

The Practical Lender

Highlighting the practical effects of law on the finance business.

Spring–Summer 2001

SPECIAL REPORT

GETTING READY FOR REVISED ARTICLE 9 A PRACTICAL GUIDE

This issue focuses on significant changes made by Revised Article 9 of the Uniform Commercial Code including the modifications in procedures and documentation that secured lenders need to implement. Not all of the changes brought about by Revised Article 9 are addressed in this summary.

Getting Ready For Revised Article 9: A Practical Guide

INTRODUCTION

The effective date for Revised Article 9 of the Uniform Commercial Code is July 1, 2001 (the “Effective Date”). Virtually all lenders are now generally aware of the sweeping changes made by Revised Article 9. Over the next few weeks, lenders will need to modify their loan documents and procedures to address the changes made by Revised Article 9. Many of the required modifications should be made prior to the Effective Date. The first two parts of this bulletin highlight some of the modifications a lender should make to its loan documents and procedures to address Revised Article 9. The last part highlights certain “transition rules” of Revised Article 9 in addition to the implications for a lender’s existing transactions and security interests.

LOAN DOCUMENTS

Revised Article 9 modifies certain collateral descriptions and includes within its scope collateral which was outside the scope of Current Article 9. Revised Article 9 also changes the rules relating to perfection and priority, filing and enforcement. These changes necessitate changes to a lender’s form of security agreement and related documents, in addition to procedures and practices in use prior to the Effective Date.

Collateral Descriptions. Revised Article 9 changes the definitions of many of the collateral categories used in Current Article 9. These changes will result in some collateral being classified differently under Revised Article 9 than was the case under Current Article 9. For example, Revised Article 9 has broadened the definition of “accounts” to include certain rights to payment that currently fall within the definition of “general intangibles,” such as rights of payment for licensed intellectual property. The scope of Revised Article 9 has been broadened to include deposit accounts (except in consumer transactions), health care insurance receivables, commercial tort claims, non-possessory agricultural liens, supporting obligations, property securing rights to payment, certain security interests created by states and

governmental units of states, the sale of general intangibles and the sale of most payment intangibles and promissory notes. Lenders will need to modify their form of security agreement (and financing statement collateral descriptions) in use prior to the Effective Date to address these changes.

Terms describing collateral by reference to a term defined in Current Article 9 (e.g., accounts) in a security agreement entered into prior to the Effective Date, are interpreted after the Effective Date in accordance with the meanings provided by Current Article 9, unless it is clear from the security agreement that the parties otherwise intended. Therefore, to include the new and changed collateral terms which are defined in Revised Article 9, the security agreement must clearly state that the parties intend to incorporate the new and changed collateral terms of Revised Article 9. This can be accomplished by defining collateral terms by reference to the “UCC as presently in effect or hereafter in effect.”

Revised Article 9 provides that for non-consumer transactions, most collateral can be described by a term defined in Revised Article 9, such as “goods” and “general intangibles.” One exception is that a commercial tort claim must refer to a specific tort claim, although the claim need not be referred to by case number and court, which may not be known. Super-generic descriptions, such as “all of the debtor’s personal property” are not sufficient for purposes of the security agreement under Revised Article 9 (but may be sufficient for use in the financing statement).

Presently, most security agreements exclude from the collateral licenses and leases that prohibit the granting of a security interest therein. Under Revised Article 9, such carve-outs are unnecessary. Generally, Revised Article 9 renders ineffective any prohibition on the creation of the security interests which may be contained in a lease or license. However, Revised Article 9 also protects the third party lessor and licensor by restricting the secured party’s ability to enforce its security interest in the lease or license. The secured party’s ability to create a security interest in such collateral is nonetheless important in that the secured party’s security interest will attach to any proceeds of such collateral, such as proceeds of a bankruptcy sale of a license or lease.

Representations of Debtor. Representations in the security agreement should be drafted to require the debtor to disclose the information required for post-Effective Date financing statements and pre-Effective Date initial financing statements. In particular, the representations should require disclosure of debtor’s exact legal name, state of organization, type of organization and organization identification number. Under Revised Article 9, minor errors in the debtor’s name may render the filing ineffective where it may not have been ineffective under Current Article 9.

Security agreements in use prior to the Effective Date typically require the debtor to disclose to the secured creditor certain types of collateral in respect of which secured party may or must take additional perfection steps beyond filing, such as goods covered by certificate of title statutes, instruments and investment property. Revised Article 9 increases the collateral types for which there are perfection methods other than filing. Some of these changes are summarized in the following table:

REVISED ARTICLE 9 METHOD OF PERFECTION				
COLLATERAL	FILING	CONTROL	POSSESSION	OTHER
<i>Letter of Credit Rights</i>		X		
<i>Commercial Deposit Account</i>		X		
<i>Electronic Chattel Paper</i>	X	X		
<i>Investment Property</i>	X	X		
<i>Instruments</i>	X		X	
<i>Sale of Promissory Notes</i>			X	Automatic Perfection
<i>Certain Bailee Collateral Perfected by Notice</i>				Acknowledgment of Bailee

The identification of this type of collateral is not only important in connection with the proper perfection of the secured party’s security interest, but also in connection with new priority rules under Revised Article 9. For example, a

secured party that perfects its security interest in letter-of-credit rights or investment property only by filing will not have priority against a secured party *that later perfects* by control. Similarly, perfection by filing with respect to an instrument does not protect the secured party against another secured party that perfects by taking possession of the instrument, unless the second secured party knows that its transaction violates the rights of the first secured party. In anticipation of Revised Article 9, where alternative perfection methods exist, it is recommended that the secured party perfect by both methods.

Covenants of Debtor. In order to protect the secured party's perfected status, the covenants in the security agreement should prohibit a change in the debtor's state of organization and organization type and, without sufficient prior written notice to the secured party, the exact legal name of the debtor. The covenants should require the debtor to notify the secured party upon debtor's acquisition of collateral that may or must be perfected by control, possession or other method other than filing, including the collateral summarized in the above table. The secured party should further require the debtor to take any actions necessary to deliver control, possession or take other steps necessary to perfect the secured party's security interest in such collateral. The security agreement should require the debtor to identify any commercial tort claims now existing or hereafter arising, and to take any actions, including an amendment to the security agreement, which are necessary to grant the secured party a security interest in commercial tort claims. Revised Article 9 provides that an "after-acquired property" clause will not include a commercial tort claim as after-acquired property. Accordingly, an amendment to the security agreement may be required to grant the secured party a security interest in a commercial tort claim arising after the date of the security agreement.

Financing Statement Authorization. A security agreement entered into before the Effective Date should contain a specific provision authorizing the secured party to file financing statements under Revised Article 9. After the Effective Date, such a provision is not necessary because the debtor's authentication of the security agreement itself will be sufficient authorization for the secured

party to file a financing statement covering the collateral under the security agreement. The security agreement will not constitute an authorization for an amendment to a financing statement that adds collateral or that adds a debtor to the financing statement. If the secured party desires to pre-file financing statements under Revised Article 9, the secured party will need the debtor's authorization prior to filing.

Enforcement-Related Provisions. Revised Article 9 clarifies and changes certain of the enforcement provisions of Current Article 9. A secured party should modify its security agreement for post-Effective Date transactions to address such changes to the enforcement provisions. For example, Revised Article 9 expands the provisions of Current Article 9, which permitted the secured party to enforce a debtor's claims against account debtors and obligors on instruments, to also include enforcement of a debtor's claims generally against all persons obligated with respect to the collateral. For example, under Revised Article 9, a secured party may enforce a breach of warranty claim arising out of a defect in equipment that serves as collateral. Revised Article 9 also makes significant changes with respect to foreclosure sales and strict foreclosures, which may require the secured party to modify its security agreement and its foreclosure procedures.

FINANCING STATEMENTS

Revised Article 9 changes greatly the procedures governing financing statements including, with respect to information required by the financing statement, the description of collateral, debtor's signature and the place of filing. These changes will require the lender to modify its financing statement practices.

Information Required by Financing Statement. Revised Article 9 requires a financing statement to provide the debtor's name and mailing address, the secured party's name and an indication of the collateral. In addition, Revised Article 9 requires that an initial financing statement and certain amendments indicate whether the debtor is an individual or an organization and, if the

debtor is an organization, provide the type of organization, the jurisdiction of organization and an organizational identification number for the debtor (or indicate that the debtor has none). As noted, the secured party must take care to use the debtor's correct name in the financing statement. If a search of the record in the filing jurisdiction under the debtor's correct name would not reveal the secured party's financing statement, the financing statement will be deemed to be seriously misleading and therefore ineffective.

The secured party should require the debtor to provide the information necessary for filing financing statements under Revised Article 9 as early in the loan transaction as possible. Debtors that are registered organizations, such as corporations, limited partnerships and limited liability companies, should provide the secured party with recently certified copies of the certificate of incorporation, certificate of limited partnership or certificate of formation. These certificates will provide the type of organization, the jurisdiction of organization, the organizational identification number for the debtor (if any), and the exact name of debtor. With respect to individuals, the secured party should obtain a birth certificate, social security card or driver's license to assure itself that it has the individual's correct name.

Collateral Description. With certain exceptions, Revised Article 9 allows collateral in a financing statement to be described by type of collateral (e.g., accounts) or, where appropriate, by an indication that the financing statement covers all assets or all personal property. Super-generic descriptions should not be used in financing statements prior to the Effective Date (or in the security agreement). Financing statements filed before the Effective Date should be drafted to take into account the changes (e.g., accounts and general intangibles) and additions (e.g., commercial deposit accounts and commercial tort claims) to collateral types discussed above.

Debtor's Signature. Revised Article 9 does *not* require the debtor to sign the financing statement (except in instances where pre-filing is required). This change was made to facilitate paperless filing. However, until the Effective Date, the secured party will need to include Debtor's signature on financing statements.

Place of Filing. Revised Article 9 changes the choice-of-law rules governing perfection (*i.e.*, where to file) for most collateral to the law of the *jurisdiction where the debtor is located*. Revised Article 9 provides that a registered organization which is organized under the laws of a state (such as a corporation, limited liability company and limited partnership) is located in its state of organization. An organization which is not registered (such as a general partnership) which has its place of business or, if it has more than one place of business, its chief executive office, in the United States, is located in its place of business or chief executive office, as applicable. An individual that has his or her principal residence inside the United States is located at his or her principal residence. Revised Article 9 provides similar rules for identifying the location of foreign organizations and individuals, organizations registered under federal law and certain other special entities.

These changes have the potential to greatly simplify filing procedures. Consider, for example, a debtor which is a Delaware corporation with inventory located in twenty states. Prior to the Effective Date, a secured party desiring to perfect a security interest in the inventory would need to file a financing statement covering inventory in each of the twenty states. However, after the Effective Date, a secured party would only have to file one financing statement in Delaware.

In Lieu Financing Statement. For transactions prior to the Effective Date, the secured party should file the financing statement required by Current Article 9 and, if the application of Revised Article 9 would result in filing in a different jurisdiction or office, the secured party should consider filing now an “in lieu” financing statement under the provisions of Revised Article 9. An “in lieu” financing statement is essentially an initial financing statement containing certain additional information required by Revised Article 9, filed in the office specified by Revised Article 9 for the filing of an initial financing statement (which is different from the office required by Current Article 9). In particular, an in-lieu financing statement must (i) satisfy the requirements for the filing of a financing statement under Revised Article 9 discussed above, and (ii) identify the pre-Effective Date financing statement by indicating the office in which the financing statement was filed, providing the

dates of filing and file numbers, if any, of the financing statement and of the most recent continuing statement filed with respect to the financing statement, and indicate that the pre-effective date financing statement remains effective.

If, prior to the Effective Date, the secured party does not file an in lieu financing statement, but instead files a regular initial financing statement in the office required by Revised Article 9 (which is different from the office required by Current Article 9), the priority achieved by the initial financing statement will only run from the Effective Date, not the date of the filing of the pre-Effective Date financing statement. An in lieu financing statement allows the secured party to continue the effectiveness of a pre-Effective Date financing statement *from the date of the filing of such original financing statement*.

TRANSITION RULES: IMPLICATIONS FOR AMENDMENTS

The transition rules in Revised Article 9 provide guidance as to what actions the secured party will be required to take with respect to *existing transactions* to remain perfected through the transition from Current Article 9 to Revised Article 9. For the most part, the transition rules are designed to preserve what the debtor and secured party have done. Nonetheless, the secured party should take certain actions in light of the transition rules.

Transactions Prior to Effective Date. Generally, unless otherwise provided in the transition rules, Revised Article 9 applies on and after the Effective Date to all transactions within its scope, *including transactions entered into prior to the Effective Date*. One exception to the general rule applies to transactions and liens existing prior to the Effective Date which are not governed by Current Article 9, but that fall within the scope of Revised Article 9 (*e.g.*, commercial tort claims, agricultural liens, commercial deposit accounts and health care receivables). Revised Article 9 provides that such transactions and liens may be enforced as required or permitted by Revised Article 9 or the law that would otherwise apply if Revised Article 9 had not taken effect. However, as discussed in the next section, “perfection” of such liens may only last for one

year after the Effective Date (*i.e.*, until June 30, 2002), unless the secured party takes action to perfect the liens under the new rules of Revised Article 9.

Security Interest Perfected Prior to Effective Date. A security interest that is enforceable and perfected under Current Article 9 or other law, and for which the requirements under Revised Article 9 for enforceability and perfection are met on the Effective Date, remains enforceable and perfected under Revised Article 9. However, except for a security interest that is perfected by filing under Current Article 9, a security interest that is *enforceable* and *perfected* under Current Article 9 or other law, but that would *not* meet Revised Article 9's requirements for enforceability or perfection on the Effective Date, retains its perfected status *for one year only* after the Effective Date. The security interest will remain continuously perfected under Revised Article 9 if the secured party meets the requirements for enforceability and perfection within the one-year period. For example, a secured party may perfect a security interest in instruments under Current Article 9 by possession in the form of a bailee's receipt of written notification of the secured party's interest. However, under Revised Article 9, the secured party is required to obtain the bailee's *acknowledgment* that it holds possession of the instruments for the secured party's benefit in order to perfect its security interest. As a result, the secured party's security interest would remain perfected for one year only after the Effective Date, unless the secured party obtains the required acknowledgment from the bailee.

Enforceable, Unperfected Security Interest Prior to Effective Date. A similar rule applies to a security interest which is *enforceable* but *unperfected* under Current Article 9 or other law prior to the Effective Date, and does not meet Revised Article 9's requirements for enforceability: it remains enforceable for *one year after* the Effective Date. The security interest remains enforceable after the one-year period only if the secured party takes the requisite steps within the one-year period for enforceability under Revised Article 9. A security interest which is enforceable but unperfected under Current Article 9 or other law prior to the Effective Date, becomes perfected under Revised Article 9 on the Effective Date if the secured party took appropriate steps to perfect under Revised Article 9 prior to the Effective Date or when the secured

party takes appropriate perfection steps under Revised Article 9 after the Effective Date. For example, if a security interest in collateral has attached prior to the Effective Date but is unperfected under Current Article 9 because the financing statement describes the collateral as “all personal property,” the security interest becomes perfected on the Effective Date, assuming that the financing statement is filed in the proper office under Revised Article 9, because the financing statement meets the requirements of Revised Article 9 only.

Effectiveness of Action Taken Before Effective Date. A security interest is perfected after the Effective Date and remains perfected for *one year* after the Effective Date if the secured party has taken the steps necessary to perfect (other than filing a financing statement) under Current Article 9 as of the Effective Date and the security interest attaches after the Effective Date. The perfection will continue after the one-year period only if the secured party before or within one year after the Effective Date takes the steps necessary to perfect under Revised Article 9. For example, if a secured party has a security interest in goods perfected solely by notice to the bailee and the bailee acquires additional goods of the debtor after the Effective Date, then the security interest will be perfected in the goods acquired after the Effective Date until one year after the Effective Date and, if the secured party obtains the bailee’s acknowledgment within the one-year period, then it will remain perfected thereafter.

The foregoing transition rules require that certain actions be taken by the secured party. The secured party should consider amending now its existing form of security agreement and financing statements to include collateral that was outside the scope of Current Article 9, but within the scope of Revised Article 9 where such collateral is relevant and material. The “enforceability” and “perfection” of a security interest in collateral that was previously outside the scope of Current Article 9 is determined under non-uniform local law, making the determination of enforceability and perfection less certain. Revised Article 9 was expanded in scope to bring greater certainty to transactions dealing with collateral or transactions previously outside the scope of Revised Article 9 (e.g., deposit accounts). The secured party can

achieve increased certainty with respect to such collateral and transactions by including them in its form of security agreement. The secured party should also determine whether collateral perfected other than by filing under Current Article 9 meets the requirements for enforceability and perfection under Revised Article 9. If not, the secured party must take any additional steps required within one year of the Effective Date.

Perfection by Filing. The filing of a financing statement prior to the Effective Date is effective to perfect the security interest after the Effective Date to the extent the financing statement would be effective under Revised Article 9. This is true even if the filing of the financing statement would not have been effective under Current Article 9 to perfect the security interest. For example, debtor, a Delaware corporation with its place of business in Illinois, grants to secured party, prior to the Effective Date, a security interest in accounts. Secured party files a financing statement covering the collateral in Delaware, but not in Illinois. Secured party's security interest in the collateral becomes perfected on the Effective Date.

A financing statement which is effective under Current Article 9 to perfect the security interest, but that was filed in an office or jurisdiction that would not meet the requirements of Revised Article 9, remains effective under Revised Article 9 to perfect a security interest in collateral acquired before the Effective Date until the *earlier* of (i) the normal lapse date of the initial financing statement, and (ii) June 30, 2006. For example, consider the same facts as set forth in the immediately preceding example, except that secured party files a financing statement covering the collateral in the appropriate office in Illinois. The security interest in collateral remains perfected until the earlier of the lapse date or June 30, 2006, even though the financing statement was not filed in the office specified by Revised Article 9 (*i.e.*, Delaware). Accordingly, from the Effective Date until June 30, 2006, a secured party should perform security interest searches in all relevant jurisdictions under Current Article 9 and Revised Article 9.

Continuation Financing Statements. A secured party may file a continuation financing statement (other than an in lieu financing statement) under Revised

Article 9 to continue the effectiveness of a financing statement filed under Current Article 9 only if (i) the continuation financing statement is filed in the same jurisdiction and office where the financing statement was filed, (ii) the jurisdiction and office are the correct jurisdiction and office for filing an initial financing statement under Revised Article 9, and (iii) the continuation financing statement brings the initial financing statement into compliance with Revised Article 9. If, however, Revised Article 9 indicates a different office or jurisdiction for filing an initial financing statement, the financing statement filed before the Effective Date may only be continued with the use of an in lieu financing statement.

In some cases, as discussed above, Revised Article 9 may reclassify collateral covered by a financing statement filed under Current Article 9. Any continuation financing statement or in lieu financing statement must reflect the change in meaning of the collateral description. For example, a pre-Effective Date financing statement filed covering all general intangibles would include a right to payment for property that has been licensed. However, under Revised Article 9, that collateral would be classified as an account. Any continuation financing statement or in lieu financing statement would need to amend the collateral indication to include accounts or the right to payment for property that has been licensed in order to continue the effectiveness of the financing statement.

CONCLUSION

The sweeping changes made by Revised Article 9 require lenders to review and modify their loan documents and procedures even prior to the effectiveness of Revised Article 9. While the transition rules are intended to preserve existing filings for a limited time period, the transition rules require a lender to carefully evaluate its existing transactions now to determine what actions must be taken and when they must be taken to remain perfected during and after the transition period.

The *Practical Lender* is published by the law firm of Vedder, Price, Kaufman & Kammholz. It is intended to keep our clients and interested parties generally informed on developments in the commercial finance industry. It is not a substitute for professional advice.

© 2001 Vedder, Price, Kaufman & Kammholz. Reproduction of this bulletin is permitted only with credit to Vedder, Price, Kaufman & Kammholz. For an electronic copy of this newsletter, please contact Mary Pennington, Marketing Coordinator, at her e-mail address: mpennington@vedderprice.com

If you have any questions regarding material in this issue of *The Practical Lender* or suggestions for a specific topic you would like addressed in a future issue, please contact the executive editor and group leader, Michael A. Nemeroff.

Authors: Paul R. Hoffman and Thomas E. Schnur
Executive Editor: Michael A. Nemeroff

VEDDER, PRICE, KAUFMAN & KAMMHOLZ

About Vedder Price

Vedder, Price, Kaufman & Kammholz is a national, full-service law firm with approximately 200 attorneys in Chicago, New York and New Jersey.

The Finance and Transactions Group

The Finance and Transactions Group of Vedder Price actively represents publicly held and private corporations, financiers, leveraged buy-out firms, private equity funds, venture capitalists, lenders, and related parties in a broad range of matters, including mergers and acquisitions; equity and debt financing; mezzanine financing; venture capital; private equity investments; and related transactions.

Chicago

Vedder, Price, Kaufman & Kammholz
222 North LaSalle Street
Chicago, Illinois 60601
312/609-7500
Fax: 312/609-5005

New York

Vedder, Price, Kaufman & Kammholz
805 Third Avenue
New York, New York 10022
212/407-7700
Fax: 212/407-7799

New Jersey

Vedder, Price, Kaufman & Kammholz
354 Eisenhower Parkway, Plaza II
Livingston, New Jersey 07039
973/597-1100
Fax: 973/597-9607

www.vedderprice.com

Principal Members of the Finance and Transactions Group:

Chicago:

Michael A. Nemeroff
Robert J. Stucker
Thomas P. Desmond
John T. McEnroe
Daniel O'Rourke
Jonathan H. Bogaard
Michael G. Beemer
John R. Obiala
Jennifer R. Evans
Robert J. Moran
Dalius F. Vasys
Guy E. Snyder
Daniel T. Sherlock
Douglas J. Lipke
Douglas M. Hambleton
Dean N. Gerber
Gregory G. Wrobel
Richard L. Williams, III
Thomas E. Schnur
Steven J. Gray
Timothy W. O'Donnell
Lane R. Moyer
Jeffrey C. Davis
Geoffrey R. Kass
William J. Bettman
Paul R. Hoffman

Dana S. Armagno
Matthew T. O'Connor
George W. Hoffman
Maxwell N. Barnes
Eric S. Prezant
Allison Gross
David P. Kaminski
Adam S. Lewis
Jennifer Durham King
Elizabeth L. Clark
Donal M. O'Brien
Megan E. Groves
Michael J. Elm
James W. Morrissey
Meeghan O'Donnell
Leslie Allen

New York & New Jersey:

Ronald Scheinberg
Donald A. Wassall
Denise L. Blau
Barry J. Bendes*
Van Z. Krikorian
Kathleen R. White

*Admitted in NY and NJ

VEDDERPRICE

Chicago • New York • New Jersey

www.vedderprice.com