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SECURED TRANSACTIONS

Must You Attach to Perfect?

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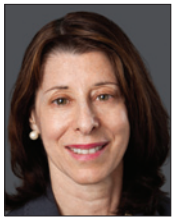

Under Article 9 of the Uniform Commercial Code, liens on most types of personal property can be created and perfected through the combination of a security agreement and a properly filed financing statement. Both documents must describe the collateral, although the documents serve different purposes. So what constitutes a sufficient description for one may not work for the other.

Under UCC §9-203, a security interest attaches and becomes enforceable against a debtor when (1) value has been given, (2) the debtor has rights or the power to transfer rights in the collateral and (3) there is evidence of the parties' intent to create a security interest. In most cases this third requirement is satisfied when the debtor has signed or otherwise authenticated a security agreement containing a description of the collateral.

According to UCC commentary, a collateral description must "make possible the identification of the collateral described." UCC §9-108(a) contains the general rule, which is that a description is sufficient if it "reasonably identifies" the collateral. Subsection (b) states that a collateral description reasonably identifies the collateral if it uses any of the following methods: (1) specific listing, (2) category, (3) type of collateral defined in Article 9 (such as "accounts," "goods," "general intangibles" and the like), (4) quantity, (5) computational or allocational formula or procedure, or (6) any other method by which the identity of the collateral is objectively determinable.

The UCC financing statement, on the other hand, simply requires an "indication" of the collateral. UCC §9-504 states that a financing statement "sufficiently indicates" the collateral if it either describes the collateral in a manner that satisfies UCC §9-108(a) (in other words, a description that "reasonably identifies" the collateral for purposes of a security agreement will suffice for a financing statement) or indicates it covers "all assets" or "all personal property." A UCC financing statement is intended simply to give public notice that a person may have a security interest in the collateral indicated, on the assumption that the searcher can then seek more information from the debtor or secured party. As compared to a security agreement, it does not need to satisfy evidentiary requirements as to the intent of the parties.

A common approach when describing collateral in a financing statement is to refer to the security agreement. This is often used when the collateral description is fairly complex, or when specific items of collateral will change over time. Courts have repeatedly upheld the validity of financing statements that incorporate external documents. However, if the document referenced in the collateral description is not attached to the financing statement, and it is necessary to know the content of such external document to satisfy the UCC requirement that the description "sufficiently indicate" the collateral, the lien may not be perfected, as two recent cases illustrate.

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'In re I80 Equipment'

First Midwest Bank v. Reinbold (In re I80 Equipment), 591 B.R. 353 (Bankr. C.D. Ill. 2018) involved a dispute between the Chapter 7 trustee for the bankrupt I80 Equipment, which was in the business of refurbishing bucket trucks for resale, and First Midwest Bank, a pre-

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bankruptcy lender to the debtor. At stake for First Midwest was over seven million dollars of unpaid debt.

The debtor signed a security agreement in March 2015 granting First Midwest a lien on twenty-six different categories of collateral, including "accounts, chattel paper, equipment, general intangibles, goods, instruments and inventory and all proceeds and products thereof." The financing statement was filed a month later with the following collateral description: "All Collateral described in First Amended and Restated Security Agreement dated March 9, 2015 between Debtor and Secured Party."

I80 filed for Chapter 7 bankruptcy in December 2017. First Midwest Bank then sought a declaratory judgment from the bankruptcy court that First Midwest Bank's collateral was sufficiently described through the option of "any other method" of identifying collateral under §9-108(b)(6). The trustee noted that while the security agreement itself contained a long list of collateral, and the financing statement referred to the security agreement, the agreement was not attached to the financing statement. The trustee argued that "the mere reference to the collateral as being described in the amended security agreement does not suffice to indicate, describe or reasonably identify any collateral." First Midwest Bank countered that the filing of the financing statement itself was enough to serve as notice to other creditors: "… the purpose behind the filing of a financing statement is merely to provide notice to third-party creditors that property of the debtor may be subject to a prior security interest, and that further inquiry may be necessary to determine the identity of the collateral."

The sole issue before the court, therefore, was whether First Midwest Bank had sufficiently described its collateral under the "other method" option of §9-108(a)(6). In a thoughtfully-worded analysis, the court noted that under this option the collateral must be "objectively determinable." The court sided with the trustee, finding that the kind of incorporation by reference method used by First Midwest was insufficient. The court reasoned that because the financing statement did not describe the collateral itself, but rather attempted to incorporate by reference a collateral description from a document not attached to the financing statement, "the financing statement, on its face, provides no information whatsoever, and therefore no notice to any third party, as to which of the Debtor's assets First Midwest is claiming a lien on, which is the primary function of a financing statement." Bankruptcy Judge Perkins highlighted the public notice function of UCC financing statements, and emphasized that "the collateral description may not be supplied in its entirety by reference to the assets described in an unfiled security agreement."

> Fundamentally, these two cases illustrate the danger of cross-referencing in a UCC financing statement collateral description to documents not attached to the filing.

'In re FOMB'

More recently, the U.S. First Circuit Court of Appeals reached a similar conclusion in the context of the Puerto Rico debt adjustment cases. *In re Fin. Oversight & Mgmt. Bd. for P.R.*, 914 F.3d 694 (1st Cir. 2019) came before the First Circuit through a series of appeals involving bonds issued in 2008 by the Employees Retirement System (ERS) of the Government of the Commonwealth of Puerto Rico. ERS, the debtor, provides pensions and other retirement benefits to employees and other members of the Puerto Rico government. In 2008, ERS, facing an unfunded liability of $9.9 billion, issued approximately $2.9 billion in bonds pursuant to a "Pension Funding Bond Resolution" (Bond Resolution), which was publicly available on several governmental websites, including ERS's own. In connection with this resolution, ERS and the bondholders also executed a security agreement in which bondholders took a security interest in "Pledged Property" belonging or owed to ERS. However, "Pledged Property" was not defined in the security agreement. The term was instead defined in the Bond Resolution, which was not attached to the security agreement.

UCC-1 financing statements were filed by the bondholders in 2008 to perfect the security interest. The then operative UCC in Puerto Rico required UCC-1s, among other things, to contain "a statement indicating the types, or describing the items, of collateral." The financing statements in this case described the collateral as the "pledged property described in the Security Agreement attached as Exhibit A hereto and by reference made a part hereof." Attached to the financing statements was the security agreement described above, which itself contained a cross-reference to "Pledged Property" but not a description of what that meant. The bondholders here made an argument similar to that of First Midwest Bank in *I80 Equipment*, which was "the mere reference in the Security Agreement to the definition of "Pledged Property" contained in a separate document, the Resolution, constituted a sufficient description, even though the Resolution, and thus its description of "Pledged Property," was not attached to the 2008 Financing Statements." They argued that a financing statement is merely "a starting point"

in providing notice to an interested party, and that the court should adopt a "liberal" understanding of the collateral description requirement.

ERS, on the other hand, countered with arguments that would have resonated with Judge Perkins in *I80 Equipment*: namely, that, consistent with the UCC goal of public notice, interested parties should not "face the burden and potential risks of further searching for a collateral description not found within or appended to a financing statement."

The First Circuit echoed ERS's argument, interpreting the provision consistent with the goals of UCC. The court pointed to three issues with the financing statements: (1) the collateral description did not indicate the type of the collateral, let alone the items; (2) the Bond Resolution, a document referred to in the collateral description, was not attached; and (3) the Bond Resolution was not on file with the UCC filing office and there was no information on how to locate it. These facts combined undercut the argument that the public notice function of the UCC was served. The court also made clear that though the "Bond Resolution" was a publicly available document, reference to it in a financing statement still does not serve the notice function if it is not attached. The court reasoned that the 2008 financing statement did not fully incorporate the definition of "Pledged Property;" and this "at best gives an interested party notice about an interest in *some* undescribed collateral, but does not adequately specify *what* collateral is encumbered" and "[r]equiring interested parties to contact debtors at their own expense about encumbered collateral … would run counter to the notice purposes of the UCC."

The perfection status of the security interest in this case ultimately did not turn on the imperfect perfection by the 2008 financing statements. The First Circuit rested its conclusion—that the bondholders held a valid perfected security interest in the collateral—on subsequent UCC-3 amendments filed in 2015 and 2016 which attached a full definition of "Pledged Property" from the Bond Resolution. The court reasoned that Article 9 contemplates situations where an amendment "cures" an earlier filing if the applicable requirements for perfection are satisfied, and the subsequent amendments in this case completed such applicable requirements.

Conclusion

Fundamentally, these two cases illustrate the danger of cross-referencing in a UCC financing statement collateral description to documents not attached to the filing. While often, as noted above, it is either impractical or burdensome to incorporate the complete collateral description from the security agreement, still, enough information should be included within or attached to the financing statement to "indicate" or "reasonably identify" the collateral, as per §9-108(b). Cross-references to other documents may be useful for additional details beyond that required in the financing statement, in which case information should be included in the UCC on how to locate those documents.

One interesting question in *In re Financial Oversight* that was not at issue on appeal was whether the security agreement in that case contained a sufficient collateral description using the same bare cross-reference to "Pledged Property" as the 2008 financing statement. As noted above, outside of the super-generic "all assets" financing statement descriptions permitted under §9-504(2), collateral descriptions for security agreements and financing statements are subject to the same rules under §9-108, although courts often apply different analytical standards given their different purposes. That was evident here. The lower court was not troubled by the same minimal collateral description in the security agreement. Rather, it distinguished the security agreement from the financing statement by its intended purpose, stating that "security agreements, as creatures of contract law … may incorporate extrinsic documents by reference if the incorporation reflects the parties' express intent. UCC financing statements, by contrast, serve a public notice function and must disclose a minimum amount of information to interested third parties." The First Circuit reiterated this same concept: "[s]ecurity agreements are private contracts between parties and do not have the same public notice purpose as financing statements."

Another takeaway from these cases is that sometimes less is more. The court noted in the *I80 Equipment* case that a financing statement collateral description such as "all assets" or "all personal property" would have been sufficient under §9-504(2) for First Midwest Bank, given its security interest against I80 Equipment covered substantially all of its personal property, instead of relying on the much more complex description in its security agreement.

Interestingly, because the *I80 Equipment* decision involved a question of state law as to which there is no controlling decision, the Seventh Circuit has accepted a direct appeal of the bankruptcy court judgment. Oral argument is scheduled for the week following the date of publication of this column. Stay tuned!