist, all potential permutations should be utilized. In addition, in the event that identifying documentation is available (driver's license, passport, etc.), include any identifying information which can be derived from these documents. In the event an individual is conducting business under a trade name, it is advisable to initiate filings under both individual and trade names.

ii. Name of the Secured Party

Article 9 mandates the proper inclusion of the secured party's name; however, because the indexing system of most records is predicated around the name of the debtor, greater latitude is accorded potential mistakes in the secured party's name. UCC § 9-502 (2013).

1. Agents / Representatives.

Utilizing the name of an agent or representative of a secured party is sufficient, but insufficient as to other joint creditors if such creditors are also not represented by the agent or representative. UCC § 9-502 (2013).

2. Affiliates.

To the extent affiliates of the secured party have rights to perfection in the collateral, they should be individually named. Automatic perfection does not occur in the absence of individual identification. *In re Adirondack Timber Enterprise, Inc.*, 2010 WL 1741378 (Bankr. N.D.N.Y. April 28, 2010) (creditor did not have a perfected security interest where the financing statement only named its affiliate).

3. Assignment by Secured Party.

If a secured party assigns a perfected security interest, a filing by the assignee in its own name is not required to continue perfection against the collateral. UCC § 9-310 (2013).

iii. Description of Collateral

Article 9 mandates that the financing statement "reasonably identify" the collateral. UCC § 9-108 (2013). However, this standard is relatively relaxed in comparison to the standards for collateral description within a financing statement, provided that the underlying financing statement possesses a sufficient description per the requirements listed above.

1. Generic Descriptions Allowed.

Supergeneric descriptions and classes of collateral (e.g., all assets, all equipment, etc.) are sufficient as to a financing statement, but a secured party must ensure that the underlying security agreement covers all desired collateral, as such a description cannot cover more than what the security agreement grants. UCC § 9-504(2) (2013).

2. Reference to Security Agreement.

Mere reference to a security agreement as the collateral description is potentially defective.

3. Collateral Attachments.

Attaching a schedule of collateral as an exhibit to the financing statement is effective, but perfection will fail in the event the schedule is not attached.

4. Cut and Paste Descriptions.

Be wary of cutting and pasting collateral descriptions directly from security agreements. Ensure that all capitalized terms utilized within an underlying security agreement's description of the collateral are properly defined.

iv. Jurisdiction

Under Article 9, the general rule for determining the proper jurisdiction in which a financing statement should be filed is the state in which the debtor is located. UCC § 9-301(1) (2013). In other words, a financing statement is properly filed as to all collateral, regardless of the location of the collateral, in the state where the debtor is deemed to be located. Article 9 contains numerous carve-outs to the "state where the debtor is located" rule.

1. Registered Organizations

For registered organizations that are organized under the law of their respective state, the filing location of the debtor is the state of organization, regardless of where the debtor actually conducts business or is headquartered. UCC § 9-307(e) (2013). For example, if a corporation is registered in Delaware, but does its business in Texas and has all of its assets in Texas, the proper place of filing would be the Delaware Secretary of State.

2. Non-Registered Organizations

For non-registered debtors, the proper location to file a financing statement is the jurisdiction in which the business resides. In cases where a business resides in more than one jurisdiction, the jurisdiction is the chief executive office of the debtor. UCC § 9-307(b)(3) (2013).

3. Individuals.

The state of an individual's principal residence governs the filing location with regard to the assets of both the individual and the individual's business. UCC § 9-307(b)(1) (2013).

4. Change in Debtor Location/Name.

If the debtor changes its location (e.g., non-registered debtor changes state of chief executive office, individual changes state of residency, etc.), or its name, the secured creditor must file a fresh financing statement in the new jurisdiction within four months of the change. UCC § 9-316(a)(2) (2013).

5. Transfer of Collateral.

If the collateral is transferred, subject to the security interest, and the new debtor is located in a different jurisdiction, a financing statement must be filed within one year in the new jurisdiction. UCC § 9-316(a)(3) 2013).

6. Exceptions to the "State Where the Debtor is Located Rule."

Article 9 contains numerous exceptions to the rule that the state where the debtor is located governs perfection, including the below exceptions. For the below types of collateral, the state in which the collateral is physically located will govern the jurisdiction of filing. It is important to note that certain states (*e.g.*, Louisiana) have largely opted out of these exceptions, and it is important to check for state permutations in standardized Article 9 when determining where to file a financing statement.

- Fixtures: "Fixtures" are defined as "goods that have become so related to particular real property that an interest in them under real property law." UCC § 9-102(41) (2013). Article 9 provides that the state in which the fixture resides governs jurisdiction as to the fixture. UCC § 9-301(3)(A) (2013).
- As-Extracted Collateral: "As-extracted collateral" is defined as "(A) oil, gas, or other minerals that are subject to a security interest that (i) is created by a debtor having an interest in the minerals before extraction; and (ii) attached to the minerals as extracted; or (B) accounts arising out of the sale at the wellhead or minehead of oil, gas or other minerals in which the debtor had an interest before extraction." UCC § 9-102(6) (2013). Article 9 provides that the state in which the as-extracted collateral resides governs jurisdiction as to the fixture. UCC § 9-301(4) (2013).
- Goods Covered by a Certificate of Title: "Certificate of title" means "a certificate of title with respect to which a statute provides for the security interest in question to be indicated on the certificate as a condition or result of the security interest's obtaining priority over the rights of a lien creditor with respect to the collateral." UCC 9-102(10). Article 9 provides that the state in which the goods covered by a certificate of title reside governs jurisdiction as to the goods. UCC § 9-303(c) 2013).

v. Timing

Filings generally expire after five years and must be continued within six months prior to the end of the five year period through the filing of continuation statement form UCC-3 (*e.g.*, the filing of a continuation statement a year prior to the end of the five-year perfection timeframe would be ineffective). UCC § 9-515 (2013). As a perfected party will have had its financing statement on file for quite some time by the time the six-month window opens up for the filing of a continuation statement, the perfected party must take great care to note the window upon initial perfection, and should calendar the start and expiration of the window immediately upon filing the initial financing statement.

A prompt filing of the initial financing statement subsequent to the attachment of a security interest is also required for perfection. Article 9 merely notes that a "reasonably prompt" filing is required, and it has been left to the courts to determine what constitutes a prompt filing. *See, e.g., In re Confabco, Inc.*, 178 B.R. 421 (Bankr. E.D. La. 1995) (filing of financing statement 13 days after execution of security agreement sufficiently prompt). Accordingly, as there is no established grace period for a "reasonably prompt" filing of a financing statement subsequent to attachment, it is good practice to file the financing statement contemporaneously with execution of the security agreement so as to ensure timeliness. Notably, Article 9 allows for the filing of a financing statement prior to attachment. UCC § 9-502(d) (2013).

vi. Formalities

There are a host of potential technical defects within a financing statement which can render the financing statement defective. With the acknowledgement that some of these issues have been noted above, these potential defects include:

- Debtor name
- Debtor address
- Debtor type (*e.g.*, registered organization, individual, etc.)
- Secured lender name
- Secured lender address
- Listing of debtor's organizational identification number
- In the event a continuation statement or amendment is filed, proper reference to the identification number of the original financing statement
- Tendering of filing to proper filing office

- Inclusion of appropriate filing fee
- Reasonable identification of collateral – do not forget to attach sheets describing collateral where applicable

B. Perfection by Possession and/or Control

In certain (more uncommon) instances, a secured creditor may achieve perfection of its security interest through possession or control of the collateral. While Article 9 does not define the terms "possession" or "control," it is generally understood that these terms have the following connotations: (i) "possession" denotes physical control over the collateral; and (ii) "control" denotes an interest in collateral held by a party through an agreement. While a detailed discussion of these other forms of perfection is beyond the scope of this paper, it should be noted that, depending on the type of collateral involved, a secured creditor may achieve perfection through more than one of these means, while in other cases, Article 9 only allows for perfection through one of these means. For clarity, a chart outlining the various means of perfection as to specific types of collateral is attached to this paper as **Exhibit A**.

EXHIBIT A
Methods of Perfection as to Various Types of Collateral

COLLATERAL	DEFINITION	METHOD OF PERFECTION
Accounts	UCC § 9-102(2) (2013)	Filing (UCC § 9-310) (2013)
Agricultural Liens	UCC § 9-102(5) (2013)	Automatic upon attachment (UCC § 9-308) (2013) Filing (UCC § 9-310) (2013)
Chattel Paper	UCC § 9-102(11) (2013)	Filing (UCC § 9-312) (2013) Possession (UCC § 9-313) (2013) Control (UCC § 9-314) (2013) – only as to electronic, not tangible
Commercial Tort Claims (no perfection in after-acquired claims)	UCC § 9-102(13) (2013)	Filing (UCC § 9-310, but note differential in description requirements) (2013)
Commodity Accounts (subset of investment property)	UCC §9-102(14) (2013)	Automatic (UCC § 9-309, security interest created by an intermediary) (2013) Filing (UCC § 9-312) (2013) Control (UCC § 9-314) (2013)
Consumer goods other than vehicles, boats, etc.	UCC § 9-102(23) (2013)	Attachment (UCC § 9-9-309, purchase money) (2013) Filing (UCC § 9-310) (2013) Possession (UCC § 9-313) (2013)
Deposit Accounts (includes non-negotiable CD's)	UCC § 9-102(29) (2013)	Control (UCC §§ 9-312 and 9-314) (2013)
Equipment	UCC § 9-102(33) (2013)	Filing (UCC§ 9-310) (2013)
Farm Products	UCC § 9-102(34) (2013)	Filing (UCC § 9-310) (2013)
Fixtures	UCC § 9-102(41) (2013)	Filing (UCC § 9-310) (2013)
General Intangibles (includes most LLC and partnership interests)	UCC § 9-102(42) (2013)	Filing (UCC § 9-310) (2013) Automatic upon attachment for sale of payment intangibles (UCC § 9-309) (2013)
Health Care Receivables assigned to service provider	UCC § 9-102(46) (2013)	Automatic Upon Attachment (UCC§ 9-309) (2013)
Instruments	UCC § 9-102(47) (2013)	Filing (UCC § 9-312) (2013) Possession (UCC § 9-313) (2013)
Inventory	UCC § 9-102(48) (2013)	Filing (UCC 9-312) (2013)
Investment Property	UCC § 9-102(49) (2013)	Filing (UCC § 9-312) (2013) Control (UCC § 9-314) (2013)
Letter of Credit Rights	UCC § 9-102(51) (2013)	Control (UCC §§ 9-312 and 9-314) (2013)
Manufactured Home, Motor Vehicles, Boats	UCC § 9-102(53) (2013)	Filing if inventory (UCC § 9-311) (2013) Possession (UCC § 9-313) (2013) Compliance with state regulations if non-inventory (UCC § 9-311) (2013)
Membership Interest in a Limited Liability Company (a subset of either General Intangibles or Investment Property)	UCC § 9-102(42) (2013) UCC § 9-102(49) (2013)	Filing as a general intangible (UCC § 9-312) (2013) If LLC has opted into Article 8, constitutes investment property; filing (UCC 9-312) or control (UCC § 9-314) (2013)
Money	N/A	Possession (UCC § 9-312) (2013)

Negotiable Documents	N/A	Filing (UCC § 9-312) (2013) Possession (UCC § 9-313) (2013) If electronic, control (UCC § 9-314) (2013)
Partnership Interest (subset of either General Intangibles or Investment Property)	UCC § 9-102(42) (2013) UCC § 9-102(49) (2013)	Filing as a general intangible (UCC § 9-312) If Partnership has opted into Article 8, filing or control as Investment Property (UCC §§ 9-312 and 9-314) (2013)
Proceeds	UCC § 9-102(64) (2013)	Automatic upon perfection (UCC § 9-315) (2013)
Promissory Notes (sale)	UCC § 9-102(65) (2013)	65Automatic Upon Attachment (UCC § 9-309) (2013)
Securities (a subset of Investment Property)	UCC § 9-102(49) (2013)	Automatic upon attachment if created by a broker or intermediary (UCC § 9-309) (2013) Filing (UCC § 9-309) (2013) Control (UCC§ 9-314) (2013)
Software (subset of General Intangibles) that is not a part of goods	UCC § 9-102(76) (2013)	Filing (UCC 9-310(a) unless other statute governs (UCC § 9-310(b)(3)) (2013)

1. When faced with the option of perfection via either filing or control, perfection by control is preferable.

2. With the sole exception of goods covered by a certificate of title, perfection by possession is always allowed.