

PUBLICATION

Attachment: Your Security Interest isn't "Perfect" Without it

May 1, 2011

It is sometimes surprising how little attention is given to the concept of "attachment" set forth in the Uniform Commercial Code (the "UCC"), especially in the context of the role it plays as a necessary element of achieving a perfected security interest.

It is not at all uncommon for a practitioner who is asked for guidance about perfecting a security interest to jump straight into a long diatribe about how and where to file a UCC-1 Financing Statement; how to describe the collateral on such statements; how to perfect by possession or control; and various other intricacies of perfection.

The process of "perfecting" a security interest is what provides a lender, lessor or other person who has been granted a security interest (each, a "Secured Party") with rights in the collateral which are superior to certain other creditors. The short version is that a "perfected" security interest prevails over any other creditor who uses judicial process to obtain a lien on collateral. Since a trustee in bankruptcy is given the status of a lien creditor under §544(a) of the bankruptcy code, a perfected security interest will "beat" a bankruptcy trustee whose job it is to free up collateral for the unsecured parties.

Depending upon the method and timing of perfection, a perfected security party may also have a "priority" position over one or more other creditors. The Secured Party with the best priority position has a "first priority" security interest. Other creditors can stand in line in order of priority such as a second priority, third priority, fourth priority interest, etc.

However, before a security interest can be "perfected" in such a manner that provides priority against other creditors, it must first be enforceable against the actual debtor/borrower/lessee that is granting the security interest (each of which is referred to for convenience in this edition of Dispatches as, a "Debtor").^[1] This concept is often referred to as "attachment" under Article 9. Attachment is essentially the moment when a security interest becomes enforceable against a Debtor. For a security interest to attach, the following events must have occurred: (A) value must have been given by the Secured Party; (B) the Debtor must have rights in the collateral; and (C) the Secured Party must have been granted a security interest in the collateral.

A. Value.

Under the UCC, a person gives value for rights if the person acquires them: "(a) in return for a binding commitment to extend credit or for the extension of immediately available credit, whether or not drawn upon and whether or not a charge-back is provided for in the event of difficulties in collection; (b) as security for, or in total or partial satisfaction of, a preexisting claim; (c) by accepting delivery under a preexisting contract for purchase; or (d) in return for any consideration sufficient to support a simple contract."^[2]

For most lenders, value is therefore given when the lender has loaned money to the Debtor, made a binding commitment to loan money or issued a letter of credit or other form of credit enhancement for the benefit of the Debtor. In the event a dealer of Goods sells them on deferred payment terms (for example where payment is due over time under a conditional sales contract), that transaction serves as a sufficient extension of credit to constitute "value."^[3]

In typical equipment leasing documents, value has been given when the lessor pays the vendor for the equipment or has a binding obligation to do so.

B. Debtor has Rights in Collateral.

In order for a security interest to attach to collateral, a Debtor must have rights in the collateral. It is worth noting that the Debtor's rights do not have to be clear title. For example, the Debtor can have a leasehold interest in certain property and a Secured Party could have a security interest in those leasehold rights. At the end of the day, however, the Debtor must have some interest in the property in order for it to be collateral in which a security interest granted to the Secured Party. Equipment leasing and finance companies have historically been more thorough in their efforts to trace title from a vendor to the Debtor than traditional lenders (in part because of the reliance by some equipment leasing and finance companies on the priority afforded a purchase money security interest in goods).

C. Grant of a Security Interest.

The Debtor must grant a security interest to the Secured Party. For lenders, the grant of a security interest is usually contained in a security agreement or other document and frequently takes the form of an express grant—for example, the Debtor hereby grants and conveys to the Secured Party a security interest in the following collateral....However, the grant of the security interest could come in a couple other ways such as the Debtor voluntarily granting possession of the collateral to the Secured Party or the Secured Party having “control” of the collateral to the extent it is investment property, a deposit account or a letter of credit right.^[4] Generally speaking, most lenders/lessors should always be relying on an executed security agreement.

In equipment lease forms that serve double duty as true leases and leases-intended as security (depending on the nature of the purchase option granted and other structural aspects of the particular transaction), the grant of a security interest is sometimes conditional. For example, the applicable provision may generally state that if, notwithstanding the intent of the parties, the lease is deemed to evidence a loan rather than a true lease, lessee shall be deemed to have granted to lessor as security for lessee's obligations to lessor, a first priority security interest in the leased equipment and all proceeds thereof. Some lease forms are missing this conditional grant of a security interest. Lessors under those forms “hang their hat” on language in UCC §1-203 which governs when “a transaction in the form of a lease **creates** a lease or security interest.” The idea is that a document described as a lease may actually **create** a security interest rather than a leasehold interest. Cautious lawyers prefer to have an express grant of a security interest but it certainly seems like an uphill argument for a lessee or other creditor to argue that a security interest has not attached to leased equipment that a judge has determined creates a security interest rather than a lease under UCC §1-203.

In order to modernize the UCC and allow for electronic transactions, many of the UCC provisions are “medium neutral” and allow for “authentication” of a “record” rather than a “signing” of a “writing”. Authentication includes not only a normal signature but also an electronic transmission made under procedures which show an intention of the Debtor to be bound by the transaction (clicking a box on the internet when borrowing money on-line for example).

It should be noted that UCC financing statements filed now generally do not contain a grant of the security interest and generally are not signed or otherwise authenticated by the Debtor and therefore would not satisfy the requirement of a security agreement.

Article 9 requires that the security agreement “reasonably identify the collateral” and outlines several methods for doing so, including (1) a specific listing; (2) category of collateral; (3) a type of collateral defined in the

Uniform Commercial Code; (4) quantity; (5) computational or allocational formula or procedure; or (6) any other method, if the identity of the collateral is *objectively determinable*.^[5]

It is good and common practice to designate a type of collateral as defined in the UCC, such as "accounts", "equipment", "inventory", and so forth. It is also useful and common to attach additional details as to the collateral if specific lists are available. It should be noted that a "serial number test" has been expressly rejected in the most recent version of Article 9 effective as of 2001.^[6]

Although super generic descriptions are allowed in financing statements, more detail is necessary for the actual grant of a security interest between the Debtor and the Secured Party before attachment can occur. In particular, Article 9 expressly provides that "[a supergeneric] of collateral [such] as 'all the Debtor's assets' or 'all the Debtor's personal property' or...words of similar import does not reasonably identify the collateral [for purposes of attachment]".^[7] In addition, more detail is needed for commercial tort claims or certain collateral involved in consumer transactions.^[8]

When reviewing financing statements for sale-leaseback transactions, refinancings or other transactions involving used equipment, searchers should be mindful of the sixth description methodology set forth above. It is very broad and would allow reference to external documents that are not part of the UCC filing. For example, if a Secured Party filed a UCC Financing statement which were to generally cover "all goods and personal property described on [specific purchase orders]" and those purchase orders were in a file and could be verified, then such method allows the collateral to be "objectively determined." The options under this approach are endless, although Secured Parties generally prefer to describe the collateral with more specificity so as to better place other creditors on notice.

D. Conclusion

None of the aforementioned rules or concepts are particularly complex and the attachment provisions in Article 9 are generally described in a few short sections.^[9] The key point of this edition of Dispatches from the Trenches is to provide a friendly reminder that attachment is a cornerstone to a perfected security interest and that it is worthwhile to consider the requisite steps to attachment and their timing. For example, those relying on purchase money security interests in inventory must have a perfected security interest at the time the Debtor receives possession of the goods. As such, equipment lease forms (which often commence on the date the lessee "accepts" the goods as evidenced by the execution of a Certificate of Acceptance), need to be carefully worded so that the grant of the security interest occurs prior to acceptance in the event goods are not accepted before or simultaneously with delivery.

[1] UCC §9-308(a): "[A] security interest is perfected **if it has attached** and all of the applicable requirements for perfection in...have been satisfied." (emphasis added)

[2] See U.C.C. §1-204.

[3] U.C.C. §9-103(a).

[4] U.C.C. §9-203(b).

[5] U.C.C. §9-108.

[6] See U.C.C. §9-108, Official Cmt. 2 (explaining that (i) description of collateral is required for evidentiary purposes; (ii) description will be sufficient if it identifies collateral described; and (iii) "serial number" test is unnecessary).

[7] U.C.C. §9-108(c).

[8] A Consumer Transaction "a transaction in which (i) an individual incurs an obligation primarily for personal, family, or household purposes, (ii) a security interest secures the obligation, and (iii) the collateral is held or acquired primarily for personal, family, or household purposes. The term includes consumer-goods transactions." U.C.C. §9-102(a)(26).

[9] See U.C.C. §§9-203 through 9-206.