7 The Uniform Commercial Code

Overview

Laws governing sales began in England when merchants developed the law of merchants or a system of rules, customs and usages that regulated their transactions. Eventually, the law of merchants was combined with British common law. By 1882, the English Bills of Exchange Act was adopted by the British Parliament, followed by the Sale of Goods Act in 1893.

Using these two English laws as an example, two sets of laws were created by the National Conference of Commissioners on Uniform State Laws in the United States: the Uniform Negotiable Instruments Act (1896) and the Uniform Sales Act (1906). Other laws relating to commercial transactions were also created in the early 1900s such as the Uniform Warehouse Receipts Act (1906), the Uniform Stock Transfer Act (1909), the Uniform Bills of Lading Act (1909), the Uniform Conditional Sales Act (1918) and the Uniform Trust Receipts Act (1933). By the mid-1900s, it became clear that these various laws needed revision to keep current with business and to be integrated into one set of laws.

Think About This

Q. Is the Uniform Commercial Code uniform? Why or why not?

Q. How would buyers and sellers conduct business without uniform laws across the 50 states?

Q. What are some expectations a buyer may have upon receiving a product or service?

Q. Under what conditions would a company want a tangible asset to secure an extension of credit?

Disciplinary Core Ideas

After reading this chapter, the reader should understand:

- The history of the UCC.
- Article 2: Sales.
- Article 2A: Leases.
- Article 6: Bulk Sales.
- Article 9: Secured Transactions.

Chapter Outline

A Brief Guide to the UCC

In 1942, the Uniform Commercial Code was designed as a joint project between the American Law Institute and the National Conference of Commissioners of Uniform State Laws. It took 10 years for the appointed editorial board and drafting committees to produce an official text, which underwent several revisions. Today, the Permanent Editorial Board (PEB) for the UCC is the body responsible for the uniformity of enactment and construction of the UCC and for evaluating and preparing proposals for amendment.

The UCC is **not** federal law; each state adopts the Code. Additionally, each state may adopt the code with numerous variations in the basic UCC, which requires considerable care in conforming to the local variations, so caution must be used and counsel should be sought. Pennsylvania was the first state to adopt the Uniform Commercial Code in 1954, and Louisiana is the only state that has not adopted the Code in its entirety. The Code applies to sales made in the District of Columbia and in the Virgin Islands, but it is not valid for sales made in Puerto Rico.

The basic premise on which the Uniform Commercial Code is based is that the personal property commercial transaction is a single subject of the law, involving the sale of and payment for goods. The concept of the UCC is to cover every phase of commercial transactions that can involve the sale and payment of goods.

The UCC is divided into nine articles and extends over the laws of sales, negotiable instruments, bank deposits and collections, letters of credit, bulk sales, documents of title, investment securities and secured transactions. The following lists each Article and the basic subjects covered:

Article 1	General Provisions	Purposes and policies, including definitions
Article 2	Sales	Contracts for Purchase/Sale of goods
Article 2A	Leases	Transfer of the right to possession and use of goods for a term in return for consideration
Article 3	Negotiable Instruments	Commercial paper, Promissory notes, Drafts, Checks, Certificates of Deposit, Money Orders,
Article 4	Bank Deposits and Collections	Deposit/Collection of checks
Article 4A	Funds Transfers	Electronic transfers of funds (CHIPS, Fedwire)
Article 5	Letters of Credit	Domestic and Foreign commercial letters of credit
Article 6	Bulk Sales	Special protection for creditors of seller in bulk inventory sales and transfers
Article 7	Documents of Title	Special rules for documents that evidence ownership or right to possession of goods, Bills of Lading, warehouse receipts
Article 8	Investment Securities	Stock Certificates
Article 9	Secured Transactions	Security interests, collateral, priority among secured creditors

Article 2: Sales (Effective 2002)

Comprehension Check
Article 2 applies to which kind of transactions?

Article 2 of the UCC applies to sale transactions in goods.

Goods

Goods are defined as *all things, other than money, stocks and bonds, that are movable.* Goods also include the unborn young of animals and growing crops. Goods that are not yet in existence or not yet under the control of people are called future goods. Examples of future goods are fish in the sea, minerals in the ground, goods not yet manufactured and commodities futures. Article 2 does not cover contracts to provide services or sell real property; these are covered by general contract common law and real property law.

Article 2 of the UCC is generally a part of the law of contracts; general contract common law applies to sales laws unless displaced by a particular provision of the UCC. And the **elements of contract common law**—*offer and acceptance, mutual assent, capacity to contract, legality of subject matter and consideration*—all apply. Article 2 states that a contract for the sale of goods for the price of $500 or more is not enforceable unless there is some writing sufficient to indicate that a contract for sale has been made between the parties.

Comprehension Check
Under Article 2, what rule applies to sales worth more than $500?

Merchant

The sales article of the UCC distinguishes between merchants and casual or inexperienced sellers. The UCC defines a **merchant** as *"a person that deals in goods of the kind or otherwise holds itself out by occupation as having knowledge or skill peculiar to the practices or goods involved in the transaction ..."* The UCC recognizes that more reliance can be placed on professional sellers like merchants—holding them, in effect, to a higher standard.

Comprehension Check
Why does Article 2 distinguish between a merchant and casual or inexperienced sellers?

Location of Title

A significant aspect of Article 2 is that it states the law without reference to the location of title. Historically, many controversies between buyers and sellers were answered by early common law decisions, and secondarily by the Uniform Sales Act, by determining the location of title to the goods. However, the drafters of Article 2 took the position that this "lump concept thinking," or merely determining the location of title to goods, created many uncertain and unfair results since it is frequently difficult to predict when title passes or is even established. Furthermore, passing of title may have no logical relationship to the rights in question. There is, however, a general title provision in Article 2.

Obligation of Good Faith

Within the UCC, every contract has an obligation of good faith or honesty in the transaction concerned in its performance. This is an important concept because if a contract contains an unfair or unconscionable clause, or if the contract as a whole is unconscionable, the courts have the right to refuse to enforce the unconscionable clause or contract.

Comprehension Check
Within UCC Article 2, every contract has an obligation of good faith or honesty in the transaction concerned. Why is this an important concept?

Tender Delivery

In general, the performance obligation of the seller is to tender delivery of goods, in a commercial unit, that conform to the contract with the buyer. A **commercial unit** is *any unit of goods that is treated by commercial usage as a single whole (as a machine or carload), a set of articles (as a suite of furniture) or a quantity (as a bale).* **Tender delivery** *means that the seller must make the goods available to the buyer. The basic obligation of the buyer is to accept the goods and to pay in accordance with the contract.* Additionally, the buyer has the right, before payment or acceptance, to inspect the goods, to reject the goods if they fail to conform to the contract or to accept the goods in spite of non-conformity. The seller has the right to correct or cure improper delivery. Acceptance of goods occurs when the buyer, having had a reasonable opportunity to inspect the goods, either accepts or rejects them.

The buyer must state the grounds for rejection where a defect in the tender could have been ascertained by reasonable inspection and could have been cured by the seller. The UCC introduces the concept of cover, which applies where the seller fails to perform; **cover** *gives the buyer an alternative right to purchase substitute goods and to recover from the seller the difference between the contract price and the purchase of the replacement goods as an absolute measure of damages, provided the buyer purchases in a reasonable manner.*

If the buyer refuses to accept goods that conform to the contract or repudiates the contract, the seller has a claim for damages against the buyer. The seller has two ways of determining the damages that the buyer is liable for because of the buyer's breach of contract: (1) the difference between the contract price and the market price at which the goods are currently selling, or (2) the profit the seller lost when the buyer did not go through with the contract.

If the buyer rejects a shipment, rightly or wrongly, the seller must first resell the goods at the best price obtainable and then sue for the difference between the proceeds and that which was due, plus any incidental damages. The only exception is where the merchandise is of a special nature and not readily salable at a reasonable price; in that case, the old rule still applies and the seller can sue for the full purchase price. If the buyer retains the shipment and then tries to return it much later, the seller is not obligated to accept the return and can sue for the full amount.

There are many variations of this kind of problem and the UCC provides several rules to deal with them. Consequently, the seller can no longer hold rejected merchandise for a buyer and then sue for the purchase price; instead, they have to sell the goods first and then only sue for any loss. If the seller has no loss on the resale, then only the profit on the original sale can be recovered.

The UCC acknowledges that terms are frequently omitted from agreements or contracts by defining common trade practices. The UCC also recognizes that a contract for the sale of goods may be performed even though the price is not settled. An open-price term may occur when the parties intend to be bound by a contract but pricing will be set at a later date, if at all.

Comprehension Check

What does **tender delivery** mean?

What options does a buyer have if goods delivered by the seller do not conform to the contract?

If a buyer refuses to accept goods that conform to the contract, how can the seller determine the damages for which the buyer is liable because of the breach of contract?

Title

The courts will initially consider one very specific question: did the parties contract as to when title passes? If the contract does not specify the passing of title, then the courts look to the UCC.

In its general title section, the UCC provides that title passes to the buyer when the seller has completely performed their duties concerning physical delivery of the goods. Therefore, if the contract only requires the seller to ship the goods, title passes to the buyer when the seller delivers the goods to the carrier. If the contract requires delivery of the goods by the seller, title passes to the buyer when the goods are delivered and tendered to the buyer. If delivery is made without moving the goods, the title passes at the time and place of contracting if the goods have been identified in the contract.

Comprehension Check

What does the general title section of the UCC state?

Risk of Loss

The UCC also has specific rules governing risk of loss, which is an issue separate and apart from title. Risk of loss depends on the terms of the agreement, the moment the loss occurs and whether one of the parties was in breach of contract when the risk of loss occurred. Risk of loss can be contractually addressed by using commonly accepted shipping terms.

The following are commonly used shipping terms that create shipment contracts, whereby the seller turns the goods over to a carrier for delivery to the buyer. In a shipment contract, both title and risk of loss pass to the buyer when the goods are given to the carrier; the seller has no responsibility for seeing that the goods reach their destination.

Commonly used shipping terms that create shipment contracts are:

- **FOB (Free on Board).** The place of shipment requires the seller to deliver the goods free of expense and at the seller’s risk to the carrier.
- **FAS (Free Alongside).** At a named port requires the seller to deliver the goods, at their own risk, alongside the vessel or at a dock designated by the buyer.
- **CIF (Cost, Insurance and Freight).** The price of the goods includes the cost of shipping and insurance to a named destination. The seller bears this expense and the risk of loading the goods.
- **CFR (Cost and Freight).** The price of the goods includes the cost of shipping and freight to a named destination. The seller bears the risk of loading the goods.

If the contract requires the seller to guarantee delivery of the goods to a specific destination, the seller bears the risk and expense of delivery to that destination. Commonly used shipping terms that create destination contracts are:

- **FOB Destination or an FOB term with the place of destination of the goods** puts the expense and risk of delivering the goods to that destination on the seller.
- **Ex-Ship** places the expense and risk on the seller until the goods are unloaded from whatever ship is used.
- **No Arrival, No Sale** places the expense and risk during shipment on the seller. If the goods fail to arrive through no fault of the seller, the seller has no further liability to the buyer.

If no agreement has been made for either a shipment contract or a destination contract, then the risk passes to the buyer on receipt of the goods if the seller is a merchant. If the seller is not a merchant, the risk passes to the buyer when the seller tenders (offers) delivery of the goods.

Comprehension Check

List the conditions that relate to risk of loss.

What is a **shipment contract?**

What is a **destination contract?**

Reclamation and Stoppage of Delivery

Unless the seller has agreed to extend credit to the buyer, the buyer must pay for the goods at the time they are delivered. When the seller is ready to make delivery of the goods, they may withhold delivery until the payment is made, even in cases where they have agreed to extend credit to the buyer. If the seller discovers that the buyer is insolvent before making delivery, the seller has the right to withhold delivery until the buyer pays cash for the goods and for any goods previously delivered for which payment has not been made (the existing accounts receivable balance). If a seller discovers that a buyer is insolvent, the seller has the right to stop delivery of any goods in transit.

The seller has the right to require the insolvent buyer to return any goods obtained from the seller within the previous 10 days. Under the UCC, the seller must demand the return of merchandise from an insolvent buyer within 10 days of the receipt of the shipment. Insolvency under the UCC is defined to include the so-called equity rule (inability to pay debts as they mature) as well as the bankruptcy definition (liabilities exceeding assets).

Comprehension Check

What does **reclamation** mean under Article 2?

Figure 7-1 Reclamation: Stoppage of Delivery Notice

RECLAMATION: STOPPAGE OF DELIVERY NOTICE

________, 20__

VIA EMAIL, FAX, FEDERAL EXPRESS, AND CERTIFIED MAIL, R.R.R.

[CARRIER/WAREHOUSE]

RE: STOPPAGE OF DELIVERY DEMAND: [NAME OF CUSTOMER]

Dear [INSERT]:

Demand is hereby made on you to stop delivery of all of the goods of the above customer in your possession, including, without limitation, all of the goods identified in the Schedule annexed hereto, pursuant to §§2-702, 2-703 and 2-705 of the Uniform Commercial Code.

Please contact the undersigned for instructions in connection with the return of the goods. We make this demand for stoppage of delivery without prejudice to all other rights and remedies available to us, at law or in equity.

Very truly yours,

[NAME OF CREDITOR]

By: ___________________________________

Title: __________________________________

cc: [Name and Address of Debtor]

SCHEDULE TO STOPPAGE OF DELIVERY DEMAND

Invoice No.	Invoice Date	Invoice Amount	Bill of Lading No.

Real World Perspectives

RWP 7-1

RECLAMATION DEMAND CURES THE JOHN DOE BLUES

Many years ago, there was a regional retail chain customer in the Mid-Atlantic States, and for this story, let's call them, the John Doe Widget Company. They were always difficult to deal with: chronically late with payments, constantly needing several collection calls per invoice, and they always took deductions on anything and everything.

The company's name became a verb in our office lexicon, as in "We've been John Doe'd again!" This company set the standard now used by today's big-box stores that use accounts payable as a profit center with those same tactics. John Doe was the master of evasion and deductions!

Over several years, the John Doe Widget Company expanded by buying not one, but two, smaller chains that were in bankruptcy. With its expansion, they became even more difficult to deal with; payments got even slower, requests for deductions increased, constant calls were required for collections. More chasing. More frustration. Why were we surprised? We talked to supervisors, managers, the controller, the finance director, the chief financial officer—you name it, we talked to them to get paid.

After months of intense run-around, enough was enough. I was done playing their games and took a tough stance. The John Doe Widget Company account was flagged against any new business. That got their attention. Once the account was current, we shipped existing confirmed orders, but did not take any new ones. And the cycle would start again: slow payments, unreasonable requests for deductions, and again a flag was placed on their account. One day, they called, desperate to receive one of their confirmed orders. After getting a commitment from John Doe's finance director that they would overnight payment for their outstanding invoices in exchange for letting two more truckloads of products ship, I approved the new purchases.

As one can guess, the overnight did not arrive. One truck had already delivered; the other was in transit and I had no way to stop the delivery. No one was taking my calls—not even the finance director who made the promise the day before. "John Doe'd again!"

I was young, having just completed NACM's Credit Administration Program. With the information from the legal class fresh in my mind, I sent a reclamation letter overnight, demanding that my material be returned immediately. I immediately received a call from their legal counsel asking why I had sent the demand letter. In my youthful enthusiasm, I stated emphatically, "You're not meeting your debts as they come due, which is one definition of insolvency and apparently you don't have the money to pay me. If this is the case, then I would like to come and get my material." The attorney assured me that his client was indeed solvent and that this whole thing was unnecessary. I asked for immediate payment of everything, and he stated he would see what he could do.

After a few days and several unreturned calls to the attorney, I received a check for all open invoices with the attorney's letter restating that his client, the John Doe Widget Company, was indeed solvent. It was just a misunderstanding, he wrote, and enclosed were the appropriate payments.

Sixty days later, the John Doe Widget Company filed for bankruptcy, and 60 days after that came the notice from the bankruptcy trustee with a preferential payment demand for $40,000. I provided my reclamation documents and the attorney's letter assuring me of the debtor's solvency. Happily, I never heard from the trustee again. At least we got the last hurrah after years of being "John Doe'd."

Loretta April

Warranties

Article 2 addresses several warranty issues. A **warranty** *is a contractual promise by the seller regarding the quality, character or suitability of the goods sold.* An **express warranty** *is an oral or written statement, promise or other representation about the quality of a product.*

Examples of express warranties include:

- A statement of fact or promise made by the seller to the buyer that relates to the goods.
- A description of the goods which is made part of the basis of the agreement that the goods will conform to the description.
- A sample or model of the goods.

Whenever a seller of goods makes a statement of fact about the goods to a buyer as part of the transaction, an express warranty is created.

An **implied warranty** *is a warranty that is imposed by law rather than by statements, descriptions or samples given by the seller;* it relates to all sales transactions, whether they are business-to-consumer transactions or business-to-business transactions. Implied warranties are designed to promote high standards in business and to discourage harsh dealings. There are four basic types of implied warranties:

1. An implied warranty of merchantability.
2. An implied warranty of fitness for a particular purpose.
3. An implied warranty that is derived from a course of dealing or usage of trade.
4. An implied warranty of title (owner has title to the item).

Disclaimer of warranties is permitted as a matter of freedom of contract, but with the condition that the disclaimer must be conspicuous if placed in a written contract. To disclaim the implied warranty of merchantability the writing must mention the word "merchantability." **Merchantability** *is the concept that goods are reasonably fit for the general purpose for which they are sold.*

Comprehension Check

Define the term **warranty.**

What is an **express warranty?**

What is an **implied warranty?**

Article 2A: Leases (Effective 2002)

Leases *are defined as the transfer of the right to possession and use of goods for a term in return for consideration.* Leasing allows the lessee to use valuable assets without making an initial large capital investment and allows firms with limited capital budgets an alternative way to obtain resources. Additionally, leases are frequently tailored to meet the cash budget requirements of the lessee.

Included within the scope of Article 2A are transactions as diverse as the lease of a hand tool for a few hours and the leveraged lease of a complex line of industrial equipment. This Article generally preserves the concept of freedom of contract except that there are special rules for consumer leases. A **finance lease,** *a lease in which the lessor does not manufacture or produce the goods and only acquires the goods in connection with the lease,* is also governed by this Article.

A lease contract is enforceable if the total payments to be made, excluding payment for options to renew or buy, are less than $1,000 or if there is a written agreement. A lease contract can be made in any manner that shows agreement between the parties. If a court finds, as a matter of law, that a lease or clause is unconscionable at the time it was made, it can refuse to enforce the lease or clause. A lease imposes an obligation on each party that the other's expectation of receiving the performance will not be impaired.

A lease is also enforceable if the goods are to be specifically manufactured or maintained for the lessee and are not suitable for lease or sale to others in the ordinary course of business; or if a party admits that the lease was made; or if the goods have been received and accepted by the lessee.

Promises made by a lessor to a lessee create a warranty that the goods will conform to the promises made. Any description of the goods creates an express warranty that the goods will conform to the description; likewise, any sample or model used creates a warranty that the goods will conform to the sample or model. In a finance lease, there is an implied warranty of merchantability in a lease contract if the lessor is a merchant with respect to goods of that kind.

General Default

If either party is in default under the lease, the party seeking enforcement may obtain a judgment or otherwise peacefully enforce the lease by self-help or any available judicial or non-judicial procedure. If a lessor discovers the lessee to be insolvent, the lessor may refuse to deliver the goods; and if the lessee is in default, the lessor may peacefully take possession of the goods without judicial process. After default by the lessee under a lease contract, the lessor may recover from the lessee damages for goods accepted by the lessee and for conforming goods lost or damaged within a commercially reasonable time, accrued and unpaid rent, the value of the lease and incidental damages.

Comprehension Check
When is a lease contract enforceable?

Article 6: Bulk Sales (Effective 1989)

Bulk transfers have created special problems for business people. Merchants, owing debts, would sometimes sell out their entire inventory for less than what it was worth. This left creditors with no way of reaching and selling the goods to obtain the money owed to them. Article 6, Bulk Sales, protects creditors from this practice, known as bulk transfer. While many states have repealed their bulk sales statute, other states have either retained the existing Article 6 or revised Article 6. Consulting legal counsel in the state in which the transfer is taking place is recommended to determine which laws apply to that particular jurisdiction. For more details, refer to the NACM *Manual of Credit and Commercial Laws.*

A **bulk transfer** *is any transfer of a major part of the materials, supplies, merchandise or other inventory of an enterprise that is not made in the ordinary course of business;* under revised Article 6, the transferor must be going out of business as well.

The general concept of Article 6 is to protect the creditors of a merchant by voiding a bulk transfer of the merchandise not in the ordinary course of trade, unless the merchant (who is the transferee) gives written notice of the contemplated transfer to all known creditors before taking possession. The granting of a security interest for the performance of an obligation is not a bulk transfer under Article 6, but a legitimate financing transaction. Creditor protection under this Article is designed to prevent two types of fraud:

1. To stop the conveyance type of sale where both parties, the debtor and the buyer/transferee, may have conspired to defraud creditors by transferring goods at less than their true value so the debtor may then reestablish the business.
2. To prevent a debtor from selling the bulk of stock in trade, even for full value, to a buyer/transferee that may not be in collusion with the debtor, and then either dissipating the proceeds or disappearing with them, leaving creditors unpaid.

The UCC lists requirements that must be followed whenever a bulk transfer is made. If the requirements are not met, the transferee of the goods can lose all ownership rights to them. Further, creditors who suffer damages can demand the return of all goods bought, with no obligation to reimburse the buyer. Revised Article 6 gives creditors a united damage claim against the transferee. The requirements are:

1. The buyer/transferee must require the transferor/seller to furnish a list of any existing creditors with their addresses and amounts owing.
2. The parties must prepare a schedule of the property being transferred so that it can be identified.
3. The buyer/transferee must maintain or preserve the list and schedule for six months following the transfer and make it available for inspection.
4. The buyer/transferee must give notice of the transfer to all creditors from 10 to 45 days (depending on state law) before taking possession of the goods or paying for them, whichever happens first.
5. Revised Article 6 also requires the preparation of a schedule of distribution of proceeds to be given to all creditors by the seller, which enables the creditor and the transferee to know the disposition of the proceeds of the sale.

After following these requirements, the transferee may pay for and take possession of the inventory.

Creditors' Actions

A creditor receiving notice that a customer is selling under a bulk sale must immediately contact both the debtor and buyer to ascertain how much time will elapse before the sale; obtain a description of the property to be sold, its value, and the names of other creditors and the amounts due them; determine whether the debtor's debts are to be paid in full or in part from the proceeds; and find out where claims should be sent.

A creditor who did not receive any such notice but learns that a sale of the debtor's goods has been made, which may be subject to Article 6, should find out whether the debtor, the sale or both are subject to the UCC; whether a claim can be filed; or, if a claim cannot be filed, what rights creditors have against the buyer/transferee if either the debtor or buyer has failed to comply with the UCC. The creditor must move quickly in order not to be barred from relief under the law. Therefore, consult counsel once it's clear that a bulk transfer has occurred. Creditors who have not taken any action to interrupt the transfer lose their right to do so.

Comprehension Check

What is the general concept behind Article 6?

Under UCC Article 6, five requirements must be followed whenever a **bulk transfer** is made. What are they?

Article 9: Secured Transactions (Effective 2013)

Overview

Whenever the payment of a debt is guaranteed or secured by personal property owned by the debtor or in which the debtor has a legal interest, the transaction becomes known as a **secured transaction.** The concept of the secured transaction is as basic to modern business practice as the concept of credit. Logically, sellers and lenders do not want to risk nonpayment, so they usually will not sell goods or lend funds unless the promise of payment is somehow guaranteed. Business could not exist without laws permitting and governing secured transactions.

The Terminology of Secured Transactions

A brief summary of the terms relating to secured transactions follows.

- **Collateral** is the *subject* of the *security interest* [UCC 9-102(a)(12)].
- A **debtor** is the "party" who *owes payment* or other performance of a secured obligation [UCC 9-102(a)(28)].
- A **financing statement**, referred to as the **UCC-1 form**, is the *document normally filed to give public notice to third parties of the secured party's security interest* [UCC 9-102(a)(39)].
- A **secured party** *is any creditor who has a security interest in the debtor's collateral*. This creditor can be a seller, a lender, a cosigner and even a buyer of accounts or chattel paper [UCC 9-102(a)(73)].
- A **security agreement** is an *agreement* that *creates* or provides for a *security interest* [UCC 9-102(a)(74)].
- A **security interest** is the *interest* in the collateral (personal property, accounts, etc.) that *secures payment or performance of an obligation* [UCC 1-201(35)].

These basic definitions form the concept of a secured transaction relationship between debtor and creditor.

Article 9 of the UCC contains the law of secured transactions for personal property and fixtures. It also contains the rules for obtaining a security interest in personal property and fixture collateral. A credit grantor must first satisfy all Article 9 requirements in order to obtain a valid and perfected security interest in all of the collateral securing payment of its claim against its customer or the performance of the customer's obligations. Then, a credit grantor must determine whether a secured creditor of its customer has satisfied all of the requirements for obtaining a perfected security interest that would confer upon it priority over junior secured and judgment lien creditors and a bankruptcy trustee.

Comprehension Check
Under UCC Article 9, what is a **secured transaction?**

What is a **security interest?**

Article 9 has been enacted and is currently in effect in all 50 states and the District of Columbia. Certain states, however, passed Article 9 with some changes to the official text. The following discussion is a review of the creation and enforcement of security interests in personal property; the general discussion, however, will not apply in all states. When creating a security interest, counsel should be sought in regard to a particular state's version of Article 9 to check for any variance from the official text.

Basic Coverage of the Uniform Commercial Code

While the UCC covers transactions that are intended by the parties to create security interests in personal property or fixtures to secure the future payment of debts or performance of obligations, certain types of personal property are specifically excluded. Unless one of the exceptions listed below applies, any transaction involving personal property is probably subject to the UCC. In any case not excepted, compliance with the UCC to create and perfect an enforceable security interest is required.

Excepted Transactions

If the transaction involves a security interest or lien on real estate, aircraft and certain vessels, wages or certain types of insurance claims that are not proceeds of UCC collateral or consumer tort claims, the UCC does not apply. Motor vehicles present a special problem since creation of a security interest may be subject to the UCC, but perfection is subject to other law.

- **Mechanic's Liens and Other Statutory Liens.** Statutory mechanic's, contractors' or similar liens are created by state law for persons furnishing labor or materials for the improvement of real property. The repair of vehicles or equipment or the feeding of livestock is also covered by statutory liens and not by UCC Article 9. The nature and extent of mechanic's liens and other statutory laws is the subject of state law and may vary widely from one state to another. Such liens often take precedence over security interests in the same property, including security interests under the UCC that attach before the work is done.
- **Aircraft, Ships and Motor Vehicles.** Certain types of aircraft, barges, oceangoing ships and other means of conveyance registered by the federal government under federal law are excluded from the operation of UCC Article 9 to a limited extent. Certain motor vehicles titled under state law are partially excluded. Security interests in aircraft and barges may be created under the UCC through the execution of a security agreement. The perfection of the security interest, however, is a question of federal law. Motor vehicles are subject to security interests created in a security agreement under the UCC, but generally perfected under the motor vehicle law of the state in which the vehicle is titled. Aircraft are covered by various federal and state laws, depending on whether they are aircraft being used for transport or whether they are aircraft sitting in a showroom of an aircraft dealer. In many states the notation of the security interest must be made on the vehicle's title issued by the state. Questions of the perfection of security interests in vehicles, ships and aircraft should be referred to counsel.
- **Wages.** The UCC expressly excludes the assignment of an individual's wages. This is rarely an issue in commercial sales of goods and the granting of commercial credit.
- **Insurance Contracts.** While UCC Article 9 generally traces a security interest in goods into any casualty insurance proceeds, as a general rule, Article 9 does not apply to the transfer or assignment of any interests in an insurance policy itself. Taking a security interest in

goods in most states automatically establishes a security interest in any proceeds if the goods are destroyed and covered by insurance. A security interest cannot be taken in most insurance policies. However, Article 9 applies to healthcare insurance receivables. They include claims under health insurance policies of the debtor's patients.

Comprehension Check
What transactions are excepted from Article 9?

Theory of UCC Sections on the Creation of Security Interests in Personal Property

Article 9 grants the parties a great deal of flexibility to tailor the creation of a security interest in many types of personal property to fit their particular transaction. The specific form of the security interest and its enforceability may be the subject of an agreement between the parties. In the absence of a specific contract setting out terms, the UCC provides specific remedies upon default.

A security interest may be limited to identified items of collateral or may be broad enough to cover all collateral of a particular kind or type, then owned or thereafter acquired by the debtor. One of the most flexible features of the UCC grants the parties *the right to create a security interest in property the debtor does not yet own or possess at the time that the security interest is created;* referred to as the **floating lien** of the UCC. A floating lien attaches to all of the debtor's property of a particular kind, properly described in the security agreement, even though the property of that kind is acquired long after the execution of the agreement. Property that is acquired thereafter is automatically covered and is likewise automatically released from the lien as items are sold by the debtor in the ordinary course of business.

The UCC further permits a secured creditor to trace a security interest to the proceeds received by the debtor upon the disposition of the collateral. Under certain circumstances, proceeds of the collateral to the debtor's bank account may be traced, or the collateral itself may be traced into the hands of the person buying the property from the debtor unless the buyer is a good faith purchaser.

Classification of Collateral

The first step in creating a secured transaction is to review the classifications of personal property under the UCC. No matter how designated in a particular industry, all collateral will fall within one of the classifications under the UCC. For the most part, be concerned with the types of property that will eventually become inventory or equipment in the hands of the purchaser (referred to here as the "debtor"). If the transaction is going to involve more than one type of collateral, greater care should be taken.

The categories of collateral covered under Article 9 include:

- Accounts and general intangibles.
- Deposit accounts.
- Goods, such as inventory and equipment.
- Instruments.
- Investment property, such as securities and brokerage accounts.
- Chattel paper (any writing evidencing a debt secured by personal property).

Comprehension Check
List the six categories of **collateral.**

Under Article 9, **accounts** *include the right to payment arising from the sale, lease, license and other disposition of all types of tangible and intangible property.* Accounts include:

- Fees and royalties payable under intellectual property licenses, such as patent, trademark and copyright licenses, the right to lottery winnings, the right to payment under an installment real estate sales contract and manufacturers rebates.
- Credit card receivables.

- Health care insurance receivables that are owed to healthcare providers. They are interests in claims under a policy of insurance evidencing a right to payment of money for providing healthcare goods and services.

Article 9 has a subcategory of general intangibles called **payment intangibles** *where the obligor's principal obligation is the payment of money.* Examples of payment intangibles include loan agreements or commercial debt instruments that may be sold. General intangibles also include software consisting of a computer program and any supporting information in connection with a transaction relating to the program. For example, a retailer's inventory of CDs containing computer programs for sale are general intangibles and not inventory. On the other hand, software consisting of a computer program embedded in goods and any supporting information provided in connection with a transaction relating to the program are goods with the program, and considered part of the goods.

Chattel paper *is any writing evidencing both a monetary obligation and a security interest in specific goods, including electronic as well as tangible chattel paper.* It also includes promissory notes as a subcategory of instruments.

A **commercial tort claim** *is a tort claim in favor of an organization or in favor of an individual that arises in the course of the individual's business or profession.* It does not include a personal injury or death claim.

A **deposit account** *is a bank account, such as a demand, time, savings, passbook or similar account, maintained with a bank.* A security interest can be granted in a deposit account as original collateral or the security interest can attach to the sums on deposit in the account as proceeds of other collateral.

A **letter of credit right** *is a right to payment or performance of a letter of credit.* This does not include the right to make a drawing under a letter of credit, which is reserved only to a letter of credit beneficiary.

Proceeds *include whatever is realized from the sale, exchange, collection or other disposition of collateral.* Proceeds also include rights arising from the lease or license of collateral, distributions on account of collateral and claims arising out of defects in or damage to collateral. Cash or stock dividends from pledged stock and claims against a third party for infringement of intellectual property collateral are, likewise, proceeds.

Under Article 9, a **security interest** automatically continues in identifiable proceeds of the original collateral. Cash proceeds and other non-goods proceeds are identifiable to the extent the secured party identifies the proceeds by a method of tracing, which is permitted under non-Article 9 law for commingled property of that type. Where the proceeds are goods that become commingled with other goods such that their identity is lost in the product or mass, identifiable proceeds include the entire product or mass.

Article 9 also includes **supporting obligations** that support payment or performance of other collateral, such as accounts. Where a creditor has a valid and perfected security interest in an account and payment of the account is secured by a letter of credit or guarantee, or other third-party support, the third party is automatically subject to the creditor's security interest.

The collateral categories are mutually exclusive and a particular item of collateral cannot fall into two classifications or categories at the same time in the hands of one debtor. Certain goods, depending upon whether they are being held for resale or for use by the debtor, may fall into a different class under limited circumstances. Proper classification is essential for determining the appropriate language to be used in a security agreement and financing statement as well as determining the proper method of perfecting the security interest through filing, control or possession.

Comprehension Check
List the items covered under Article 9's definition of **account.**

Determining Primary Use or Purpose

While the classification of certain types of collateral, such as accounts, does not change depending upon use, goods may be classified in several subcategories depending upon their primary use by the debtor. The difficulty faced by most secured parties is that a particular good may be held by different individuals for different purposes or uses and, therefore, fall into different classes. As the same item is passed from hand to hand through the chain of commerce, it may change classification. For example, a computer in the hands of a wholesaler or retailer is inventory, but may become consumer goods when sold to an individual for home use, or equipment if sold to a company for office use. Distinction in use is critical. A security agreement covering inventory would be ineffective if the debtor purchased the property for business use since the computer is no longer inventory. Likewise, a financing statement covering equipment would not be effective against the retailer holding the property as inventory for resale.

The classification of goods is usually obvious, except where a debtor uses machinery or other goods for more than one purpose. For example, a debtor operating a retail store selling equipment, but also using much of the equipment in a service business, will present special problems. The same item of goods that may be considered inventory if held for resale would be equipment if used by the debtor for repair of customers' purchases. If there is any question, a security agreement and financing statement should cover both classifications that the collateral may conceivably fall into. This may present special problems for manufacturers whose products would normally be purchased for resale. In such situations, the purchaser may also have financing covering both inventory and equipment used in the operation of the business. The primary lender may have already perfected a security interest in all inventory and equipment. The creation and perfection of a *purchase money security interest* in inventory and equipment require extra steps to prime or come ahead of existing security interests.

If there is any question concerning the classification of collateral in a particular debtor's hands, counsel should review the documentation, including a comprehensive summary of all financing statements and other documents of record.

Comprehension Check
Why is determining primary use or purpose critical?

Creation of Security Interests

The following requirements for the creation of a security interest must be satisfied in order to become a secured creditor:

- The creditor provided value to the debtor.
- The debtor has rights in the collateral and the power to transfer such rights to the secured party.
- There is a valid security agreement that describes the collateral in which the creditor is granted a security interest.

A **valid security agreement** *must contain a sufficient description of the collateral and be authenticated by the debtor.* A security agreement signed by the debtor is an authenticated record. It is no longer necessary for a debtor to actually sign a security agreement for it to be valid and enforceable. The term "authentication" refers to a manual signature or the use of any electronic means by which the debtor as an authenticating party could be identified and the authenticity of the record can be established. The parties no longer have to rely on paper as long as they can demonstrate in some retrievable form that the debtor intended to grant a security interest in particular assets. A **record** *is information that is inscribed on a tangible medium, such as on paper as a written security agreement, or which is stored in an electronic or other medium and is retrievable in perceptible form.*

A security agreement must describe the collateral by item or type. The collateral may be identified as accounts, instruments, chattel paper, documents, investment property, inventory, equipment and general intangibles. A generic collateral description of "all personal property" or "all assets" of the debtor is not sufficient. For most assets, the security agreement could describe the collateral as all present and future collateral or as a floating lien. This does not apply to commercial tort claims. When a security interest is granted in a commercial tort claim, the security agreement must contain a specific description of the claim. An adequate description would be "all claims arising out of the explosion at the debtor's chemical factory in Boston, Massachusetts, on July 1, 2015."

A security agreement could be a full-blown agreement; it could be contained in a purchase order or a confirmation, which provides the necessary security interest grant language, sufficiently describes the collateral and is authenticated by the debtor. While a written security agreement is not necessary where a security interest in the collateral could be perfected by possession or control, a secured party should insist upon one for such collateral as additional proof of its security interest.

Most security interests are created through an agreement that contains standardized provisions and with the blanks completed with the necessary information. Nonstandard security agreements may be used if they are carefully reviewed to meet the minimum requirements of UCC Article 9. The security agreement must contain the necessary minimum legal language to create a simple security agreement. (The *Manual of Credit and Commercial Laws* contains sample language for such, as well as instructions for completing an agreement.)

Article 9 continues the sole exception under the UCC to the requirement of a written security agreement where the creditor has possession or control of the collateral, provided that the possession or control is with the debtor's agreement. Questions may arise as to whether the debtor has provided permission, a best practice dictates that even in those situations when possession or control is taken, a written security agreement authenticated by the debtor should be obtained.

At a minimum, any security agreement should contain the following:

- **Identification of Parties.** A security agreement must contain a provision identifying both the debtor and the secured party. It must also contain the debtor's correct legal name and should include the mailing address.
- **Granting Clause.** The law requires the use of the magic words "expressly grants security interest" in all present and future collateral described in the security agreement to secure all present and future indebtedness of the debtor to the secured party.
- **Collateral Description.** The description of the collateral covered by the security interest is the essence of the security agreement. The form should either have a preprinted description of the collateral or provide a space for inserting a written description of the collateral. It should contain language stating that the security interest attaches to all similar types of collateral now owned or subsequently acquired by the debtor as well as to any proceeds generated by the disposition of the collateral and all supporting obligations relating to the collateral.
- **Debtor's Warranties, Covenants and Agreements.** While the UCC gives the parties great latitude in creating documentation to suit their particular transaction, it does not require that the debtor warrant that it owns or has the right to grant a security interest in the collateral or that the agreement contain any specific events of default. However, a typical form of security agreement contains provisions setting out assorted warranties (such as that the debtor owns or has the right to grant a security interest in the collateral) and gives a comprehensive list of events of default, an acceleration clause and anti-waiver clause. The contract language in the sample agreement is typical. Additional provisions, such as a provision for obtaining insurance for inventory collateral or governing accounts receivable generated by the sale of the collateral, are also common.

Comprehension Check

What requirements must be satisfied for the creation of a security interest?

What is a **security agreement?**

What does a security agreement establish?

At a minimum, a security agreement should contain four essential elements. What are they?

The basic elements of Article 9 are that a security interest is an interest in personal property granted by the debtor to secure repayment of a debt. Also, a security interest is consensual and requires that the debtor authenticate a security agreement, which describes the goods to be covered, known as the collateral. A security interest attaches when the security agreement is executed and the debtor acquires rights in the assets subject to the security interest. A security interest is perfected when the secured creditor either takes possession or control of the collateral or files a proper financing statement with the appropriate state authority. As a general rule, competing security interests have priority in the order they are perfected or, if all competing interests are unperfected, in the order in which they attached.

Perfection

Perfection *is the process of taking the legal steps necessary to ensure that a secured party's interest in collateral will withstand attack by competing secured creditors, judgment lien creditors and a bankruptcy trustee.* A security interest is said to be perfected when all the steps have been taken to ensure its priority in the collateral described against all possible competing claimants. Generally, a security interest is perfected either through the taking of possession or control of the collateral or the filing of a financing statement under the UCC or both. In a limited number of cases, perfection is obtained through compliance with other state or federal law.

Perfection generally determines a creditor's priority to proceeds from the disposition of the collateral. Perfected security interests generally have priority from the date of perfection where the perfection was accomplished through filing, possession, control or some other means. Proper classification of the collateral into the appropriate category is essential since the proper means of perfection is based upon the classification of collateral.

Figure 7-2 will assist in determining the means of perfection applicable. Where two methods of perfection are listed, the method in bold is considered the preferred method. The subsequent explanation should assist in perfecting a security interest.

Comprehension Check
What is **perfection?**

Figure 7-2 Perfection Methods by Type of Collateral

Type of Collateral	Method of Perfection Under Article 9
Accounts	Filing (9-310(a))
Agricultural Liens	Filing (9-310(a))
Certified Securities	Possession or Filing (9-313(a))
Commercial Tort Claims	Filing (9-310(a))
Deposit Accounts	Control (9-312(b)), (9-314(a))
Electronic Chattel Paper	Filing (9-312(a)) Control (9-314(a))
General Intangibles	Filing (9-310(a))
Goods	Filing (9-310(a), 9-312(c)) Possession (9-313(a) and (b))
Healthcare Insurance Receivables	Filing (9-310(a)) Attachment (9-309(5))
Instruments	Filing (9-312(a)) Possession (9-313(a))
Investment property (other than certified securities)	Filing (9-312(a)) Control (9-314(a))
Letter-of-Credit Rights	Control (9-312(b)(2), 9-314(a))
Money	Possession (9-312(b)(3), 9-313(a))
Negotiable Documents	Filing (9-310(a), 9-312(a)) Possession (9-313(a))
Oil, Gas or Other Minerals Before Extraction	Filing (9-310(a))
Tangible Chattel Paper	Filing (9-312(a)) Possession (9-313(a))

Perfection by Possession

The secured party taking physical possession of the collateral may perfect security interests in most types of tangible collateral. The courts have generally held that if a secured party has exclusive control of, access to, or the use of the collateral, it has possession of it. Therefore, a negotiable instrument, such as a stock certificate in the company's safe, creates possession. Similarly, inventory or equipment stored in a warehouse in the company name is also in the company's possession. Article 9 also deals with the way to perfect a security interest where a third party has possession of the collateral. Notice of the security interest to the third party alone is not sufficient. The third party must acknowledge the security interest in an authenticated record that states that the third party is holding the collateral for the secured party's benefit.

Comprehension Check
Explain what is meant by the term **perfection by possession.**

Perfection by Control

Control *applies to situations where a secured party may not be in physical possession of the collateral but can still exercise a sufficient amount of power over the collateral to control it.* This frequently requires that a third party having possession of the investment property collateral, such as a bank, broker or other financial institution, enter into an agreement with the secured party where the third party agrees to comply with the secured party's instructions concerning the disposition of the collateral without the debtor's consent.

A secured party obtains control over a deposit account in a similar manner to obtaining control over investment property. Control over electronic chattel paper requires a unique "marking" of it. Control over a letter of credit right occurs when the secured party obtains the consent of the letter of credit issuer to the assignment of the proceeds of the letter of credit. However, there is automatic perfection of a security interest in a letter of credit right that is a supporting obligation of another category of collateral subject to a properly perfected security interest.

Comprehension Check
Explain what is meant by the term **perfection by control.**

Perfection by Filing

The most common method of perfecting a security interest under the UCC is through the filing of a **UCC financing statement.** A writing that meets all of the statutory requirements for a qualified financing statement must be filed with the proper authorities. The security interest must be continued to extend the validity of the perfection beyond the five-year period usually allowed. Article 9 contains the rules governing perfection by filing a UCC financing statement. These rules are designed to simplify procedures for UCC filings, reduce the cost of compliance by UCC filing and reduce the risk of inadvertent errors.

Comprehension Check
Explain what is meant by the term **perfection by filing.**

UCC Filing Rules

Article 9 substantially reduces the burden on a secured party by requiring the filing of a UCC financing statement for all types of collateral in the state where the debtor is located.

Where to File

A **registered organization**, such as a corporation, limited liability company and limited partnership, is located in the state where it is organized and registered. This term refers to *an entity organized solely under the law of a single state or the United States by the filing of a public organic record with the issuance of a public organic record by, or the enactment of legislation by the state or the United States*. The term includes a business trust that is formed or organized under the law of a single state if a statute of the state governing business trusts requires that the business trust's organic record be filed with the state. For example, a corporation is located in the state where it is incorporated. If a debtor is incorporated in Delaware and has its inventory in New Jersey and its chief executive office in New York, a UCC financing statement must only be filed in Delaware under Article 9.

Where the debtor is an unregistered organization, such as a general partnership, it is located in the state where it has its place of business; a UCC financing statement must be filed in that state. Where the debtor has a place of business in more than one state, it is deemed to be located in the state where it has its chief executive office, which is the state where a UCC must be filed.

Where the debtor is an individual, a UCC financing statement must be filed in the state of the debtor's principal residence. Where the debtor is a foreign entity that is located in a jurisdiction outside of the U.S. and the foreign jurisdiction does not provide for a public filing system that would enable a secured creditor to prevail over a subsequent lien creditor, the debtor is deemed to be located in the District of Columbia.

Article 9 simplifies the rules for filing a UCC financing statement in a particular state. Almost nationwide, the filing of a UCC financing statement is now done electronically with the Office of the Secretary of State. Louisiana remains an exception and requires filing at the local parish level, but such filing will constitute a statewide filing. An exception continues for fixtures where local filings continue to be required.

The filing of a UCC financing statement is deemed completed upon presentation of a proper UCC financing statement and the tender of the necessary filing fee or the acceptance of the UCC financing statement by the filing officer. Follow-up should be done for actual receipt and filing of the UCC financing statement. A secured party may wish to conduct a UCC search immediately after submitting the UCC filing to confirm that the UCC financing statement was properly filed and indexed.

Contents of UCC Financing Statement

A UCC financing statement must contain all of the following:

- **Name of Debtor.** A UCC financing statement must contain the debtor's correct legal name. The use of a trade name for a debtor that is a registered entity (such as a corporation) is not acceptable and may subject the secured creditor to the rights of a subsequent secured creditor. The question of whether an individual debtor's correct legal name must be used or whether a debtor may use a nickname has engendered substantial litigation and should discourage identifying individual debtors by their nickname.
- **Name of Secured Party or Its Representative**
- **Description of Collateral.** Under Article 9, a UCC financing statement can contain a generic "all asset" or "all personal property" description of collateral only if the description of collateral in the security agreement includes all categories of collateral or the security agreement otherwise authorizes it. However, the security agreement cannot contain such a generic "all assets" or "all property" description of collateral. Also, the extent of the perfected security interest is limited to the collateral described in the security agreement. For fixtures, the UCC must contain a real estate description and the name of the record owner of the real estate where the debtor does not have an interest in the real property, and should be filed in both the central location for personal property UCC filings and the real property records.

If a financing statement does not contain this information, it is ineffective and will not be accepted for filing. A financing statement should also contain the address of the debtor and secured party, the debtor's type and jurisdiction of organization and the debtor's organization identification number.

Article 9 does not require the debtor to sign a UCC financing statement. The debtor's authentication of a security agreement that describes the collateral referred to in the UCC financing statement authorizes the secured party to file a UCC financing statement. This facilitates the electronic filing of UCC financing statements and electronic UCC financing statement searches. As part of this rule, a secured party must obtain the debtor's authorization to pre-file a UCC financing statement where the debtor had not yet authenticated the security agreement.

Article 9 contains a uniform UCC financing statement. Virtually every state will now accept this uniform UCC form for filing (*see* Figure 7-3). In most states, Article 9 continues the rule that a UCC financing statement is effective for five years after the date of filing of the original UCC. The secured party must file a UCC continuation within six months prior to the fifth anniversary date of the original UCC filing. Unless a continuation is timely filed, the perfected security interest lapses the day after the fifth anniversary of the original filing. While a continuation does not have to be signed, a secured creditor should verify that its security agreement permits the continuation and does not contain a termination date which would disallow the filing of a continuation. Once filed, the continuation continues the perfection of the UCC financing statement for an additional five years, running from the end of the first five-year period and every succeeding five-year period, and not five years from the date of the filing of the continuation.

UCC filing amendments should be made: (1) when the name of the original debtor changes so that an existing UCC financing statement is "seriously misleading"; (2) to cover additional items or types of collateral and to correct

Figure 7-3 UCC Financing Statement

UCC FINANCING STATEMENT

FOLLOW INSTRUCTIONS

A. NAME & PHONE OF CONTACT AT FILER (optional)

B. E-MAIL CONTACT AT FILER (optional)

C. SEND ACKNOWLEDGMENT TO: (Name and Address)

Print Reset

THE ABOVE SPACE IS FOR FILING OFFICE USE ONLY

1. DEBTOR'S NAME: Provide only <u>one</u> Debtor name (1a or 1b) (use exact, full name; do not omit, modify, or abbreviate any part of the Debtor's name); if any part of the Individual Debtor's name will not fit in line 1b, leave all of item 1 blank, check here ☐ and provide the Individual Debtor information in item 10 of the Financing Statement Addendum (Form UCC1Ad)

1a. ORGANIZATION'S NAME				
OR 1b. INDIVIDUAL'S SURNAME	FIRST PERSONAL NAME	ADDITIONAL NAME(S)/INITIAL(S)		SUFFIX
1c. MAILING ADDRESS	CITY	STATE	POSTAL CODE	COUNTRY

2. DEBTOR'S NAME: Provide only <u>one</u> Debtor name (2a or 2b) (use exact, full name; do not omit, modify, or abbreviate any part of the Debtor's name); if any part of the Individual Debtor's name will not fit in line 2b, leave all of item 2 blank, check here ☐ and provide the Individual Debtor information in item 10 of the Financing Statement Addendum (Form UCC1Ad)

2a. ORGANIZATION'S NAME				
OR 2b. INDIVIDUAL'S SURNAME	FIRST PERSONAL NAME	ADDITIONAL NAME(S)/INITIAL(S)		SUFFIX
2c. MAILING ADDRESS	CITY	STATE	POSTAL CODE	COUNTRY

3. SECURED PARTY'S NAME (or NAME of ASSIGNEE of ASSIGNOR SECURED PARTY): Provide only <u>one</u> Secured Party name (3a or 3b)

3a. ORGANIZATION'S NAME				
OR 3b. INDIVIDUAL'S SURNAME	FIRST PERSONAL NAME	ADDITIONAL NAME(S)/INITIAL(S)		SUFFIX
3c. MAILING ADDRESS	CITY	STATE	POSTAL CODE	COUNTRY

4. COLLATERAL: This financing statement covers the following collateral:

5. Check <u>only</u> if applicable and check <u>only</u> one box: Collateral is ☐ held in a Trust (see UCC1Ad, item 17 and Instructions) ☐ being administered by a Decedent's Personal Representative

6a. Check <u>only</u> if applicable and check <u>only</u> one box: ☐ Public-Finance Transaction ☐ Manufactured-Home Transaction ☐ A Debtor is a Transmitting Utility

6b. Check <u>only</u> if applicable and check <u>only</u> one box: ☐ Agricultural Lien ☐ Non-UCC Filing

7. ALTERNATIVE DESIGNATION (if applicable): ☐ Lessee/Lessor ☐ Consignee/Consignor ☐ Seller/Buyer ☐ Bailee/Bailor ☐ Licensee/Licensor

8. OPTIONAL FILER REFERENCE DATA:

FILING OFFICE COPY — UCC FINANCING STATEMENT (Form UCC1) (Rev. 04/20/11) International Association of Commercial Administrators (IACA)

Figure 7-4 UCC Financing Statement Amendment

[redacted]

UCC FINANCING STATEMENT AMENDMENT

FOLLOW INSTRUCTIONS

A. NAME & PHONE OF CONTACT AT FILER (optional)

B. E-MAIL CONTACT AT FILER (optional)

C. SEND ACKNOWLEDGMENT TO: (Name and Address)

Print Reset

THE ABOVE SPACE IS FOR FILING OFFICE USE ONLY

1a. INITIAL FINANCING STATEMENT FILE NUMBER

1b. ☐ This FINANCING STATEMENT AMENDMENT is to be filed [for record] (or recorded) in the REAL ESTATE RECORDS
Filer: attach Amendment Addendum (Form UCC3Ad) and provide Debtor's name in item 13

2. ☐ TERMINATION: Effectiveness of the Financing Statement identified above is terminated with respect to the security interest(s) of Secured Party authorizing this Termination Statement

3. ☐ ASSIGNMENT (full or partial): Provide name of Assignee in item 7a or 7b, and address of Assignee in item 7c and name of Assignor in item 9
For partial assignment, complete items 7 and 9 and also indicate affected collateral in item 8

4. ☐ CONTINUATION: Effectiveness of the Financing Statement identified above with respect to the security interest(s) of Secured Party authorizing this Continuation Statement is continued for the additional period provided by applicable law

5. ☐ PARTY INFORMATION CHANGE:

Check one of these two boxes:
This Change affects ☐ Debtor or ☐ Secured Party of record

AND Check one of these three boxes to:
☐ CHANGE name and/or address: Complete item 6a or 6b; and item 7a or 7b and item 7c
☐ ADD name: Complete item 7a or 7b, and item 7c
☐ DELETE name: Give record name to be deleted in item 6a or 6b

6. CURRENT RECORD INFORMATION: Complete for Party Information Change - provide only one name (6a or 6b)

6a. ORGANIZATION'S NAME

OR

6b. INDIVIDUAL'S SURNAME	FIRST PERSONAL NAME	ADDITIONAL NAME(S)/INITIAL(S)	SUFFIX

7. CHANGED OR ADDED INFORMATION: Complete for Assignment or Party Information Change - provide only one name (7a or 7b) (use exact, full name; do not omit, modify, or abbreviate any part of the Debtor's name)

7a. ORGANIZATION'S NAME

OR

7b. INDIVIDUAL'S SURNAME

INDIVIDUAL'S FIRST PERSONAL NAME

INDIVIDUAL'S ADDITIONAL NAME(S)/INITIAL(S) | SUFFIX

7c. MAILING ADDRESS	CITY	STATE	POSTAL CODE	COUNTRY

8. ☐ COLLATERAL CHANGE: Also check one of these four boxes: ☐ ADD collateral ☐ DELETE collateral ☐ RESTATE covered collateral ☐ ASSIGN collateral

Indicate collateral:

9. NAME OF SECURED PARTY OF RECORD AUTHORIZING THIS AMENDMENT: Provide only one name (9a or 9b) (name of Assignor, if this is an Assignment)
If this is an Amendment authorized by a DEBTOR, check here ☐ and provide name of authorizing Debtor

9a. ORGANIZATION'S NAME

OR

9b. INDIVIDUAL'S SURNAME	FIRST PERSONAL NAME	ADDITIONAL NAME(S)/INITIAL(S)	SUFFIX

10. OPTIONAL FILER REFERENCE DATA:

FILING OFFICE COPY — UCC FINANCING STATEMENT AMENDMENT (Form UCC3) (Rev. 04/20/11)

International Association of Commercial Administrators (IACA) errors in or to change the names and addresses of the debtor or secured party; and (3) for any amendment of an existing UCC financing statement. The UCC Amendment does not have to be signed, but it must be authorized by the debtor's authentication of the security agreement.

The Amendment refers to the original UCC filing by filing number, date and filing office and describes the change from the original UCC financing statement, such as a name change or change in collateral (*see* Figure 7-4).

Comprehension Check

List three elements that should be included in a UCC financing statement.

As a general rule, how long is a filing valid?

*Mistakes in a UCC Financing Statement's Collateral Description Can Be Hazardous to a Perfected Security Interest!**

A trade creditor dealing with a financially distressed customer may seek a security interest in its customer's property to increase the likelihood of payment of the creditor's claim. One of the requirements for obtaining a valid security interest with priority over future security interests in the same collateral is for the creditor to properly identify its collateral in both (1) the security agreement executed by its customer, and, just as importantly, (2) the publicly filed UCC financing statement.

The holding of the United States Court of Appeals for the Sixth Circuit, in *1st Source Bank vs. Wilson Bank & Trust, et al.*, is a reminder of the unintended and harsh consequences of an inconsistency between the description of the collateral in the security agreement and the UCC financing statement. The Sixth Circuit held that a bank did not have a perfected security interest in certain trucking company debtors' accounts receivable because the bank had failed to include "accounts" or "accounts receivable" as part of the bank's collateral in its UCC financing statement, notwithstanding the inclusion of the term "accounts" as collateral in the parties' security agreement.

Requirements for Perfecting a Security Interest in Personal Property

A creditor seeking to obtain a security interest in personal property must satisfy the requirements included in Article 9 of the Uniform Commercial Code. First, a creditor must satisfy the requirements for the creation or attachment of a security interest in its collateral. A creditor obtains a security interest in personal property through a security agreement, signed by the debtor, which describes the collateral in which the creditor is granted a security interest. The security agreement must describe the collateral by class or type. For example, the collateral can be described as accounts, chattel paper, instruments, inventory, equipment, general intangibles and other categories of personal property.

Second, the creditor must perfect its security interest in the collateral. Perfection ensures that a creditor's security interest in the collateral will withstand attack by another secured creditor, a judgment lien creditor or a bankruptcy trustee. A creditor frequently perfects its security interest by filing a UCC financing statement in the appropriate filing office. A UCC financing statement must include the debtor's correct legal name, the name of the secured party and a description of the collateral. The description of the collateral in the security agreement must conform to the description of the collateral in the UCC financing statement.

The Facts of the Sixth Circuit Case

In 2004, 1st Source Bank (1st Source) sold or leased tractors and trailers to two trucking companies: K&K Trucking and J.E.A. Leasing (the Debtors). The parties' security agreements granted 1st Source a security interest in the Debtors' tractors and/or trailers, *accounts* and in the proceeds from the agreed upon collateral. On the other hand, the UCC financing statements, properly filed pursuant to Tennessee state law, contained a narrower description of 1st Source's collateral, identifying the collateral as tractors and/or trailers "together with all present and future attachments, accessories, replacement parts, repairs, additions and exchanges thereto and therefore, documents and certificates of title, ownership or origin, with respect to the equipment and *all proceeds thereof*, including rental and/or lease receipts." Significantly, 1st Source's financing statements, unlike the security agreements, did *not* include "accounts," "accounts receivable," or any other similar descriptive terms.

Wilson Bank & Trust, Pinnacle Bank, and TransCapital Leasing, Inc. (the Defendants) then lent money to the Debtors. The Debtors granted the Defendants a security interest in the Debtors' "accounts receivable now outstanding or hereafter arising." This security interest was reflected in a security agreement that the Debtors had executed.

In addition, the Defendants properly filed their UCC financing statements that, unlike 1st Source's UCC financing statements, specifically and correctly described the collateral as "all accounts receivable now outstanding or hereafter arising."

The Debtors defaulted on their loans in late 2009. 1st Source repossessed its collateral consisting of the Debtors' tractors and trailers. The Defendants collected the Debtors' accounts receivable in which they claimed a first priority security interest.

1st Source sued the Defendants alleging that 1st Source had a first priority security interest in the Debtors' accounts receivable because the language "and all proceeds hereof" included in 1st Source's financing statements, was sufficient to put third parties on notice of 1st Source's security interest in the Debtors' accounts receivable. The Defendants filed a motion for summary judgment seeking to dismiss 1st Source's complaint. The lower court granted summary judgment in favor of Defendants, holding that, under Tennessee law, 1st Source did not have a perfected security interest in the Debtors' accounts receivable because 1st Source's financing statements were insufficient to put the Defendants on notice that 1st Source's security interest extended to accounts receivable. In particular, the term "proceeds" as used in 1st Source's financing statements, could not be construed to include the Debtor's accounts's receivable.

The Sixth Circuit's Holding and Analysis

The Sixth Circuit upheld the lower court's decision. The court emphasized the importance of notice of a creditor's security interest in its collateral that its UCC financing statement is supposed to provide.

The priority of 1st Source's and the Defendants' security interests in the Debtors' accounts is governed by Chapter 9 of Tennessee's Commercial Code. Section 47-9-203 of the Tennessee UCC makes clear that 1st Source's security interest attached to the Debtors' "accounts" when the parties had entered into the security agreements. However, the issue was not whether 1st Source had a valid security interest in the Debtors' accounts, but, instead, whether 1st Source had a properly *perfected* security interest in the Debtors' accounts that had priority over the Defendants' later perfected security interest in the accounts. According to § 47-9-502(a)(3) of the Tennessee UCC, 1st Source was required to file a UCC financing statement that properly described the collateral (which 1st Source asserted included the Debtors' accounts) as a condition to properly perfecting its security interest in the Debtors' accounts.

The Sixth Circuit recognized that the filing of a UCC financing statement is required to notify third parties "that a person may have a security interest in the collateral indicated" in the financing statement. While minor mistakes in a UCC financing statement are excusable, a financing statement must be "sufficiently accurate such that third parties are put on notice." In addition, "only collateral that is adequately described in the financing statement will be perfected—*even where the security agreement confers a security interest in other collateral*" (emphasis added). In other words, if the collateral description contained in a publicly filed UCC financing statement is narrower than the collateral description contained in a security agreement, a subsequent secured creditor and/or bankruptcy trustee is only bound by the narrower (publicly ascertainable) collateral description included in a UCC financing statement.

The Sixth Circuit applied these principles observing that the "limiting language in 1st Source's financing statements identified the only items that were subject to the security interest," which did not include the Debtors' "accounts" or its "accounts receivable." The Defendants were not put on notice that 1st Source was claiming a security interest in the Debtors' accounts receivable, as the term was not referenced in the financing statements. Consequently, the Defendants' security interest in the Debtors' accounts receivable was superior to that of 1st Source by virtue of the Defendants' UCC financing statement identifying accounts as collateral.

The Sixth Circuit also rejected 1st Source's argument that the phrase "all proceeds thereof" included in the financing statements was sufficient to put third parties on notice that 1st Source had a properly perfected security interest in the Debtors' accounts receivable. Although the court recognized the very broad definition of "proceeds" included in the Tennessee UCC, 1st Source's interpretation of the term "proceeds" would render meaningless the term "accounts" (which is separately defined in § 47-9-102(a)(2) of the Tennessee UCC). The court was hesitant to expand the definition of the general term "proceeds" in a manner that would subsume the more specific term "accounts."

The Sixth Circuit also focused on how the Tennessee UCC's drafters sought to limit the definition of the term "proceeds" by explaining in the Tennessee UCC's commentary that the term "proceeds" does not include "income generated from the debtor's own use and possession of goods," where there was "no disposition of the goods by the security lease." Further, relying on the lower court's decision and other precedent, the Sixth Circuit held that in order for rights to "arise out of collateral," those rights "must have been obtained as a result of some loss or disposition of the party's interest in that collateral, not simply by its use" as "revenues earned through the use of collateral are not proceeds."

The Sixth Circuit's holding that "accounts receivable" cannot ever qualify as "proceeds" is disturbing and inappropriately broad. The court might have reached a different conclusion if the Debtors were selling or leasing tractors and trailers to third parties, instead of operating a trucking company. The tractors and trailers that the Debtors sold or leased would have been characterized as "inventory" under the Tennessee UCC instead of "equipment." Under these circumstances, the sale or lease of the tractors and trailers could be "dispositions" of collateral that would generate "proceeds." The first generation proceeds could take the form of "accounts" or "chattel paper." These first generation proceeds could then become cash proceeds when payment is received from a buyer or lessee of the tractors and trailers. In this scenario, 1st Source's financing statements should have automatically covered accounts as proceeds, regardless of whether the financing statements included the term "proceeds."

Conclusion

The litigation leading to the Sixth Circuit's decision could have easily been avoided if 1st Source had included a reference to "accounts" or "accounts receivable" in the description of collateral in the financing statements. All creditors seeking to perfect a security interest in assets taken as collateral for the payment of their claims should make it a practice to conform the description of their collateral in the security agreement and UCC financing statement. The alternative, which all creditors should strive to avoid, is costly ligation over the technical issue of what categories of collateral the terms used in a UCC financing statement actually cover and the risk that the creditor loses its perfected security interest in some or all of the collateral described in its security agreement.

**Excerpted from "Mistakes in a UCC Financing Statement's Collateral Description Can Be Hazardous to a Perfected Security Interest!" by Bruce S. Nathan, Esq. and Eric S. Chafetz, Esq., Lowenstein Sandler PC.*

Priority Rules

Article 9's long-standing rule is that *the first secured party to file a UCC financing statement or otherwise perfect its security interest has* **priority** *over competing secured parties.* However, there is an exception to this rule for certain categories of collateral: *A later perfection by possession or control of the collateral has priority over an earlier perfection by UCC filing.* For example, a security interest in an instrument that is perfected by possession has priority over a competing security interest that was previously perfected by a UCC filing. A security interest in tangible chattel paper that is perfected by possession also has priority over a competing security interest perfected by an earlier UCC filing, unless the latter security interest is legended on the chattel paper. In addition, a security interest in either electronic chattel paper or investment property that is perfected by control has priority over a competing security interest that is perfected by an earlier UCC filing (*see* Figure 7-2).

As a general rule, where two secured parties perfect by control, priority is determined by which secured party first obtains control. However, a *depository bank's security interest* or **right of setoff** with respect to a debtor's deposit account has priority over all other security interests in the account, whether such competing security interests are taken as original collateral or are proceeds of other collateral. A security interest in favor of the debtor's securities intermediary perfected by control of the debtor's brokerage account always has priority over a competing security interest in the account perfected by control.

A security interest in a letter of credit right that is perfected by control has priority over a secured party's interest in letter-of-credit rights that was automatically perfected as a supporting obligation.

A buyer of goods, such as inventory, in the ordinary course of business defeats a secured party that perfects by UCC filing. However, Article 9 provides that an ordinary course buyer of goods takes the goods subject to the rights of a secured party that has possession of the goods.

Comprehension Check
How is **priority** established?

Purchase Money Security Interests

A **purchase money security interest** *is a security interest granted to a trade creditor in goods sold on credit terms to the debtor for the purchase price of the trade creditor's goods or a security interest granted to a third party lender in goods purchased by the debtor and paid for by loans or advances made by such lender.* Assets subject to a purchase money security interest are usually goods, such as inventory or equipment. A purchase money security interest can also be granted in software. There can be no purchase money security interest in intangible collateral.

A nexus, or connection, is required between the acquisition of the goods and the obligation to pay for them. A security interest does not qualify as a purchase money security interest if a debtor acquires property on unsecured credit terms and subsequently creates a security interest to secure the purchase price.

A purchase money security interest is granted superpriority status that has priority over existing perfected security interests. The secured party must take certain steps, depending on the type of collateral, to achieve this superpriority status. To obtain a purchase money security interest in collateral (other than livestock and inventory), such as a purchase money security interest in equipment, a secured party must have the debtor execute a security agreement containing the appropriate granting language in the collateral and file a UCC financing statement in the appropriate jurisdiction within 20 days after the debtor receives possession of the collateral. Where the purchase money collateral is inventory, the debtor must execute or authenticate a security agreement identifying the purchase money inventory collateral; file a UCC financing statement in the appropriate jurisdiction before the debtor gains possession of the inventory; and notify all secured creditors with UCC filings in the same type of inventory that the secured party intends to take a purchase money security interest in the inventory within five years of the debtor's possession of the inventory. However, a secured party with a possessory purchase money security interest in inventory that has not been delivered to the debtor does not have to give advance notice to existing secured parties to achieve superpriority status. Finally, a purchase money financier of livestock must notify earlier filed secured parties as in the case of inventory.

Under Article 9, the scope of a purchase money security interest in non-consumer transactions has a "dual status" rule. A purchase money secured creditor does not lose its superpriority purchase money status:

- Where the purchase money collateral also secures payment of other obligations.
- Where the obligation secured by the purchase money collateral is also secured by other collateral.
- Where the purchase money obligation is refinanced.

A creditor that satisfies all of the requirements for a purchase money security interest has priority over an earlier filed security interest in the same collateral as after-acquired property. A superpriority purchase money security interest in goods other than inventory extends to all identifiable proceeds of the goods to which the security interest is perfected. A purchase money security interest in inventory extends to identifiable cash proceeds received on or before delivery of the inventory and to chattel paper and instruments generated by the sale of the inventory if the secured party takes possession of, or places a legend on, the chattel paper or instruments. The superpriority status of a purchase money security interest in inventory does not extend to accounts arising from the sale of the inventory or to trade-ins. A purchase money security interest in inventory and equipment is subordinate to the security interest of a bank into which the cash proceeds of the collateral have been deposited.

Article 9 has created special priority rules for livestock financiers in proceeds of their purchase money collateral. A purchase money security interest in livestock extends to all proceeds, including accounts and all identifiable products in their unmanufactured states.

Finally, Article 9 changes the priority rules for multiple purchase money security interests. A supplier's purchase money security interest for the purchase price of the collateral has priority over a third-party lender's purchase money security interest for an enabling loan. Multiple purchase money security interests asserted by third-party lenders having made enabling loans rank in order of UCC filing.

Comprehension Check

How is a **purchase money security interest** established?

Real World Perspectives

RWP 7-2

PMSI (PURCHASE MONEY SECURITY INTEREST) HELPS LEAD THE WAY TO SATISFACTION

The Credit Situation: Historically, Donlamor, Inc. had been a high-volume retail customer of Pennsylvania House furniture (subsidiary of La-Z-Boy). In better times, the retailer had a high credit of $450,000. However, during difficult economic times, the retailer's financial condition deteriorated, causing a reduction of the credit limit to $150,000.

At the beginning of the year, Donlamor owed Pennsylvania House approximately $130,000. Due to cash flow constraints, the retailer's ability to pay the existing balance was questionable. The retailer had a backlog of consumer orders totaling $630,000 at wholesale cost. Consumer deposits on these orders were around $300,000. If the orders could not be filled, we determined that it would create tremendous consumer dissatisfaction with our brand name, even though our company would not be directly responsible for the unfilled orders.

Pennsylvania House inventory security included a purchase money security interest (PMSI) in the retailer's inventory and personal guarantees from the principals. Since any inventory released would be shipped immediately to consumers, the new inventory would not be available as collateral. The financial statements of the guarantors would not justify a significant increase in the credit limit.

The Problem: Whether to take a loss of the existing balance of $130,000 or to risk increasing the credit to as much as $650,000 so that the backlog orders could be filled.

The owner of Donlamor proposed granting Pennsylvania House a second mortgage in a warehouse (net equity of $230,000) and first lien in other floor samples (estimated wholesale value of $200,000). We could justify loaning 80 to 90 percent of the equity in the warehouse and 50 to 70 percent of the inventory value. On paper, this would have justified a credit increase of about $280,000 to $350,000.

To prevent the retailer from immediately exhausting the additional credit extension (and leaving half of the backlog orders unfilled), we required that 70 percent of each order released be paid immediately once the merchandise was loaded onto a truck and ready for shipment. The retailer's normal practice had been to collect the remaining balance from the consumer, once the furniture was ready for shipment. Our thought was that the consumer collections would partially or fully fund the 70 percent cash-in-advance requirement. The remaining 30 percent of each invoice would be added to a revolving promissory note secured by the warehouse and the other inventory. Ten monthly payments of around $35,000 would pay the revolving note in full (with interest at prime plus 1 percent). The benefits: (a) the existing balance could be paid over 10 months, (b) about $650,000 in new sales would be recognized by Pennsylvania House, (c) consumer dissatisfaction of cancelled orders would be avoided and (d) about $12,500 interest would be earned on the revolving note.

The Outcome: Pennsylvania House was aware of another retailer who expressed a desire to expand its business. After extensive negotiations, the Pennsylvania House "gallery" portion of the Donlamor business was sold and the selling price of $240,000 was pledged to Pennsylvania House, which also reduced exposure.

The entire transaction represented approximately $800,000 invoiced, including prior exposure and completed consumer shipments. The promissory note was essentially pre-paid as the customer remitted $365,000 within five weeks, and we transferred $160,000 of inventory to the new retailer. We also reduced the receivable by $240,000 based on a six-month interest bearing (prime plus 1 percent) signed by the new buyer and payable to Pennsylvania House.

We not only were able to protect our accounts receivable assets, but we also satisfied numerous deposit consumers. We subsequently shipped $300,000 to the new buyer for floor samples and back-up stock. The entire transaction resulted in more than $1.1 million of added sales for Pennsylvania House.

$800,000	**— A/R**
($400,000)	**— payments**
($160,000)	**— inventory transfer**
($240,000)	**— sale of Pennsylvania House gallery**
$ 0.00	**— net**

Dave Carpenter

Consignments

Article 9 defines a **consignment** *as a transaction, regardless of its form, in which a person delivers goods to a merchant for the purpose of sale and the following:*

- The transaction does *not* create a security interest that secures an obligation.
- The goods are not consumer goods immediately before delivery.
- The merchant deals in goods of that kind under a name other than the name of the person making delivery; is not an auctioneer; and is not generally known by its creditors to be substantially engaged in selling the goods of others.
- With respect to each delivery, the aggregate value of the goods is $1,000 or more at the time of delivery;

This definition excludes consignments of consumer goods and consignments of small quantities of commercial goods (valued at less than $1,000). However, commercial consignments are not subject to Article 9 where the consignee is generally known by its creditors to be substantially engaged in selling the goods of others (which is difficult to prove).

A consignment is treated as a purchase money security interest in inventory. A consignor will have to follow the rules under Article 9 for the creation and perfection of security interests in inventory and the rules applicable to purchase money inventory security interests to obtain priority over existing floating inventory secured lenders.

There are three steps that a consignment vendor must take to properly protect its business transactions with its customer and protect its consigned goods.

1. **Enter into a properly written consignment agreement with the customer.** This consignment agreement should fulfill all the requirements of a business contract and must be signed by an appropriate person for each party involved.
2. **A consignment vendor must run a UCC search of its customer to determine what creditors have already filed UCC financing statements and perfected a lien against the customer's inventory.** The UCC search must be run where the customer is located. Location is specifically defined in the UCC. The definition of location differs depending on the customer. A corporation, limited liability partnership, limited partnership or other registered artificial entity is located in the state of its registration.

   Once the UCC search is run and the consignment vendor knows who has filed UCC financing statements before it, the consignment vendor must provide notification to each prior secured creditor that it is about to or has entered into a consignment agreement with the customer. While the UCC states that one only has to notify lien creditors that have liens in the same goods or types of goods as the trade vendor, it recommended to notify each and every prior secured creditor to eliminate future arguments over whether or not notice was required. Send the notification by certified mail or overnight courier so that the trade vendor has proof that the prior secured party received it.
3. **A UCC financing statement must be filed with the appropriate office (generally the Secretary of State) where the customer is located, as defined by the UCC.** If a consignment vendor is selling to an entity that has different corporate or other artificial entities, then a UCC financing statement must be filed with each appropriate office where each distinct corporate or artificial entity is located.

There is no protection for consigned goods until all three steps are achieved. Any one step missing leaves the consignment vendor at risk. A consignment vendor that delivers goods before each of these steps is finalized subjects its goods to the claims of a prior lien creditor's rights in inventory.

Comprehension Check
What is **consignment?**

Real World Perspectives

RWP 7-3

CHAPTER 11 FILINGS CAUSE HAVOC FOR AN UNPERFECTED CONSIGNMENT CREDITOR

Sports Authority Holdings, Inc. and seven related corporations ("referred to herein as TSA") filed Chapter 11 proceedings on March 2, 2016. Approximately 170 consignment vendors sold inventory to TSA under various consignment or vendor agreements. Among the first-day motions filed by TSA was a motion to authorize TSA to continue to sell its consignment inventory in the ordinary course of business, provide replacement liens to consignment vendors in post-petition inventory and continue to pay consignment vendors in the ordinary course of business. TSA's motion stated how important consignment vendors are to its continued business operations because they allow TSA to "receive and resell a wide range of popular goods in [its] stores without having to commit working capital up front to cover the cost of selling such inventory." TSA stated further that it relies "on their ability to provide a wide selection of goods to meet customers' needs and drive customers' traffic."

Consignment vendors were excited to see this motion filed by TSA until the language within the motion was read carefully. Within that motion, TSA stated that it would only grant replacement liens to and/or pay the consignment vendors that have "[a] valid, enforceable, non-avoidable and perfected lien on consigned goods."

In one fell swoop, TSA promised protection to the consignment vendors and then took it away. As information has unfolded, it appears that about 90% of the TSA consignment vendors did not provide notification to prior secured creditors and did not file proper UCC Financing Statements.

TSA has now commenced a multitude of adversary proceedings (lawsuits) against consignment vendors seeking to have the Bankruptcy Court declare these consignment vendors to have unperfected security interests, permitting TSA to sell all inventory unfettered by these consignments and deem these consignment vendors to be nothing other than general unsecured creditors.

Clearly, that is a far cry from the protection these vendors intended to have when they entered into the original agreements with TSA.

A similar dispute took place in the Family Christian Bookstore Chapter 11 proceeding. That case was slightly different. Whereas in TSA, the Debtor has commenced the lawsuits to determine the consignment interests to be invalid, in the Family Christian Bookstore case, the consignment vendors banded together to prevent Family Christian from selling the consignment inventory. They claimed that the consignments were "true consignments outside the scope of Article 9" because the debtor is "generally known by its creditors to be substantially engaged in selling the goods of others." The consignment vendors claim that because of this exception, neither notification nor UCC filings were necessary to protect the consignment status of these vendors. The Family Christian litigation resulted in a settlement whereby the consignment vendors were paid a portion of the sale price of the consigned inventory so that they received somewhat better treatment than the general unsecured creditors.

This argument is now being discussed in the TSA case by myriad consignment vendors that have been sued. The outcome cannot be predicted at this time although one would hope that a settlement will be reached that will be favorable to consignment vendors.

The moral of this story is consignment vendors must take the necessary steps to protect one's consignment interest or risk diminished treatment. Even if a consignment vendor believes it can convince a court that its business with a customer is that of a "true consignment" a consignment vendor is best served by taking the steps described above to properly notice and perfect its consignment interest and not risk losing the protection and treatment it anticipated by entering into a consignment agreement in the first instance.

Wanda Borges, Esq.
Borges & Associates LLC

Merger/Successor Debtor

Article 9 addresses a number of issues generally referred to as double debtor. **Double debtor issues** *occur when collateral is either transferred to a successor debtor or the original debtor merges with a third party.*

A filed UCC financing statement remains effective with respect to collateral transferred to a third party, unless the secured party consents to the transfer free of its security interest or the transfer is an ordinary course of sale to a good faith or *bona fide* purchaser. The secured party does not have to file a new UCC under the name of the transferee unless the transferee is located (organized, such as incorporated) in a different state. Where the transferee is located in another state, the original UCC will become ineffective as against the transferred collateral unless a new UCC is filed within one year of the transfer.

Where a successor of the original debtor is subject to an existing security agreement because of a merger with an existing debtor, a reincorporation of an existing debtor, or after a transfer of collateral, and the successor is located (organized) in the same state as the original debtor, a UCC filed in the name of the original debtor will continue to be effective to perfect a security interest in assets acquired by the successor following the merger or transfer unless the UCC becomes seriously misleading. That would be the case where the name of the successor is not substantially the same as the name of the old debtor.

When the UCC filing becomes seriously misleading the secured party has four months to file a new UCC that names the successor as debtor. If the secured party does so, its security interest remains perfected in collateral acquired by the successor. Where the secured party fails to do so, its security interest will become unperfected in collateral that the successor acquires after the four-month period.

Where the successor or other new debtor is located (organized) in a different state than the original debtor, the UCC financing statement filed against the original debtor is no longer effective to perfect a security interest in collateral acquired by the successor or other new debtor immediately after the merger or other act that created the new debtor. The secured party must immediately file a new UCC in the name of the successor or other new debtor in the new state in order to continue the perfection of its security interest in collateral acquired by the debtor.

In a priority dispute between the secured party of the original debtor and the secured party of the successor or other new debtor, the original debtor's secured party will have priority in collateral transferred to the successor or other new debtor, even where the secured party of the successor or other new debtor was the first to file a UCC. However, the secured party of the successor or other new debtor will have priority in all new collateral acquired by that debtor.

Perfection of Security Interests in Certain Specialized Collateral

Security interests in certain assets are perfected through means other than a UCC filing. These assets include titled motor vehicles, aircraft, boats, trademarks and patents, and most copyrights. Consult with counsel concerning the requirements for perfecting a security interest in these types of assets.

Default and Enforcement

Although a debtor's possible default may be the last thing actually anticipated when credit is extended, sales and security documentation must be prepared as if default were certain. The whole point of having a security interest in the debtor's assets is the secured party's ability to dispose of those assets toward payment of the debt if default occurs. That assumes that the secured party correctly assesses the value of its collateral and the market available at the time of default. A creditor has two main concerns if the debtor defaults or fails to pay the debt as promised:

1. Satisfaction of the debt through the possession and (usually) sale of the collateral.
2. Priority over any other creditors or buyers who may have rights in the same collateral.

This section will generically outline the possible events of default, the alternative steps to take to realize on collateral after default and the steps necessary to preserve a right to a deficiency judgment against the debtor, guarantors and other secondary obligors if the collateral is insufficient to pay the debt. It focuses on commercial transactions, rather than consumer transactions where the rules may be different.

Definition of Default

While the UCC does not define default, it does provide the parties with latitude in defining the term in the security documentation. Unlike other provisions of the UCC, which generally define a term where the parties fail to do so, Article 9 makes no specific provision for a definition of default.

Even though the UCC does not require a definition of default in security documentation, it is generally advisable to do so. A secured party should define default in such a fashion as to cover most of the probable bases for the need to foreclose. A common definition of default in security documentation includes the following "events of default":

1. The debtor's failure to make any payment when due.
2. The debtor's failure to satisfactorily insure the collateral.
3. The debtor's refusal to allow an inspection of the collateral within a reasonable time after a request for inspection by the secured party.
4. The debtor's failure to pay taxes on the collateral when due.
5. The debtor's removal of the collateral permanently from the agreed location without the written approval of the secured party.
6. The debtor's failure to periodically provide financial statements and other financial information.
7. The debtor's sale of the collateral without the consent of the secured party.
8. The debtor's death or incapacity.
9. The debtor's cessation of business.
10. The debtor's filing of bankruptcy or a filing of an involuntary bankruptcy against the debtor.
11. The appointment of a receiver, conservator or trustee for the debtor's business and property or both.
12. The debtor's assignment of assets for the benefit of creditors.
13. The debtor's insolvency.
14. The debtor's failure to make payments of debts to other secured creditors or to its lender.
15. The secured party's determination that the prospect of repayment is impaired.
16. The debtor's breach of the terms or covenants contained in any related agreement between the debtor and the secured party or any other secured lender.
17. The destruction of, or substantial damage to, any of the collateral.
18. The encumbrance, seizure or attachment of any of the collateral by the IRS or any other governmental entity, or by any judgment creditor.

Comprehension Check
List at least five "events of default."

Assuming the debtor is in default, the secured party may pursue any of the following enforcement remedies.

Collection Rights

Under Article 9, following the debtor's default, the secured party may exercise collection rights with respect to intangible collateral, such as accounts and general intangibles, or to instruments or chattel paper. The secured party may notify an account debtor or other obligor to make payment directly to the secured party. The secured party could also compel the other obligor's performance of other obligations, such as enforcing warranties and obtaining injunctions regarding intellectual property rights. The secured party may also receive and apply funds in a deposit account over which it has control in reduction of its claim against the debtor.

Comprehension Check
What is a secured party entitled to under collection rights?

Nonjudicial Repossession of Collateral

Article 9 permits a lender to take possession of the collateral upon default without any court action if it may do so peacefully. Any nonjudicial attempt to repossess collateral that involves or threatens to result in the use of force by either the secured party or the debtor is probably improper and may result in the imposition of liability on the secured party. When in doubt, consult counsel on nonjudicial repossession rights.

The UCC specifically authorizes the secured party to place language in the security agreement requiring the debtor to assemble and deliver collateral to the secured party. In some cases it is impractical for a secured party to take possession of equipment or fixtures that are collateral.

Judicial Foreclosure of Article 9 Security Interests

A secured party may pursue judicial foreclosure in any court with jurisdiction over the parties. While federal jurisdiction may exist, generally foreclosures of Article 9 security interests take place in state court in the state where the collateral is located, unless the government is a party. It would be impractical to attempt to summarize the civil procedures of all states in which the UCC applies.

Generally, the foreclosure process will involve the retention of counsel and the filing of a complaint or petition with the appropriate court and the payment of a filing fee. The pleadings filed with the appropriate court will seek the foreclosure of security interests in the property, the sale of the property and the distribution of proceeds to the secured party. If there is any amount unsatisfied after sale of the collateral, judgment will be entered against the debtor for the deficiency. If there is a surplus, after application of the proceeds to the sale expenses and the outstanding debt (and the attorney's fees of the secured party to the extent provided for by agreement and not precluded by law) the surplus must be distributed back to any junior secured creditors and then the debtor. In some cases an Article 9 foreclosure action may be combined with a real estate foreclosure action where the collateral includes both personal and real property.

Disposition of Collateral after Default

Article 9 has clear rules governing a secured party's rights and obligations upon the disposition of collateral. A secured party may sell, lease, license or otherwise dispose of its collateral by public or private disposition and apply the proceeds in reduction of its secured claim. All subordinate interests in the collateral would be discharged by such disposition. Every aspect of the disposition must be commercially reasonable. A secured party's obligation to act in a commercially reasonable manner in disposing of its collateral cannot be waived by the debtor or guarantor or other secondary obligor.

As a general rule, a secured party must give advance notice of the disposition of collateral. That includes sending notice of the time and place of any public disposition, or reasonable authenticated notification of the time after which any private disposition of collateral will occur. However, no advance notice of disposition is required where the collateral is perishable; where there is a threat of a quick decline in its value; or where the collateral is of a type that is customarily sold on a recognized market.

The secured party must send notice of the disposition of collateral to the debtor and all guarantors and other secondary obligors. The debtor and guarantors and other secondary obligors may waive their advance right to notice of disposition in an authenticated agreement following default. The secured party must also give notice to all secured parties and lienholders with an interest in the collateral that is disclosed on a search of the proper filing office within certain time parameters.

Article 9 creates a number of safe harbors as it relates to the secured party's obligation to give advance notice of disposition of its collateral. In a commercial transaction, 10 days advance notice of the disposition is deemed to be commercially reasonable. Notice of disposition of the collateral would also be deemed proper if it follows the form of notice provided in the statute.

Under Article 9, a secured party's realization of a low price from its disposition of collateral does not by itself render a disposition commercially unreasonable. However, a low price may prompt a court to carefully scrutinize all aspects of the disposition. If a secured party or related party, or a guarantor or other secondary obligor, acquires the collateral at a price that is significantly below the price that would have been realized from a disposition to an unrelated party, the secured party's deficiency claim would be reduced to reflect the higher price that would have been paid by a hypothetical unrelated party.

Article 9 also allows a secured party to receive noncash proceeds, such as a note, from the disposition of its collateral. The secured party does not have to apply any noncash proceeds, prior to their conversion to cash, toward the payment of its claim unless a failure to do so would be commercially unreasonable. This enables the secured party to place a value on the noncash proceeds and apply an appropriate discount rate.

Article 9 affords a transferee of a disposition of collateral the benefit of any title, possession, quiet enjoyment and similar warranties (such as ordinary warranties arising from sales, or warranties of quality or fitness for a particular purpose) that would have accompanied the disposition of the asset by operation of non-Article 9 law had the disposition been under other circumstances. Article 9 also permits a secured party to disclaim or modify such warranties.

Finally, under Article 9, a secured party may purchase collateral through a public disposition, such as a public auction. A secured party may not purchase collateral by private disposition, unless the collateral is of a kind customarily sold on a recognized market or subject to standard price quotations.

Strict Foreclosure

Under Article 9, strict foreclosure is another remedy available to a secured party following the debtor's default and involves the secured party's acceptance of its collateral in full, or partial satisfaction of its secured claim. A strict foreclosure, like an ordinary foreclosure and disposition of collateral, discharges all subordinate interests in the collateral. This remedy is also available to a secured party in a commercial transaction even where the secured party does not have possession of its collateral.

As part of any full strict foreclosure, a secured party must send an authenticated notice to the debtor and all secured parties and other lienholders with a junior interest in the collateral where the secured party proposes to retain the collateral. If the secured party receives an objection from any of these parties within 20 days after sending the proposal, the secured party cannot retain the collateral. Otherwise, the secured party can retain its collateral in full satisfaction of its claim. The secured party's retention of its collateral over a long period without sending such notice does not give rise to a strict foreclosure.

Article 9 also permits a secured party to retain collateral in partial satisfaction of its secured claim, known as a partial strict foreclosure. The debtor must consent to a partial strict foreclosure in a record authenticated after default. The proposal must also be sent to all guarantors and other secondary obligors as well as to all junior secured parties and other lienholders with an interest in the collateral. If the secured party does not receive an objection within 20 days, the partial strict foreclosure can proceed; otherwise, it cannot.

The debtor and guarantors and other secondary obligors can waive this notice requirement or agree to a secured party's retention of its collateral in full or partial satisfaction of its secured claim following the debtor's default.

Application of Proceeds of Disposition

Under Article 9, a secured party can apply the proceeds of the disposition of its collateral first toward payment of the expenses of disposition, including attorney's fees, if provided for under the debtor's agreement with the secured party and not prohibited by law; then toward the payment of the secured party's claim; and then toward the payment of the claims of creditors with a junior lien in the collateral. Any remaining surplus proceeds would be paid to the debtor.

Accounting for Distribution of Proceeds

Under Article 9, the secured party must account to the debtor for the distribution of the proceeds of the disposition of collateral and pay any surplus to the debtor.

Remedies

Article 9 adopts a rebuttable **presumption rule** *where the secured party fails to comply with its provisions on the disposition of collateral*. Where the secured party fails to comply with Article 9, there is a presumption that *the value of its collateral equaled the amount of the secured claim, which eliminates its deficiency claim.* This presumption, however, is subject to rebuttal by the secured party.

Key Terms and Concepts

Comprehension Check

1. Article 2 applies to which kind of transactions?
2. Under Article 2, what rule applies to sales worth more than $500?
3. Why does Article 2 distinguish between a merchant and casual or inexperienced sellers?
4. Within UCC Article 2, every contract has an obligation of good faith or honesty in the transaction concerned. Why is this an important concept?
5. What does **tender delivery** mean?
6. What options does a buyer have if goods delivered by the seller do not conform to the contract?
7. If a buyer refuses to accept goods that conform to the contract, how can the seller determine the damages for which the buyer is liable because of the breach of contract?
8. What does the general title section of the UCC state?
9. List the conditions that relate to risk of loss.
10. What is a shipment contract?
11. What is a destination contract?
12. What does **reclamation** mean under Article 2?
13. Define the term **warranty.**
14. What is an **express warranty?**
15. What is an **implied warranty?**
16. When is a lease contract enforceable?
17. What is the general concept behind Article 6?
18. Under UCC Article 6, five requirements must be followed whenever a **bulk transfer** is made. What are they?
19. Under UCC Article 9, what is a **secured transaction?**
20. What is a **security interest?**
21. What transactions are excepted from Article 9?
22. List the six categories of **collateral.**
23. List the items covered under Article 9's definition of **account.**
24. Why is determining primary use or purpose critical?
25. What requirements must be satisfied for the creation of a security interest?
26. What is a **security agreement?**
27. What does a security agreement establish?
28. At a minimum, a security agreement should contain four essential elements. What are they?
29. What is **perfection?**
30. Explain what is meant by the term **perfection by possession.**
31. Explain what is meant by the term **perfection by control.**
32. Explain what is meant by the term **perfection by filing.**
33. List three elements that should be included in a UCC financing statement.
34. As a general rule, how long is a filing valid?
35. How is **priority** established?
36. How is a **purchase money security interest** established?
37. What is **consignment?**
38. List at least five "events of default."
39. What is a secured party entitled to under collection rights?

Summary

- The UCC is not federal law. Each state adopts the code, and each state may adopt variations to the basic code outlined in the UCC.
- The UCC was created in order to cover every phase of commercial transactions that can involve the sale and payment of goods. Specifically, Article 2 of the UCC applies to sales of transactions in goods.
- Goods are defined as all things, other than money, stocks and bonds, that are movable.
- The UCC distinguishes between merchants and casual or inexperienced sellers by defining merchants as “a person that deals in goods of the kind or otherwise holds itself out by occupation as having knowledge or skill peculiar to the practices or goods involved in the transaction,” which in turn enables merchants to be held to a higher standard.
- It is also important to note, the courts have the right to refuse to enforce contracts that are deemed to contain unfair or unconscionable clauses.
- A buyer has the right to inspect goods before payment, reject the goods if they fail to conform to the contract or accept in spite of non-conformity. If the goods do not meet the contracted standard, the seller has the right to correct or cure improper delivery. The UCC institutes the concept of **cover**, by which the buyer has the right to purchase substitute goods and recover from the seller the difference between the contracted price and the purchase of replacement goods.
- If the buyer refuses an order that conforms to the contracted standard, the seller also has the right to claim damages against the buyer. The seller must first resell the goods at the best obtainable price and then sue for the difference.
- The UCC provides that the passage of title passes to the buyer when the seller has completely performed their duties concerning physical delivery of goods.
- Risk of loss can be contractually addressed by using commonly accepted shipping terms. The seller has no liability in shipping contracts when goods are given to the carrier. Commonly used shipping contracts:
  - **FOB (Free on Board)**
  - **FAS (Free Alongside)**
  - **CIF (Cost, Insurance and Freight)**
  - **CFR (Cost and Freight)**
- In destination contracts, the seller remains liable until the product is delivered to the specified destination. Common destination contracts include:
  - **FOB destination**
  - **EX-Ship**
  - **No Arrival, No Sale**
- If the seller discovers the buyer is insolvent before making the delivery, the seller has the right to withhold the delivery until the buyer pays cash for the goods and for any previously delivered items that have yet to be paid. This includes goods in transit. Sellers also have the right to demand the return of merchandise from an insolvent buyer within 10 days of the receipt of shipment.
- A warranty is a contractual promise by the seller regarding the quality, character, or suitability of the goods sold, and whenever a seller of goods makes a statement of fact about the goods to a buyer as a part of the transaction, an express warranty is created.

- The four basic types of **implied warranties** include:
  - **An implied warranty of merchantability**
  - **An implied warranty of fitness for a particular purpose**
  - **An implied warranty derived from a usage of trade**
  - **An implied warranty of title**
- Leasing allows the lessee to use valuable assets without making an initial large capital investment.
- If the lessee is discovered to be insolvent, the lessor may refuse the delivery of goods or fully take possession of the goods without judicial process.
- Bulk transfers create special problems for businesses. Therefore, Article 6 was created within the UCC to protect creditors from merchants who are debtors from selling their entire inventory for less than it is worth.
- The UCC lists requirements for the transfer of goods, which if not fulfilled, forfeits the rights to ownership of the goods. If this occurs, a creditor must move quickly to assess how much time will elapse before the sale, a description of the property being sold, the property's value, any other creditors and the amount due to them, and whether debts should be paid in full.
- Business could not exist without laws permitting secured transactions. Article 9 of the UCC contains the law of secured transactions in personal property and fixtures.
- The UCC does not apply to liens on real estate, aircraft and certain vessels, wages, or certain types of insurance claims. Motor vehicles may be subject to UCC, but perfection is subject to other law.
- A security interest must be classified under the following categories:
  - Accounts and general intangibles
  - Deposit accounts
  - Goods
  - Instruments
  - Investment property
  - Chattel paper
- It is vital that a creditor determines the primary use of the collateral, because when handled by different individuals the item may change classification.
- The following requirements are needed to create a **security interest**:
  - **Creditor provided value to the debtor**
  - **Debtor has rights to the collateral and the power to transfer rights to the secured party**
  - **There is a valid security agreement that describes the collateral in which the creditor is granted security interest**
- At a minimum, a **security agreement** should contain:
  - **Identification of parties**
  - **Granting clause**
  - **Collateral description**
  - **Debtor's warranties, covenant and agreements**
- Perfection is necessary to ensure the secured party's right to collateral given that other parties may have interest in the collateral. Generally, a security interest is perfected either through the taking of possession or control of the collateral or the filing of a financing statement under the UCC. Perfection can also occur if both steps are taken.

- A **UCC financing statement** should contain:
  - **Name of the debtor**
  - **Name of the secured party or its representative**
  - **Description of collateral**
- Priority rules can vary, but the longstanding rule is that the first secured party to file a UCC financing statement or otherwise perfect its security interest has priority over competing secured parties. The rules often vary depending on the category of collateral.
- For **purchase money security interests,** it is important to note that a security interest does not qualify as a purchase money security interest if the debtor acquires the property on unsecured credit terms, and subsequently creates a security interest to secure the purchase price. However, if done correctly, the secured party has superpriority status over existing perfected security interests.
- When a **merger or successor debtor** occurs, a creditor should research whether the UCC financial statement has become invalid and should be refiled. This commonly occurs if the debtor is located or changes states.
- The whole point of having a security interest in the debtor's assets is the secured party's ability to dispose of those assets toward payment of the debt if default occurs.
- If a debtor is in default, the secured party may pursue the following **enforcement remedies**:
  - **Collection rights**
  - **Nonjudicial repossession of collateral**
  - **Judicial foreclosure of Article 9 interests**
  - **Disposition of collateral after default**
  - **Strict foreclosure**
  - **Application of proceeds of disposition**

References and Resources

Borges, Wanda, Esq. "Consignment Agreements Under Fire: If Not Done Right, You Can Get Burned." *Business Credit.* Columbia, MD: National Association of Credit Management. May, 2016.

Business Credit. Columbia, MD: National Association of Credit Management. (This 9 issues/year publication is a continuous source of relevant articles and information. Archived articles from *Business Credit* magazine are available through the web-based NACM Resource Library, which is a benefit of NACM membership.)

Manual of Credit and Commercial Laws. Columbia, MD: National Association of Credit Management, current edition.

Manual on Trade Creditors' Rights of Reclamation & Stoppage of Delivery of Goods. American Bankruptcy Institute, 2002.

Miller, Roger LeRoy, and Gaylord A. Jentz. *Business Law Today,* Comprehensive 6th ed. South-Western/Thomson Learning, 2004.

Nathan, Bruce S., Esq. and Eric S. Chafetz, Esq. "Mistakes in a UCC Financing Statement's Collateral Description Can Be Hazardous to a Perfected Security Interest!" *Business Credit.* Columbia, MD: National Association of Credit Management. May, 2014.

Uniform Commercial Code and Related Procedures. Registré's, 2001.

www.law.cornell.edu/ucc/. The full text of the UCC can be found here.