SECURED TRANSACTIONS: PRACTICAL TIPS FOR UTILIZING UCC ARTICLE 9

By Lisa D. Love, Esq., Richardo I. Kilpatrick, Esq., and Shanna Kaminski, Esq.

In the United States, secured transactions are a vital component of business and our economy. By formalizing the process by which debtors grant lenders security interests in property and other assets, the law of secured transactions provides lenders with legal remedies in case of a default by debtors and prioritizes the competing claims of parties in the same assets. The existence of such remedies promotes the availability of capital to business and the terms and conditions of such capital, directly impacting the economic stability and continued development of our country.

This CLE will review the basic principles of obtaining a security interest in collateral, including attachment and perfection (filing and non-filing methods), and establishing (and maintaining) a secured party's priority in the collateral. We will also review obtaining a security interest in common forms of collateral, as well as how to perfect a security interest in some special forms of collateral. In addition, our expert panel of UCC practitioners will cover the impact of bankruptcy on secured transactions. Throughout the course, we will provide practical tips for utilizing UCC Article 9 in your practice. This article covers only key perfection and priority issues affecting commercial transactions and presents the subject matter in an overview format rather than an in-depth analysis. This article is not intended as a substitute for specific legal advice for any specific transaction.

IMPORTANCE AND APPLICATION OF UNIFORM COMMERCIAL CODE ARTICLE 9

Article 9 of the Uniform Commercial Code governs the creation, perfection and priority of security interests in certain personal property and fixtures and applies to "a transaction, regardless of its form, that creates a security interest in personal property or fixtures by contract." UCC §9-102(a)(20)(D), UCC §9-109(a)(1). The functional test created by the "regardless of its form" language makes Article 9 applicable to so-called "dirty leases,", which are transactions in the form of a lease but which in substance constitute a purchase money security interest transaction (i.e. conditional sale where lessee has option to own the goods for no or nominal additional consideration). Article 9 also includes (i) retention of title transactions where the seller of goods retains title in the goods shipped or delivered to a buyer (§9-109(a)(5), §9-110 and §9-202), (ii) true assignments where goods are delivered to a

merchant for the purpose of sale and the "consignments intended as security" (See Official Comment ("OC") 14 to §9-102, §9-109(a)(1), OC 6 to §9-109, OC 4 to §9-505) and (iii) sales of payment rights (UCC §9-109(a)(3)), including accounts, chattel paper, payment intangibles and promissory notes. Article 9 excludes government debtors in some states (UCC §9-109(c)(2)) and consumer deposit accounts (UCC §9-109(d)(13)).

Although the use of the word "uniform" suggests that the UCC is identical throughout the United States, it is not uniform but has state variations. In addition, despite its breadth of its coverage, the UCC does not apply to the extent that a statute, regulation or treaty of the United States preempts the UCC or to the extent that another state statute expressly governs the perfection, priority or enforcement of a security interest in the specified collateral.

Attachment

The first step in the perfection of a lien is to cause "attachment" of the collateral to occur, which will thereafter allow the secured party to "perfect" its security interest in the collateral. For a security interest to attach to the collateral, (a) value must be given, (b) the debtor must have rights in the collateral, and (c) a security agreement must be entered into which has been authenticated by the debtor, describes the collateral, and describes the land if the collateral includes timber to be cut.

Value in the context of Article 9 is broader than the contractual concept of "consideration." Value includes any consideration sufficient to support a simple contract, a security interest in total, or partial satisfaction of a pre-existing debt and commitments to extend credit. Value also includes value given to a third party when the security interest is granted by a guarantor. For purposes of Article 9, the debtor need not own the collateral to have *rights in the collateral*. It is sufficient if the debtor has some limited rights in the collateral or power to transfer the collateral. UCC §9-203(b)(2). The security interest would then only attach to the limited rights the debtor has or has power to transfer. To the extent that there are limitations on the transferability of the collateral (e.g. operating agreements limiting transfer of limited liability interests), such limitations are generally overridden in full for rights to payment UCC §9-406(d) and (f).

No particular form of *Security Agreement* is required for a security agreement. It may be contained in a promissory note, deed of trust, or loan agreement. It must, however, contain language granting a security interest. While there is no magic language, a grant of a security interest should be evidenced from the words. The security agreement must also contain a description of the collateral to be secured. Under UCC §9-108 and UCC §9-110, the description of the collateral in the security agreement does not have to be exact and detailed, but must reasonably identify the collateral that is subject to the security interest. It is sufficient if the security agreement lists the collateral by category, such as "all equipment, inventory and accounts."

Proceeds

In Article 9 terminology, proceeds means, among other things, any property acquired upon the sale, lease, exchange or other disposition of collateral that is subject to a security interest, anything collected or distributed on account of the collateral, and the insurance proceeds upon the loss or destruction of the collateral up to the value of the collateral. §9-102(a)(64). There is no need to put a statement in the security agreement providing for a security interest in the proceeds of collateral. The attachment of a security interest in collateral automatically gives a secured party rights to the identifiable proceeds. §9-203(f).

After- Acquired Property

After–acquired property is property in which the debtor had no rights in at the time of the secured transaction, but in which it subsequently acquires rights. In order for a security interest to attach to after-acquired property, there must be an affirmative statement in the security agreement creating or providing for a security interest in after-acquired property. It is sufficient to insert the phrase “now owned or hereafter acquired” in the description of collateral in the security agreement. §9-204(a). After-acquired security interests are not permitted in commercial tort claims and consumer goods, unless acquired within ten days after the secured party gives value (§9-204(b)).

Future Advances

A security interest in collateral may also secure future obligations owed by the debtor to the secured party. Those future obligations or advances do not need to be made pursuant to a commitment or even be contemplated at the time the security agreement was entered into. §9-204(c). All that is required is a statement in the security agreement whereby the debtor grants the security interest to secure future advances. The language should be broad enough that the agreement grants the security interest to secure any and every other obligation of any kind ever owed by the debtor to the secured party.

Perfection

An unperfected security interest is subordinated to a lien creditor, a bankruptcy trustee and a debtor in possession. A security interest becomes perfected when it has attached and all applicable steps for perfection for the particular collateral in question have been taken. Perfection establishes rights against third parties. There are four basic methods of perfecting an attached security interest under Article 9:

1. filing a financing statement in a public office §9-310(a));
2. taking possession of the collateral (§9-313(a));
3. obtaining control of the collateral §9-314(a)); and
4. accomplishing attachment alone – automatic perfection §9-3090.

Perfection by Filing

A security interest in many types of collateral may be perfected by filing a properly completed financing statement in the appropriate UCC filing office. Except for security interests arising out of certain sales of accounts and payment intangibles under UCC §9-310(a), the filing of a financing statement is the *only* method of perfecting a security interest in accounts and general intangibles including commercial tort claim intangibles because these types of collateral have no physical presence that enables perfection by possession. The filing of a financing statement is an alternative method of perfecting a security interest in various types of collateral, including chattel paper, negotiable documents, instruments, investment property and goods. Security interests in these types of collateral also may be perfected by control or possession. A security interest in these types of collateral, which if perfected by filing, is subordinate to a security interest perfected by control or possession, which method of perfection achieves higher priority. The filing of a financing statement is not sufficient to perfect a security interest in money, deposit accounts, letter of credit rights and where otherwise made insufficient by federal or state law.

The proper place to file a UCC financing statement filing is determined generally by the debtor's location, regardless of the type of collateral §9-301(1). The location of an entity created by a filing with a state (e.g., corporation, limited liability company and limited partnerships) is the state where the filing is made. §9-307(e). The location of an entity other than a registered organization (e.g. a general partnership) is the location of its place of business, or if it has multiple places of business, then the location is its chief executive office. If the debtor is an individual, his or her location is his or her principal residence. §9-307(b).

The rules regarding the debtor's location are subject to a number of qualifications. One such qualification states that the location rules apply only for debtors whose "residence, place of business, or chief executive office … is located in a jurisdiction whose law generally requires information concerning the existence of a non-possessory security interest to be made generally available in a filing, recording or registration system as a condition or result of the security interest's obtaining priority over the rights of a lien creditor." §9-307(c). In other words, the rules in §9-307(c) for determining a debtor's location do not apply when the debtor's residence, place of business, or chief executive office is located in a jurisdiction that has not adopted Article 9 or some similar statute. In such case, this section, which is intended generally for non-U.S. debtors, provides that the debtor is located in the District of Columbia. The United States is also deemed to be located in the District of Columbia.

In addition, UCC §9-307(f) specifies the location of a registered organization that is organized under the law of the United States, e.g. a federally chartered banking association. Deference is given to federal law to the extent that it determines, or allows the debtor to determine, the debtor's location. Otherwise, the debtor's location is deemed to be the District of Columbia.

Perfection by Possession

Perfection by possession applies only to tangible collateral. A secured party may perfect a security interest by taking possession itself or through a third party. Possessory security interests are the oldest form of security interests in personal property. As commerce has expanded, however, possessory security interests are increasingly less common. Article 9 does not define "possession." However, it is intended that the establishment of physical control of the tangible asset by the secured party or the secured party's agent is required. To determine whether the secured party has possession, the rules of agency apply. OC 3, §9-313. If the collateral is in the possession of someone who is clearly the secured party's agent, then it is deemed to be in the possession of the secured party.

A security interest in money *may only* be perfected by its possession. §9-312(b)(3) A security interest in instruments may be perfected by filing or possession. Priority as between a secured party having possession and the secured party having a filing goes to the secured party having possession. A secured party's possession of a security certificate, without any necessary endorsement, constitutes perfection. A security interest in tangible chattel paper is perfected by possession. Electronic chattel paper may not be perfected by possession; rather, it may be perfected by control or filing. For goods that are in the possession of a bailee, see §9-313(c).

Perfection by Control

"Control" means asserting an interest in collateral held by a third party through an agreement. Article 9 permits perfection of a security interest by control for investment property, deposit accounts, electronic chattel paper and letter-of-credit rights. Filing is not even an optional method of perfection for deposit accounts (except as proceeds) or letter-of-credit rights (except as proceeds or supporting obligations), which may be perfected only by control.

Deposit Accounts

The only way to perfect a security interest in a deposit account is by obtaining control of the deposit account (except as proceeds). The filing of a financing statement does not work. A secured party has control of a deposit account if it is the depository bank, or if the deposit account in the depository bank is in the secured party's name. A secured party also has control if the depository bank agrees with the secured party that the depository bank will comply with the instructions from the secured party concerning the deposit account without the further consent of the debtor. See UCC §9-104(a). The debtor's continued right to access the deposit account is not inconsistent with the secured party's control. §9-104(b). Both the secured party and the debtor may have access to the account. The security interest remains perfected only while the secured party retains control. §9-314(b).

Investment Property

"Investment property" is a catchall-term to include certificated securities, uncertificated securities, securities entitlements and securities accounts. If the collateral does not qualify as "investment property" it is probably a "general intangible." §9-102(a)(49). Perfection of a security interest in investment property occurs by control. Control of investment property includes (i) delivery, with endorsement, of a certificated security that the issuer will honor instructions from the secured party without further consent of the debtor, and (ii) an agreement by a bank, a broker or another securities intermediary holding a securities account that it will honor the instructions from the secured party concerning the securities account without further consent of the debtor. Control also includes registering a security or a securities account in the name of the secured party. In addition, if the secured party is also the debtor's securities intermediary, the secured party automatically has control. The secured party that has perfected by control has priority over the secured party who perfects by filing. Perfection by filing is usually done as a backstop.

A secured party may have control even though the original entitlement holder remains authorized to direct the securities intermediary to make trades and even to withdraw assets. See OC 4, §8-106. The secured party, however, must have the power to direct the securities intermediary to comply with the secured party's entitlement orders with no further consent of the debtor. The power of the secured party to direct the securities intermediary may be conditional, e.g. it may arise only upon the debtor's default. Official Comment 7, §8-106.

Letters-of-Credit Rights

A security interest in letter-of-credit rights is perfected when the secured party obtains control. §9-314(b). Under UCC §9-107, a secured party obtains control of a letter-of-credit right if the issuer or nominated person (e.g. a confirmer or negotiating bank) consents to an assignment of the proceeds of the letter of credit. §9-107/5-114(c). Perfection of a security interest in the original collateral also perfects a security interest in a letter-of-credit right as a supporting obligation. §9-308(d). The secured party remains perfected only while the secured party retains control. §9-314(b).

Partnership Interests and Limited Liability Company Interests

An interest in a partnership or a limited liability company is not a security unless it is dealt in or traded on a securities exchange or in securities markets, or unless its partnership agreement or articles of organization expressly state that it is governed by Article 8. Thus, under the general rule, partnership interests and membership interests will fall into the catch-all category of general intangibles. The only method to perfect a security interest in such collateral is to file a UCC financing statement in the state where the debtor is located.

If the partnership or limited liability company has opted into Article 8 by making a statement to that effect in its partnership agreement or organizational articles or operating agreement, then a UCC filing would not protect against a competing secured party who had "control" of the security by possession (if the interest is certificated) or through a control agreement with the partnership or LLC (if the interest is uncertificated).

Automatic Perfection (By Attachment Alone)

Under UCC §9-309, in each of the following circumstances, the security interest is perfected upon attachment, without requiring the secured party to take possession of the collateral, obtain control of the collateral or file a financing statement: (a) purchase money security interest in consumer goods; however, if there is no filing, transfers of the collateral to certain bona fide transferees will be free of the security interest §9-320(b); (b) assignment of "insignificant" accounts, provided that the assignment "does not by itself or in conjunction with other assignments to the same assignee transfer a significant part of the assignor's outstanding accounts or payment intangibles" §9-309(2); (c) security interests (i) arising from a sale of a payment intangible or promissory note (a sale of a participation interest in a promissory note is perfected automatically); (ii) created by the assignment of a "health-care-insurance receivable" (§9-102(a)(46)) to the provider of the healthcare goods or services (a subsequent assignment from the healthcare provider to another is not automatically perfected); (iii) arising in delivery of a financial asset under §9-206(c); (iv) in investment property created by a broker or securities intermediary or in a commodity contract or commodity account created by a commodity intermediary; and (v) arising from an security interest in a "supporting obligation" (§9-102(a)(77) if a security interest in the collateral related to the supporting obligation is perfected §9-308(d).

Basic UCC Priority Rules

Article 9 establishes a system to determine priority among classes of competitors against whom the secured party will compete for the assets of the debtor in case of the debtor's default. A complete analysis of this system is beyond the scope of this article. However, there are some basic priority concepts that are important to understand.

Secured Creditor vs. Unsecured Creditors and Judgment Creditors

Generally, a secured party holding a perfected security interest in the assets of the debtor has priority over unsecured creditors and lien creditors in those assets. A lien creditor is one who has acquired a lien against the debtor's property by attachment, levy or similar manner – i.e., an unsecured creditor which has obtained a judgment against the debtor.

Secured Creditor vs. Secured Creditor

Priority between conflicting security interests in the same collateral is determined, in general, by who is the first to file or perfect the security interest. This is the so-called "first-to-file-or-perfect" rule. Actual knowledge of an unperfected security interest is irrelevant. It is a pure "race" system.

Purchase Money Security Interests

A purchase money security interest is a security interest taken or retained by a seller of collateral to secure all or a part of its purchase price, or for value given, to enable the debtor to acquire rights or use the collateral if the value is in fact as used. §9-2013(a)(2). The most important exception to the "first-to-file-or-perfect" rule is the super priority of the purchase money security interest. This rule protects a supplier of inventory against an earlier filer whose interest includes after acquired inventory, as well as those who finance equipment, consumer goods, and farm products against a prior floating lien that would otherwise have priority under the first-to-file-rule. Without providing purchase money creditors priority, secondary sources of credit would be unavailable unless suppliers were willing and able to obtain subordination agreements from the floating lienors. In exchange for super priority, a purchase money creditor must satisfy various conditions to maintain its priority security interest in the collateral over a prior security interest in the collateral filed first. See §9-324.

Priority by Subordination

One of the most important priority provisions of Article 9 is §9-339, which states that "[t]his article does not preclude subordination by agreement by any person entitled to priority." The most sophisticated type of subordination agreement is the intercreditor agreement executed by a number of secured creditors of a borrower. The intercreditor agreement seeks to establish priorities in the collateral as a matter of contract, rather than relying on the priority rules of Article 9.

Secured Party vs. Bank's Right of Setoff

A depository bank's common law right of setoff has priority over a security interest held by another secured party, including one who claims the deposit accounts as cash proceeds of an asset based loan, i.e. receivables and inventory financing. This "depository bank always wins" rule is intended to protect the payment system. Only if the competing secured party takes "control" of the deposit account or gets a subordination agreement is its security interest senior to the bank's right of setoff.

Secured Party vs. Federal Tax Lien

The U.S. Treasury Department, Internal Revenue Service uses the tax lien machinery of the Internal Revenue Code ("IRC") to recover unpaid taxes. Failure to pay income, withholding, social security, and other taxes leads to a delinquency assessment, which in turn constitutes a lien in favor of the United States on all property and rights of property belonging to the taxpayer. The lien continues until the tax

liability is paid. Although the lien arises on assessment, it does not become valid against third parties (any purchaser, holder of a security interest , mechanic's lienor, or judgment creditor) until notice thereof meeting certain requirements has been filed by the federal government. The place of filing is (a) in the appropriate office where real estate is physically located if realty is involved, and (b) in a single office designated by state law where the taxpayer resides when the filing is made involving tangible and intangible personal property. The Article 9 filing office for a security interest and the filing office for a federal tax lien may be different given the status of the debtor. The filed Notice of Tax Lien is valid for ten years.

In addition, courts have held that the IRC is exempt from the UCC filing requirements regarding the names of debtors. The Sixth Circuit gave an IRC tax lien priority over the secured party's prior perfected security interest even though the IRS's tax lien filing did not use the registered corporate name of the debtor in the public state records. The secured party filed under the correct organic public document name and the IRS filed under the name used by the debtor on its tax return. The IRS notice was filed prior the secured party's UCC. The IRS prevailed. In view of this case, secured lenders should obtain the borrower's returns for several years back and perform UCC searches and tax lien searches under all names used by the debtor on its returns.

Special Types of Collateral

Vehicles

A financing statement is not required to be filed to perfect a security interest in a vehicle and, if filed, is not effective §9-311(a)(2). Compliance with the motor vehicle lien statute of the relevant state is equivalent to filing a financing statement under Article 9. A security interest in a vehicle is not valid against any creditor of the owner or any subsequent transferee of the owner or other secured party unless the security interest is perfected under the relevant motor vehicle code. A security interest in a vehicle may be perfected only by compliance with the motor vehicle code, and a security interest so perfected remains perfected even though use or possession of the vehicle is transferred. §9-311(b); §3-207. Perfection occurs by delivery to the relevant motor vehicle office of the existing certificate of title and an application for a new certificate of title containing the name and address of the secured party and the appropriate filing fee §3-202(b). The local law of the jurisdiction that issues the certificate of title governs perfection, the effect of perfection or non-perfection, and the priority of a security interest in vehicles from the time the vehicle becomes covered by the certificate of title until it ceases to be covered. §9-303(c). This law governs, even if there is no other relationship between the jurisdiction and the vehicle or the debtor §9-303(a).

A security interest in vehicle inventory held for sale or lease by a person in the business of selling or leasing goods of that kind is not perfected by notation on a certificate of tile and must be perfected by filing a financing statement. §9-311(d). Perfection of a security interest in inventory of a dealer is governed by the general perfection rules even though the vehicles will be covered by a certificate of title in the hands of a buyer.

Boats and Vessels

Procedures governing perfection of security interest in boats depend on the size of the boat and the jurisdiction. If a boat weights more than five tons, is more than 26 feet in length and meets certain other requirements, then the boat may be federally "documented" with the United States Coast Guard. The creation and perfection of security interests in such vessels are governed by the Ship Mortgage Act of 1920 (U.S.C. Title 46, Chapter 313) and accomplished by recordation under federal law. A federal filing with the National Vessel Documentation Center is required in order to perfect an interest in a documented boat. 46 U.S.C. §31321. Generally, this federal filing takes the form of a "preferred mortgage," which is given status and priority as a maritime lien.

However, smaller personal pleasure boats not covered under the federal documentation system that meet the definition of "motorboat" are subject to applicable state registration and/or titling requirements (similar to those for automobiles), which are not uniform in all states. In states that issue certificates of title, a security interest is typically perfected by noting the security interest on the certificate of title. In states that do not employ certificates of title, perfection of a security interest in the vessel is accomplished by filing a UCC financing statement.

Aircraft

Federal Registration

The Federal Aviation Act of 1958 (U.S.C. Title 49, Sections 44107 – 44108) contains an express recording system for security interest in aircrafts. Security interests in civil aircraft and their parts are subject to federal law which preempts Article 9 rules. The distinct types of collateral that may be perfected under the Federal Aviation Act include (a) civil aircraft, (b) aircraft engines of 550 or more rated takeoff power, (c) aircraft propellers capable of absorbing 750 or more rated takeoff shaft power, and (d) aircraft engines, propellers, appliance and spare parts maintained by an air carrier certified under 49 U.S.C. §44705; 49U.S. C. §44107(a). To perfect a security interest in aircraft, the instrument granting the security interest must be recorded with the Federal Aviation Administration Registry on AC Form 8050-93 Recording of Aircraft Ownership and Security Documents. The instrument must be signed by the debtor, who must be the registered owner, and must be notarized. 49. U.S. C. §44107. The security interest that has been recorded with the FAA is perfected from the date of filing. 49 U.S.C. §44108.

International Registration

Pursuant to the Cape Town Treaty, to which the United States is a party, and the Cape Town Treaty Implementation Act of 2004, a worldwide electronic registry system for aircraft exists that works in tandem with the Federal Aviation Act's recording system intended to standardize transactions involving aircraft. It applies to aircraft which can carry at least eight people or 2750 kilograms of cargo, aircraft engines with thrust exceeding 1,750 pounds-force (7,800 N) or 550 horsepower (410 kW), and

helicopters carrying 5 or more passengers. In perfecting a security interest in aircraft, a secured party will need to comply with the treaty's electronic registry system in addition to the filing of a UCC reflecting its lien in the appropriate state filing office, which requires a filing with the International Registry of Mobile Assets in Ireland.

Patents, Trademarks and Copyrights

Copyrights

The United States Copyright Act (U.S.C. Title 17) outlines a process for recording security interests in copyrights. To perfect a security interest in a copyright that is federally-registered, a secured party must record their security interest with the United States Copyright Office. However, to perfect an interest in an unregistered copyright, a secured party should file a UCC-1 financing statement in the appropriate state filing office.

Trademarks

Although the federal trademark statute (U.S.C. Title 15, Chapter 22) known as the Lanham Act does not explicitly provide for a means of perfecting security interests in federally-registered trademarks, federal law does not preempt the UCC with respect to perfection, and a filing of a state UCC-1 financing statement is necessary to perfect security interests in trademarks. However, the United States Patent and Trademark Office (USPTO) has a procedure for recording security interests in registered trademarks. As a practical matter, to address any confusion over the process of perfection, the best practice for secured parties is to perfect their security interest in trademarks by filing a UCC-1 financing statement and record their security interest with the USPTO.

Patents

The United States Patent Act (U.S.C. Title 35) also does not explicitly provide a mechanism for perfecting security interests in patents. However, prior to the adoption of the UCC, perfecting security interests in patents required recording of such interests with the USPTO. Since the law of perfection in the area of patents is unsettled, secured parties should record their liens with the USPTO, in addition to filing UCC-1 financing statements.

Government Receivables

If the debtor has receivables from the United States Government, it is imperative that the secured party insure that the loan and loan documents comply with the Federal Assignment of Claims Act ("Act "). The Federal Assignment of Claims Act is often misunderstood. The Act, found at 41 U.S.C. § 15, applies to all obligations owing by the federal government or any agency or department of the federal government. It is supplemented by the Federal Acquisition Regulations ("FAR") found in Title 48 of the Code of Federal Regulations. The Act only governs notices of assignment and payment instructions. If the

secured party does not comply with the Act, it may still have a valid assignment or security interest and prevail against junior security interests, judgment creditors and bankruptcy trustees. However, if the secured party does not comply with the Act and the government agency pays someone other than the secured party, the secured party has no claim against the government agency.

The Act encourages lenders to finance government contractors by permitting the contractors to assign the right to payment from receivables as loan collateral. Despite the name of the Act (The Assignment of Claims Act), permissible assignments only capture the right to receive payments due under the contract rather than the contract itself or claims other than for payment arising under the contract. Under FAR, an assignment of money due or to become due under a government contract as security for a loan is valid if: (a) the contract specifies payment of at least $1,000; (b) the contract does not prohibit an assignment; (c) the assignment is made to a bank, trust company or other financing institution (i.e., institution that deals in money as the primary function of its business activity); (d) unless otherwise expressly permitted in the contract, the assignment: (i) covers all unpaid amounts payable under the contract; (ii) is not subject to further assignment; (iii) is made to one party, and such party participates directly in the financing, except that any assignment may be made to one party as agent or trustee for two or more parties participating in the financing of the contract; and (iv) Lender sends an original plus three copies of the notice of assignment and a true copy of the assignment instrument to (x) the administrative contracting officer performing all contract administrative functions, (y) any surety on bonds applicable to the contract, and (z) the disbursing officer authorized under the contract to make payments. The administrative contracting officer is given a reasonable time after receipt of the notice of assignment to determine if the assignment is valid.

In addition to the foregoing, FAR requires that a lender be registered in the Central Contractor Registration database ("CCR"). CCR is used to collect, store and disseminate a variety of information for the Federal government and, for purposes of an assignment of money due under a government contract, facilitate paperless payment through electronic funds transfer.

IMPACT OF BANKRUPTCY ON SECURED TRANSACTIONS

The acid test of a security interest under Article 9 is its resistance to attack by the debtor's trustee in bankruptcy. A lender who fails to perfect or makes a last minute perfection will face a formidable array of avoidance powers possessed by the bankruptcy trustee.

Maintenance of the Status Quo

§ 546(b) of the Bankruptcy Code reconciles the conflict between the prohibitions imposed by the automatic stay under §362(a) of the Bankruptcy Code and provisions that require post-petition actions in order to perfect or enforce a lien in property of the estate. §546(b) of the Bankruptcy Code provides that the maintenance or continuation of a perfection of a security interest in property is not a violation of the automatic stay.

DIP Financing

Court Approval

The trustee or debtor in possession may use, sell, or lease property in the ordinary course of business without a court order. A court order is necessary, however, for non-ordinary course transactions.

Cash Collateral

Cash collateral includes cash, negotiable instruments, documents of title, securities, deposit accounts or other cash equivalents in which the estate and an entity other than the estate have an interest. Cash collateral may not be used by the debtor in either ordinary or non-ordinary course of business transactions unless the creditor with an interest in the cash collateral consents or the bankruptcy court, after notice and a hearing, authorizes use of the collateral. A debtor may not use, without the creditor's consent or a court order, rental payments or proceeds from sales of accounts receivable, inventory, or equipment if such payments or proceeds are pledged as collateral to a creditor. A bankruptcy court may not authorize a debtor to use cash collateral unless the debtor has the ability to provide adequate protection for the creditor's interest in the collateral. The debtor will typically demonstrate that it can adequately protect the creditor's interest in the cash collateral by showing that: (1) the value of the creditor's collateral will remain substantially greater than the amount owed, even with the contemplated use of cash collateral, or (2) the proposed use of cash collateral will increase the value of the debtor's estate, rather than reducing it.

Whether the creditor will be adequately protected is a question of fact. The bankruptcy court must determine the value of the creditor's interest in its collateral, the risks to that value resulting from the debtor's proposed use of cash collateral, and whether the debtor's adequate protection proposal protects the creditor's collateral position. Empirically and logically, the bankruptcy court will have fewer problems authorizing the use of cash collateral in the middle of a debtor's manufacturing cycle than when the debtor is about to take one season's proceeds and commence the manufacturing cycle for the next season.

Post-Petition Financing

§364 of the Bankruptcy Code allows the debtor to obtain post-petition extensions of credit. In substance, these provisions create a variety of protections or inducements for a creditor willing to provide post-petition financing, ranging from the granting of an administrative expense claim on account of the amounts lent to granting of a lien that will be senior to existing liens in collateral. Section 364 of the Bankruptcy Code distinguishes among: (1) obtaining unsecured credit in the ordinary course of business, (2) obtaining unsecured credit out of the ordinary course of business, and (3) obtaining credit with specialized priority or with security.

***Administrative Priority* -** The debtor may obtain unsecured credit or incur unsecured obligations in the ordinary course of business as an administrative expense. Notice, opportunity for hearing, and a court order are not required unless such credit is obtained outside the ordinary course of the debtor's business.

***Super Priority* -** The court, after notice and hearing, may authorize a debtor to obtain credit with an administrative priority superior to all other administrative expenses. The debtor may also obtain secured credit, with court approval, subject only to preexisting liens.

***Senior Liens* -** The court, after notice and hearing, may also authorize a debtor to obtain credit secured by a lien senior or equal to preexisting liens. This extraordinary alternative is available only if: (a) credit is otherwise unavailable, and (b) the preexisting lien is adequately protected. Parties extending credit to the debtor are protected from being adversely affected by a subsequent reversal or modification on appeal of the bankruptcy court's order authorizing the provision of post-petition financing. Under §364(e) of the Bankruptcy Code, if the order authorizing the debtor to incur the debt in question is reversed or modified on appeal, it does not affect the validity of the administrative priority, super priority, or lien granted as long as the credit was extended in good faith. Obviously, without this protection, creditors would be reluctant to actually extend credit to reorganizing debtors until the time for appeal had expired or if an appeal was filed, until the resolution of such appeal.

Insufficiency of Secured Collateral

Section 506(a) of the Bankruptcy Code provides that a claim is secured to the extent of the value of the collateral. Any claim by the creditor above the value of the collateral is an unsecured claim. In Chapter 13 cases, §506(a) requires the debtor to bifurcate all secured claims into secured and unsecured claims based on the value of the property securing the claim. The value of the collateral is determined on a case-by-case basis. In Associates Commercial Corp. v. Rash, 520 U.S. 953 (1997), the United States Supreme Court determined that the replacement value of collateral is the appropriate standard in determining the amount of a secured claim under §506(a).

Avoidance Actions

***Trustee as Lien Creditor and Bona Fide Purchaser* - Unperfected Security Interests**

The trustee or debtor in possession has the status of a hypothetical judicial lien creditor. Since an unperfected security interest is inferior to the rights of a judicial lien creditor, a trustee or debtor in possession may invalidate a security interest that is not perfected prior to filing (unless the security interest is a purchase money security interest that is perfected no later than twenty (20) days after it attaches).

Unrecorded Interests in Real Property

The trustee or debtor in possession, as a hypothetical judicial lien creditor or hypothetical bona fide purchaser for value, may also avoid unrecorded real property interests.

Strong Arm Powers

The trustee or debtor in possession may use state laws to invalidate transfers and obligations. This may permit the trustee or debtor to review and seek to avoid transfers that took place as many as six (6) years prior to the commencement of a bankruptcy case, depending on the jurisdiction.

Preference

The trustee or debtor in possession is authorized to avoid "preferences." A preference involves a transfer of the debtor's property to or for the benefit of a creditor for or on account of an antecedent debt made while the debtor was insolvent within ninety (90) days before bankruptcy (or within one year if the creditor is an "insider") the effect of which was to give the creditor more than he otherwise would have received in a Chapter 7 liquidation. The preference laws recognize that a financially troubled debtor tends to pay only certain creditor obligations, whether out of loyalty or necessity, due to insufficient cash flow. Preference laws were created to promote the principle of equality of distribution among creditors.

Substantially contemporaneous exchanges, exchanges for new value, and ordinary course of business transactions are defenses to preference actions. Effective October 17, 2005, the BAPCPA also creates a new preference exception for aggregate transfers totaling less than $5,000 when the debtor's debts are not primarily consumer debts.

Post-Petition Security Interests

Section 552(a) of the Bankruptcy Code invalidates the attachment under non-bankruptcy law of all consensual liens arising from security agreements entered into by a debtor before the commencement of the case to post-petition property acquired by either the estate or the debtor. If a security agreement covers both prepetition property of a debtor and the after-acquired proceeds ("proceeds" covers any property into which property may be converted and is not limited to the technical definition of that term under the UCC"), products, offspring, rents, or profits of the post-petition property, the security agreement can effectively attach a security interest to property into which the prepetition property is converted, property derived from the prepetition property, and income from the prepetition property that is acquired by the estate after the commencement of the case.

Automatic Stay

A filed bankruptcy petition immediately operates as an automatic stay, holding in abeyance various forms of creditor action against the debtor. The automatic stay provisions protect the debtor against certain actions from the creditor, including: (a) beginning or continuing judicial proceedings against the debtor; (b) actions to obtain debtor's property; (c) actions to create, perfect or enforce a lien against a debtor's property; and (d) set-off of indebtedness owed to the debtor before commencement of the bankruptcy proceeding. A court may grant a creditor relief from the stay if the creditor can demonstrate that the stay does not give the creditor "adequate protection" or if it jeopardizes the creditor's interest in certain property. The court may grant relief to the creditor in the form of periodic cash payments or an additional or replacement lien on the property.

Fraudulent Conveyances

The trustee or debtor in possession may invalidate transfers and obligations made or incurred within two years of the bankruptcy filing if the transfer or obligation was made or incurred with actual intent to hinder, delay or defraud creditors, or the debtor received less than reasonably equivalent value for the transfer or obligation when the debtor was insolvent.

The grounds for avoiding a third party's guarantee or collateral pledge are contained in Section 548 of the United States Bankruptcy Code and the Uniform Fraudulent Transfer Act. In substance, a court can find constructive fraud and set aside the transfer where the debtor received less than "reasonably equivalent value" and was insolvent at the time of the transfer or became insolvent thereby. "Reasonably equivalent value" does not require dollar-for-dollar equality between the property the grantor gives up and the property the grantor receives in return. There is room for some imbalance and hence the "reasonably equivalent" standard. Courts try to balance the need to permit parties to make deals, some good and some not so good, and the need to establish a point at which transfers will be invalidated that too profoundly impairs the transferor's ability to discharge its obligations to its creditors. Generally, courts will find "reasonably equivalent value" if the grantor received some of the loan proceeds or if the transfer was "downstream" – a shareholder guaranteeing the debts of the borrower is "reasonably equivalent" consideration, unless the borrower is hopelessly insolvent. Adequacy of consideration becomes more problematic when the transfer is from an affiliate (two entities owned by a common shareholder which is a "cross-stream" transaction, and where the transfer is in the "upstream" context, which is a subsidiary guaranteeing the debt of its parent.

Lisa D. Love, Esq. is the Managing Partner of Love and Long, L.L.P., a boutique minority and woman owned transactional law firm that has significant experience in project finance, concentrating in corporate finance and governance, commercial transactions, secured transactions, project finance and real estate. Ms. Love represents lenders in corporate finance and project finance transactions secured by equity securities and commitments, real estate, specific assets, including vehicles, containers,

aircrafts, ships, receivables, personal property and intellectual property, and credit enhancements including warrants and letters of credit. In addition, Ms. Love represents issuers in securities offerings registered under the Securities Act of 1933 and private placement.

Richardo I. Kilpatrick, Esq. is the President of Kilpatrick & Associates, P.C., a minority owned firm that represents corporations, financial institutions, government agencies, Chapter 7 trustees and individual creditors in matters involving bankruptcy and creditors' rights, commercial collections, and commercial litigation. The firm's commercial clients span a range of industries but the firm has particular depth of experience in the automotive, financial services and governmental sectors.

Shanna M. Kaminski is an Associate Attorney at Kilpatrick & Associates, P.C. Ms. Kaminski specializes in all aspects of creditors' rights, but her practice focuses primarily on commercial and consumer bankruptcy. She is a member of the State Bar of Michigan, the American Bankruptcy Institute, and the Consumer Bankruptcy Association. Ms. Kaminski is an active participant in the Debtor/Creditor Rights Section of the State Bar of Michigan and has served as an editor for the Michigan Business Law Journal.

This Article does not provide legal advice or any other form of advice, but is designed to give a basic overview of Article 9 of the Uniform Commercial Code ("Article 9"). Article 9 is a complex and comprehensive system concerning security interests. This Article does not seek to comprehensively cover all aspects of the system's functionality or the consequences and considerations surrounding its use. You should seek your own advice and refer to Article 9 as adopted in the applicable state for further information as well as considerations and consequences surrounding the system. The authors are providing this information to give the reader some basic information and relevant reference to Article 9 and are not making any representation or warranty, express or implied about the accuracy or comprehensiveness of this information, nor shall they have any legal obligation or liability whatsoever relating to the provision of the same. This information is liable to change from time to time without notice to you and you should check Article 9 of the applicable state for state variations and to obtain the latest version of Article 9 adopted by such state.