

Security Interests Financing Statements Uniform Commercial Code

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Security Interests

- **States and political subdivisions pledge different types of security.**
 - Ad valorem, sales/use or other taxes
 - Revenues
 - Real property
 - Personal property
- **Security for the creditor comes in two forms:**
 - By agreement with debtor (consensual liens)
 - By operation of law, without agreement or notice (nonconsensual)
- **Creditors need a security interest to**
 - establish their right to foreclose on or repossess and sell collateral in an event of default and apply the proceeds to repay the debt, and
 - establish priority over competing creditors if the debtor files for bankruptcy, or in the event of competing claims on pledged property.

The Uniform Commercial Code (“UCC”)

- Article 1 – General Provisions
- Article 2 – Sales
- Article 2A – Leases
- Article 3 – Negotiable Instruments
- Article 4 – Bank Deposits
- Article 4A – Funds Transfers
- Article 5 – Letters of Credit
- Article 6 – Bulk Transfers
- Article 7 – Warehouse Receipts, Etc.
- Article 8 – Investment Securities
- Article 9 – Secured Transactions

- **Article 9 of the UCC governs security interests in personal property.**
- **A comprehensive model code for commercial law written by experts.**
- **Every state (+ DC, PR and the VI) has adopted the UCC in some form.**
- **Ongoing legislative amendments and judicial interpretation.**

Basic UCC Terminology

- **Collateral** is the personal property or fixtures subject to a security interest.
- A **security interest** is the interest (i.e., a lien or legal right) held by one party in personal property or fixtures of another party to secure payment or performance of an obligation.
- The **secured party** is the party in whose favor a security interest is created. The secured party is often the same party that made the loan or extended credit (the **creditor**).
- The **debtor** is the party that owns the collateral. The debtor is usually the same party that received the loan or extension of credit and owes payment or performance (the **obligor**).
- A **security agreement** is the contract that creates a security interest.

Creation of Security Interests

- **A security interest becomes enforceable when it when it “attaches” to the collateral. There are three general requirements for attachment:**
 - Secured party must give value.
 - Making of a loan.
 - Debtor must have rights in collateral.
 - Cannot pledge collateral you don't own or have other interests in.
 - Debtor must have signed a security agreement.
 - Written contract
 - Pledging collateral as security
 - Describes collateral in detail (i.e., by category, but not “all assets” or “all personal property”)
- **No third-party notice required.**

Property Subject to Security Interests

- **What types of property can be put up as security (i.e., collateral) under UCC Article 9?**
 - Tangible property (“Goods”)
 - Inventory
 - Fixtures
 - Equipment – the catch all
 - Intangible property
 - Accounts (e.g., rights to payment for goods sold or services rendered, but not deposit accounts)
 - Chattel paper (i.e., written / electronic record of monetary obligation and interest in goods)
 - General intangibles – the catch all
 - Other
 - Investment property
 - After-acquired property
 - Sale proceeds
- **Real property security is governed by other state laws.**

Perfection of Security Interests

- “Perfection” is how a secured party puts the rest of the world on notice to establish its claim on the collateral.
- Unless the security interest is perfected, the rights of the secured party might be subordinated to the rights of other secured parties, lien creditors, bankruptcy trustees, or buyers who give value without knowing about the secured party’s security interest.
- After the security interest is created (attached), you can perfect it by:
 - filing a financing statement (a/k/a the UCC-1 form), or
 - taking possession or control of the collateral (e.g., chattel paper), or
 - other methods authorized by state law (e.g., certificates of title for vehicles, airplanes, boats, etc.).
 - Automatic perfection is possible, but only for purchase-money security interests in consumer goods.

UCC-1 Financing Statements

- **Requirements / Best Practices**

- Use state specific form
- File in appropriate office(s) – based on location of debtor
- Use debtor's legal name of public record (no trade names)
- Use secured party's legal name
- Accurately describe all collateral (should recite description in security agreement)
- Security agreement must authorize filing by secured party
- Include real estate description for fixture filings

- **Duration**

- Effective for 5 years (with 5 year UCC-3 continuation filing).
- Effective for 30 years if public entity and debt securities with initial maturity of 20+ years.

Common UCC Filing Mistakes

- **Overlooking Article 9 or state-specific rules**
- **Expecting SOS office to catch or correct**
- **Debtor name incorrect or abbreviated**
- **Generic or overbroad collateral descriptions (not double checking against security agreement)**
- **Late or delayed filing**
- **Untimely continuation statements (within 6 months before expiration)**
- **Checking the wrong box on the UCC-3 amendment (continuation, assignment or termination)**
- **Not referencing UCC-1 on UCC-3**
- **Not getting authorization to file UCC-1 or UCC-3**
- **Filing UCC-1 instead of perfecting by title**
- **Not filing UCC-1 on escrowed funds**
- **Unintentional termination**
- **Filing UCC-1 before signing security agreement**
- **Checking the 30-year public finance box when N/A**
- **Not checking the recording box or leaving real estate description off of a fixture filing**

Priority of Security Interests

- **General Rule: The first to do the best job of perfecting wins.**
 - If two parties have perfected, the first to perfect wins.
 - If one party has perfected, and one attached, the perfected party wins.
 - If one party has attached (not perfected), and one is unsecured, the attached party wins.
 - If neither party has attached, they are both unsecured creditors.
- **Exceptions:**
 - PMSI

Special Considerations

- **UCC Article 9 may have limited applicability to states and political subdivisions, BUT FILE**
 - May not apply to security interests created by a government or governmental subdivision or agency.
 - May only apply to the extent another statute or home rule charter doesn't govern.
 - May not be a means to perfect governmental pledges.
- **Prior security interests may exist.**
- **Taking a security interest in real or personal property can be problematic in certain states (note security interests in tangible personal property versus chattel paper).**
- **Certain states have specific requirements for UCC-1 filings, UCC-3 amendments and continuations, recording taxes for fixture filings, etc.**
- **Federal laws may supersede UCC Article 9 or limit security interests in certain types of collateral (e.g., insurance receivables in health care organization).**
- **Gross and net revenues pledges may present unique challenges.**

Special Considerations – Fixture Filings

- **Fixtures are “goods that have become so related to particular real property that an interest in them arises under real property law.”**
 - Windows, HVAC, plumbing, etc.
 - Built-ins (e.g., walk-in freezer)
- **Personal property versus real property**
 - Intent of the parties (often controlling factor)
 - Reasonable expectations of third parties
 - Degree of affixation, ease of removal, essentiality to functioning of the real property
- **Effective against real property claimants by local recording and personal property claimants by state / central filing.**
 - UCC-1 and UCC-3 (check box 1b, provide legal description and name record owner).
- **Priority**
 - Against fixture creditors, normal UCC Article 9 priority rules apply.
 - Against real property creditors / owners other than debtor, subordinate UNLESS
 - Fixture filing filed first
 - Purchase money security interests if filed within 20 days

Case Law Update – *In re Financial Oversight & Management Board*

2008

- Employees' Retirement System of the Government of the Commonwealth of Puerto Rico ("ERS") issued \$2.9B in pension bonds.
- Pension Funding Bond Resolution
 - Available on ERS and EMMA websites
 - Granted security interest in "pledged property"
 - Defined pledged property in detail
- Security Agreement
 - Granted security interest in "(i) Pledged Property, and (ii) all proceeds and all after-acquired property"
 - Cross-referenced resolution for definition of Pledged Property.
- UCC-1 Financing Statement
 - Described collateral as "pledged property described in the Security Agreement"
 - Attached Security Agreement

Case Law Update – *In re Financial Oversight & Management Board*

2013-2016

- ERS changed its name to Retirement System for Employees of the Government of the Commonwealth of Puerto Rico (“RSE”)
- UCC-3 Amendments
 - Restated collateral to describe pledged property in full detail.
 - Used ERS not RSE for debtor name.

2016-2018

- PROMESA / Debt Restructuring
- ERS/RSE was required to deposit part of pledged revenues into a segregated account and bondholders claimed perfected security interest

Case Law Update – *In re Financial Oversight & Management Board*

2018

- District Court
 - 2008 collateral description insufficient to perfect security interest
 - 2015/16 fixed the collateral description but got the name wrong
 - UCC-1 did not perfect the bondholders' security interest
 - Under bankruptcy law, unperfected security interest is invalid and unenforceable; bondholders rendered unsecured creditors

2019

- Court of Appeals
 - 2008 collateral description insufficient to perfect security interest
 - ERS was a valid name under the RSE law
 - 2015/16 amended UCC-1 perfected bondholders' security interest

Case Law Update – *In re Financial Oversight & Management Board*

- **Takeaways**

- Perfection is critical
- Minor errors okay unless the statement is materially misleading.
 - ❑ An incorrect name is misleading unless a UCC search of the correct name would disclose UCCs filed against the bad name.
 - ❑ Confirm debtor name on public records.
- Collateral description could be insufficient if it requires a search beyond the filing office's records
 - ❑ Don't shortcut drafting by relying on cross-references for defined terms.
 - ❑ If referencing attachments, attach all relevant documents.
- Confirm perfection
 - ❑ A senior interest could attach and be perfected at any time

Case Law Update – *UMB Bank, N.A. v. Orrick, Herrington & Sutcliffe LLP*

2012

- California School Finance Authority issues \$27.5M bonds on behalf of Tri-Valley Learning Corp (“TVLC”) and its charter schools
 - UMB Bank (successor to BONY), as trustee
 - Orrick, as bond counsel
 - Security included deed of trust and gross revenues pledge
 - Bond documents require TVLC to perfect security interest
 - Deed of trust recorded by Orrick
 - UCC-1 Financing Statements never filed

2014

- TVLC entered into banking relationship with Heritage Bank of Commerce (“Heritage”)
 - Heritage filed UCC-1 Financing Statement

Case Law Update – *UMB Bank, N.A. v. Orrick, Herrington & Sutcliffe LLP*

2016-2018

- TVLC draws on reserve fund
- TVLC files for Chapter 11 (converted to Chapter 7)
- TVLC default on bond payments
- Heritage challenges Trustee's first priority security interest
- Heritage jumps ahead of UMB and bondholders (first to perfect)
- UMB sues Orrick for failure to perfect or confirm perfection of security interest
- Orrick claimed UCC filings were not part of bond counsel engagement
- Settled for undisclosed amount

Case Law Update – *UMB Bank, N.A. v. Orrick, Herrington & Sutcliffe LLP*

- **Takeaways**

- Perfection is critical
- Bond counsel may not be responsible for perfecting.
 - Bond counsel represents the interests of the issuer, not trustee, bondholders or direct purchaser
 - Bond counsel scope of engagement may be limited
- Bond counsel opinion is NOT a perfection opinion.
- Secured party (trustee or direct lender) is ultimately responsible for confirming perfection.