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## UNIFORM COMMERCIAL CODE

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### Making Loan Portfolios Comply With Revised Article 9



Revised Article 9 of the Uniform Commercial Code will be effective nationally on July 1, 2001. Although Revised Article 9 has not yet been enacted in New York, responsible parties in the New York State Legislature have indicated their understanding of the significant consequences that will befall borrowers and lenders should New York fail to enact Revised Article 9 in uniform form.<sup>1</sup>

Revised Article 9 affects virtually every aspect of a secured transaction, whether that transaction was entered into prior to July 1, 2001 or whether it will be entered into after the effective date. Therefore, it is important for a lender to prioritize the steps to be taken in order to bring its entire portfolio into conformity with the changed rules, and to ensure that it is properly protected from exposures arising during the transition period.

Readers who have been following discussions of the Article 9 transition rules may be surprised that this article does not approach reperfecting (by refile or otherwise) as the first priority. That is because in many cases no further action need be taken. If, for example, a borrower is a New York corporation with its chief executive office in New York and all of its tangible collateral located in New York, the fact that Revised Article 9 shifts the place of filing to the jurisdiction of incorporation will have no immediate impact on the lender. Second, if refile or reperfecting by another method is required by Revised Article 9, the transition rules (Part 7) contain various grace periods during which perfection will be maintained.

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Therefore, this article addresses first the steps that a lender should complete by July 1, 2001.

#### Security Agreement

First, the lender will want to have a new standardized security agreement in place by July 1, 2001.<sup>2</sup> This is the step that is likely to take the longest to complete because: (1) it requires the drafter to become familiar with all the terminology and substantive provisions of Revised Article 9; (2) in any lending institution there may be a number of officers who will be required to review the draft agreement and sign off on it; and (3) and there may be different types of security agreements for various classifications of borrowers, each of which will require substantial revision. Therefore, the security agreement is the task that should be addressed first.

Although a complete discussion of the requirements of a complying security agreement is outside the scope of this article, there are several areas of general concern. First, Revised Article 9 expands its scope to include many new types of collateral. Not all of these collateral types are best perfected by filing and in some instances (such as deposit accounts) filing is not a permissible method of perfection.<sup>3</sup> The security agreement should be expanded to

include these new collateral types, to sufficiently describe all collateral as required by Revised Article 9,<sup>4</sup> and to detail the actions the borrower agrees to take in order to enable the lender to become perfected and to maintain perfection. For example, instead of authorizing the filing of a financing statement the borrower may be required to execute a "control agreement",<sup>5</sup> to instruct a bailee to acknowledge that it is holding collateral for the lender's benefit,<sup>6</sup> or to request an assignment of the proceeds of a letter of credit.<sup>7</sup> Simultaneously, the lender should revise the standard collateral description used on financing statements.

Second, lenders will now have to file in the borrower's state of organization rather than the state where the borrower maintains its chief executive office or where tangible collateral is located. The new form of financing statement also requires information not required by current financing statements. Therefore, the borrower should be required to provide, on an initial and going-forward basis, all of the information related to its organizational status that will be required by the lender in order to comply with the Revised Article 9 requirements and such information concerning its organizational history as will enable the lender to locate any prior filings. Additionally, the borrower should be prohibited from taking any action that will render the lender's security interest unperfected (see discussion below). Finally, taking any of these actions without advance notice to the lender should become immediate events of default.

#### Deposit Accounts Policy

Revised Article 9 permits commercial deposit accounts to be taken as original collateral (as opposed to proceeds of other collateral), thus raising the possibility that, on

July 2, 2001, there may be business banking customers requesting that their accounts be assigned to a third party.<sup>8</sup>

To be sure, one way of quickly addressing this possibility is to develop a policy that the bank does not permit its deposit accounts to be assigned to a third party. Revised Article 9 does not require that a bank agree to the assignment, even if the customer so requests,<sup>9</sup> and, inasmuch as perfection by filing is not permitted for a bank account,<sup>10</sup> the depositor cannot assign its account without the bank's cooperation.<sup>11</sup>

Such a policy, however, might be shortsighted. First, there will undoubtedly be situations in which it will be to the bank's financial interest to permit such assignments. For example, suppose that a bank has made a loan to its business depositor and that a nonbank lender would like to take out the bank's position if it can obtain the deposit account as collateral. If the bank does not have a procedure to effectuate and control such assignments, it may find its lending officers improvising in order to accommodate such situations.

Furthermore, as customers become aware of this right, they may expect this service, particularly if they are aware that brokerage firms frequently permit such assignments. Thus, there may be competitive considerations that would affect a bank's decision to permit or refuse such assignments.

Finally, assignment of such accounts does not prejudice the bank as a lender to the depositor. The bank's right of set-off will prevail, except in rare circumstances, irrespective of timing.<sup>12</sup> Likewise, the assignment does not affect the bank's rights or duties; the bank may continue to operate the account normally until notified to pay over the funds to the secured party.<sup>13</sup>

If a bank is going to permit assignments, it should develop a "control form" that will satisfy the requirements of Revised Article 9. It should also develop an internal system for tracking all such assignments and a central control point so that a bank officer can correctly respond to an inquiry from a third party (such as the nonbank lender in the foregoing example) as to whether the account is already assigned to another person.<sup>14</sup> While nothing in Article 9 requires the bank to assume duties equivalent to those of a filing

office with respect to assignments of its deposit accounts, it is possible that the recipient of incorrect information could find a basis in tort law for imposing liability upon the bank if the recipient acts on the basis of an incorrect response that the account has not been assigned and suffers thereby.

## 'Consumer' Borrowers

Revised Article 9 contains a number of new consumer rules that will require lenders to identify persons within this category. At first, this would appear to be an easy task — banks already have departments that deal separately with businesses and consumers. The problem, however, is that while Revised Article 9 employs familiar terminology to determine who is a consumer — "a transaction in which ... an individual incurs an obligation primarily for personal, family, or household purposes",<sup>15</sup> Revised Article 9 (unlike much other legislation that deals with consumer rules), does not establish a dollar cap for a consumer transaction. A private jet, yacht, or art collection qualifies.<sup>16</sup> Therefore, the new consumer rules apply to individuals who may be serviced by the private banking department, or by other departments that do not now think of themselves as dealing with consumers.<sup>17</sup>

In New York, Revised Article 9 is expected to contain nonuniform rules that will bring security interests in cooperative apartments squarely within the framework of Revised Article 9. Therefore, one of the most prevalent types of "consumer transaction" in New York City will be the cooperative apartment loan.<sup>18</sup>

For several reasons, departments that deal with such consumers will have to have procedures to deal with the new consumer rules in place by July 1, 2001.<sup>19</sup> One is that former owners of private jets and classic sixes, unlike many other consumers, are likely to be able to retain counsel to assert their consumer rights effectively. Second, Revised Article 9 leaves it to courts to fashion remedies for noncompliance with Article 9 in consumer transactions.<sup>20</sup> These court-established remedies may impair the collection of a deficiency from the debtor.<sup>21</sup> Finally, an innocent violation of the consumer rules, repeated enough times, may be the predicate

for a class or mass action, a result that was recognized during the negotiations on consumer rules. Therefore, these rules (many of which are, fortunately, fairly mechanical) should be well understood, particularly by bank officers and outside litigators involved in the enforcement of such security interests.<sup>22</sup>

## Fraudulent Changes

Revised Article 9 contains several rules that deal with the acquisition of substantially all of the assets of an existing debtor. The acquirer (called a "new debtor")<sup>23</sup> becomes bound by the old debtor's security agreement as through it had signed or authenticated the security agreement itself if the new debtor "becomes generally obligated for the obligations of the other person [the old debtor], including the obligation secured under the security agreement, and acquires or succeeds to all or substantially all of the assets of the other person."<sup>24</sup> The Comments to this section explain that this language is intended to embrace some instances in which a jurisdiction's corporate law would not consider the existing security agreement to be the new company's liability.<sup>25</sup>

So far, so good: the security agreement continues to be enforceable against the new debtor. But what happens if the new debtor is located in a different jurisdiction than the old debtor? The lender has one year in which to discover that the change has taken place and reperfect in the jurisdiction where the new debtor is located; otherwise it becomes unperfected retroactively as against a purchaser of the collateral for value, including another secured party.<sup>26</sup>

Take a typical example:

Debtor is a Pennsylvania corporation. Lender perfects a security interest in Debtor's equipment by filing in Pennsylvania. Debtor's shareholders decide to "reincorporate" in Delaware. They form a Delaware corporation (Newcorp) into which they merge Debtor. The merger effectuates a transfer of the collateral from Debtor to Newcorp, which thereby becomes a debtor and is located in another jurisdiction. Under subsection (a)(3), the security interest remains perfected for one year after the merger. If a financing statement is filed in Delaware against

Newcorp within the year following the merger, then the security interest remains perfected thereafter . . . .<sup>27</sup>

A "reincorporation" of the type described above may or may not be fraudulent. For example, a subsidiary may have its own borrowing line. The parent's tax department may determine that, for tax reasons, the company should be reincorporated in another jurisdiction. The tax department may have no idea that this change affects the company's credit line.

One might ask: Is not this the same risk we have today? For several reasons, the lender's exposure is greater than under present Article 9. Recall that under Revised Article 9 the filing should be made where the debtor is "located," which, for a corporation or other "registered organization,"<sup>28</sup> will be the jurisdiction of organization. Under current Article 9 filings are made where the debtor has a physical location or where the collateral is located. If a chief executive office is removed to another state, the lender is likely to discover it. Likewise, lenders have developed procedures to monitor collateral. A change in organization, however, is a paper transaction that does not announce itself to a field examiner.<sup>29</sup>

Not only is a change in jurisdiction difficult to detect, it is easier to effect than a change in a brick and mortar office or the location of collateral. Finally, the consequences for the secured lender — retroactive unperfection — are severe.

There are two related problems. If the debtor simply changes the jurisdiction in which it is located without a reincorporation, the lender has four months in which refile in the new jurisdiction.<sup>30</sup> Failure to so file leads to retroactive lack of perfection.<sup>31</sup> The same four month period applies to a name change that renders a filed financing statement seriously misleading.<sup>32</sup> A change in the borrower's name may go unnoticed by the lender if the borrower operates under a trade name.

Finally, a debtor may file a termination statement indicating that the debt has been extinguished or that there was no security interest in the first place.<sup>33</sup> The termination statement must indicate that it was filed by

the debtor.<sup>34</sup> If a legitimate debt has not been repaid, the filing of a termination statement by the debtor may violate Revised Article 9;<sup>35</sup> however, it is not entirely clear from the language of the statute whether it operates to terminate the existing financing statement and whether a subsequent filer would therefore achieve priority.<sup>36</sup>

Lenders may wish to review their portfolios to determine where their greatest exposures arise, and what steps are cost-efficient to take in order to detect such changes. Additionally, lenders may consider revising loan documentation in order to address these risks more effectively than at present.



(1) The author was a member of the Drafting Committee to Revise Article 9 and is a member of the Stand-by Committee that will consider post-effective amendments on a national basis. She represents New York State on the Conference of Commissioners on Uniform State Laws and also serves as Legislative Liaison for the New York State Delegation. Although there are still some outstanding issues that will have to be resolved before Revised Article 9 is enacted, the author is not aware of any concerns that have been raised that would affect the conclusions reached in this article.

(2) The term "security agreement" is used to refer to any agreement that establishes the terms and conditions for lending, whether those terms appear in a credit and security agreement, letter of credit reimbursement agreement, or other document.

(3) Revised Article 9-312(b)(1).

(4) Revised Article 9-108.

(5) Revised Article 9-106.

(6) Revised Article 9-313(c).

(7) Revised Article 9-107.

(8) Only business accounts can be assigned. Consumer deposit accounts cannot be pledged under Revised Article 9 (Revised 9-109(d)(13)).

(9) Revised Article 9-342.

(10) Revised Article 9-312(b)(1).

(11) Except for funds on deposit that are represented by certificates of deposit and that continue to be "instruments."

(12) Revised Article 9-340(c) and Revised Article 9-104(a)(3) provide that if the secured party has an account at the depository bank in the name of the secured party that contains funds of the debtor, the depository bank may not set off against such funds based on a claim against the debtor. Thus, this account will be treated as if it were the account of the secured party.

(13) Revised Article 9-341.

(14) The customer must make this request to the bank on behalf of the third party (Revised Article 9-342).

(15) Revised Article 9-102(a)(26).

(16) The lender may argue that it understood the loan to be "primarily" for business purposes. Revised Article 9-628(c)

appears to require: (1) a debtor's statement of nonconsumer purpose and (2) the secured party's reasonable reliance thereon.

(17) Why is there no cap? If history is any guide, Revised Article 9 will not be overhauled for another fifty years or so. Given the difficulty of imagining what a cap of, say, \$250,000 would be worth fifty years from now, consumer interests were unwilling to cap the consumer transaction.

(18) Considering that a family's investment in its cooperative apartment may be its most significant financial asset, there is nothing inherently unfair in this result.

(19) Note that some of these new rules apply only to "consumer goods transactions" and others apply to "consumer transactions" or "consumer debtors" generally. The buyer of a cooperative apartment would be entering into a consumer transaction but would not be entering into a "consumer goods transaction" because the cooperative apartment provisions are expected to carve the interest in a cooperative apartment out from the definition of "goods."

(20) Revised Article 9-626(b). For nonconsumer transactions, Revised Article 9-626(a) provides remedies for non-compliance.

(21) Revised Article 9-626 Comment 4.

(22) The cooperative apartment provisions are expected to permit enforcement either under Article 9 or by any judicial means. While it is arguable that judicial enforcement permits the secured party to opt out of its duties to the debtor under Part 6 of Article 9, it is difficult to make the argument that one can enforce a security interest in personality under Part 6 in disregard of those duties.

(23) Revised Article 9-102(a)(56).

(24) Revised Article 9-203(d)(2).

(25) Revised Article 9-508, Comment 3.

(26) Revised Article 9-316(a) and (b).

(27) Comment 2 to Revised Article 9-316.

(28) Revised Article 9-102(a)(70).

(29) This risk was generally considered to be an acceptable trade off for the greater efficiencies to be achieved by requiring filing in one easily-determined location.

(30) Revised Article 9-316(a)(2).

(31) Revised Article 9-316(b).

(32) Revised Article 9-507(c).

(33) Revised Article 9-509(d). This rule was considered useful because under Revised Article 9 a financing statement need not be signed by the debtor. Therefore, bogus filings may be more frequent under Revised Article 9 than under current Article 9. Second, lenders making genuine filings may have little incentive to clean up the record for the borrower's benefit once the loan has been repaid; thus some mechanism should be provided for borrowers to do so when necessary. New York has a comparable provision in its real property law (Real Property Actions and Proceedings s 1921). Revised Article 9's rule was based on the New York statute.

(34) Revised Article 9-509(d).

(35) *Id.*

(36) Revised Article 9-510(a) provides that a filed record is effective "only to the extent that it was filed by a person that may file it under Section 9-509". The better view is that this language encompasses not only the identity of the filer but all of the attendant facts and circumstances that would make the filing accurate. If this view is adopted, the fraudulent termination statement would be ineffective.