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Attachment and Perfection of Security Interests

Small Errors, Fatal Consequences

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While most secured parties focus their energies on negotiating and drafting contract documents, they must also pay careful attention to ensure that security interests properly attach and are perfected, as slight errors can have devastating consequences on security interests. Because security agreements and UCC financing statements are routinely prepared as a matter of course, the potential for drafting errors exists. This article addresses common attachment and perfection problems raised in recent cases, and provides suggestions on how secured parties can avoid these pitfalls.

Problem: The Security Interest Fails to Attach, Due to a Typo In the Security Agreement

A security interest is enforceable against third parties when it attaches to collateral and is duly perfected. A security interest does not attach unless: 1) value has been given; 2) the debtor has rights in the collateral or the power to transfer rights in the collateral to a secured party; and 3) the debtor has authenticated the security agreement that provides a description of the collateral. *See* UCC § 9-203. A security interest attaches to property described in a security agreement and becomes enforceable against third parties when it is perfected with the filing of a UCC-1 Financing Statement. *See* UCC § 9-302.

"If the description of collateral contained in the security agreement is *narrower* than that in the financing statement, a security interest does not attach to the omitted property. Thus, a security interest [in the omitted property] would not be enforceable against either the debtor or a third party." *In re Martin Grinding & Machine Works, Inc.*, 793 F.2d 592, fn. 3 (7th Cir. 1986). Similarly, parol evidence, whether oral or written, cannot expand a security interest beyond what is stated in an *unambiguous* security agreement, because a subsequent creditor must be able to rely upon the face of the security agreement to determine what property is subject to a prior security interest. *Id.* at 596. Therefore, even if collateral is omitted from a security agreement by the parties' mutual mistake, the security interest in that omitted collateral cannot attach, and, accordingly, cannot be enforced against the debtor or third parties. *Id.* at 595.

In *In re: Equipment Acquisition Resources*, 692 F.3d 558, 561 (7th Cir. 2012) ("*EAR*"), the Seventh Circuit revisited its opinion in *Martin Grinding,* and emphasized that parol evidence may not alter an unambiguous security agreement. In *Martin Grinding*, the parties intended for the debtor to grant a security interest in the debtor's machinery, equipment, furniture, fixtures, inventory and accounts receivable. 793 F.2d at 593. However, the security agreement inadvertently omitted inventory and accounts receivable from the collateral description. *Id.* Consequently, the court held that no security interest attached to the debtor's inventory and accounts receivable. *Id.* The court in *Martin Grinding* specifically relied upon the fact that the agreement at issue was unambiguous. 793 F.2d at 595.

In *EAR*, the Seventh Circuit evaluated the bankruptcy court's approval of a settlement of an adversary proceeding, under which the Plan Administrator sought to declare that Republic Bank of Chicago ("Republic") did not have a valid, enforceable security interest in the assets of the debtor, *EAR*, *Id.* at 560. When Republic and EAR entered into a lease amendment, the parties intended for EAR to grant Republic a blanket lien on all of its assets; however, the amendment contained a typo that incorrectly gave Republic a blanket lien in its own assets, rather than EAR's assets. *Id.* at 559. Republic and the Plan Administrator entered into a settlement agreement, whereby the parties agreed to retroactively modify the typo to reflect that Republic had a blanket lien on EAR's assets. *Id.* at 560.

A creditor in EAR's bankruptcy filed an objection to the proposed settlement agreement, arguing in part that *Martin Grinding* precluded the parties from retroactively reforming a fatal defect in the earlier lease amendment. *Id.* While the bankruptcy court specifically noted it was not making a final determination on whether the reformation was proper, the bankruptcy court found that reformation was at least possible and approved the settlement. *Id.* at 563. Both the district court and the Seventh Circuit affirmed the bankruptcy court on appeal, reasoning in part that the typo in *EAR* renders the description of the collateral between EAR and Republic ineffective and unable to stand alone, unlike the unambiguous conveyance in *Martin Grinding*.

The courts further reasoned that "public statements filed by Republic reflected that Republic had a blanket security interest in EAR, thus reducing the potential that any creditor of EAR's would get duped," which was the Seventh Circuit's primary concern in *Martin Grinding*. 692 F.3d at 562; *In re: Equipment Acquisition Resources*, 465 B.R. 801, 806 (N.D. Ill. 2011). In addressing the public filings by Republic, the district court and the Seventh Circuit appeared to contradict the precise holding in *Martin Grinding*; namely, that a creditor's filed financing statement has no effect, if the underlying security agreement does not properly grant a security interest in the collateral.

Even so, the Seventh Circuit held that because the facts in *Martin Grinding* were distinguishable from those in *EAR*, and because of the deference granted to bankruptcy courts regarding approval of settlement agreements, it was reasonable for the bankruptcy court to determine that it was at least *possible* for the lease amendment

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to be reformed and the typo corrected retroactively. 692 F.3d 562. The bankruptcy court, however, was not called upon to decide whether reformation of the fatal defect in the lease amendment was permissible, and the Seventh Circuit did not address that question. Nonetheless, absent the approved settlement, the blanket lienholder in *EAR* was at risk to have its lien invalidated, simply because a typo precluded its security interest from attaching.

Problem: The Creditor Mistakenly Terminates Its Security Interest, Due to an Erroneous UCC Filing

Once a security interest attaches, the security interest must be perfected, providing additional opportunity for error. To perfect a security interest, a secured party must file a UCC-1 Financing Statement (the "UCC-1") with the applicable state filing authority. A secured party may add or change information previously filed on a UCC-1 by filing a UCC Financing Statement Amendment by using Form UCC-3 (the "UCC-3"), which is substantially uniform among the states. In executing the UCC-3, a secured party may elect to: 1) check Box No. 2, titled "Termination," to effectively terminate the secured party's security interest in the collateral ("Termination"); 2) check Box No. 3, titled "Continuation," to continue the security interest for another set number of years pursuant to applicable law ("Continuation"); 3) check Box. No. 4, titled "Assignment," to assign the security interest ("Assignment"); or 4) amend the security interest by completing Box No. 5, titled "Amendment (Party Information)" and/or Box No. 8 titled "Amendment (Collateral)," to either (i) add, delete or change the name of a debtor or secured party; or (ii) add, delete or restate collateral ("Data Change").

In the instructions to the UCC-3, secured parties are advised that the filer may use the UCC-3 Form to simultaneously accomplish a Data Change and a Continuation. A simultaneous filing of a Termination with any other item on the UCC-3 is incongruous. Accordingly, checking the Termination box may be fatal to the existence of the security interest, even if the Termination box was selected in error.

"[U]pon the filing of a termination statement with the filing office, the financing statement to which the termination statement relates ceases to be effective." UCC § 9-513(d). Accordingly, the Ninth and Fourth Circuit Courts of Appeals have held that the effect of filing a UCC-3 with its Termination box checked, even in error, is fatal. *See In re Pacific Trencher & Equipment, Inc.*, 27 B.R. 167, 168 (B.A.P. 9th Cir. 1983); aff'd 735 F.2d 362, 365 (9th Cir. 1984); *In re Kitchin Equipment Co. of Va., Inc.*, 960 F.2d 1242, 1247 (4th Cir. 1992). While the secured parties in *Pacific Trencher* and *Kitchin* solely checked the Termination box on their respective UCC amendments, they also listed items of collateral which they intended to delete from the security interest, as the intent was to amend, and not terminate, the security interest. *See* 735 F.2d at 363-64; 960 F.2d at 1244-45. The Ninth Circuit held that if the Termination box is checked, "the listing by the [secured party] of items in its termination statement is mere surplusage," and "[o]nce the termination statement was filed, it destroyed the perfection of all items listed in the financing statement." 735 F.2d at 365. Similarly, the Fourth Circuit held that when a termination statement is filed, its "effect on a secured interest is dramatic and final." 960 F.2d at 1247.

In a recent unpublished case, the Michigan Court of Appeals refused to apply the holdings from *Pacific Trencher* and *Kitchin* to a case involving a UCC-3 with two incongruous boxes checked; namely, the boxes for Termination and Amendment (Collateral). *See Monroe Bank & Trust v. Chie Contractors, Inc.*, Docket No. 310226, 2013 WL 1629300 (Mich. Ct. App. April 16, 2013). In *Monroe Bank*, after the secured party, Monroe Bank & Trust ("MBT"), filed an initial financing statement evidencing a blanket lien in the debtor's property, MBT filed a UCC-3 with *both* the Termination box *and* the box to delete collateral checked, and with a single piece of equipment listed (the "Disputed Financing Statement"). 2013 WL 1629300, at *1. Later, MBT filed a Continuation of the initial financing statement, which was also subject to the Disputed Financing Statement. *Id*. Subsequent lien creditor Blackstone Equipment Financing, L.P. ("Blackstone") contested the Disputed Financing Statement, arguing that by checking the Termination box, MBT's entire blanket lien was effectively terminated. *Id*.

MBT claimed that the Disputed Financing Statement was effective and not "seriously misleading." *Id*. A financing statement that otherwise complies with the UCC "is effective, even if it has minor errors or omissions, unless the errors or omissions make the financing statement seriously misleading." UCC § 9-506(a). "A financing statement is considered 'seriously misleading' if it fails to serve its central purpose of providing notice to third parties of the possible interest of the secured creditor, which would lead interested parties to inquire further to get the full picture." 2013 WL 1629300, at *3 (quoting *Continental Oil Co. v. Citizens Trust & Savings Bank*, 244 N.W.2d 243 (Mich. 1973) (dissenting opinion by Williams, J).

The Michigan Court of Appeals held that because two incongruous boxes were checked on the UCC-3, and the error was plainly apparent on the face of the financing statement, "any interested party should have realized that further investigation was required to ascertain [MBT's] actual interest." *Id*. at *3. The court found that "the financing statement provided notice to an interested party that further inquiry was required to get the full picture." *Id*. The Michigan appellate court further held that because the UCC-3 erroneously indicated that it was both a collateral change amendment and a termination, it was not merely a termination statement within the contemplation of UCC § 9-513. *Id*. at *4. Accordingly, the court reasoned that the fatal result of *Pacific Trencher* and *Kitchin* is inapposite, where the UCC-3 filing has two boxes checked, rather than just the Termination box. *Id*.

While there is limited case law on the issue of erroneous terminations, it is clear that simple errors in drafting UCC-3 forms may cause peril for secured creditors, and subsequent creditors must investigate any confusing or ambiguous filings by previous secured creditors.

The Takeaways: What Can a Secured Party Learn from These Mistakes?

Aside from ensuring that the security agreements and UCC filings are flawless, secured parties should be defensive in the analysis of competing security interests. If a prior secured party checked the Termination box in error, it is possible that a search for "active" UCC financing statements will fail to include the erroneously terminated financing statement, as a simple UCC search may reflect nothing more than the termination of a financing statement. A prudent party should request copies of all filed UCC statements relevant to the particular debtor to analyze whether the debtor's property may be subject to a prior security interest.

If a financing statement gives notice of a prior security interest conflicting with the intended interest, a copy of the security agreement directly from the secured creditor should be reviewed to analyze if the financing statement is aligned with the security agreement. If there are questions about the attachment or perfection of a security interest, a prudent party should make further inquiry by contact the competing creditor directly to ascertain the extent of the collateral covered by the competing creditor's security agreement. The intended secured party must ensure that any issues are identified and satisfy any duty to inquire that may be relied upon by the court in future priority disputes.