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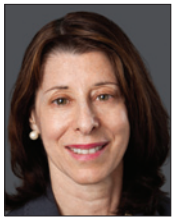
SECURED TRANSACTIONS

'In re I80 Equipment:' A Matter of Reference

By **Barbara M. Goodstein**



In April of this year we examined two recent cases involving UCC financing statement collateral descriptions that relied entirely on cross-references to the related security agreement.

The first of these cases, *First Midwest Bank v. Reinbold (In re I80 Equipment, LLC)*, 591 B.R. 353 (Bankr. C.D. Ill. 2018), was decided in August 2018 by the Bankruptcy Court for the Central District of Illinois. The second decision, *In re Fin. Oversight & Mgmt. Bd. For P.R.*, 914 F.3d 694 (1st Cir. 2019), was issued in January 2019 by the U.S. Court of Appeals for the First Circuit. Both cases involved UCC-1 financing statements that contained no collateral information but simply sent the searcher to a document that was not annexed to the financing statement. Both courts concluded that the collateral description was therefore insufficient.

Because *In re I80 Equipment* involved a question of state law as to which there was no controlling precedent, the Seventh Circuit accepted a direct appeal. In September of this year, the court issued its opinion in that case (*In re I80 Equipment*, __ F.3d.__, 2019 WL 4296751 (7th Cir. Sept. 11 2019)). In doing so, it reversed the lower court and held that a UCC-1 collateral description with nothing but a cross-reference to an unattached security agreement did "sufficiently indicate" the collateral for purposes of UCC Article 9. Today we discuss that decision.

Background

Under UCC Article 9, a security interest becomes enforceable against a debtor when the following three elements of UCC §9-203(b) are satisfied: the debtor has received value, the debtor has rights or the power to transfer rights in the collateral to the secured party and, in the case of most types of personal property, the debtor has signed or otherwise authenticated a security agreement containing a description of the collateral. UCC §9-108 contains the rules for determining whether a security agreement description is sufficient for purposes of UCC §9-203.

In order to make that security interest enforceable against third parties (i.e., "perfect" that security interest), the secured party must in most instances file a UCC financing statement which, pursuant to UCC §9-502(a), "indicates the collateral covered by the financing statement." UCC §9-504 then provides two alternative safe harbors for a financing statement that "sufficiently indicates" the collateral, those being:

1. a description of the collateral pursuant to UCC§9-108; or
2. an indication that the financing statement covers all assets or all personal property."

The first safe harbor also takes us to UCC§9-108.

> The Seventh Circuit's reading of the "any other method" language of UCC §9-108(b)(6) is a broad interpretation of the words "objectively determinable."

Although collateral descriptions in a security agreement and financing statement serve different purposes—the first is intended to constitute evidence as to the intent of the parties and the second to simply give notice to third parties that a security interest has been created in the collateral—UCC §9-108 applies to both documents and provides that a description of personal property is

BARBARA M. GOODSTEIN *is a partner at Mayer Brown.* TAL BEN-PORAT, *an associate at Mayer Brown, assisted in the preparation of this article.*

sufficient if it "reasonably identifies" the collateral. It then lists six ways to do so: (1) specific listing, (2) category, (3) type of collateral defined in Article 9 (e.g., "accounts," "general intangibles," "goods"), (4) quantity, (5) computational or allocational formula or procedure or (6) "any other method by which the identity of the collateral is objectively determinable." It is this last category that has become the heart of a disagreement among courts.

The Illinois Bankruptcy Court

The facts of the *I80 Equipment* case are briefly as follows: In 2015, I80 Equipment obtained a loan from First Midwest Bank, and, in return, granted it a lien on substantially all of its assets. The security agreement in fact specified 26 different categories of collateral. The related financing statement, however, contained the following very simple collateral description: "[a]ll Collateral described in First Amended and Restated Security Agreement dated March 9, 2015 between Debtor and Secured Party." First Midwest then neglected or chose not to attach the security agreement to the financing statement.

I80 Equipment ultimately defaulted on its loan and in December 2017 filed for Chapter 7 bankruptcy. The trustee in bankruptcy argued that First Midwest failed to perfect its security interest because the financing statement did not properly indicate the collateral covered by the lien.

As noted above, the Illinois bankruptcy court found this description insufficient. In so doing it focused on the words "objectively determinable" in §9-108(b)(6). The court stated that since the financing statement contained no description of the collateral but simply incorporated an unfiled document by reference, it provided no notice to a third party as to which assets were subject to the lien, and therefore failed to satisfy the basic public notice function of a UCC financing statement.

The Seventh Circuit

On appeal, the Seventh Circuit correctly framed the question: "We must decide whether the statutory language of Article 9 requires that the four corners of the financing statement include a specific description of the secured collateral (either by type, category, quantity, etc.), or if incorporating such a description by reference to a security agreement sufficiently 'indicates' the collateral."

> We tend to side with the Illinois Bankruptcy Court and First Circuit. Indeed, a financing statement should be short and concise, serving its main purpose of giving notice to third parties that a security interest has attached to the debtor's collateral.

The court proceeded to distinguish between "describing" the collateral and "indicating" the collateral, noting that under pre-2001 revised Article 9 either was sufficient, but under revised Article 9 only an indication of collateral was required. The view of the Seventh Circuit was that "indicating" does not mean "describing," indication being a lesser standard akin to a "signal" that "point[s] out" or "direct[s] attention to" a security interest (citing Webster's Dictionary).

The court then turned to official UCC commentary, citing Comment 2 to §9-502: "The notice itself indicates merely that a person may have a security interest in the collateral indicated. Further inquiry from the parties concerned will be necessary to disclose the complete state of affairs."

The Seventh Circuit concluded that a "plain and ordinary" reading of the statute allows incorporation by reference to a security agreement under the §9-108(b)(6) approach of "any other method" of describing the collateral. In the view of the Seventh Circuit, the fact that the security agreement was not attached to the financing statement should not avoid perfection—public notice had been given, a red flag had been raised, and a prudent would-be creditor should approach the debtor and start asking questions.

The position of the Seventh Circuit puts it at odds with the First Circuit *In re Fin. Oversight* decision from earlier this year. There, as in *I80 Equipment,* the financing statement contained solely a cross-reference to the security agreement. The First Circuit held that description insufficient:

> Here, as said, the 2008 Financing Statements do not describe even the type(s) of collateral; instead, they describe the collateral only by reference to an extrinsic document located outside the UCC filing office, and that document's location is not listed in the financing statement. This at best gives an interested party notice about an interest

in some undescribed collateral, but does not adequately specify what collateral is encumbered. That is, an interested party knowing nothing more than this does not have "actual knowledge" and has not "received a notice," … of the collateral at issue. Requiring interested parties to contact debtors at their own expense about encumbered collateral, with no guarantee of a timely or accurate answer, would run counter to the notice purpose of the UCC.

Notably, the Seventh Circuit wrote that its interpretation was reinforced by Illinois bankruptcy courts and cited to three cases. However, in one of those cases (*In re Grabowski*, 277 B.R. 388 (Bankr. S.D. Ill. 2002) the financing statement did in fact contain a listing of asset categories (i.e., inventory, chattel paper, accounts, equipment and general intangibles). The court in that case rejected a challenge to the collateral description that asserted the description to be "too general." Neither of the other two cases actually ruled on the sufficiency of incorporation by reference but merely acknowledged that it might be acceptable in certain circumstances.

There is certainly precedent for the view that the collateral description in the financing statement does not and should not have the specificity required in the security agreement itself. The Illinois bankruptcy court in the *I80 Equipment* case, whose decision was overturned, acknowledged this principle: "While it is permissible for the financing statement to describe the collateral with the same specificity as the security agreement, it is not necessary. Whereas the full extent of the security interest must be set forth in the security agreement, the financing statement is often an abbreviated or streamlined version "for the purpose of giving notice to third parties of the essential contents of the security agreement.""

However, the need for some indication of the collateral within the four corners of the financing statement is a compelling argument supported by the goal of the UCC's notice regime. Providing a proper description of the collateral allows a potential creditor to quickly and cheaply identify the type of collateral subject to the lien and ascertain how to proceed. Such an approach reduces transaction costs and avoids unnecessary burdens on other creditors.

Conclusion

The Seventh Circuit's reading of the "any other method" language of UCC §9-108(b)(6) is a broad interpretation of the words "objectively determinable." There are certainly courts that have disagreed and may continue to do so with that reading, and therein lies the current dilemma for practitioners. Ultimately, it is difficult to discern exactly where Code drafters wanted to draw the line between burdening third parties versus the debtor and secured party, and therefore exactly how much sleuthing is required by third parties.

We tend to side with the Illinois Bankruptcy Court and First Circuit. Indeed, a financing statement should be short and concise, serving its main purpose of giving notice to third parties that a security interest has attached to the debtor's collateral. However, providing a simple description of the collateral does not necessarily contradict the goal of notice; rather it can be argued that a simple description of the collateral serves the purpose of notice and is even required by the "plain and ordinary" reading of UCC §9-108. That was not the view of the Seventh Circuit and it remains to be seen whether courts outside of the Seventh Circuit will follow its lead.

Practitioners would be well-advised to continue with the conservative practice of including some information as to the collateral within the confines of the financing statement (including attachments). If incorporation by reference to another document is used, in whole or in part, we recommend including in the financing statement information to assist the searcher to obtain a copy of that document.

As an aside, given the *I80 Equipment* lien was intended as a blanket security interest, both courts agreed that First Midwest's security interest would have been perfected by using the safe harbor "all assets" description. Less is more when it comes to that type of lien and so "all assets" or "all personal property," as suggested by UCC §9-504(2), is certainly the best option in that circumstance.