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ATTORNEYS AT LAW

REVISED ARTICLE 9

Changes for the Commercial Lender

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INTRODUCTION

Article 9 of the Uniform Commercial Code, the legal cornerstone of secured commercial transactions in all fifty states of the United States, received its last major updating in 1972. Since then, significant changes in the practices of commercial finance, as well as the accumulation of years of experience regarding the current operation of Article 9, have prompted the drafting bodies responsible for the promulgation of Article 9—the American Law Institute (ALI) and the National Conference of Commissioners on Uniform State Laws (NCCUSL)—to propound and approve a restatement of Article 9 incorporating a variety of new concepts and rules.

Revised Article 9 has been enacted into legislation in a number of states (twelve as of April 21, 2000) and has been introduced in the legislatures of many more states, including Illinois.[1] It is the goal that by July 1, 2001, the delayed effective date of Revised Article 9, all states will have enacted the new legislation.

We have prepared this article in order to apprise our clients and friends of those revisions enacted by Revised Article 9 which will have a material effect on typical loan documentation used by our clients and enforcement actions taken by our clients in ordinary course secured loan transactions—i.e. the making of commercial loans to business entities secured by substantially all of the assets of such business entities. No effort is made here to catalogue all legislative changes made by Revised Article 9, many of which are very technical in nature and are likely to arise only in certain specified transactions.

As indicated, Revised Article 9, where adopted, will not become effective until July 1, 2001. Accordingly, while there is no immediate need for changed practices on the part of our commercial finance clients, lending institutions should nonetheless begin to develop policies in anticipation of the changeover and consider certain changes to existing documents and practices at this time. As we approach July 1, 2001, this firm will make recommendations to its clients as to when loan and security documents should be conformed to Revised Article 9 and as to when actions should or must be taken to comply with Revised Article 9.

SCOPE

Since the 1972 legislative overhaul, new kinds of properties and interests in properties have been developed which have generated tremendous finance opportunities. Largely in response to these developments, Revised Article 9 expands the types of assets subject to this legislation. In other words, Revised Article 9 will make it possible for lenders to obtain perfected security interests in certain assets in which they cannot perfect a security interest under current Article 9. The list of assets governed by Revised Article 9 but not current Article 9 includes the following:

- Health-care insurance receivables [9-102(a)(46), 9-109]
- Non-consumer deposit accounts [9-102(a)(29), 9-109][2]
- Commercial tort claims in existence on the date of execution of the security documents [9-102(a)(13), 9-109]

[1] For a current listing of the states in which Revised Article 9 has been adopted or introduced, see the web site of the National Conference of Commissioners on Uniform State Laws at www.nccusl.org.

[2] Under current Article 9 as adopted in a handful of states (including Illinois and California), a lender may obtain a perfected security interest in a deposit account. A significant majority of states have adopted the uniform rule that deposit accounts, other than those constituting proceeds of collateral, are excluded from the coverage of Article 9.

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As a result of the inclusion of these and certain other classes of collateral in Revised Article 9, lenders intent on creating comprehensive "blanket" liens will need to revise their security documents to make specific mention of such assets. Other changes, not discussed above, will also need to be made to certain collateral descriptions contained in security agreements in order to reflect changes made to the definitions of various asset categories within Revised Article 9.[3] Finally, although not relevant to our clients whose core businesses consist of making commercial loans, other types of collateral have been added to the scope of Revised Article 9 to facilitate securitizations.

ATTACHMENT

Attachment is the term used to describe the legal elements that must be satisfied in order for a lender to obtain an enforceable security interest against a debtor's assets. These elements, such as the requirement that the debtor have lawful rights in the collateral it proposes to pledge, are limited in number and fundamental in importance, and Revised Article 9 makes few changes to these bedrock requirements [9-201 to 9-204].

There are, however, two important changes in this arena. The first change derives from the general legislative goal that Revised Article 9 be "media neutral." Current Article 9, enacted when bellbottoms first achieved popularity, did not anticipate the development of e-mail, the Internet, magnetic tape and any number of other technological advances affecting and, in many ways, redefining the practice of commercial finance. In order to limit the risk of future obsolescence, the drafters of Revised Article 9 have endeavored to avoid language which presumes certain methods of data transmission. An important illustration of this principal concerns the element of attachment pertaining to the granting of a security interest under a security agreement. Under current Article 9, a security agreement must be "signed" by the debtor. Under Revised Article 9, by contrast, a security agreement must be "authenticated" [9-203(b)]. The term "authenticate" means either to sign or to execute or otherwise adopt a symbol or encrypt or similarly process a record (which may be maintained on an electronic medium) with the present intention of adopting or accepting such record [9-102(a)(7)]. Revised Article 9 expressly accommodates "paperless" closings, electronic signatures and other forms of business transactions far removed from the world of paper and pen.

The means of perfecting a security interest in various types of collateral is the area in which lenders will see the most significant (and in most cases favorable) changes between current Article 9 and Revised Article 9.

The second change illustrates a second important legislative goal, briefly mentioned above, that Revised Article 9 should serve to foster the development of certain commercial finance markets by extending its coverage over transactions presently outside the reach of current Article 9. For example, under current Article 9, contractual provisions precluding the free assignability of accounts receivable and certain general intangibles are deemed ineffective to prohibit the creation of a security interest in such assets. This provision is critical to the routine financing of accounts receivable, as it removes legal strictures which could otherwise be a drag on the liquidity of such receivables. Current Article 9, however, does not extend the same benefits to other financial assets including many general intangibles, such as ordinary business contracts, permits, licenses, franchises, promissory notes and letters of credit rights, among others. Revised Article 9 sweeps all such assets within its "anti-assignment" provision [9-406 to 9-409].[4]

PERFECTION

Attachment makes a security interest enforceable against the debtor that grants the security interest; perfection is the process by which a secured creditor obtains priority for its interest against third parties, including a bankruptcy trustee. The means of perfecting a security interest in various types of collateral is the area in which lenders will see the most significant (and in most cases favorable) changes between current Article 9 and Revised Article 9. The principal means of perfection consist of filing financing statements, possession of collateral and "control," a specialized term currently used in Article 9 with respect to investment property and expanded under Revised Article 9 to other forms of collateral.

FILING. Several significant changes have been made to the requirements and methodology of perfection by filing financing statements.

The most important change regarding perfection by filing concerns the location of filing. As a general rule, under current Article 9, financing statements must be filed in each jurisdiction in which tangible personal property is located and, with respect to intangible personal property, in the jurisdiction where the debtor is located (generally, the debtor's chief executive office). As a result of the current rules, multiple financing statements are required in situations where the debtor's tangible personal property is located in multiple jurisdictions. By comparison, Revised Article 9 provides

[3] Examples include the definition of "goods," which will include embedded software (software that is customarily part of the good) [9-102(a)(44)] and the definition of "accounts," which will include rights to payment for licensed intellectual property [9-102(a)(2)].

[4] With respect to general intangibles and certain other assets, this anti-assignment "override" provision may not permit the secured party to proceed against the account debtor, but the provision does assure that the secured party will have a valid security interest in the event the debtor enters bankruptcy. It also removes a potential preference risk in situations where the consent of the account debtor to the grant of security interest is not obtained at the time financing is extended, but may be bargained for in the future. In such an event, the secured creditor's lien dates back to the time of the initial financing.

that merely one financing statement, filed in the jurisdiction in which the debtor is located, will suffice to perfect a security interest in almost all types of personal property [9-301, 9-307].[5] Under Revised Article 9, debtors which are corporations, limited liability companies or limited partnerships are deemed to be located in the jurisdiction in which they are organized [9-307]. As a result of the foregoing, even if a Delaware corporation has property located in 50 states, one filing with the Secretary of State of Delaware will perfect the security interest in all tangible and intangible property of that corporation that may be perfected by the filing of a financing statement (with the exception of fixtures and certain other non-traditional forms of collateral such as minerals and timber to be cut).

Importantly, the streamlined rules regarding location of filing (along with all other new provisions of Revised Article 9) will not bind states that do not adopt Revised Article 9. Of course, it is the drafters' intentions that all states will ultimately adopt the new legislation. It presently remains unclear, however, whether all states will have ratified the new legislation prior to the July 2001 effective date. Should ratification be less than complete by this date, a careful examination of collateral locations on a deal-by-deal basis will be needed to determine which sets of rules (current Article 9, Revised Article 9 or some combination of both sets) will need to be satisfied to assure perfection.

Another important change relates back to the general policy goal that Revised Article 9 be "media neutral." Under current Article 9, a UCC financing statement must be signed by the debtor. By contrast, Revised Article 9, in order to facilitate the electronic filing of financing statements, dispenses with the requirement of a debtor signature. Instead, a lender must have the authority of its debtor to file a financing statement against that debtor [9-509(a)]. Such authority is deemed automatically granted upon the execution of a security agreement by the debtor, at least to the extent that the financing statement does not include collateral outside the scope of the security agreement [9-509(b)]. Separate authorizations to file financing statements will be required for secured parties that have policies of filing financing statements before the closing, since the security agreement will not yet have been authenticated. Separate authorizations may be incorporated in proposal or commitment letters signed by the debtor.[6]

Revised Article 9 also incorporates material changes to the form and content of financing statements, generally to the advantage of secured creditors. The minimally sufficient contents of a financing statement, for instance, have been reduced to just the debtor's name, the secured creditor's name (or its representative)[7] and the collateral covered [9-502]. Note that not even the debtor's address is a required element, although filing offices may (but need not) lawfully reject filings on the grounds that the debtor's address is not indicated [9-516]. Filing offices may also (but need not) reject filings that fail to disclose whether the debtor is an individual or an organization, and if an organization, the jurisdiction of organization and organizational identification number [9-516]. Revised Article 9 also reverses certain court decisions upholding the effectiveness of trade name filings by squarely stating that such filings do not sufficiently indicate the debtor's legal name [9-503]. Finally, Revised Article 9 for the first time permits financing statements to indicate that they cover "all assets" or "all personal property," thereby obviating the need for lengthy collateral descriptions filling multiple pages [9-504]. Note, however, that a security agreement still must contain a specific collateral description [9-108]. The shift to generic collateral descriptions in financing statements does, nonetheless, remove the risk associated with inconsistent descriptions in the security agreement and related financing statements, and also removes the risk that filing agents will improperly record (or lose) multiple page collateral descriptions.

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Finally, and as discussed in more detail below, under Revised Article 9 a lender may perfect a security interest in instruments by filing (current Article 9 only permits perfection by possession) [9-312].

POSSESSION. Under current Article 9, possession is the exclusive method of perfecting a security interest in certain collateral, such as money and instruments, and the non-exclusive method of perfecting a security interest in other types of collateral, such as chattel paper and certificated securities. Revised Article 9 makes one important change with respect to these rules by allowing perfection of security interests in instruments by either possession or filing [9-312]. As with other forms of collateral that may be perfected in this matter, such as chattel paper, lenders should be aware that when a security interest is perfected merely by filing, the lender's priority may be defeated by certain subsequent purchasers of the collateral, including other secured creditors. Thus in situations when a security interest may be perfected by either filing or possession, perfection by possession is safest (although usually more cumbersome for the lender) [9-330].

[5] A separate filing in the jurisdiction in which a debtor's real estate is located will still be necessary to perfect a security interest in fixtures located at that real estate.

[6] The debtor's authorization is also needed prior to amending a financing statement to include additional collateral. For all other amendments to financing statements, the secured party may file the amendment without debtor authorization [9-509(d)].

[7] A financing statement does not even have to disclose that a lender is acting as an agent for many lenders. Even without that disclosure, the security interests of all lenders will be perfected.

Another important change under this heading concerns bailments. When a lender desires to perfect a security interest in goods which are held by a third party bailee such as a processor or a warehouseman, current Article 9 permits the lender to perfect by notifying the third party bailee of the lender's security interest. This notice is sufficient to give the secured creditor constructive possession of the collateral. Revised Article 9, however, requires that the bailee acknowledge that it is holding the collateral for the benefit of the lender [9-313(c)]. This is one of the few areas where Revised Article 9 places a greater burden upon lenders seeking to perfect security interests.

In general, Revised Article 9 does not change existing rules governing priority of competing perfected security interests.

CONTROL. As indicated above, "control" is a specialized term currently used in Article 9 to indicate whether a lender has a perfected security interest with respect to investment property. Whether "control" exists or not depends upon the specific collateral at issue [9-314]. For example, under current Article 9 (which incorporates various provisions of Article 8, which is dedicated to the law of investment securities), a lender has "control" over a stock certificate if the certificate is delivered to the lender, along with an effective indorsement either in the name of the lender or an indorsement in blank (such as a typical stock power). By contrast, a lender has "control" over a securities account if the account is either registered in the lender's name or the securities intermediary agrees, through a tri-party agreement, to comply with the lender's instructions concerning the account contents without further consent of the debtor. Revised Article 9 adds deposit accounts [9-312, 9-314], electronic chattel paper [9-314] and letter of credit rights [9-312, 9-314] to the categories of collateral that may be perfected by control, and provides special rules for determining whether "control" has been achieved for each new category [9-104 to 107]. As a general matter, in the case of property which may be perfected by either filing a financing statement or by control (including chattel paper and investment property), the rights of a secured party which has perfected by control will defeat the rights of a secured party who has perfected by filing [9-328]. Filing, where permitted, will always defeat the rights of a bankruptcy trustee.

AUTOMATIC PERFECTION. Revised Article 9 provides that perfection is automatic for certain collateral. In other words, the lender will not have to file a financing statement, obtain possession or obtain control. Automatic perfection is limited to collateral which supports other collateral in which the lender has perfected its security interest. For example, if a lender perfects its security interest in the accounts of a debtor and if one or more of the accounts is credit enhanced by a letter of credit, a guaranty or a lien on property, the lender will automatically have a security interest in the supporting letter of credit, guaranty or property [9-308(d) and (e)].

PRIORITY

In general, Revised Article 9 does not change existing rules governing priority of competing perfected security interests. When perfecting by the filing of a financing statement, the first to file will win [9-322]. When perfecting through control, the first to obtain control will win. Revised Article 9 does make a few changes concerning priority rules governing purchase money liens and deposit accounts. With respect to purchase money liens, various case decisions have construed current Article 9 to provide that a purchase money lender loses its preferred purchase money status if it seeks to have its debt secured by assets other than the assets acquired with the purchase money obligation. Revised Article 9 reverses these decisions by providing that the additional security will not destroy the priority lien for the purchase money lender on the assets acquired with the purchase money obligations [9-103(f)]. With respect to deposit accounts, Revised Article 9 affords the depository bank priority setoff rights over a competing secured lender unless the depository bank expressly waives those rights or the secured lender has the deposit account placed in its own name [9-327]. The preferential setoff rights for depository banks reverses current law, thereby emphasizing the importance of subordination agreements for secured lenders that wish to have priority rights in bank accounts.

ENFORCEMENT

Revised Article 9 provides a few new rules pertaining to the enforcement of security interests.

First, prior to conducting a foreclosure sale, a secured party must provide a sales notice to all guarantors of the underlying indebtedness (referred to as "secondary obligors" in Revised Article 9) as well as all other secured parties of record claiming an interest in the property subject to sale [9-611]. This will require the party conducting the foreclosure sale to conduct a UCC search to determine the identity of all other perfected secured parties. Under existing Article 9, the foreclosing party had no such duty. Revised Article 9 somewhat ameliorates this new burden on secured creditors by providing form disposition notifications which, if used, cannot be challenged as commercially unreasonable [9-613].

Revised Article 9 also contains, from the lender's perspective, improved provisions pertaining to retention of collateral in satisfaction, or partial satisfaction, of the secured debt. Unlike current Article 9, Revised Article 9 expressly permits retention of collateral in partial satisfaction of the secured debt [9-620]. In construing provisions of current Article 9, certain courts have held that a secured lender that possesses collateral for an extended period of time may, solely by virtue of such possession, be deemed to have opted to retain the collateral in satisfaction of the underlying debt. Revised Article 9 reverses these court decisions by providing that

no such election is effective without the secured lender's express consent or proposal to retain the collateral in lieu of the debt [9-620(b)]. Revised Article 9 also provides that a lender may retain collateral in satisfaction of its debt, even if the lender isn't in possession of the collateral [9-620 (comment 7)].

Revised Article 9 also reverses certain existing court decisions concerning the validity of a secured lender's deficiency claim where the lender has conducted a foreclosure sale in a commercially unreasonable manner. On this topic, Revised Article 9 adopts the "rebuttable presumption rule," which provides that the sale price is presumptively equal to the value of the full amount of the debt. The lender may, however, rebut this presumption with appropriate evidence, thereby potentially preserving a deficiency claim notwithstanding its participation in a commercially unreasonable sale. Revised Article 9 therefore rejects the "absolute bar rule," which, as its name suggests, absolutely precluded a lender engaging in a commercially unreasonable sale from recovering any deficiency on its debt [9-626].

Revised Article 9 also provides that a secured party need not reduce the balance of secured debt by the amount of non-cash proceeds received pursuant to an enforcement action. In other words, if a secured party is owed $1,000,000 and conducts a foreclosure sale of all of the debtor's inventory, which foreclosure sale nets $500,000 of cash and $200,000 in the form of a promissory note issued by the purchaser of the inventory, the secured party must reduce the amount of debt by $500,000, but need not reduce the debt by the amount of the promissory note until cash is received upon the promissory note [9-615(c)].

Finally, Revised Article 9 provides that if a secured party or an affiliate of a secured party acquires collateral at foreclosure at amounts "significantly below the range of proceeds" that a sale to an unrelated party would have brought, then the amount of the debt will be reduced by the amount of proceeds that would have been received from a third party purchaser [9--615(f)]. This new rule will place new emphasis on the value of a third-party appraisal or other evidence of asset value prior to credit bidding (i.e. purchasing a portion of the collateral in exchange for a reduction of the debt) by secured lenders.

TRANSITION PROVISIONS

The most frequent question which a lender will ask with respect to Revised Article 9 is "If I perfected my security interest under current Article 9, what, if anything, must I do on or before the July 1, 2001, effective date of Revised Article 9 to retain my perfected status?" That question can be answered as follows:

First, if an action taken under current Article 9 to perfect a security interest is also sufficient to perfect that security interest under Revised Article 9, the lender need not take any additional action until the routine lapse of perfection status [9-703(a)]. In other words, if the lender has filed a financing statement with the office of a particular secretary of state, and that office is the appropriate office for filing under both existing Article 9 and Revised Article 9, the lender need not take any further action until the financing statement would require continuation.

Second, if a lender has perfected a security interest under current Article 9 other than by filing (see below), but a different type of action to assure perfection is required under Revised Article 9, the lender must take that additional action within one year of the effective date of Revised Article 9 [9-703(b)]. If the lender takes that action within that one-year period, the security interest will be deemed to have been perfected at all times and will relate back to the date of the original perfection [9-703(b)]. The foregoing does not apply to perfection by filing. Perfection by filing is discussed below.

Third, any proper filing under existing Article 9 will remain effective until the earlier of (a) the lapse of the filing (without giving effect to a continuation statement filed after the effective date of Revised Article 9), and (b) June 30, 2006 [9-705]. Thus, lenders need not file financing statements in the jurisdictions specified by Revised Article 9 on or before the Revised Article 9 effective date. Lenders must, however, file in the jurisdictions dictated by Revised Article 9 as filings made under current Article 9 lapse.

Lenders need not file financing statements in the jurisdictions specified by Revised Article 9 on or before the Revised Article 9 effective date.

Furthermore, Revised Article 9 clarifies that a continuation statement filed after the effective date of Revised Article 9 in the state in which collateral is located does not continue the effectiveness of the source filing (unless that state is the same state in which the debtor is located, as determined under Revised Article 9) [9-705(e)]. Instead, to continue the perfected status of their security interests, lenders must file what Revised Article 9 labels an "initial financing statement in lieu of continuation statement" [9-706]. Special rules govern these filings, which will be of particular concern to most secured lenders during the early years of Revised Article 9. Fortunately, these rules are designed to make the transition easier from the secured lender's perspective, and to avoid technical rules that can invalidate routine continuation statements. A summary of these rules is set forth below:

1. An effective "in lieu" filing must (i) satisfy the minimal requirements of an initial financing statement (described above under the subheading "Filing"), (ii) identify the pre-effective date financing statement by indicating the filing office, the date of filing and file numbers, if any, of the original filing and of the most recent continuation statement and (iii) indicate that the pre-effective date financing statement remains effective [9-706].

2. In contrast to the rules governing routine initial filings, "in lieu" filings do not need to be authorized by the debtor. Secured creditors can unilaterally prepare and file these transitional filings.

3. "In lieu" filings may be filed at any time during the effectiveness of the original financing statements to which they relate. In contrast to routine continuation statements, therefore, lenders do not have to wait until the six-month period prior to the lapse of the original filing.

4. "In lieu" filings may be made prior to the effective date of Revised Article 9.

5. A single "in lieu" filing may continue the effectiveness of more than one financing statement. As a result, one centralized "in lieu" filing may consolidate multiple filings covering collateral located in multiple jurisdictions.

6. "In lieu" filings begin a new effectiveness measurement period. This period, beginning with the date of filing, will terminate in five years from filing, for filings made after the effectiveness of Revised Article 9, and in the number of years specified in current Article 9 (generally five years, although certain states have opted to extend this time period) for filings made before the effectiveness of Revised Article 9.

ACTIONS TO BE TAKEN IN ANTICIPATION OF REVISED ARTICLE 9

1. Revise collateral description:
   - Expand definition of "accounts" to include health-care insurance receivables
   - Add deposit accounts
   - Add commercial tort claims
   - Expand definition of "chattel paper" to include electronic chattel paper
   - Expand definition of "goods" to include embedded software
   - Expand definition of "general intangibles" to include payment intangibles
   - Add letter of credit rights
   - Add investment property (this should have been added a few years ago)
2. Consider, on a case by case basis, depending on the collateral, a provision stating that terms which are not defined in the security agreement will have the meanings given to them by the Uniform Commercial Code as in effect from time to time.
3. Proposal and commitment letters should contain an express authorization by the debtor for the secured party to file financing statements with respect to "all assets" of the debtor.
4. The security agreement should be revised to contain a representation as to the debtor's form of organization and jurisdiction of organization.
5. Borrowing base certificates should be revised to provide that inventory in possession of third party bailees will only be "eligible" if the third party acknowledges that it is holding the inventory for the benefit of the secured party.
6. Begin conducting UCC searches in the jurisdiction of organization of the debtor.
7. File a financing statement against the debtor in its jurisdiction of organization. That filing should describe the collateral as "all assets."
8. With respect to goods in the hands of a third party, obtain the acknowledgement of the third party that it is holding such goods for the benefit of the secured party.
9. Add a covenant to the security agreement obligating the debtor to assist the secured party in obtaining control of deposit accounts, investment property, letter of credit rights and electronic chattel paper. The secured party should then take action to obtain control of those assets, including, with respect to deposit accounts and investment property, entering into agreements with the depository institution and the securities firm that such persons will follow the instructions of the secured party. Electronic chattel paper should electronically identify the secured party as a secured party.
10. The security agreement should be revised to require that the debtor provide notice to the secured party prior to the debtor changing its jurisdiction of organization.
11. The remedies section of the security agreement should be revised to contain the acknowledgement of the debtor that the secured party may disclaim all warranties upon selling the collateral.
12. The remedies provision of the security agreement should be revised to permit the secured party to retain a portion of the collateral in exchange for a portion of the debt.

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