International Journal of Business Management and Commerce; Vol. 5 No. 2; August 2020
International Journal of Business Management and Commerce
Published by Center for Contemporary Research

Managing Financial Stress for Debtors and Creditors in the Midst of a Pandemic Part I: Security Interests under Article 9 of the UCC

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Abstract

This article is written within the context of the financial crisis that attenuated the Coronavirus pandemic of 2020, which has caused uncertainty among both creditors and debtors as to their rights and obligations. The article focuses on Article 9 of the Uniform Commercial Code which governs security interests in personal property by establishing rules under which the rights of the parties are determined. The article cites several important cases relating to issues raised in court proceedings which deal with complex Article 9 filings. The article is written from a non-technical, managerial perspective.

Key Words: Uniform Commercial Code, Security agreements, Article 9, personal property, UCC 1, bankruptcy

1. Introduction

Business financial transactions are often confusing under the best of circumstances. As more and more business are failing or are forced to offer refunds to customers due to the Coronavirus or other factors (e.g., Wolff-Mann, 2020), both debtors and creditors have become increasingly uncertain as to their rights and obligations upon default (Pritchard, 2020).

According to National Business Capital and Services (2020), "An astonishing 6.5 million businesses launch every year, but only a handful enjoy long-term success." Startup failure rates continue to hover around an astonishing 90% (see Bednar & Tariskova, 2017; Mason & Hornsby, 2019). Statistics indicate the failure rates by year of non-startups:

- First year: 21.5%
- Second year: 30%
- Fifth year: 50%
- 10th year: 70%

Studies also point out mistakes these entrepreneurs tend to make, including:

- Entering an industry in which they have no experience
- Hiring an inexperienced team
- Putting together a team that can't cooperate to work together efficiently

- Failing to recognize the market has no need for their products or services
- Ignoring what customers want
- Refusing to be flexible and adapt to changing trends

However, not unsurprisingly, coupled with these "managerial mistakes" are those relating to debt and finance. Bednar & Tariskova (2017, p. 240) note that "finance is the biggest problem…." Financial factors include:

- The startup has hurt its investors several times and failed to fulfill the required goals in the basic series, thereby losing confidence;
- The startup did not produce any evidence to increase its potential to convince the investor of its exponential growth potential; and
- Lack of logic of the business model from the investor perspective, - insufficient investor awareness of all issues, - time has shown that there is no understanding between the startup team and the investor.

The Uniform Commercial Code (UCC) provides a "method of analysis" to understand the complexity of issues relating to security for creditors and debtors. Article 9 regulates the creation of security interests, and the enforcement of those interests in both tangible and intangible property and fixtures. Article 9 encompasses a wide variety of "possessory liens" [where the asset used as collateral in a possessory lien is held by the lender until the debtor fulfills their financial obligation and pays off the debt (Beers, 2020)] and determines the legal rights of a secured creditor if a debtor does not meet his or her obligations and defaults on a loan obligation.

Article 9 governs secured transactions (see Nation III, 1998; Smith 1999). According to Sherman, 2020, p. 2230): "The simplest example of a secured transaction occurs between one lender and one debtor: the lender gives the debtor a loan and, in return, the debtor grants the lender a security interest in its property. If the debtor fails to comply with the terms of the loan and defaults, the creditor may repossess, sell, or otherwise dispose of tangible collateral, or if the agreement so permits, accelerate the debt."

Similarly, Kagan (2019) defines a security interest as "an enforceable legal claim or lien on collateral that has been pledged, usually to obtain a loan. The borrower provides the lender with a security interest in certain assets, which gives the lender the right to repossess all or part of the property if the borrower stops making loan payments. The lender can then sell the repossessed collateral to pay off the loan."

By way of contrast, if a creditor makes an unsecured loan or extends credit to a debtor without the benefit of a security agreement and the debtor defaults, the creditor must ordinarily commence an action (file a lawsuit) and obtain a judgment against the debtor. After a judgment is entered, the creditor cannot simply *take* possession the debtor's property. The creditor must enforce the judgment by a process called *execution* through a sheriff or some other judicial officer through the issuance of a *writ of execution.* [A writ of execution is a judicial order authorizing a local law enforcement official to seize and sell any of the nonexempt real or personal property of a debtor within the court's jurisdiction after the entry of judgment in the underlying case.] This can be a time-consuming, often frustrating, and expensive process. In some cases, the property of the debtor may be exempt from execution. For example, closely mirroring the bankruptcy code, many states have adopted a homestead exemption of a certain amount for individuals over a certain age. In addition, the following items may be exempted from seizure based on state law:

- Household goods, appliances, and home furnishings (up to a set amount);
- Clothing;
- Equity in a motor vehicle (up to a certain amount); and
- Tools and other instruments required to carry out a trade.

In the end, the debtor may file for bankruptcy (Moo, 1973; Brinkmann, 2008; LoPucki & Warren, 2020), in which case an unsecured credit ordinarily would receives little, if any, compensation in case of a default.

2. Creation of a Security Interest

In order to enforce a security interest against a debtor, or against the claims of other parties who are seeking compensation for their claims (perhaps in a bankruptcy proceeding), the security interest must be properly *created and perfected.* Perfection is the process of "putting the world on notice" (Weiler, 2006; Sterk, 2007; Hill, 2015) that there is a security interest in an item of personal property so that the secured party's rights are fully enforceable.

However, Article 9 does not apply in the case of real property. Rather, in order to protect the interests of the lender or mortgagee, the common law requires that a mortgage must exist and the mortgage must be properly recorded. Generally, the mortgage will be recorded in either the *grantor-grantee index* or in the *Torrens System*. Szypszak (2003, p. 680), however notes: "The Torrens system's limitations under American law and public policy resulted in its complete abandonment in most of the states that adopted it, and very infrequent use in the others. In those states that enacted Torrens systems, registration is optional. An advocate for Torrens registration called it the "most infrequently used method of land conveyancing in the United States.""

In most states, mortgages are ordinarily recorded on the deed to the property subject to the mortgage under the lot and block number or some other valid "legal description" of property. As an "interest in land," a mortgage must be "in writing" under the Statute of Frauds (Amiranashvili, 2016).

3. Creation of a Security Interest in Personal Property

There are two types of personal property: tangible personal property and intangible personal property (Bridge, Gullifer, Low, & McMeel, 2017; Sepinuck, 2018). Tangible personal property is generally *movable* and would include certain "hard assets" such as automobiles, inventory, equipment, fixtures, and other goods.

Intangible personal property includes such assets as accounts receivable, promissory notes, securities (such as stocks and bonds), letters of credit (Dolan, 1999; Dolan, 2007) (dealing with the payment for goods, often involving international business transactions), and other interests (see Wolverton , Lennhoff, Vernor, & Marchitelli, 2002).

3.1. How to Create a Security Interest

In order to create a security interest enforceable against a debtor which would protect the interests of the creditor, three requirements are set forth in UCC Section 9-203(b):

1. The secured party must "give value (normally by supplying funding to acquire the asset or property);
2. The debtor must have rights in the collateral (generally the debtor must own or have title to the property or be in possession of the property under a valid lease or contract of bailment);
3. The debtor has authenticated (i.e., signed) the security agreement,

To "authenticate" generally is understood as "to sign." Today, based upon modern technology, authentication may also include electronic signatures or any other symbol, encryption, or similar process with identifies the debtor and indicates an acceptance of the underlying obligation (see Balovich, 2001). A creditor can use an agent to create a security agreement (Nation III, 2003)

An enforceable security interest can also be created by *pledge* under which the "borrower retains ownership of the assets and continues to earn and report interest or capital gains on those assets. However, the bank would be able to seize the assets if the borrower defaulted on the mortgage. The borrower continues to earn capital appreciation on the pledged assets and gets a no-down-payment mortgage" (Murphy & Brock, 2020). In certain circumstances, an enforceable security interest can be created by a *re-pledge* (*Texas Bank v. Bozorg*, 1984) or in certain circumstances by "control" of the assets by the creditor (Section 9-305).

In *New Orleans Silversmiths, Inc. v. Toups*, a case dealing with a re-pledge of property, the court held that the pledgee must prove that:

> (1). The initial pledge was properly confected (created); (2). The parties mutually agreed at the time of the original pledge that the pledge would also secure obligations thereafter arising; (3). Each subsequent loan was especially secured by the pledge of the original collateral mortgage note; (4). The pledged collateral has continuously remained in the hands of the pledgee; and (5). The parties acted in good faith.

4. What Are the Elements of the Security Agreement?

There are certain required elements necessary to create a legally enforceable security agreement. They include:

1. Signature;
2. Intention; and
3. A description of the collateral.

4.1. Signature Required

The debtor (and the owner of the collateral if the owner is different party), must sign the security agreement in order for the security agreement to be effective. Special care should be taken to ensure that the name of the debtor (and owner, if applicable) is correct. A security agreement may be invalidated if the name of the debtor is not correctly stated (Sherman, 2020). If the debtor is a corporation or other business entity, the actual name of the debtor may be different than the name under which they are doing business (DBA) and the actual name must be found on the security agreement (see, e.g., Crockett, 2016, pp. 46-48; Cappellino, 2020).

4.2. Intention

The security agreement is the document that serves as the foundation of the creation of a security interest in property, and must be agreed to by both the debtor and creditor. The statement of intention should be as specific as possible. For example, the following statement is regularly found on a security agreement: "*The debtor hereby grants a security interest in the property described in the agreement*." This wording is sufficiently clear to confirm the intent of the debtor to grant a security interest in the property to the creditor.

4.3. Collateral Must Be Sufficiently Described

The property subject to the security agreement must be described in sufficient detail in order to identify it properly (Grant, 2006). A complete and detailed description is preferable. For motor vehicles and some other types of equipment, a serial number or VIN would be sufficient to identify the property. However, for the sake of clarity, the description should also include the make, model, and year of any vehicle if available. For collateral such as *inventory*, a *general inventory list* would be sufficient without additional details. However, the more that a creditor fails to provide a detailed description of the collateralized property, the description is open to challenge by the debtor or a third party—and the possibility that a security interest in that property would not be recognized by a court.

If a creditor takes a security interest in *all* or virtually all of the property of the debtor, a *blanket security interest* is created (Fu, 2019). The security interest may also take the form of a "floating lien" over inventory (Tabac, 2007). [Think of the inventory of a car dealership or of a seller that fluctuates based on sales and the season of the year.] The agreement may provide for a security interest in "after acquired property" (Haemmerli, 1996)—that is, property acquired *after* the original security interest is created—which grants the secured party rights "in all collateral in which the debtor now has or *hereafter* acquires an interest."

A secured party who perfects his or her security interest in collateral may also have a continued security interest in the *proceeds* (East & Byerly, 1986; Kauders, 1994) from the sale of that collateral for a certain period of time. Under UCC Section 102(a)(64), proceeds is defined as "whatever is acquired on the sale, lease, or other disposition of property, whatever is collected on or distributed on account of collateral, rights arising out of collateral, and certain claims arising out of the collateral." Thus, a secured party with priority in collateral will also maintain priority in the proceeds from the sale of that collateral as well.

5. Methods of Perfection of a Security Interest

There are four methods of perfection of a security interest in personal property.

1. The most common method of perfection is by *filing the financing statement* called the UCC 1 (Hansford, 1982). Perfection by filing is the preferred method for:

    - Chattel paper
    - Documents of title
    - Accounts
    - General intangibles
    - Equipment
    - Farm products
    - Inventory
    - Fixtures

2. *Perfection by possession.* In addition to filing, Article 9 provides for perfection of a security interest by possession; that is, the creditor will take physical possession of an instrument or other property. Possession is generally the safest way to prove perfection and to protect the interests of a creditor (*In re Midas Coin Co.*, 1967; Dolan, 1999). Perfection by possession is the preferred method for:

   - Chattel paper
   - Documents of title
   - Instruments such as stocks, bonds, checks)
   - Pawnbroker holding jewelry and other valuables

3. *Perfection by control*: Article 9 created a category of perfection wherein a secured party can perfect a security interest by taking actions that indicate sufficient control over certain accounts, commercial paper, letters of credit or investment accounts, even though the secured party does not have actual physical possession (Smith, 1999).

   For example, a secured party may have control of a debtor's deposit account if the bank, the debtor, and the secured party have all agreed that the secured party may have access to the funds in that account "without further consent by the debtor." As another example, a secured party has control over investment property such as securities (shares of stock or the like), if the property is delivered to the secured party, and, if necessary, "endorsed" (signed) to the secured party.

4. Other methods under federal or state law such as filing of a certificate of title by the secured party on such items as cars, boats, airplanes, etc. "Title" will only be released to the debtor upon full payment of the underlying obligation (see Hunter, Shannon, & Amoroso, 2019).

In addition, there is automatic perfection for purchase-money security interests in consumer goods (goods purchased for "personal, family, or household use") (*In re Robert O. Troupe and Dawn Lynn Troupe*, 2006).
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6. The UCC 1: What is Required on the UCC 1?

Garcia (2020) offers the following comments on the details necessary to creation of a UCC 1:

"The name of the debtor is required on the UCC 1 filing form. You should list the full name of every person who is liable to you for the debt. The debtor can be an individual or can also be a corporation, organization, partnership, or any other kind of business entity. Use the name from any available legal documents that establish the identity of the particular entity, such as articles of incorporation and certificates of formation. If the business name contains a legal designation, such as "LLP," for limited liability partnership, include that in the name, too."

"You will also need to provide in your filing the complete address for each person, company or organization responsible for the debt to you. The list can be any combination of names and entities, as long as all names are included. As the secured party — the one who is holding the collateral and to whom the debt is owed — your full name is also required in the UCC 1 filing. This includes any business name you have. The names of any other people, businesses, or organizations involved with you in the financial transaction should also be listed."

"A description of whatever constitutes the collateral you hold should be listed in your filing. Collateral can be many things. It is important that the items are identified as accurately as possible. Your description is part of the notice given to others of the nature and identity of the collateral you hold. If possible, include things such as serial and model numbers." [Remember, however, that the financing statement can recite that it covers "all assets" or "all inventory."

"You will also need to list the names of any person to whom you have assigned or given some or all of your right to collect the debt; this person is known as an assignee. This can be more than one person, a business, or other entity. The same information that you provided about the debtor and yourself must be provided about any assignees."

> "Once a UCC 1 filing is complete, it can be extended or renewed prior to its expiration, which is generally five years. You can also add or create an assignment of rights, make updates, or terminate the original filing. This is done by submitting a UCC 3 statement referring back to the number given to your original UCC 1 filing. The UCC 1 can be extended by re-filing."
>
> "Most state governments will have online UCC 1 forms that can be filed electronically. There are also many business organizations that have Internet sites with tips about UCC forms and filings."

The UCC's general rule is that a financing statement remains valid for a period of five years from the date of filing. Unless a *continuation statement* is properly filed before expiration of the five year period, the effectiveness of the financing statement will lapse and it will no longer afford the creditor or its assignees with protection (Kagan, 2018).

6.1. FILING THE UCC 1

Where is the UCC 1 filed (Adams, Nickles, Sande, & Shiefelbein, 1995)? Under the prior version of Article 9, there was still great confusion as to where the financing statement had to be filed. Was it the place of business of the debtor, the place of business of the secured party, or the location of the collateral? Today, the most important "place" for filing is the location of the debtor, meaning the state of residence of the debtor or where the debtor is organized, if the debtor is a business (Crockett, 2016).

For a corporation, a limited partnership, and an LLC, the place of filing is the state of organization. For individuals, the place of filing is the state of residence. For unregistered entities, such as a proprietorship, the place of filing is the place of business, or if there is more than one place of business, it is the residence of the CEO or chief operating officer. Generally, a creditor will file the UCC 1 in the county seat in the appropriate recording office, or in some cases, with the Secretary of State. (If there is any confusion or doubt as to where to file, it would be wise to file at any location available.)

7. Enforcement of the Security Agreement

If a debtor defaults according to the terms of the agreement, the secured party may resort to any appropriate remedy or remedies to protect their interests. The secured creditor can effect repossession of the collateral without judicial process so long as the repossession does not "breach the peace" (Korybut, 2014)—that is, without force or without committing a trespass (see *Lingross v. Heilig-Meyers Furniture*, 1999; *Price Auto Sales v. Sanders*, 2012). If there is any doubt about whether or not repossession will result in a "breach the peace," it may be wise to secure the aid of a marshall, the local sheriff, or some other court officer to affect the repossession.

If the collateral is seized by the secured party, the secured party can choose not to take any further action against the debtor—in essence, releasing the debtor from any further payment obligation. The debtor would be wise to seek such a release or waiver in writing. The security agreement may contain such a writing requirement in order to protect the interests of the debtor.

However, the secured party may elect to sell or otherwise dispose of the collateral in a "reasonably commercial manner" and upon providing proper notice to the debtor (*Hicklin v. Onyx Acceptance Corporation,* 2009). The burden of proof is entirely on the secured creditor to prove proper notice by a preponderance of the evidence (*M&T Bank v. Bolden,* 2012). (The Code requires that in the case of certain consumer goods, the collateral must be disposed of through a mandatory disposition by resale.) The secured party is required to "give an explanation of calculations of surplus or deficiency in a consumer goods transaction." By statute, the secured party is entitled to recover the reasonable expenses of collection, including reasonable attorney's fees, if provided for in the agreement.

The proceeds will be applied as follows (in order):

- The costs and expenses of repossessing the collateral, and any reasonable attorney's fees (if provided for in the agreement);
- The obligations to the secured party;
- The claims of any third parties upon the receipt of a notice and proof of position;
- Any surplus, if any, is then paid to the debtor.

The debtor is potentially liable for any deficiency, unless released or the deficiency is waived.

As a matter of good practice, notice should be provided to the debtor or other parties who might have an interest in the collateral. Because the secured party may purchase the collateral at a public or a private sale (Bolton, 2013), the debtor must be given notice by the secured party of the intention to dispose of the collateral in this manner so that the debtor can take appropriate actions in order to protect their position—including possibly arranging for suitable financing—even at this late date.

If the secured party assigns the rights to the security agreement to another party (see Plank, 2001), that party will assume all of the rights of the secured party. Under these circumstances, the party to whom the interest is assigned should give notice to the debtor of the assignment at the time of the assignment.

If the property is sold or transferred to a third party under Section 9-617 "in the ordinary course of business" (see *In re Girolamo Afonica,* 1994) after the transferee has conducted a proper search of records (unless not required) (*Fordyce Bank & Trust v. Bean Timberland, Inc.,* 2007) within the proper time frame to indicate whether a security interest had been perfected on the property, the transferee will be considered as a "good faith transferee (purchaser) for value" of the property (Carlson, 2019) and will take the property free of that security interest (see *Merrill v. Abbott*, 1987; *In re Health Gourmet, Inc.*, 2002). Law Insider (2020) notes that a buyer in the ordinary course of business "means a person who in good faith and without knowledge that the sale to him is in violation of the ownership rights or security interest or leasehold interest of a third party in the goods, buys in the ordinary course from a person in the business of selling goods of that kind but does not include a pawnbroker. 'Buying' may be for cash or by exchange of other property or on secured or unsecured credit and includes receiving goods or documents of title under a preexisting contract for sale but does not include a transfer in bulk or as security for or in total or partial satisfaction of a money debt."

If the debtor pays the full amount of the debt as required by the security agreement, the secured party must file a *termination statement* with the filing office where the agreement was originally filed. The termination statement is an amendment to the financing statement that provides that the debtor has no further obligation to the secured party (Section 9-513(a)). After repayment, the secured party has one month in which to file the termination statement. If a debtor makes a written request to the secured party to file the termination statement, the secured party has 20 days to file the termination statement. Failure to file the termination agreement within the 20 day period after the written request has been made permits the debtor to recover $500 from the secured party.

8. Concluding Comments

There is no doubt that times of acute financial stress will weigh heavily on both debtors and creditors who become concerned whether and under what circumstances their rights and obligations will be respected and enforced. Article 9 of the UCC provides the parties with a workable framework in which these issues can be adjudicated in an orderly manner so that the parties can adequately plan for reasonable capitalization of their businesses and protection of the parties' rights.

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