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Drafting Pointers for Success

Under Revised Article 9 of the Uniform Commercial Code

REVISED ARTICLE 9 of the Uniform Commercial Code became effective on July 1, 2001, in Michigan and throughout the United States. This new Article 9 represents significant changes from its predecessor, the 1972 version. The changes were intended to bring greater certainty to financing secured transactions while reducing transactional costs. A number of these changes solidify the secured party's confidence with respect to the transaction through clarifying drafting content rules in both the security agreement and the financing statement. This article outlines drafting pointers for Revised Article 9 writings to strengthen the position of the secured party in avoiding litigation, and when defending perfected secured status against the trustee in bankruptcy.

THE SECURITY AGREEMENT

As the contract between the debtor and secured party, the terms of the security agreement are critical for establishing the obligations of the debtor and avoiding litigation. While form books may provide templates for general provisions, it is essential to individualize the security agreement to represent the unique interests of the parties and the debtor's business. Below are some general drafting tips aimed at conforming with Revised Article 9 provisions; however, it is incumbent upon counsel representing the secured party to customize language of the security agreement.

Granting Language

The question of the necessity of "granting" language in the security agreement remains unresolved under Revised Article 9. Although the Code never required the security agreement to contain formal language, numerous courts required granting language in order to find an enforceable security interest. The Revised Article 9 continues to require only that the security agreement provide a description of the collateral.[1] Accordingly, the best drafting advice is to title the writing or record[2] "Security Agreement" and create the security interest by stating that "the debtor grants to the secured party a security interest in the following described collateral."

Description of the Collateral

The problematic 1972 provision stated that a description of collateral was sufficient whether or not it was specific "if it reasonably identifies what is described."[3] Some courts held that a description in the security agreement using a collateral category label such as "equipment" was too general, and did not reasonably identify the collateral. As a result, drafters included detailed descriptions of collateral in the security agreement, sometimes resulting in a court determination that a specific piece of collateral was not

covered by the security agreement because it did not fit within the precise description. The Revised Article 9 gives examples of reasonable identification, including listing "a type of collateral defined in the Uniform Commercial Code."[4] Describing the collateral as all equipment, inventory, accounts, chattel paper, etc., is the best approach to avoid having a court determine that some of the collateral is not covered by the security agreement. Importantly, however, the Revised Article 9 stopped short of endorsing a super-generic description of collateral in a security agreement. A security agreement claiming "all of the debtor's assets" is deemed not to reasonably identify the collateral in the security agreement. Use of collateral type labels is expressly approved by the Revised Article 9 and should present no interpretation problems in litigation.

The other question concerning description of collateral involves when and how to use an after-acquired property clause. When describing collateral as "all equipment," the agreement's security interest attaches only to equipment the debtor has a property interest in at the time of the execution of the security agreement, when value is given. Without additional language, the security interest will not cover later-acquired equipment, potentially resulting in a diminution in the value of secured party's collateral over the term of the indebtedness. Consequently, it is important to use after-acquired language in describing the collateral; for example, "all equipment now owned and hereafter acquired."

One question concerning after-acquired property clauses remains unanswered under the Revised Article 9. Specifically, a number of courts have held that "after-acquired" language is not required when the collateral is inventory or accounts. This approach recognizes that with inventory and accounts collateral, the lien is a floating lien since the collateral changes on a daily basis as, for example, when existing inventory is sold and new inventory acquired. Some courts, however, have insisted on after-acquired language even with inventory and accounts collateral. The Revised Article 9, like its predecessor, is silent as to the necessity of including after-acquired language with inventory and accounts.[5] Accordingly, the best drafting advice is to always use "after-acquired" language in the security agreement regardless of the type of collateral encumbered. There is no need to refer to after-acquired property in the financing statement.[6]

Fast Facts:

Changes in Revised Article 9 were intended to bring greater certainty to financing secured transactions while reducing transactional costs.

It is essential to individualize the security agreement to represent the unique interests of the parties and the debtor's business.

Many secured parties find themselves unperfected or unsecured because they fail to consistently describe the collateral in the security agreement and financing statement.

Purchase Money Collateral

The great advantage to purchase money collateral is that the second-in-time purchase money secured party will be given priority over the previously perfected secured party. The policy behind this important exception to the general first-to-file or perfect priority rule is to encourage the infusion of new assets into the debtor's business. The 1972 Code was silent as to the status of a secured party when the underlying obligation was secured by purchase money and non-purchase money collateral, or when the purchase money obligation was refinanced or consolidated. Accordingly, two approaches were taken by courts. Some courts held that the purchase money interest was automatically transformed into a non-purchase money interest.[7] The effect of this approach was to eliminate the super-priority of the purchase money secured party and, in the bankruptcy arena, to permit the bankruptcy debtor to avoid the purchase money secured party's interest in consumer goods exemption cases. Other courts found that a security interest could be partially purchase money and partially non-purchase money; the purchase money portion of the transaction was not destroyed by refinancing or by securing the original obligation with purchase money and non-purchase money collateral. This second approach is the dual status rule, and it is adopted by Revised Article 9 in non-consumer goods transactions.[8] As a result, it is now practicable to finance a purchase money transaction for a debtor, and take a security interest in non-purchase money collateral in the same security agreement to secure repayment of the underlying debt with sufficient collateral. This is particularly important when the purchase money collateral is likely to depreciate in value at a rate faster than the payoff obligation. Note, however, that this dual status rule does not apply to consumer goods transactions. The status of a secured party in a consumer goods secured transaction that combines purchase money and non-purchase money aspects is left up to the court.[9]

Deposit Accounts

Several types of collateral, previously expressly excluded, were brought within the scope of Article 9 for the first time under the Revised Code provisions. The most important type of collateral now within the scope of Revised Article 9 is commercial deposit accounts. Deposit accounts are demand, time, savings, passbook, or similar accounts maintained with a bank.[10] Deposit accounts are extremely important collateral when debtor's business generates cash. Generally, when the collateral is money, the only way to perfect an interest in the collateral is by possession. And although perfected purchase money secured parties with inventory collateral have priority to identifiable cash proceeds, the problem of identifying the proceeds through tracing into bank accounts presented difficulties under the 1972 Code. The Revised Article 9 offers a workable solution to the problem by bringing commercial deposit accounts within the scope of Article 9 as a type of collateral. While this type of collateral is extremely important to banks as secured parties, it is also an important type of collateral

for a non-bank secured party when the debtor's business generates cash revenues.

The method for perfecting a security interest in a deposit account is by acquiring control over the bank account. The Revised Article 9 provides three methods for acquiring control, two of which are important to non-bank secured parties.[11] An agreement between the debtor, secured party, and the bank may provide that the bank will comply with the secured party's instructions concerning disposition of the funds on deposit. Alternatively, the secured party may become the bank's customer with respect to the deposit account. In either situation, the non-bank secured party has acquired control over the deposit account into which cash proceeds or revenues are deposited, and has priority over all competing parties claiming an interest in the cash. In order to effectuate this security interest, the security agreement should require the debtor to make regular deposits (daily deposits when the cash generating business is open seven days per week) into the account over which the secured party has control. Debtor's failure to make the required deposits constitutes default of the security agreement, triggering secured party's right to take possession of the collateral subject to the security agreement, including the cash in the deposit account. Whether the secured party is a purchase money seller of inventory, or a non-purchase money lender loaning money for general operating purposes, perfecting a security interest via control in a deposit account is one of the best avenues available under Revised Article 9 when debtor's business generates cash.

Special Terms in the Security Agreement

One special consideration involves drafting to avoid future conflicts with second-in-time purchase money sellers and lenders. The best method to avoid these conflicts for a first-in-time, non-purchase money secured party is to insert a provision in the security agreement barring the debtor from acquiring goods in a purchase money transaction. Such a provision renders meaningful the duty of an inventory purchase money secured party to give notice to conflicting security interest holders of record, in that the authenticated notification[12] will trigger default of the agreement, and potentially deter the debtor from entering into the purchase money transaction.

Signature of the Debtor

The final requirement for a security agreement to be enforceable is that it be authenticated by the debtor. Authentication replaces the signature requirement of the previous Code, recognizing that secured transactions may be recorded electronically. The term "authenticate" includes signing a writing, as well as adopting or accepting an electronic record.[13]

FINANCING STATEMENT

The second essential writing for Revised Article 9 secured transactions is the financing statement or UCC 1 form, which when filed gives notice of the secured party's claimed perfected security interest. The notice filing system requires indexing financing statements alphabetically under the debtor's name. Only a limited amount of information is required on the form, since record searchers may obtain additional information from debtors and secured parties. Note that "[t]he failure of the filing office to index a record correctly does not affect the effectiveness of the filed record."[14]

Under Revised Article 9, the financing statement is a standardized national form, and a filing office may not refuse to accept an initial financing statement on this form found at MCLA 440.9521. One section of Revised Article 9 provides that a financing statement is sufficient if it provides the names of the debtor and the secured party, and indicates the collateral covered;[15] however, failure to provide additional information directs the filing officer to refuse to accept the financing statement.[16] Completion of all sections on the national form is the best method for assuring compliance with Code provisions.

Description of the Collateral

Many secured parties find themselves unperfected or unsecured because they fail to consistently describe the collateral in the security agreement and financing statement. Drafters tend to overdescribe collateral in the security agreement or fail to use the same type labels in both records. The Revised Article 9 has adopted a provision that eliminates this problem. Specifically, a financing statement sufficiently indicates the collateral covered by stating that it "covers all assets or all personal property."[17] Use of this language to indicate the collateral on the financing statement will insure that the secured party is perfected with respect to all collateral sufficiently described in the security agreement, so long as it is a type of collateral that may be perfected by filing a financing statement. Since a financing statement may be used to perfect a security interest in all types of Revised Article 9 collateral except money, deposit accounts, letter-of-credit rights, and goods covered by certificate of title provisions, the use of this super-generic language in the financing statement is ideal. Remember, however, that this language is *insufficient* when describing the collateral in the security agreement.

Debtor's Name

The importance of correctly identifying the debtor's name on a financing statement cannot be overemphasized. A recent case found that using "Mfg." in the debtor's name rather than "Manufacturing" rendered a tax lien ineffective since a searcher would not have notice because of rigid computer search logic.[18] A financing statement that fails to sufficiently provide the name of a debtor is seriously misleading and ineffective to perfect a security interest.[19] Aside from spelling errors, failure to properly identify the organizational format of the debtor is the most common error resulting in unperfected status for the secured party. Differentiating between corporate and sole proprietorship status is critical since the financing statement is indexed under the individual debtor's name when the debtor is a sole proprietorship, rather than the d/b/a name. The secured party should always examine the debtor's organizational papers to guarantee that the correct name is being used for filing purposes. If the debtor is a "registered organization," such as a corporation or limited liability company, the financing statement is sufficient only if it provides the debtor's name indicated on the public record of the debtor's jurisdiction of organization.[20]

Debtor's Signature

Finally, the signature requirement of the 1972 Code has been modified. A secured party may file a financing statement without the debtor's signature if the debtor "authorized" the filing.[21] By authenticating a security agreement, the debtor authorizes the filing of a financing statement. Consequently, a secured party needs express authorization to file a financing statement only if the filing will predate execution of the security agreement. ◆

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Footnotes

1. MCLA 440.9203(2)(c)(i).
2. The term "record" has been substituted for the word "writing" to recognize the use of electronic secured transactions. Record is defined as "information that is inscribed on a tangible medium or which is stored in an electronic or other medium and is retrievable in perceivable form." MCLA 440.9102.
3. 1972 Section 9-110.
4. MCLA 440.9108(2)(c). With commercial debtors, a description by type of collateral is effective and the recommended methodology except for a commercial tort claim, which must be specifically described.
5. MCLA 440.9204.
6. MCLA 440.9204, comment 7.
7. A case discussing the two approaches is *In re Short,* 170 BR 128 (1994).
8. MCLA 440.9103(6).
9. MCLA 440.9103(8).
10. MCLA 440.9102(cc).
11. MCLA 440.9104(1)(b) and (c).
12. MCLA 440.9324(2)(b).
13. MCLA 440.9102(g).
14. MCLA 440.9517.
15. MCLA 440.9502(1).
16. MCLA 440.9520.
17. MCLA 440.9504(b).
18. *In re Spearing Tool and Mfg Co, Inc,* 302 BR 351 (ED Mich 2003).
19. MCLA 440.9506.
20. MCLA 440.9503(1)(a).
21. MCLA 440.9509(1)(a).