

The Importance of a Proper Collateral Description in a UCC Financing Statement



Bruce S. Nathan, Esq., is a partner in the New York office of the law firm of Lowenstein Sandler LLP, practices in the firm's Bankruptcy, Financial Reorganization & Creditors' Rights Group, and is a recognized expert on trade creditors' rights and the representation of creditors in bankruptcy and other legal matters. He is a member of NACM, a former member of the board of directors of the American Bankruptcy Institute and a former co-chair of ABI's Unsecured Trade Creditors Committee. Bruce is also the co-chair of the Avoiding Powers Advisory Committee working with ABI's commission to study the reform of Chapter 11. He can be reached at bnathan@lowenstein.com.

Michael Papandrea, Esq., is an associate in Lowenstein Sandler's Bankruptcy, Financial Reorganization & Creditors' Rights Department focused on providing practical solutions for debtors, creditors' committees, individual creditors, and other interested parties involved in bankruptcy and creditors' rights matters. Prior to joining the firm, Mike clerked for multiple bankruptcy judges in the District of New Jersey and Eastern District of Pennsylvania. He can be reached at mpapandrea@lowenstein.com.



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A trade creditor can obtain a security interest in its customer's property to increase the likelihood of payment of the creditor's claim. A creditor seeking a valid and perfected security interest in its customer's personal property, with priority over future security interests in the same property, must properly identify its collateral in both (i) the security agreement executed by its customer, and, just as importantly, (ii) the financing statement that was publicly filed pursuant to the Uniform Commercial Code (the "UCC").

Recent court holdings in *First Midwest Bank v. Reinbold* serve as a warning to secured creditors of the importance of properly describing their collateral in the UCC financing statements they file to perfect their security interests. At issue in this case is whether a description of collateral in a UCC financing statement that incorporates a description in another document that is not attached to the

financing statement is sufficient to perfect the creditor's security interest.

The bankruptcy court held that a bank's security interest was unperfected because the UCC-1 financing statement filed by the bank described the relevant collateral by merely referencing the description of collateral provided in an unattached security agreement, and the financing statement did not sufficiently identify the collateral. The United States Court of Appeals for the Seventh Circuit reversed the bankruptcy court's decision, holding that the UCC financing statement's mere reference to the collateral description provided in another document (such as a security agreement) that was not attached to the financing statement was sufficient to perfect the security interest.

However, not all courts may agree with the Seventh Circuit's ruling in *First Midwest Bank v. Reinbold*. The United States Court of Appeals for the First Circuit, in *In re Financial Oversight and Management Board for Puerto Rico*, recently asserted, in dicta, that a security interest was not perfected where the UCC financing statement's description of collateral referred to a collateral description in a separate document that was not attached to the financing statement. Therefore, regardless of the Seventh Circuit's decision, creditors

seeking to obtain a perfected security interest based on a description of collateral contained in the underlying security agreement or another document should play it safe by providing a summary description of the collateral in the financing statement and attaching the referenced document to the financing statement.

Creating and Perfecting a Security Interest Under the UCC

A trade creditor seeking to obtain an enforceable security interest in its customer's assets must satisfy the requirements specified in Article 9 of the UCC. First, a creditor must satisfy Article 9's requirements for the creation or attachment of a security interest in its customer's property that will serve as the creditor's collateral securing payment of its claim. A security interest is created by the customer's execution of a security agreement, which adequately describes the creditor's collateral by category or type. A description such as all of a debtor's present and future accounts, inventory, equipment and general intangibles, and all cash and non-cash proceeds thereof should suffice. A description of all of a debtor's assets will not pass muster.

Second, a creditor's security interest must be perfected according to UCC Article 9's requirements. By obtaining a perfected security interest, a creditor's security interest in a debtor's property will withstand a challenge by a junior secured creditor, a judgment lien creditor, a bankruptcy trustee or a creditors' committee. A creditor frequently perfects a security interest by filing a UCC-1 financing statement in the appropriate filing office. A UCC-1 financing statement must identify the debtor by its correct legal name and address and describe the collateral in a manner that is consistent with the collateral described in the security agreement, and may contain other required information. If the collateral description in a security agreement is broad enough to include all of a debtor's assets, then the collateral description in the UCC financing statement only needs to state, "all assets," or, "all personal property," of the debtor (unlike security agreements which must be more specific pursuant to the UCC).

The public filing of a UCC-1 financing statement serves two main purposes. First, it

confirms a secured creditor's priority rights in the collateral identified in the financing statement. It also provides notice to third parties that a secured creditor is claiming an interest in the assets identified in the financing statement.

As the UCC is a "notice filing" system, the filing of a UCC-1 financing statement is only intended to provide notice that a person *may* have a security interest in the specified collateral. A subsequent creditor has the burden to conduct additional diligence where there is a potential ambiguity in a financing statement.

The adequacy of the description of collateral in a UCC-1 financing statement was at issue in *First Midwest Bank v. Reinbold*. According to UCC Section 9-504, a financing statement "sufficiently indicates the collateral that it covers" if the financing statement provides (1) a description of the collateral pursuant to UCC Section 9-108, or (2) a generic description of all assets or all personal property of the debtor if the description of collateral in the security agreement is broad enough to include all of the debtor's assets.

UCC Section 9-108 governs the sufficiency of a description of collateral in a UCC financing statement. UCC Section 9-108(a) states that a financing statement adequately describes the collateral if the UCC "reasonably identifies" the collateral being described. UCC Section 9-108(b) provides that a description reasonably identifies collateral by any of the following: specific listing; category; except as otherwise provided in UCC Section 9-108(e), a type of collateral defined in the UCC; quantity; computational or allocational formula or procedure; or, any other method (except for "supergeneric" descriptions described in UCC Section 9-108(c)), if the identity of the collateral is objectively determinable.

Creditors have sought to satisfy the requirement of adequately describing their collateral in a financing statement by making reference to a description of the collateral in another document—such as the applicable security agreement—without attaching the document to the financing statement. While the Seventh Circuit's holding in *First Midwest Bank v. Reinbold*

upheld the sufficiency of this practice, the better practice is for a creditor seeking to perfect its security interest by referring to collateral described in another document to include a summary description of the collateral in, and attach the document containing the description of collateral to, the financing statement.

The Facts and Procedural History of the *First Midwest Bank v. Reinbold* Decisions

The Debtor, 180 Equipment, LLC (the "Debtor"), was an Illinois-based business that purchased and refurbished trucks for resale. The Debtor obtained a commercial loan from First Midwest Bank ("First Midwest"). The Debtor and First Midwest executed a first amended and restated security agreement on March 9, 2015 that granted First Midwest a security interest in substantially all of the Debtor's assets. The description of First Midwest's collateral included 26 categories of assets, such as accounts, chattel paper, cash, equipment, goods, instruments, inventory and all proceeds and products of such assets. First Midwest then sought to perfect its security interest by timely filing a financing statement with the Illinois Secretary of State. The financing statement's description of collateral stated the security interest covered "[a]ll Collateral described in the First Amended and Restated Security Agreement dated March 9, 2015 between Debtor and Secured Party." The financing statement did not attach the amended security agreement, despite relying on it by reference.

The Debtor defaulted on the loan in November 2017. Then, on December 6, 2017, the Debtor filed a Chapter 7 bankruptcy petition in the United States Bankruptcy Court for the Central District of Illinois, and a Chapter 7 trustee (the "Trustee") was appointed to manage and oversee the liquidation of the Debtor's assets. First Midwest filed a proof of claim in which First Midwest stated that it was owed more than \$7.6 million. First Midwest then sued the Trustee, seeking a declaratory judgment that First Midwest's security interest was properly perfected and senior to the interests of all other claimants (including the Trustee). The Trustee asserted a counterclaim to avoid First Midwest's security interest pursuant to Section 544(a) of the Bankruptcy Code,

arguing that First Midwest did not perfect its security interest because the financing statement's incorporation of the amended security agreement's collateral description by reference did not comply with the requirements of UCC Article 9.

Both parties filed motions for judgment on the pleadings. First Midwest asserted that its financing statement had complied with UCC Section 9-108(b)(6) as an "other method" of reasonably identifying its collateral where the identity of its collateral was "objectively determinable" by an examination of the amended security agreement referenced in the financing statement. While the amended security agreement was not attached to the financing statement, First Midwest contended that the financing statement placed subsequent creditors on notice that some or all of the Debtor's assets were subject to First Midwest's prior security interest and additional inquiry was necessary to determine the extent of First Midwest's collateral described in the amended security agreement. This is consistent with UCC Article 9's notice filing system where a UCC financing statement's primary purpose is to provide notice to third-party creditors that a debtor's property may be subject to a security interest, and creditors might be required to make a further inquiry to determine the extent of a secured creditor's collateral.

The Trustee countered that First Midwest lacked a perfected security interest because its financing statement did not contain a standalone description of First Midwest's collateral. The financing statement's reference to collateral described in an unattached amended security agreement had failed to adequately describe or reasonably identify First Midwest's collateral as required by UCC Section 9-108.

The Bankruptcy Court's Ruling That First Midwest's Security Interest Was Not Perfected

The bankruptcy court held that First Midwest did not adequately describe its collateral in its UCC-1 financing statement by merely referencing all collateral described in the amended security agreement—without attaching the security agreement or providing any other

description of the collateral—to perfect its security interest. The bankruptcy court then avoided First Midwest's lien based on the Trustee's strong arm powers under Section 544(a) of the Bankruptcy Code.

The bankruptcy court noted that the description of First Midwest's collateral had to be contained in the four corners of its filed financing statement and found no such description in the financing statement. The bankruptcy court further stated that UCC Article 9 makes clear that a UCC financing statement must provide notice of the specific items of collateral, the kinds or types of property subject to a security interest, or all of a debtor's assets or personal property where the security agreement's collateral description is broad enough to grant a security interest in all of a debtor's assets. The bankruptcy court concluded that the financing statement's description of collateral had failed to satisfy these requirements and provide adequate notice of the collateral to any third party.

The bankruptcy court also refused to admit any extraneous evidence to correct any errors or clarify any ambiguities about First Midwest's collateral as described in the financing statement. This same policy dictates that a collateral description in a financing statement cannot be provided by referring to the assets described in an unattached/unfiled security agreement. Interestingly, the bankruptcy court noted that "[b]y authorizing usage of a supergeneric description in financing statements, the drafters of [the UCC] drew a line in the sand at that point for the most general type of collateral description that could be used in order to sufficiently indicate the collateral. The drafters could have gone one step further by authorizing a mere reference to the underlying security agreement ... [t]hey did not do so."

Notably, the bankruptcy court acknowledged the different purposes behind security agreements and financing statements. The bankruptcy court noted that "the purpose of a financing statement is to put third parties on notice that the secured party who filed it may have a perfected security interest in the collateral described, and that further inquiry into the extent of the security interest is prudent."

However, the bankruptcy court simply did not believe First Midwest had satisfied this purpose by incorporating by reference the collateral description in the amended security agreement that was not attached to the financing statement.

First Midwest appealed the bankruptcy court's decision, which appeal went directly to the Seventh Circuit because the decision involved a question of state law for which there is no controlling decision.

The Seventh Circuit's Ruling in Favor of First Midwest

The Seventh Circuit reversed the bankruptcy court's holding and ruled that First Midwest's UCC financing statement sufficiently described the collateral by reference to the description of the collateral in the unattached amended security agreement. In doing so, the Seventh Circuit relied on the broad catch-all embodied in UCC Section 9-108(b)(6) that a description of collateral in a financing statement is sufficient if it reasonably identifies the described collateral "by any other method" as long as the identity of the collateral is "objectively determinable." The Seventh Circuit explained that the inclusion of the "any other method" catch-all for describing collateral in the current version of Section 9-108 made the collateral description requirement for a financing statement less stringent than the collateral description requirement under previous versions of UCC Article 9, where a financing statement had to "contain a statement indicating the types, or describing the items, of collateral." According to the Seventh Circuit, while the previous version of the UCC required a financing statement to "contain" a collateral description, the current version requires only that the financing statement "indicate" the collateral by pointing or directing attention to a description of that collateral. That includes a financing statement that describes collateral by directing attention to a description of the collateral in the parties' security agreement, even where the security agreement is not attached to the financing statement. The court found the collateral description in First Midwest's financing statement, which included all collateral referenced in the parties' unattached security agreement, to be sufficient where the security agreement referred to 26

independent categories of collateral, such as accounts, chattel paper, cash, equipment, goods, investments, instruments, inventory and all proceeds and products of such assets.

The Seventh Circuit reasoned that its interpretation is consistent with the widely accepted view of numerous courts (including the bankruptcy court in *First Midwest Bank v. Reinbold*) that the purpose of a financing statement is merely to put third parties on notice of a perfected security interest and that further inquiry into the extent of the security interest may be necessary. As the Seventh Circuit had elaborated, a financing statement itself is “an abbreviation of the security agreement” intended to be “a streamlined paper to be filed for the purpose of giving notice to third parties of the essential contents of the security agreement.” The security agreement’s role is to define and limit the collateral; the financing statement’s role is to merely give notice of the existence of the creditor’s security interest in such collateral. Against this backdrop, the Seventh Circuit concluded that First Midwest’s financing statement “notified subsequent creditors that a lien may exist in First Midwest’s favor and that further inquiry was necessary to disclose the complete state of affairs,” consistent with the plain and ordinary meaning—and purpose—of the UCC’s financing statement requirements.

Conclusion

The Seventh Circuit’s decision in *First Midwest Bank v. Reinbold* can largely be viewed as a win for secured creditors, as it ratifies a less stringent standard for adequately describing a secured creditor’s collateral in the context of determining the validity of UCC financing statements and perfecting a security interest. That said, creditors or other interested parties that may seek to challenge a secured creditor’s security interest (such as debtors and bankruptcy trustees) can take solace in the fact that not all courts may agree with the Seventh Circuit’s decision that a financing statement’s collateral description that merely references the collateral in an unattached separate document (such as a security agreement) constitutes sufficient identification of collateral in a financing statement to perfect a security interest.

For example, in a January 30, 2019 decision in *In re Financial Oversight and Management Board for Puerto Rico*, the United States Court of Appeals for the First Circuit questioned, in dicta, the viability of a financing statement that merely referenced the “Pledged Property described in the Security Agreement attached as Exhibit A” even though the term, “Pledged Property,” was not defined in the security agreement itself but rather in an ancillary agreement that was not attached to the financing statement. Interestingly, the Seventh Circuit did not discuss or distinguish the First Circuit’s viewpoint despite the fact that the Seventh Circuit’s decision came after the First Circuit’s opinion. It remains possible that the Seventh Circuit’s ruling in *First Midwest Bank v. Reinbold* may be revisited either if a request for rehearing is filed before the Seventh Circuit or the Trustee files a petition for a writ of certiorari with the United States Supreme Court.

In any event, a creditor seeking to perfect a security interest by referring to a description of collateral in a separate document, such as a security agreement, should avoid the potential pitfall illustrated by *First Midwest Bank v. Reinbold* and *In re Financial Oversight and Management Board for Puerto Rico* by simply including a summary description of the collateral in, and attaching the relevant security agreement or other document describing the collateral to, the applicable UCC financing statement. Otherwise, the creditor may find itself embroiled in expensive and time-consuming litigation that a trustee may commence to avoid the creditor’s security interest based on a failure to perfect the security interest, and ultimately risk losing its superior rights in its collateral. While financing statements and security agreements are both subject to the collateral description requirements set forth in UCC Section 9-108 (other than to the extent financing statements may use supergeneric descriptions pursuant to UCC Section 9-504), it is clear that courts may apply different analyses in determining whether such documents satisfy UCC Section 9-108’s requirements. Courts may be inclined to interpret UCC Section 9-108 more loosely when assessing collateral descriptions contained in financing agreements and

allow a description of collateral that refers to an unattached separate document in light of the limited purpose of financing statements—to merely provide notice of a security interest, not define it. But there is a risk that other courts could reject this looser collateral description requirement and avoid a creditor’s security interest as not perfected if the relevant financing statement’s collateral description merely refers to an unattached document. ■■■■■

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