Perfectly Splendid: Back to the Basics of Attachment and Perfection of Security Interest

Steven N. Kurtz returns to the basics and offers up guidance on attaching and perfecting security interest in an article inspired by and in memory of Steve Johnson and David Rains.

I frequently look at what's happening around me for inspiration for this column, and some recent unpleasant news triggered the idea for this article. The International Factoring Association lost two longstanding and prominent members this year in Steve Johnson of J D Factors and David Rains of Commercial Finance Consultants/ FactorHelp. Steve and David were friends that I have known for more than 20 years and hold in high regard. They both shared a love of imparting their knowledge to others. Steve worked with youngsters through his church and scouting. David's passion was teaching prison inmates life and business skills. The void caused by their passing made me realize there is a whole new group of people in the factoring and commercial finance industry who could benefit from learning the basics. This article will do a deep dive into the attachment and perfection of security interest, which is the foundation

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of the industry. While designed for newcomers, more experienced folks may learn a thing or two as well.

Whether you are extending credit and taking collateral or purchasing accounts, you need to comply with Article 9 of the Uniform Commercial Code. In fact, the UCC recognizes the line is often blurred between a true sale of accounts and a loan. The first step for Article 9 is the attachment of your security interest. Provided that your security interest attaches and you perfect, which for most collateral is recording your financing statement correctly, you are both attached and perfected as to your collateral and, if applicable, have taken steps necessary to own the accounts you purchase.

PURSUING PERFECTION

However, before documenting your transaction, you have some preliminary work to do. Each factor's diligence process includes gathering prospect information, including credit history, financial health, company name and state of organization. Upon determining the latter piece, you must order a lien search using that state's official search logic and certify accuracy. You also need to obtain the actual organizational documents filed in the state, including the articles of incorporation or the LLC registration statement, because you must know the exact name that your prospect is using, which often can be different than the trade name. For those who are financing an individual, you need to get that name right as well. This requires a valid copy of the person's official ID. However, if you finance an individual, it's better to have them convert the business to a corporation or LLC.

Now that you have the name of the prospect, your factoring or security agreement will contain the first step to obtain perfection, which is the attachment of your security interest. Attachment of a security interest requires that the debtor have rights in the collateral, that value is given and, in most instances, that the debtor has authenticated a security agreement that describes the collateral. These steps are easy, and the last step occurs in the granting clause of your agreement in which your client grants you the security interest in the collateral. Before Article 9 was overhauled on July 1, 2001, security agreements often had long and meandering collateral descriptions. Article 9 now allows you to simplify your collateral descriptions by describing categories of collateral. If you are using the super long collateral description, you are probably on an older form.

As for existing collateral that is perfected, you will always be ahead of a lien creditor. Issues arise when you make new advances on after acquired collateral.

Unless you are dealing with exotic collateral, such as chattel paper, or collateral for which the UCC provides alternative places for perfecting your lien, such as titled vehicles or registered copyrights, you perfect your security interest by filing in the state in which your client is organized. But first you need to ensure you describe your collateral correctly in your financing statement. This step is easy now, but understanding this concept requires another history lesson.

Before July 1, 2001, financing statements had to be signed by the debtor, and in many instances, had to be filed in multiple states, and creditors often lost priority challenges against the collateral because it was easy to get things wrong when you had to file financing statements in multiple jurisdictions. Plus, if the debtor opened a new location, the creditor was exposed.

Now you perfect your security interest in all collateral perfected by a financing statement in the state where the debtor is registered. But again, another history lesson. Before July 1, 2001, your UCC-1 had to match the exact grant of your security interest. So if your agreement had a super long collateral description, your financing statement signed by the debtor had to match your language in the security agreement. If you accidently left something off, then the secured party was in danger of losing its perfection on whatever it left off. Sometimes transcription errors produced strange results when the person preparing the UCC-1 left off parts of long flowy collateral descriptions. Another common mistake was that the person drafting the UCC-1 thought that since the creditor was getting a blanket lien, often referred to as all assets, it was OK to say "all assets." Before July 1, 2001, this was wrong and led to the creditor losing its lien. Now your financing statement can say "all assets."

The bottom line way to make sure you are perfected is as follows. Your security interest attaches through the granting language in your agreement, where you can describe the collateral in basic categories. A written agreement to extend credit satisfies the "value" provision in UCC 9-203 and contains language that affirms the factor client owns the collateral, which means it has the "rights" in your collateral. You perfect by either describing the collateral exactly as the security agreement states or you can simply say "all assets" on your UCC. I prefer using all assets since it's hard to mess up those two words. If you say all assets, your actual collateral

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is what's described in your security agreement. Your financing statement must be filed exactly in the name as it is registered in the articles of incorporation or LLC on file with the state. Write the debtor's name exactly as it's written in the registration papers. Once you file the UCC-1, you should run what is called a "search to reflect." That means, after you file, you conduct a search using the name as reflected in the official state records, in the state where you filed, using the state's official search logic system. If your lien shows up in your search to reflect, you are perfected. If not, then you need to figure out why. The UCC is what is known as a "race statute," meaning that whoever records first wins the priority fight, no matter what.

LOSING PRIORITY

Now that we have discussed perfection, you need to be cognizant as to how you may lose your priority or have your rights violated by other creditors. This can happen easily even if you do everything right. The most common ways to lose priority is through a lien creditor, a tax lien or a secured creditor junior to you. Again, a lien creditor is typically either a creditor levying on your collateral through a judgment or pre-judgment remedy, or a bankruptcy trustee. Outside of bankruptcy, it's common for your client to get into trouble with creditors and get sued. The litigation often turns into a lien creditor situation.

As for existing collateral that is perfected, you will always be ahead of a lien creditor. Issues arise when you make new advances on after acquired collateral. The lien creditor problem kicks in the UCC 45-day rule set out in §9-323. Generally, you will be senior on new advances if you did not know about the lien creditor or if the advances were made pursuant to a commitment. Once you know about the advances, you have a 45-day safe harbor in which you can make advances and be ahead of the lien creditor on the newly acquired collateral. The UCC 45-day rule has an exception for those who buy accounts, but I never recommend continuing to fund after 45 days for a factor because most factors do full recourse factoring, which is often treated by courts as a loan and not a true sale of accounts. The best rule of practice is that once you learn of a lien creditor levying on your collateral, you should stop funding and address the issue. But, as a safe harbor, you do have 45 days in which to fund with knowledge of the lien creditor, and you can still be senior on after acquired collateral and the new advances.

Another way to lose priority is through a federal tax lien. The federal tax lien has its own 45-day rule, which is different than the UCC 45-day rule. The federal tax lien 45-day rule is as follows: If the IRS files a tax lien, you will keep your priority on new advances or new collateral on the earlier of 45 days after the lien is recorded, or immediately upon your learning (or when you should have learned) of the tax lien.

Do not confuse the federal tax lien 45-day rule with the UCC 45-day rule. The IRS jumps ahead of you 45 days after its tax lien is recorded, if you never learned about it, or the instant you learn before the 45 days expire. This means you must stop funding the instant you learn about the IRS lien. If you want to continue to fund, you will need to enter into a written subordination agreement with the IRS, which is always on its lousy form. State tax liens will be governed by the law of the state, but you should always stop funding the instant you learn. Many states track the IRS priority rules but not all.

Another way to have your priority interfered with is through another secured creditor. Even though your agreement may prohibit the granting of other liens in your collateral, it still happens and the other creditor's financing agreement with your client is valid. The issue is not one of priority because in most instances, the factor or asset-based lender is in the first position. The issue with the junior creditor is whether it is violating your rights. While there are cases all over the place on this issue, if you are putting a warning on your UCC-1 and your agreement prohibits the granting of a junior lien without your consent, you have the upper hand if you have to go to court.

This article was inspired by Steve Johnson and David Raines because of their love of teaching beginner level subjects to their students. As a means of honoring their memories, you may wish to donate to their favorite charities: the Claremont School of Theology and the Prison Entrepreneurship Program. •