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SECURED LENDING ALERT

An Updated Review of Collateral Perfection For Commercial Loans

It is useful to review the different types of collateral under Article 9 of the Uniform Commercial Code (the "Code") and how a security interest in such collateral can be perfected.

The three basic methods for perfecting a security interest in collateral under the Code for commercial transactions are as follows (and such perfection method varies for different types of collateral):

- a. By taking possession of the collateral under Code Section 9-313(a).
 - b. By filing a UCC Financing Statement in a public office under Code Section 9-310(a).
 - c. By obtaining control of the collateral pursuant to Code Section 9-314(a).
1. **Mandatory UCC Filing.** Filing a UCC Financing Statement is the only manner of perfection for each of the following types of collateral (but note some of the limitations and other comments detailed below):
 - a. **Accounts.** A security interest in accounts can be perfected only by filing a UCC Financing Statement.

It is important to note that with regard to bonded accounts (i.e., bonded jobs) in which a surety issues a payment and/or performance bond for the account debtor (typically, a contractor or subcontractor), if the surety either makes payments under such bond or completes the bonded job upon default by the account debtor, the surety will be given priority in all retainage funds being held for the affected job and will prime a lender's prior perfected security interest in the account(s) based on the equitable doctrine of subrogation. The surety is not required to file a UCC Financing Statement to achieve such priority and sureties routinely do not file UCC Financing Statements. As a result, a lender's due diligence to confirm that the borrower's jobs are not bonded is essential to

evaluate the risk of a surety priming the lender's security interest in the borrower's accounts.

Note that the term "account" under the Code does not include a "deposit account". Perfection in a "deposit account" is described in Section 3(a) below.

b. General Intangibles. Perfection of a security interest in general intangibles is accomplished solely by filing a UCC Financing Statement. Note that "general intangibles" is a broad catch-all category for a variety of types of collateral under the Code including, without limitation, payment intangibles (defined as a "general intangible under which the account debtor's principal obligation is a monetary obligation"), software, patents, trademarks and other forms of intellectual property, goodwill, equity interests in limited liability companies, partnerships and joint ventures, tax refunds, residual interest in trusts and all other intangible property of the debtor of every kind that is not an account, chattel paper, commercial tort claim, deposit account, document, good, instrument, investment property, letter-of-credit right, letter of credit, money, or oil, gas or other minerals before extraction.

c. Fixtures. A security interest in goods which are classified as "fixtures" under local real estate law is perfected by filing a UCC fixture filing against the debtor (i.e., owner of the fixtures) in the county where such goods are located. The Code also provides that a UCC filing in the central filing office of the state where the debtor is located covering fixtures will also perfect a security interest in fixtures. However, for the reasons stated below, it is a best practice to file both a UCC statement in the central filing office and a UCC fixture filing in the county where the goods are located.

If the secured party only files against fixtures in the central filing office, such UCC filing will (i) insulate the secured party from an attack by a bankruptcy trustee of the debtor and (ii) have priority over subsequent judgment lien creditors. However, such central UCC filing will not give the secured party priority over recorded mortgages covering the fixtures or other county fixture filings.

If the secured party only files against fixtures at the county level, and does not file at the state level, and it turns out that the equipment is not a "fixture", then a state level UCC filing is necessary to perfect a security interest in the equipment.

If the secured party's security interest in fixtures perfected by filing at the county level qualifies as a PMSI Fixture Filing under Code Section 9-334(d), the secured party will have priority over all later recorded mortgages and most earlier recorded mortgages. There is an exception for a construction mortgage which would have priority over a county fixture filing (including a PMSI fixture filing) if (i) such construction mortgage was recorded before the goods became fixtures and (ii) the goods in question became fixtures before the completion of construction. Such priority is also given to a mortgage which refinances the construction mortgage.

When preparing a fixture filing, the best practice is to refer to the collateral as both equipment and fixtures (and the security agreement should similarly describe both).

It should be noted that a county UCC Fixture Filing requires a full description of the applicable real estate and real estate tax identification number (using the same full legal

description that a real estate mortgage would require) as well as the name and address of the real estate owner (if different than the debtor).

If the debtor owns the real estate and is executing a mortgage, the mortgage itself can also serve as a fixture filing provided it has the requisite grant of security interest language and otherwise complies with Code Section 9-502. It should be noted that one advantage of having the mortgage serve as a fixture filing is that the fixture filing encased in a mortgage need not be continued every five (5) years and is valid so long as the mortgage remains outstanding under Code Section 9-515(g). A UCC Fixture Filing, on the other hand, must be continued every five (5) years.

The Code does not provide a clear definition of the term "fixtures" but instead describes "fixtures" as "goods that have become so related to particular real property that an interest in them arises under real property law". This vague definition requires examination of case law under local law where the real estate is located to determine whether the goods in question are "fixtures". The most important factors in determining whether goods qualify as fixtures are: (1) the degree of physical affixation and ease of removal; (2) the intention of the parties; (3) the reasonable expectation of a third party vendee of the real estate; and (4) the extent to which the presence of the fixtures is critical to the function of the real estate. The Code's lack of a specific definition for fixtures has led to a significant amount of litigation over whether the equipment in question constituted a "fixture".

Some examples of goods that were held to constitute "fixtures" under case law and thus required the filing of a UCC Fixture Filing for perfection purposes include a generator, HVAC equipment, a water system, a mobile home, underground storage tanks, computerized gasoline pumps, industrial lighting and circuit breakers and broadcast antennas. In some case law examples, an advertising display sign, a coal-washing plant, laundry machinery, and a radio transmission tower were held not to be "fixtures" because in those cases, the parties intended that these goods not become permanently attached to the real estate. However, had there been an intent to permanently affix these goods to the real estate, the court may have found them to constitute "fixtures" and thus would have required the filing of a UCC Fixture Filing.

It should also be noted that some goods that become part of the real estate are not "fixtures" but are deemed part of the realty and owned by the real estate owner (such as ordinary building materials, a roof and windows), and as a result, such goods are not subject to an Article 9 security interest.

If a secured party is in doubt as to whether some equipment could constitute "fixtures" under local real estate law, the conservative approach would be to file both a UCC Financing Statement in the appropriate office where a security interest in equipment would be perfected (central filing office in the debtor's state of formation in most states) and a UCC Fixture Filing in the recorder's office where the real estate and equipment are located.

2. **Permissive UCC Filing**. A lender may perfect a security interest in the following types of collateral by filing a UCC Financing Statement:

a. **Chattel Paper**. Perfection of a security interest in tangible chattel paper (which includes equipment leases, certain notes and security agreements, and installment sale

agreements for the purchase of vehicles or other goods) can be perfected either by filing a UCC Financing Statement under Code Section 9-312(a) or by taking possession of the original chattel paper under Code Section 9-313(a). Most lenders both file and take possession of the original chattel paper. Under Code Section 9-330, a qualifying secured party or purchaser of the chattel paper who takes possession of the original chattel paper can prime an earlier security interest in the chattel paper perfected solely by a UCC Financing Statement.

Although both filing a UCC Financing Statement and taking possession of the original chattel paper provides the most protection to the lender and is the recommended course of action, there are certain instances where it is not feasible for the lender to take possession of the original chattel paper and in such cases, the lender will make a business decision to allow the original chattel paper to remain in the possession of an agent of the lender (or sometimes the borrower itself), provided that the original chattel paper is stamped with a conspicuous legend on its face stating that the chattel paper has been assigned to the lender and including the lender's name and address. Absent a fraud by the borrower, the stamping of the lender's assignment on the face page of the original chattel paper will serve to protect a lender from a qualifying secured party or purchaser from taking possession and obtaining purchase money priority in the chattel paper under Code Section 9-330.

It should be noted that (i) leaving the original chattel paper in the borrower's possession presents a business risk for the lender, and (ii) the borrower cannot be the lender's agent for the purpose of deeming the lender to be "in possession" of the chattel paper.

Perfection in electronic chattel paper is governed by Code Section 9-105. The field of electronic chattel paper is growing and we expect in the future an increase in the number of equipment lease financing transactions funded with the use of electronic chattel paper. Very briefly, a lender engaging in electronic chattel paper financing must obtain an electronic vault (eVault) from a service provider (such as eOriginal), and the borrower/lessor must also acquire its own eVault from the same service provider. The electronic lease is created in the borrower's eVault and when it is ready to be financed by the lender, such electronic lease is transferred from the borrower's eVault to the lender's eVault. All aspects of such transaction must comply with the requirements set forth in Code Section 9-105 in order for a lender to be deemed in "control" of the electronic chattel paper and its security interest therein perfected.

b. Instruments. A security interest in an instrument (which term includes promissory notes) may be perfected either by filing a UCC Financing Statement under Code Section 9-312(a) or taking possession of the instrument under Code Section 9-313(a). However, under Code Section 9-330(d), a purchaser for value who takes possession of the instrument without knowledge that the purchase violates the rights of the secured party would achieve priority over a security interest in the instrument perfected by filing. It should be noted that such a purchaser can prevail over a lender who has only filed a UCC Financing Statement even if the purchaser is aware of the security interest so long as the purchaser takes without knowledge that the purchase violates the rights of the holder of the security interest.

c. Investment Property. The term "investment property" under Code Section 9-102(49) includes securities, whether certificated or not, security entitlements, securities accounts, commodity contracts and commodity accounts.

To achieve a first priority security interest in investment property, the lender needs to take "control" of the investment property under Code Sections 9-106 and 8-106. A lender can also file a UCC Financing Statement to perfect a security interest in investment property, but such perfection is an inferior method of perfection in investment property and would generally only be relied upon by a second lien lender who is unable to obtain "control" of the investment property.

Control over investment property is bifurcated depending on whether the securities are certificated or uncertificated: (i) for certificated securities, the lender takes possession of the original stock certificates and obtains signed stock powers, and (ii) for uncertificated securities, the lender will be deemed "in control" if (A) the lender obtains a three-party written agreement (i.e., control agreement) executed by the securities intermediary (i.e., broker), lender and pledgor containing the broker's agreement that it will comply with entitlement orders originated by the lender without further consent by the pledgor, or (B) the lender itself becomes the entitlement holder (i.e., becomes the broker's customer).

d. Inventory. A security interest in inventory can be perfected either by filing a UCC Financing Statement under Code Section 9-310(a) or by taking possession of the inventory under Code Section 9-313(a). Obviously, it is not practical in most situations for the lender to take possession of a borrower's inventory.

e. Equipment. A security interest in equipment can be perfected either by filing a UCC Financing Statement under Code Section 9-310(a) or by taking possession of the equipment under Code Section 9-313(a). Obviously, it is not practical in most situations for the lender to take possession of a borrower's equipment.

It should also be noted that for lenders financing leased equipment, it is common to also file a precautionary UCC Financing Statement against the lessee in favor of the lessor (and assigned to the lender) describing the leased equipment in case the equipment lease should later be determined by a court not to be a "true" lease, but instead a lease "intended as security" (in the latter case, the lessee would be deemed the owner of the equipment, and the precautionary UCC Financing Statement would then be essential for the lender's perfection in the equipment).

f. Collateral Assignment of Beneficial Interest in Illinois Land Trust. A security interest in the beneficial interest in an Illinois land trust can be perfected by filing a UCC Financing Statement against the beneficiary. However, a lender who obtains "control" of the beneficial interest will prime a security interest in such beneficial interest perfected by filing a UCC Financing Statement. Under Section 9-107.1 of the Illinois Uniform Commercial Code, a lender gains "control" of an Illinois land trust by lodging the collateral assignment of beneficial interest or security agreement with the land trustee and obtaining the land trustee's signed acceptance.

Although many Illinois lenders exclusively rely on this "control" method of perfection and no longer file a UCC Financing Statement, if the beneficiary of the land trust is a resident of another state, it is recommended that a UCC Financing Statement be filed against such resident in the state of its residence, in addition to lodging the collateral assignment or security agreement with the land trustee. The lender must also be vigilant throughout the duration of the loan transaction should an individual beneficiary change its state of

primary residence (either from Illinois to another state or from another state to a state other than Illinois).

g. Patents and Trademarks. Patents and trademarks are classified as "general intangibles" under the Code. It is prudent based on the ever-changing case law to perfect a security interest in U.S. registered patents or trademarks by both filing a UCC Financing Statement and also by filing a security agreement in the U.S. Patent and Trademark Office listing the itemized Patents and/or Trademarks. Special security agreement forms for both patents and trademarks have evolved for these federal filings. By just filing a UCC Financing Statement, the lender obtains some protection against certain lien creditors, but it may not provide comprehensive protection under existing case law against all parties (including a bona fide purchaser or another secured party). Hence, the recommendation that federal perfection be obtained in addition to the UCC Financing Statement. Obviously, the value of such intellectual property in a number of cases may not warrant the extra time and expense of obtaining federal perfection and a business judgment in each case needs to be made whether to pursue federal perfection.

h. Copyrights. Liens on registered copyrights are perfected by filing a security agreement in the U.S. Copyright Office under the 1976 Copyright Act. In addition, a UCC Financing Statement covering both registered and unregistered copyrights should be filed in the appropriate state UCC filing office since a copyright is classified as a "general intangible" under the Code. If a copyright is unregistered, a security interest in such unregistered copyright can only be perfected by filing a UCC Financing Statement.

3. **When taking "control" of Collateral is Mandatory.** Taking "control" is the only method of perfection of a security interest in the following types of collateral:

a. Deposit Accounts. Perfection of a security interest in a deposit account as original collateral is achieved by taking "control" of the deposit account under Code Section 9-104. Under this section, a secured party controls a deposit account in any one of three ways:

- (i) if the secured party is the bank that maintains the deposit account;
- (ii) if the secured party obtains a three-party agreement (i.e., a control agreement) signed by the debtor, the secured party and the depository bank, containing the depository bank's agreement that it will comply with the secured party's instructions directing disposition of the funds in the deposit account without further consent by the debtor; or
- (iii) if the secured party becomes the depository bank's customer with respect to the deposit account.

A bank account evidenced by a negotiable or transferable certificate of deposit would not be classified as a "deposit account" and instead would likely be classified as an "instrument" and perfected by possession or filing of a UCC Financing Statement, so lenders need to be careful that they are in fact dealing with a "deposit account" and not an "instrument".

b. Letter-of-Credit Rights. Perfection of a security interest in a letter-of-credit right is achieved by taking control of the letter-of-credit right under Code Section 9-107. Under

this Code section, a secured party gains control of a letter-of-credit right to the extent of any right to payment or performance by the issuer or any nominated party if the issuer or nominated party has consented to an assignment of proceeds of the letter of credit to the secured party under Section 5-114(C) or other applicable law or practice. In certain cases, it would be prudent to obtain the consent of both the issuer and any nominated party (such as a confirmer or negotiating bank).

4. **UCC Filing Inadequate Means of Perfection.** A lender cannot perfect a security interest in the following types of collateral by filing a UCC Financing Statement:

a. **Titled Vehicles.** Except as set forth in the following paragraph, a lender's lien on a titled motor vehicle is achieved by having the lender's lien noted on the certificate of title to the motor vehicle under the applicable state certificate-of-title statute.

There is one significant exception to this general rule that pertains to vehicle dealers. Perfection of a security interest in a dealer's inventory of motor vehicles is accomplished solely by filing a UCC Financing Statement against the dealer's inventory. Illinois recently adopted a non-uniform version of Code Section 9-311(d) which expands this exception to also include vehicle lessors, in addition to dealers, and reads as follows: "During any period in which collateral subject to [a certificate of title law] is inventory held for sale or lease by a person or leased by that person as lessor and that person is in the business of selling or leasing goods of that kind, this Section does not apply to a security interest in that collateral..." Thus, perfection of a security interest in the inventory of a vehicle dealer (and vehicle lessors in Illinois and a few other states which have adopted this non-uniform version) is governed by the normal perfection rules (i.e., filing a UCC Financing Statement) even if the inventory is subject to a certificate-of-title statute. The Official Comment to this Code Section further provides that with respect to a dealer's inventory: "Compliance with a certificate-of-title statute is both unnecessary and ineffective to perfect a security interest in inventory to which this subsection applies."

For most other states that did not adopt such non-uniform version of Code Section 9-311(d) described above, the exception described above would not apply to a debtor that is in the business of leasing titled vehicles, but is not in the business of selling titled vehicles (in which case, placing liens on the certificates of title is necessary).

b. **Insurance Policies and Annuity Contracts.** Insurance policies (including life insurance policies) are generally excluded from the Code. However, there are some exceptions to this general rule: (i) an agent's pledged insurance commissions would be classified as "general intangibles" and covered by the Code, (ii) casualty insurance payments from collateral such as equipment or inventory are covered as Article 9 proceeds by the Code, (iii) health-care-insurance receivables are "accounts" covered by the Code, and (iv) an insurer's right to payment of the premium for a policy issued or to be issued would be classified as an "account" under Code Section 9-102(a)(2)(iii). Interests in annuity contracts have been held by several courts to constitute "general intangibles" under the Code; and in such cases the secured lenders were required to file a UCC Financing Statement describing the annuity contracts in order to have a perfected lien.

c. **Money.** Perfection of a security interest in money may be perfected only by a secured party taking possession under Code Section 9-313.

d. Railroad Rolling Stock. Liens on railroad rolling stock are governed by the Interstate Commerce Commission Act and are filed with the U.S. Department of Transportation's Surface Transportation Board.

e. Aircraft, Engines and Propellers (over 750 hp) and Aircraft Parts of "Certified Air Carrier". Liens on aircraft, engines and propellers (over 750 hp) and aircraft parts of "Certified Air Carrier" are governed by the Federal Aviation Act of 1958 and are filed with the Federal Aviation Administration in Oklahoma City. In addition, liens on certain aircraft and engines also need to be electronically filed with the international registry created by the Cape Town Treaty effective March 1, 2006 (resulting in a dual registration system for certain aircraft and engines). An overlapping UCC Financing Statement is filed to perfect a security interest in in-flight logs, records and related equipment.

f. Federally Documented Ships. Liens on federally documented ships are filed under the successor to the Ship Mortgage Act of 1920 (Chapter 313 of Title 46 of the U.S. Code). Ships not governed by this federal statute are sometimes covered by applicable state statutes which must be consulted for lien requirements. In Illinois, motorboats and sailboats over twelve feet in length are required to be registered under the Illinois Boat Registration and Safety Act (625 ILCS 45). A lender's lien on an Illinois registered boat's certificate of title needs to be registered with the Illinois Department of Natural Resources.

This article is informational in nature and is not intended to constitute, nor should it be relied upon as, legal advice to any recipient.

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