



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 and liens in the same collateral is for the creditor to properly identify its collateral in both (i) the security agreement executed by its customer, and, just as importantly, (ii) the publicly filed Uniform Commercial Code (UCC) financing statement.

The recent 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 inconsistent descriptions of 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.

The recent holding of the United States Court of Appeals for the Sixth Circuit is a reminder of the unintended and harsh consequences of inconsistent descriptions of collateral in the security agreement and the UCC financing statement.

Although the Sixth Circuit was addressing a bank's claims, the holding is equally applicable to a trade creditor that is attempting to secure payment of its claim by obtaining a security interest in its customer's property. The most important lesson from the Sixth Circuit's decision is ensuring that the description of collateral in the security agreement and UCC financing statement are consistent. Performing a double and even triple check will minimize the risk of future costly and time-consuming litigation and the loss of secured status to a subsequent secured creditor or judgment creditor asserting a competing security interest and/or lien in



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the same collateral and a bankruptcy trustee seeking to avoid the creditor's unperfected security interest.

Requirements for Perfecting a Security Interest in Personal Property

A creditor seeking to obtain a security interest in personal property must satisfy several requirements included in Article 9 of the UCC. 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, that 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. As 1st Source Bank learned from the Sixth Circuit's decision, an inaccurate description of the collateral in 1st Source's UCC

financing statements was detrimental to its ability to recover on its security interest in all the collateral identified in the security agreement.

The Facts of the Sixth Circuit Case

In 2004, 1st Source sold or leased certain 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" (emphasis added). 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" (emphasis added). Significantly, 1st Source's financing statements, unlike the security agreements, did *not* include "accounts," "accounts receivable," or any other similar descriptive terms.

Thereafter, Wilson Bank & Trust, Pinnacle Bank, and Trans-Capital Leasing, Inc. (the defendants) 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."

In particular, the term "proceeds," as used in 1st Source's financing statements, could not be construed to include the debtors' accounts receivable.

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 debtors' accounts 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.

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."

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 UCC¹, 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's holding that "accounts receivable" cannot ever qualify as "proceeds" is disturbing and inappropriately broad.

The Sixth Circuit also focused on how the Tennessee UCC's drafters sought to limit the definition of the term "proceeds" by relying on 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 decision² 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 litigation 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. ▀

1. The term "proceeds" is defined in §47-9-102(a)(64) of the Tennessee UCC as:

- (A) whatever is acquired upon the sale, lease, license, exchange, or other disposition of collateral;
 - (B) whatever is collected on, or distributed on account of, collateral;
 - (C) rights arising out of collateral;
 - (D) to the extent of the value of collateral, claims arising out of the loss, nonconformity, or interference with the use of, defects or infringement of rights in, or damage to, the collateral; or
 - (E) to the extent of the value of collateral and to the extent payable to the debtor or the secured party, insurance payable by reason of the loss or nonconformity of, defects or infringement of rights in, or damage to, the collateral.
- (emphasis added).

2. Quoting the lower court's decision, the Sixth Circuit observed, "If fruits and products from the use of collateral were treated as proceeds, every creditor with a security interest in equipment would have a security interest in all items produced from the equipment. The Court will not extend the meaning of 'proceeds' to such an extent." (quotations omitted).

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