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The Intersection of Chapter 11 and UCC Article 9

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Editor's Note: *This is a follow-up column to the contributing editors' previous column, Chapter 11 - "101," which ran in the* ABI Journal *from 2003-05. We asked the contributing authors to reintroduce an updated column because of the overwhelming response the previous column received from judges, professors, law students and professionals alike. The "201" series will examine how chapter 11 applies in conjunction with various other laws.*

About the Authors

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Chapter 11 - "201"

Some say chapter 11 practice is one of the last bastions of "general practice lawyering" in the large—or even medium-size—firm settings. This seems counterintuitive at first. After all, bankruptcy is considered a consummate example of specialization in what is increasingly a profession of specialists. Step back and consider, however, what a chapter 11 debtor lawyer does day in and day out, and one quickly understands that the lawyer's role is very similar to that of an outside general counsel, and indeed requires at least a basic working knowledge of a myriad other areas of the law.

Another apt analogy is that of a general contractor of a construction project. Sure, we're all expected to know the Bankruptcy Code "cold," but that's not enough. Just as a general contractor has to know enough about plumbing, electricity and carpentry in order to monitor and speak with subcontractors, so too a chapter 11 lawyer must know enough about litigation, corporate law, tax and a host of other specialties to adequately advance a client's interests. At a minimum we must know enough to spot issues as they arise, and consult with or bring in other specialists as needed.

It is with this perspective that we provide our first installment of Chapter 11 - "201," a new column that will discuss the intersection of chapter 11 practice with other areas of the law. To do this, each installment will be written with the assistance of specialists from a variety of legal areas.

The Basics of UCC Article 9

This month, we discuss the intersection between Article 9 of the Uniform Commercial Code and chapter 11 practice. The Uniform Commercial Code (UCC) is not the law in any state. Rather, it is a compilation of suggestions to state legislators for laws. These "suggestions," however, have been wildly successful; nearly every state has adopted nearly every provision of the UCC. The UCC is divided into 11 "Articles," each one addressing a different area of commercial law. The Articles of the UCC are:

- Article 1: General Provisions
- Article 2: Sales
- Article 2A: Leases
- Article 3: Negotiable Instruments
- Article 4: Bank Deposits
- Article 4A: Funds Transfers
- Article 5: Letters of Credit
- Article 6: Bulk Sales
- Article 7: Warehouse Receipts
- Article 8: Investment Securities
- Article 9: Secured Transactions

Article 9 of the Uniform Commercial Code governs "security interests" in personal property. It contains detailed rules regarding (a) the creation, "attachment" and "perfection" of security interests in various types of collateral; (b) the relative priorities of security interests; and (c) default and remedies upon default. When you are looking at an issue under Article 9, you should look at the applicable state's statute to see how, if at all, it differs from the UCC version. However, there typically will be no such difference, and we write this article with reference to the UCC version.

Article 9 was completely revised and restated in 2001. Every state in the nation has adopted the revised version of Article 9. Pre-2001, Article 9 remains relevant, however, due to the vast amount of case law construing its provisions, many of which have been incorporated into new provisions. The revision is so extensive that the old and new numbering do not match. Accordingly, lawyers must use care in locating applicable provisions of the revised UCC.

Security interests and liens—for our purposes, these two terms mean the

same thing—are fundamental legal tools in our modern economy. They provide lenders with comfort and a source of repayment in cases where debtors default. A security interest is a present grant of a property right.[1] It is usually, but not always, nonpossessory, as the debtor or borrower wants to be able to use the collateral while the security interest is in force. It may ripen into a full ownership interest through the process of default and foreclosure. The collateral—the "thing" that is encumbered by the security interest—may be real property, like an office building, or personal property, tangible or not, like a car, a copier, a copyright or an account receivable. (But note that the office building lien would not be covered by Article 9; instead it would be covered by state mortgage laws because the collateral is real estate).

Article 9 Is Good for Business

The UCC standardized the rules and procedures for taking, preserving, renewing and releasing security interests. The provisions of the UCC, and its widespread enactment, are among the most important developments of 20th Century American commercial law. This standardization dramatically lowered transaction and enforcement costs from the costs resulting from each jurisdiction enacting and enforcing its own rules governing personal property security interests. Although some variation between the states continues, even with the revised Article 9 such variations are relatively minor and limited in number.

Attachment

A security interest "attaches" to collateral when it is valid and enforceable *against the debtor,* but attachment does not necessarily make the security interest valid as against third parties. For example, an intervening judgment creditor can levy on the collateral, even if a security interest has previously attached, and gain a higher-priority security interest. The way the secured creditor can avoid this is to "perfect" its security interest. For personal property, perfection is generally accomplished by filing a properly completed form UCC-1 financing statement in the appropriate public records, most often the office of the secretary of state.

So when is a security interest enforceable against a debtor? Look at UCC 9-203(b). It provides that a security interest is enforceable against the debtor and third parties if (1) value has been given, (2) the debtor has rights in the collateral (or the power to transfer rights in the collateral to a secured creditor) and (3) the debtor has signed a security agreement or the collateral is in the possession of the secured creditor or, in the case of certain types of collateral, the secured creditor has "control" of the collateral.[2]

Perfection and Priority

The twin topics of perfection and priority are addressed in UCC 9-301, *et seq.* Think of "perfection" as making the security interest good against the world, not just between the parties. If a judgment creditor levies upon collateral in which a secured party has a perfected security interest, the judgment lien is junior to the security interest and will only be paid if the senior secured creditor is paid in full or agrees to take less than full payment in satisfaction of the lien.

How is a security interest perfected? A security interest is perfected when the creditor and the debtor have done everything that needs to be done (including executing and filing documents) to complete the transaction or transfer (*e.g.,* the creditor has loaned the money, the debtor has promised to pay it and has promised that the creditor has first dibs on the collateral if the debtor does not repay the loan) and that the creditor has done what is necessary under Article 9 to tell the world ("give notice") that he claims a stake in the collateral. Usually, you give notice by filing a document—a form UCC-1 (the Code calls it a "financing statement")—in the public record.

The DIP as Judgment Creditor

Of all the provisions in Article 9, the most important in terms of its interaction with the Bankruptcy Code is UCC 9-317. It is UCC 9-317 that provides that an unperfected security interest is subordinate to a judicial lien on the property. So if a judicial lien is slapped on the property before it is encumbered with a perfected security interest, that judicial lien has priority.

Why is this important in terms of the Code? Because of Code §544(a)(1). Under that section, as of the petition date, the trustee or debtor-in-possession (DIP) is cloaked with the rights and powers of:

> a creditor that extends credit to the debtor at the time of the commencement of the case, and that obtains, at such time and with respect to such credit, a judicial lien on all property on which a creditor on a simple contract could have obtained such a judicial lien, whether or not such a creditor exists.

In other words, the DIP (or trustee) is a hypothetical lien creditor that enjoys the protections of UCC 9-317.

So if a secured creditor is perfected as of the petition date, its security interest trumps the DIP, and the estate benefits from the secured creditor's collateral only *after* the secured creditor is repaid. However, if the secured creditor is not perfected as of the petition date, then the DIP prevails and the secured creditor shares *pro rata* with other unsecured creditors.

The import of UCC 9-317 can best be seen if we imagine that the section was not enacted in a particular jurisdiction. If that were the case, unperfected security interests would be enforceable against the DIP and the estate.[3] But UCC 9-317 has been enacted in every state, and that section, together with Code §544, make it clear that an unperfected security interest is subordinate to the trustee's hypothetical lien and is avoidable by the trustee. The net result is that Code §§362(a) (the automatic stay) and 544, together with UCC 9-317, on the petition date, sound a whistle and scream "freeze: All the value in the debtor's property not subject to a perfected security interest becomes the property of the estate."[4] What remains is taking a closer look at just exactly how we fit the trustee's power under §544(a) together with the UCC. The critical language is in §9-317(a)(2). It says:

> A security interest...is subordinate to the rights of...a person that becomes a lien creditor before the security interest...is perfected....

A "lien creditor" is a creditor who acquires a lien through the judicial

1 Security interests are recognized as property rights, which means that they are entitled to constitutional protection under the 5th and 14th Amendments to the U.S. Constitution which prohibit taking property interests without due process and just compensation (note the use of "due" and "just," which softens this prohibition somewhat more than some might assume).

2 Control is required for investment property, deposit accounts, electronic chattel paper and letters of credit. UCC 9-203(b) makes this clear.

3 If you believe that perfection serves a worthy notice function, then this would be an undesirable result—it would mean creditors could fail to give the required notice of their lien—perhaps inducing other creditors to extend credit to the debtor, who would believe the debtor's assets were unencumbered—and nonetheless prime those other creditors. A contrary argument is that most unsecured creditors do not extend credit in reliance upon a search for UCC-1s and an evaluation of a debtor's unencumbered assets as a source of repayment. *See* White, James J., "Revising Article 9 to Reduce Wasteful Litigation," 26 Loy. L.A. L. Rev. 823 (1993).

4 Of course, the DIP is obligated to use that value for the benefit of the estate, which is made up of the claims of creditors, post-petition claimants and equityholders. So the effect of the trustee's ability to avoid an unperfected security interest is to capture value for the benefit of all creditors that would otherwise go to a particular secured creditor.

process. Just how that's accomplished is a matter of *non-uniform* state law. Consider this hypothetical: Donald the debtor owns a case of fine champagne. Your client, Cartman Corp., just won a lawsuit against Donald. You send out the sheriff to pick up the champagne to satisfy the claim. Under California law, once the sheriff lays his hands on the champagne, you've got a lien; other states may date the lien from the time you send your order to the sheriff, or perhaps even from the time you win your lawsuit. To recap: If some secured creditor is perfected before Cartman Corp. gets its lien, then that secured creditor gets first dibs in the champagne. Otherwise, first dibs go to the Cartman Corp.

Perfection Is Not Always Necessary for the Secured Creditor to Beat a Lien Creditor

This system works well enough in practice, but oddly enough, the UCC doesn't stop there. Section 9-317 says the secured creditor may trump the lien creditor even if he does not perfect in time, provided he meets two conditions. First, there must be a "financing statement" on file to warn the world that the creditor claims a stake. Second, creditor and debtor must have taken at least a beginning step toward their deal. For example, there must be an agreement, or the creditor must have advanced money, or the debtor must have rights in the collateral. In other words, "filing plus" is enough.

The reasoning here seems to be that it is the public warning that counts; once the public is on notice, it really shouldn't matter when the deal is actually completed. This seems plausible enough on its face, but it raises a question: If you can trump the lien creditor with *only part* of a security interest, why would you ever want to bother to get *the whole thing*? In other words, if you win with this "second" rule, why do you need the first? Why would anyone bother with more than "filing plus"? One answer is that getting "the whole thing" provides you with additional rights under the UCC beyond merely defeating a judicial lien creditor. But discussion of those rights is beyond the intersection of chapter 11 and the UCC that is the subject of this article.

Another answer is that what we may have here is a case of culture lag: "Perfection" is the "old rule." It has been in the UCC since the beginning. "Filing plus something else" is new: It came into the UCC only in the year 2000. The drafters, in tentatively extending their reach, may have lost sight of the fact that they don't need the old handhold (at least not as much) any more.

Practically Speaking: The Chapter 11 Case Has Been Filed—What You Need to Understand

In an ideal world, secured creditors would make sure that their liens have been documented and perfected properly long before a bankruptcy case. But alas, we don't live in an ideal world. Often it is the bankruptcy filing that causes the secured creditor to review its credit documents and make sure that all of its ducks are in a row. At the same time, the DIP should be reviewing those documents looking to punch holes in them for the benefit of the estate. If the DIP isn't doing that job, the creditors committee—representing the interests of general unsecured creditors—is likely to do so. Questions to ask when reviewing the documents include:

- Is the collateral property in which a security interest can be perfected by a UCC-1 filing?
- Did a security interest attach for all of the collateral identified in the financing statement (as you want to know if you have a classically perfected security interest or one that you will defend based on 9-317's filing plus provisions)?
- Was the UCC-1 properly authorized by the debtor, for example through the security agreement?
- Is the collateral adequately described?
- Was the UCC-1 filed in the proper location(s)?
- Is the debtor's name correctly listed?
- If the collateral includes after-acquired property, has the debtor changed its name or business structure prior to acquiring some or all of the collateral?
- Has the debtor relocated to a different state?
- Were continuation statements timely filed?

Problems in any of these areas may create the opening for the DIP (or committee) to assert that the security interest is unperfected and may be avoided and preserved for the benefit of the estate, rendering the formerly secured creditor a mere unsecured creditor. To do this, the DIP relies on §544(b), which allows it to avoid any transaction that could be avoided by an unsecured creditor under applicable nonbankruptcy law.

Assuming that the security interest is valid, enforceable and unavoidable, what can the DIP do to or with the secured creditor's collateral? The answer is a surprising number of things, all with the caveat that the secured creditor is entitled to "adequate protection" of its interest in the collateral.

The personal property secured creditor is generally subject to the automatic stay. If it wants to exercise any remedies, it must seek relief from the stay. Alternatively, the creditor can seek adequate protection of the value of its collateral. *See* Code §362(a), (d)(1). Like the "due" in "due process" and "just" in "just compensation," the use of the word "adequate" in "adequate protection" makes a difference.

Adequate Protection

Adequate protection is defined in an open-ended fashion in §361 to include periodic cash payments, additional liens or the indubitable equivalent of the creditor's interest in the property; administrative expense status is expressly proclaimed not to constitute adequate protection.

The most common form of adequate protection for a secured creditor whose collateral consists of personal property and is being used by a debtor after the filing date is periodic payments to compensate for the wear and tear and depreciation of the personal property collateral. If there is a substantial equity cushion as of the petition date, the court may decide that the equity cushion constitutes adequate protection. For example, if the creditor is owed $20,000, but its collateral value is $35,000, the court is likely to find that the collateral value is sufficient so that the creditor doesn't face much risk and therefore is not entitled to periodic payments.

The DIP may seek to sell a secured creditor's collateral. If it is sold, it may either be subject to the lien or, under §363(f), free and clear of the lien. If sold free and clear, the most common form of adequate protection comes in the form of a replacement lien on the proceeds. The secured creditor also has, under Code §363(k), the right to "credit bid" (bid its debt rather than cash) at the sale

to ensure that an appropriate sales price is realized. In effect this gives the secured creditor a choice—take the highest price offered by a third-party bidder, or purchase the collateral in satisfaction of debt.

When a chapter 11 plan is pursued, the Article 9 secured creditor may be subject to nonconsensual cramdown of the plan, assuming that certain minimum requirements are met. These requirements are set forth in Code §1129. Grossly oversimplified, the secured creditor has the right to receive at least the present value of its collateral, either by payments up front, payments over time with interest, or conveyance to the creditor of its collateral. If the debtor can provide that to the creditor, then it has a shot at confirming a plan, even over the creditor's objection. ■

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