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SECURED LENDING ALERT

Perfection Of A Security Interest In Fixtures

Equipment sometimes gets attached to real estate, and in some cases, such equipment constitutes "fixtures" under Article 9 of the Uniform Commercial Code (the "Code"). A lender must determine before the loan is made whether any of its valuable equipment collateral could constitute fixtures under the Code. If the answer is yes, the lender must take the necessary steps to perfect its security interest in the fixtures.

1. What is a Fixture under the Code?

Unfortunately, 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 by a court to constitute "fixtures" 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.

2. Perfecting a Security Interest in 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 purchase money security interest ("PMSI") 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 will 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.

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.

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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Bennett L. Cohen is a partner in the law firm of Cohen, Salk & Huvard, P.C. Bennett concentrates his entire practice in commercial finance. He regularly represents banks, commercial finance companies and other institutional lenders in the structuring, documentation and closing of commercial financing transactions, including commercial & industrial loans, asset-based loans, commercial real estate mortgage and construction loans, equipment lease loans and factoring transactions. He served for fifteen years as general counsel to the Midwest Association of Secured Lenders, a trade association of over eighty banks and finance companies located in Chicago and outlying areas. Bennett is a member of the American Bar Association and serves on the ABA Committee on Commercial Financial Services and the ABA Subcommittees on Secured Lending, Loan Documentation and the Uniform Commercial Code.