SECURED TRANSACTIONS: PRACTICAL THINGS EVERY BUSINESS LAWYER SHOULD KNOW ABOUT UCC ARTICLE 9

By Joseph H. Flack

At the outset, Normal M. Powell captured the complexity of the law secured transactions. He said, “You can spend hundreds, if not thousands, of hours studying secured transactions and still have only scratched the surface” of this area of law. Powell made clear that the purpose of this panel was to cover only some of the core concepts in secured transactions. The Uniform Commercial Code committee of the ABA’s Business Section presented this panel as part of the Institute for the Young Business Lawyer. Janet M. Nadile and Kate A. Sawyer were the panelists and Powell moderated the panel as its chair. The panel showed excellent and extensive knowledge of the law in this area and provided plenty of apt examples to assist in understanding the various points made. This article summarizes key points made in their presentation and incorporates panel materials authored by the panelists.

1. Importance of the Security Interest Process

This segment addressed the reasons that a creditor should take a security interest. The principal reason is so that a creditor has priority over competing creditors if the debtor files bankruptcy. Without a security interest, a creditor will not even be at the dinner table with other secured creditors but will be out in the cold with the unsecured creditors. Examples of unsecured creditors include trade creditors, landlords, and senior unsecured noteholders.

Nadile provided an excellent example illustrating the importance of a creditor having a security interest. The example showed how priority of secured claims in bankruptcy works. The example assumes the debtor enters bankruptcy with $200 million in assets and $500 million in liabilities. The debtor’s assets are receivables ($50 million), inventory ($50 million), equipment ($50 million), and real property ($50 million), and the debtor’s liabilities are unsecured trade debt ($100 million), senior unsecured notes ($200 million), and bank debt ($200 million). If all claims are unsecured, then a creditor’s recovery is 40 cents on the dollar, or $80 million. If the Bank Creditor is secured only by receivables and inventory, its recovery will about $125 million. If, however, the Bank Creditor is fully secured by all the debtor’s assets, then its recovery will be $200 million.

Another reason that creditors should have a security interest is that having fully secured status can make post-petition interest and expenses available to the creditor in the debtor’s bankruptcy. A

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1 Partner, Young Conaway Stargatt& Taylor, LLP, Wilmington, DE. Powell chaired this panel.
2 For the complete materials and audio for this panel, visit the Meetings Portal of the ABA Business Section’s website.
3 Divide the debtor’s total assets of $200 million by the debtor’s total liabilities of $500 million.
4 Bank Creditor’s recovery is calculated by adding $100 million (the portion of the debt secured by receivables and inventory) and $25 million, the Bank Creditor’s pro rata portion of the remaining assets of the debtor (i.e., 25% of the remaining $100 million in assets). The pro rata amount is calculated by dividing $100 million (the remaining unsecured portion of Bank Creditor’s debt) by $400 million (the total other debt not including the secured portion of Bank Creditor’s debt) and then multiply that by the remaining assets of $100 million.
security interest also allows the creditor more control over the debtor in bankruptcy. Having a security interest in the debtor’s deposit accounts and cash allows the creditor some control the debtor’s the cash collateral position.

A security interest also affords creditors the valuable right to foreclose on or sell collateral and apply the proceeds to repay the debt, but, in bankruptcy, this right is subject to the automatic stay, from which the creditor would be required to seek relief. The main point is that having a perfected security interest gives a secured creditor a whole lot more than would be available without one.

2. Legal Framework Governing Security Interests

The most important statute governing security interests is the Uniform Commercial Code (UCC), a uniform statute adopted fairly uniformly in the 50 states and territories. The National Conference of Commissioners on Uniform State Laws (NCCUSL) drafted the UCC, which is a model act that is not law. Each state, however, after making some modifications or changes, has adopted the UCC as law. Always check your state’s version of the UCC.

Articles 8 and 9 of the UCC contain the vast majority of rules governing the creation, perfection, and priority of security interests. Article 8 governs ownership and transfer of securities and other financial assets, but security interests in such assets are governed by Article 9. Article 9 governs security interests, and applies to any transaction that creates a security interest in personal property.\(^5\) Personal property is not defined in Article 9 but is just about everything other than real property, including goods, inventory, equipment, accounts, documents, and instruments, for example. Intellectual property is a valuable type of collateral subject to security interests as well. The UCC doesn’t cover other types of collateral. The big exception is real property. Each state has its own non-uniform real property law governing the creation, perfection, and priority of security interests (e.g., mortgages and trust deeds) in land and improvements.

Fixtures are goods that are semi-permanently attached to real property. They are “goods that have become so related to particular real property that an interest in them arises under real property law.”\(^6\) Examples include fireplaces, shelving, and central air conditioning units and ductwork. Generally, the cases say that a fixture is that which has been affixed to the real property with the intention that it become a permanent and integral part. It is not possible for a lawyer to predict what a fixture is in advance of an issue over its characterization, so a lawyer should thus err on the side of caution and treat what could be a fixture both as a fixture and as non-fixture personal property.

Three key concepts to know in the area of secured transactions are (i) “creation” and “attachment” of security interests, (ii) perfection, and (iii) priority. “Creation” and “attachment” is the process by which the creditor obtains security interests in the debtor’s assets. “Perfection” is the process by which the creditor ensures its security interest will be effective against third parties—in particular, a bankruptcy

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trustee and other creditors of the debtor. “Priority” means the relative rights of one creditor with a security interest in the debtor’s assets vis-à-vis other creditors with claims to the same assets. Such other creditors may include (a) creditors with security interests in the same assets, (b) purchasers of goods, chattel paper, or instruments, and (c) landlords under leases of real property to a debtor on which the debtor’s fixtures are located.

3. Creation of Security Interests

Security interests are created by a contract called a security agreement. A “security agreement” is any agreement that creates or provides for a security interest. A security interest attaches to collateral when it becomes enforceable against the debtor with respect to the collateral (usually pursuant to a security agreement). UCC § 9-203 lists the requirements for having a valid and enforceable security interest against the debtor in personal property subject to Article 9. A security interest is enforceable against the debtor and attaches only if:

(1) value has been given;
(2) the debtor has rights in the collateral; and
(3) the debtor has authenticated security agreement that provides a description of the collateral (although possession or control may also suffice).

The description of the collateral in the security agreement is sufficient if it “reasonably identifies what is described.” If a security interest attaches to collateral, then it also attaches to identifiable proceeds of that collateral, as well as any supporting obligations for that collateral. Examples of “supporting obligations” are a letter of credit rights supporting a receivable or a guaranty. “Proceeds” refers to whatever property is acquired upon the sale or other disposition of collateral.

4. Perfection and Priority

Only a perfected security interest will have priority as against third parties. Even if a security interest is perfected, though, it may not have priority over all third parties. Without a properly perfected security

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7Id. § 9-102(a)(73).
8See Id. § 9-203(a).
9Powell explained that the term “authenticated” is a medium-neutral way of saying “signed.”
10The security agreement does not have to call itself a security agreement. It could be a paragraph buried in a loan agreement.
11Id. § 9-203(b).
12Id. § 9-108. This section gives suggestions of how to reasonably identify what is described. But it is not a reasonable description to say “all assets of the debtor” in the security agreement (though you might be able to use broader terminology in the financing statement).
13Id. §§ 9-203, 9-315(a)(2) (“a security interest attaches to any identifiable proceeds of collateral”).
14Id. § 9-102(a)(77).
15Id. § 9-102(a)(64).
interest, the creditor will have the status of an unsecured creditor in the bankruptcy of the debtor. Perfection thus gives a creditor priority over unsecured creditor’s claims in the bankruptcy of the debtor.

The general rule of priority is that the first creditor to (a) perfect, or (b) file a financing statement (even if the security interest has not yet attached or other steps for perfection were not satisfied at the time of filing) obtains priority as to the collateral. This rule, as many legal rules, is subject to many exceptions, including:

- purchase money liens
- perfection by possession or control (e.g., pledged stock)
- prior filings (need for UCC/title searches, including searches using the name of predecessor entities)
- statutory liens (need for landlord, bailee waivers)
- buyers of goods in the ordinary course of business (who take free of perfected security interests)
- perfection of another party’s security interest in goods represented by negotiable documents
- assets acquired by debtor subject to liens created by the prior owner (diligence on names of prior owner)
- proceeds of another party’s collateral
- federal tax liens in certain circumstances

Achieving perfection of a security interest, then, does not eliminate the risk in certain circumstances that competing claims could take priority.

In addition, some forms of perfection can be better than others as to certain collateral. Where perfection by more than one way is permitted, perfection by possession or control usually trumps perfection by filing. Furthermore, bankruptcy-related risks can cause a party to lose priority despite having perfected its security interest. One type of bankruptcy risk is the preference risk where transfers within a certain period of time before a bankruptcy filing are avoided by the bankruptcy trustee. Delayed UCC filings or after-acquired property can implicate this preference risk.

For UCC Article 9 collateral, perfection can be effected in several ways: by filing a UCC financing statement, by possession of the collateral, or by control of the collateral. The method of perfection depends on the type of collateral. Security interests in some types of collateral can only be perfected one way, but security interests in other types can be perfected in more than one way. For example, a security interest in goods can be perfected either by filing a UCC financing statement or by taking possession of the goods.¹⁶ A security interest in the debtor’s accounts¹⁷ or general intangibles is

¹⁶ There are exceptions to these two forms of perfection of security interests in goods. One example is perfection of security interests in vehicles, which is governed in most states by certificate of title statutes under which perfection occurs by noting the lien on the certificate of title.

¹⁷ An “account” includes a broad range of the debtor’s rights to payment. See UCC § 9-102(a)(2). A “general intangible” is defined in UCC § 9-102(a)(42) and includes payment intangibles (a general intangible under which the account debtor’s principal obligation is a monetary obligation) and software.
perfected in only one way—by filing a UCC financing statement. Similarly, a security interest in money can only be perfected by one method—taking possession of that money.

Filing a UCC financing statement usually occurs at a central filing location, such as the secretary of state’s office of the state whose laws govern perfection. For example, a creditor should file its financing statement in the Delaware Secretary of State’s office to perfect a security interest in a Delaware corporation’s receivables, inventory, or general intangibles. Fixture filings should be filed in the real estate records of the counties in which the real property is located—the same office where a mortgage or deed of trust would be recorded. Preparing a UCC-1 financing statement form must be done with great care to avoid any errors, especially in the debtor’s legal name. An error in the debtor’s legal name has the potential of causing the creditor’s security interest to lose priority.

5. Overview of the Collateral Process

The first step in the collateral process is to determine the collateral package. The lawyer’s role is to identify costs and legal obstacles and assist in identifying the debtor’s key assets. An important question is how much collateral is enough? The lawyer should consider that the creditor will be entitled to postpetition interest in bankruptcy if “over-collateralized,” meaning that the collateral value exceeds the debt. Another consideration is that collateral values may change after closing, which may erode initially strong collateral coverage. For example, the value of the collateral if the debtor is a going concern will be drastically different from such value if the debtor is in liquidation.

The lawyer’s goal should be to develop a collateral plan, consisting primarily of the checklists for the steps needed to create and perfect security interests. A perfection certificate elicits information needed to perform searches, identify signatories to collateral documents, prepare filings and take other necessary perfection steps. A list of loan parties should also be made identifying the parties to sign the security agreement. In addition, the parameters for lien searches should be well defined, and a list of lien searches should be made organizing the searches by entity and jurisdiction and ordering the searches from the search company. The lawyer should review the search results, identifying problematic liens and taking necessary action, such as arranging for UCC-3 terminations.

6. Revisions to Article 9

In 2008, NCCUSL and the American Law Institute formed an Article 9 Review Committee to consider whether a drafting committee should be formed to propose revisions. A joint review committee (JRC) was formed to address certain issues, and the JRC is currently drafting amendments to the statutory text and comments for consideration by NCCUSL and the ALI. Powell covered this segment of the panel, and the panel materials can be referenced for further information.

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18 See UCC § 9-310.
19 See id. § 9-312(b)(3).