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Alert

Lender Primes Trustee in Seventh Circuit

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A bankruptcy trustee was "not entitled to avoid" a secured lender's "lien under the Bankruptcy Code" ("Code"), held the U.S. Court of Appeals for the Seventh Circuit on Sept. 11, 2019. *In re 180 Equipment, LLC*, 2019 WL 4296751, *6 (7th Cir. Sept. 11, 2019). The court rejected the trustee's argument that the lender's "lien [was] avoidable because the [lender's] financing statement failed to properly indicate the secured collateral." *Id*., at 1. Reversing the bankruptcy court, the Seventh Circuit held that the lender had perfected its security interest under the Illinois version of the Uniform Commercial Code ("UCC") when its financing statement incorporated "by reference…an unattached security agreement," sufficiently indicating its collateral. *Id*. This decision is arguably inconsistent with *In re Financial Oversight Management Board for Puerto Rico*, 914 F.3d 694, 705-06, 711-713 (1st Cir. 2019) petition for cert. filed 2019 WL 1989185 (U.S. May 3, 2019) (No. 18-1389) (financing statements did not describe collateral but only referred "to an extrinsic document located outside the UCC filing office, and that document's location is not listed in the financing statement"; notice in financing statement held insufficient under 2008 Puerto Rican version of UCC, but cured by later amendments under revised 2012 version of Puerto Rican UCC).

Relevance

Code § 544(a)(1) permits a bankruptcy trustee to avoid a security interest held by a lender if that interest would not have been enforceable against a subsequent lien creditor under applicable state law. This so-called "strong-arm clause" gives the trustee, as of the date of bankruptcy, the rights and powers of a judicial lien creditor, regardless of whether such a creditor exists. In other words, the trustee has the powers of a creditor who extended credit and obtained a lien on the date the debtor's bankruptcy petition was filed.

Courts applying Code § 544(a) consider, among other things, whether the secured lender satisfied state law public notice requirements as of the date of the bankruptcy filing. In the case of personal property, as in *180 Equipment*, the issue is whether the lender had "perfected" its security interest in substantially all of the debtor's assets, consistent with the parties' security agreement. Outside of bankruptcy, § 9-301(i)(b) of Article 9 of the UCC gives a judicial lien creditor priority over an unperfected security interest. In a bankruptcy case, the trustee, with the status of a hypothetical lien creditor, may avoid a security interest that had not been properly perfected with a proper financing statement in accordance with Article 9. *See*, e.g., *Kors, Inc. v. Howard Bank*, 819 F.2d 19 (2d Cir. 1987) ("Section 544(a) of the Code, the 'strong-arm' clause, enables the trustee…to act as a hypothetical lien creditor as of the day the bankruptcy case is filed…. Pursuant to this section, the trustee…can avoid unperfected liens on property belonging to the bankruptcy estate…. Once the trustee has assumed the status of a hypothetical lien creditor under § 544(a)(1), state law is used to determine what the lien creditor's priorities and rights are…. Hence, the bankruptcy court and the district court examined Vermont law to determine what rights the trustee had as a hypothetical lien creditor under § 544(a)(1)…. The [lower

courts correctly] found…that under Vermont law the…Bank failed to perfect its security interest in the [debtor's] equipment [because of a defective financing statement]…. Thus, at the commencement of the bankruptcy case, the Bank had an unperfected security interest in [the debtor's] collateral.") In sum, because an unperfected security interest is "subordinate" to a judicial lien creditor, the trustee primes the lender and may avoid the lender's security interest.

Facts

The debtor in *180 Equipment* had obtained a loan by granting the lender a security interest on "substantially all of [its] assets." *Id*. at *1. The lender's security agreement described the collateral in 26 categories, including accounts, cash, equipment, instruments, goods, inventory and all proceeds of those assets. The lender promptly filed a financing statement to perfect its security interest with the Illinois Secretary of State. According to the financing statement, the lender's lien purported to cover "[a]ll Collateral described in First Amended Restated Security Agreement dated March 9, 2015 between Debtor and Secured Party."

The debtor later defaulted and filed a Chapter 7 petition. In response to the lender's claims, the trustee asserted that the lender's security interest was not properly perfected because its financing statement did not independently describe the underlying collateral, but instead incorporated the assets listed in the parties' security agreement. *Id*. The bankruptcy court agreed with the trustee, but the Seventh Circuit granted the parties' joint petition to review the bankruptcy court's decision. The sole question on appeal was whether the lender's lien was avoidable "because the financing statement failed to properly indicate the secured collateral …." *Id*.

The Seventh Circuit

The UCC. The court first cited the relevant sections of the Illinois version of Article 9 of the UCC. "In relevant part, § 9-502 requires that a financing statement … (1) provide the name of the debtor; (2) provide the name of the secured party …; and (3) *indicate the collateral covered by the financing statement*." (emphasis added). According to § 9-504 of the UCC, "[a] financing statement sufficiently indicates the collateral that it covers if the financing statement provides … (1) a description of the collateral pursuant to Section 9-108; or (2) an indication that the financing statement covers all assets or all personal property." Section 9-108 "further explains that a description of the secured property does not need to be specific but must 'reasonably identif[y]' what is described. Section 9-108 gives six distinct methods by which a description of collateral reasonably identifies the secured property: (1) specific listing; (2) categories; (3) type; (4) quantities; (5) mathematical computation or allocation; or (6) *any other method, if the identity of the collateral is objectively determinable*." *Id*. at *3 (emphasis added).

Applying Law to Facts. The court then explained why the lender's "incorporating … a description [of its collateral in a financing statement] by reference to a security agreement sufficiently 'indicates' the collateral." *Id*. A lender can "indicate collateral in a financing statement – including by 'any other method' – so long as the identity of the collateral is 'objectively determinable.'" *Id*.

Prior to 2001, explained the court, a secured lender had to indicate in the financing statement "the types, or describ[e] the items, of collateral." But, in 2001, Illinois revised its version of the UCC "to no longer require that the financing statement 'contain' a description of the collateral; after [this] revision the statement must only 'indicate' collateral." According to the court, this "pared-down approach reflects the notice function of Article 9. . . . [T]he ordinary meaning of 'indicate' is to serve as a 'signal'

that 'point[s] out' or 'direct[s] attention to' an underlying security interest." *Id*. at *4, citing *Webster's New World College Dictionary* (4th ed. 2001).

Precedent. The Seventh Circuit had previously "recognized that Article 9 ensures 'adequate public notice' of liens and security interests, … and that 'the goal of the filing system is to make known to the public whatever outstanding security interests exist in the property of debtors." *Id*., quoting *In re Blanchard*, 819 F.3d 981, 986, 988 (7th Cir. 2016). The purpose of the financing statement is to put third parties "on notice that the secured party who filed it may have a perfected security interest in the collateral described, and that further inquiry into the extent of the security interest is prudent." *Helms v. Certified Packaging Corp.*, 551 F.3d 675, 679 (7th Cir. 2008). "The financing statement itself is an 'abbreviation of the security agreement.'" *Helms*, 551 F.3d at 679. "It is a streamlined paper to be filed for the purpose of giving notice to third parties of the essential contents of the security agreement." *Id*.

"The financing statement … need not particularize in detail the collateral secured under the security agreement because … a financing statement serves to give notice that the secured party who filed may have a security interest in the collateral and that further inquiry with respect to the security agreement will be necessary to disclose the complete state of affairs." *Id*., quoting *Helms*, 551 F.3d at 680. The "prudent potential creditor would … request … a copy of the security agreement … and need look no further than the security agreement" to resolve questions about the adequacy of the collateral description." *Id*., quoting *Helms*, 551 F.3d at 680-681. In short, "the financing statement provides notice of an underlying security interest, while the security agreement creates and specifically defines that interest." *Id*.

Lower courts in Illinois have repeatedly found "that incorporation by reference is permissible … as 'any other method' under § 9-108, so long as the identity of the collateral is objectively determinable." *Id*. at *6. In *180 Equipment*, the security agreement contained a detailed list of the collateral to which the financing statement referred. The financing statement also named both the debtor and lender, had not lapsed and "includes the date and precise title of the underlying document," describing the lender's security interest -- "[a]ll [c]ollateral . . . as described in the underlying security agreement between the parties." *Id*. Thus, "the financing statement … 'notif[ied] subsequent creditors that a lien may exist and that further inquiry [was] necessary to disclose the complete state of affairs.'" *Id*. The Seventh Circuit therefore reversed the bankruptcy court, finding that the lender's security interest was properly perfected and unavoidable by the trustee under Code § 544(a)(1).

Comments

1. The holding in *180 Equipment* is consistent with 2001 changes to the UCC:

> In a major change in the law that recognizes the broad concept of notice filing, UCC 9-504(2) states that a financing statement 'sufficiently indicates the collateral that it covers' if it provides 'an indication that the financing statement covers all assets or all personal property.' In other words, supergeneric collateral descriptions are okay in the financing statement, even though not allowed in the security agreement under 9 108(c). Regardless of its breadth, of course, the financing statement cannot perfect a security interest in collateral not covered by the security agreement. On a related point, a somewhat narrower description than 'all assets,' e.g., 'all assets other than equipment,' is sufficient for the financing statement even though it is not an adequate description of collateral in the security agreement. A supergeneric collateral

description in the financing statement should be valid for notice-filing purposes even though the security agreement only covers limited categories of collateral.

Barkley Clark, *Secured Transactions*, § 2.09[b][c], at 2-222 (2016 rev. ed.). *See 180 Equipment*, 2019 WL 4296751, at *3 ("In 2001, the Illinois version of the UCC was revised to no longer require that the financing statement 'contain' a description of the collateral; after revision the statement must only 'indicate' collateral.").

2. The Eighth Circuit has similarly held that supergeneric language in a financing statement suffices, stressing the statement's notice filing function:

> The [Missouri version of the UCC] UCC gives two methods for identifying collateral in a financing statement: a description of the collateral, or an indication that the financial statement covers all of the debtor's assets. It then provides that errors or omissions do not render the statements ineffective unless they are seriously misleading. The relevant question is whether the statements—judged in their entirety—are seriously misleading, not whether one alternative, and ultimately unnecessary, means of describing the collateral therein is seriously misleading. While Defendant's specific descriptions of the annuity contracts contain errors, the statements themselves are not seriously misleading, *because a subsequent creditor should reasonably understand that the financing statements may cover all of Hanson's assets. It was then incumbent upon subsequent creditors to inquire whether specific collateral owned by Hanson is the subject of a prior security agreement*.

ProGrowth Bank, Inc. v. Wells Fargo Bank, N.A., 558 F3d 809, 815 (8th Cir. 2009) (emphasis added).

3. Some practitioners recommend filing the security agreement with the financing statement. *See*, e.g., *Financial Oversight*, 914 F.3d at 705-06, 710-711 (security agreement could have been attached to financing statement in 2008; later amended financing statements in 2015-16 did attach "a full definition of 'Pledged Property'").

4. New York apparently follows the Seventh Circuit's reasoning in *180 Equipment*. *See*, e.g., *In re Sterling United, Inc.*, 674 Fed Appx. 19, 20-21 (2d Cir. 2016) ("In New York, a financing statement perfects a security interest if it (a) states the name of the debtor and the name of the secured party, or a representative of the secured party, and (b) indicates the collateral covered by the financing statement, N.Y. U.C.C. § 9-502. The collateral requirement may be satisfied by an indication that the financing statement covers all assets or all personal property. *Id*. § 9-504, which is the minimum necessary to provide [ ] notice that a person may have a security interest in the collateral claimed, Id. § 9-504, cmt. 2. . . . We conclude that the description [here] is sufficient because it unambiguously refers to '[a]ll assets of the Debtor' irrespective of their location.").

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If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

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