

A Win for Lenders: Seventh Circuit Finds UCC-1 Collateral Description Reference Sufficient



ALERT | October 1, 2019

Deborah J. Enea | enead@pepperlaw.com

In a win for lenders, on September 11, the U.S. Court of Appeals for the Seventh Circuit reversed the U.S. Bankruptcy Court for the Central District of Illinois, holding that the collateral description in the UCC-1 financing statement referencing the corresponding security agreement was sufficient to perfect a security interest under Article 9 of the Uniform Commercial Code when all other requirements were met. *In re 180 Equip., LLC*, 2019 WL 4296751 (7th Cir. Sept. 11, 2019).

THIS PUBLICATION MAY CONTAIN ATTORNEY ADVERTISING

The material in this publication was created as of the date set forth above and is based on laws, court decisions, administrative rulings and congressional materials that existed at that time, and should not be construed as legal advice or legal opinions on specific facts. The information in this publication is not intended to create, and the transmission and receipt of it does not constitute, a lawyer-client relationship. Please send address corrections to phinfo@pepperlaw.com.

© 2019 Pepper Hamilton LLP. All Rights Reserved.

This case was a matter of first impression and provides important guidance to lenders, including:

- The purpose of collateral descriptions addressed in the UCC is not to “create a wind-fall” for parties filing for bankruptcy; instead, the financing statement is intended to act as notice to would-be subsequent creditors of an existing security interest.
- Under the UCC, the financing statement need only “indicate” the collateral covered by the financing statement. This may include reference to the underlying agreement in which the collateral is particularly described.

Background

In this case, the debtor, I80 Equipment, LLC, operated a commercial business in Illinois that purchased and refurbished trucks for resale. I80 Equipment obtained a commercial loan from First Midwest Bank and, on March 9, 2015, the parties executed the First Amended and Restated Security Agreement granting First Midwest Bank a security interest in substantially all of I80 Equipment’s assets. To perfect its interest in these assets, First Midwest Bank filed a UCC-1 financing statement with the Illinois Secretary of State. In the financing statement, the collateral was described as “[a]ll Collateral described in First Amended and Restated Security Agreement dated March 9, 2015 between Debtor and Secured party.” The security agreement was not attached to the financing statement.

Two years later, I80 Equipment defaulted under the terms of the loan and filed for bankruptcy under Chapter 7. The court appointed a trustee to manage the bankruptcy assets. First Midwest Bank sued, seeking judgment that its security interest was properly perfected and therefore First Midwest Bank was senior to other claimants, including the trustee. The trustee claimed that the security interest was not properly perfected. The trustee argued that the financing statement did not sufficiently describe the underlying collateral because the list of assets was incorporated by reference to the security agreement between First Midwest and I80 Equipment. The trustee filed a counterclaim to avoid First Midwest’s lien.

The Bankruptcy Court agreed with the trustee, holding that First Midwest's interest was unperfected because the financing statement failed to sufficiently describe the collateral. The financing statement only referenced the definition of "collateral" in the underlying security agreement without attaching the security agreement to the financing statement. Thus, any third party would not be on notice as to the specific collateral covered by the financing statement. First Midwest Bank appealed. The Seventh Circuit granted a review of first impression as to whether the Bankruptcy Court erred in its interpretation.

Analysis

The key issue is whether a collateral description in a filed financing statement that refers to an unfiled document sufficiently indicates the collateral, as required by the UCC to achieve perfection. To resolve this issue, the court needed to determine whether the statutory language in the UCC requires a specific description of the secured collateral, or if incorporating such a description by reference to another document sufficiently indicated the collateral.

In making its determination, the court conducted a four-step analysis of the UCC and its requirements for financing statements:

- The court first looked to UCC section 9-502 and its requirement that a financing statement (1) provide the name of the debtor, (2) provide the name of the secured party or its representative, and (3) *indicate the collateral covered* by the financing statement.
- The court then discussed UCC section 9-504, which states that "a financing statement sufficiently *indicates the collateral that it covers* if the financing statement provides: (1) a description of the collateral pursuant to UCC section 9-108; or (2) an indication that the financing statement covers all assets or all personal property."
- Next, the court listed the six methods to indicate collateral in a financing statement set forth in UCC section 9-108: (1) specific listing; (2) category; (3) type; (4) quantity; (5) mathematical computation or allocation; or (6) *any other method, if the identity of the collateral is objectively determinable*.
- Finally, the court explored how the Illinois UCC was revised in 2001 to make it easier to satisfy financing statement requirements and thereby perfect an interest in collateral.

Before the UCC was revised in 2001, financing statements were required to “contain” a description of the collateral; currently, section 9-502 of the UCC provides that a financing statement need only “indicate” collateral covered by the financing statement. The Seventh Circuit highlighted the notice function of the UCC. In doing so, the court specifically stated that “plain reading of the text allows a party to ‘indicate’ collateral in a financing statement by pointing or directing attention to a description of that collateral in the parties’ security agreement.” This interpretation reflects the purpose of the financing statement, which is to “make known to the public whatever outstanding security interests exist in the property of debtors.” Furthermore, the court emphasized that the purpose of the UCC is not to create a loophole for a bankruptcy estate or create an obstacle for lenders.

The court distinguished between financing statements and security agreements. The Seventh Circuit noted that, although “financing statements and security agreements both must describe the collateral,” the description requirements are different because security agreements and financing statements have different underlying functions. Security agreements create and specifically define the underlying security interest. Financing statements simply provide notice of the established interest.

The court differentiated the *180 Equipment* case from other cases. The court noted that financing statements with a collateral description incorporated by reference to a previous financing statement may be insufficient when the previous statement lapsed and did not provide any indication of the collateral whatsoever or when the lender’s security interest failed to attach to the debtor’s collateral because the security agreement itself did not sufficiently incorporate a collateral description.

The court concluded that as long as the “identity of the collateral is objectively determinable,” the financing statement’s incorporation of the security agreement description by reference is permissible. Other than the collateral description, there was no dispute that the financing statement fulfilled all other criteria required under the UCC (name of the debtor, name of the secured party, date, etc.). Furthermore, the security agreement sufficiently denoted all collateral, and the financing statement’s reference to the security agreement was clear. The court concluded that the financing statement fulfilled the requirements set forth in the UCC, and the security interest was perfected.

Outcome

The court held that First Midwest Bank's reference to the description in the underlying security agreement sufficiently described the collateral in its financing statement. As a result, First Midwest Bank had a valid financing statement, the trustee was not entitled to avoid First Midwest Bank's lien, and the earlier court's decision was reversed.

Takeaway

Lenders may use this case as a guide to ensure their financing statements properly perfect security interests. Although this case has a welcome result for the lender involved, lenders should continue to prepare financing statements carefully. Although a lender need only indicate collateral in a financing statement "by pointing or directing attention to a description of [the] collateral in the parties' security agreement," the best practice would be to avoid ambiguous collateral descriptions in financing statements. Lenders should ensure that their financing statements contain a description that reasonably identifies the collateral and that the description is contained within the four corners of the document. If a lender does not use a super-generic description, such as "all assets of the debtor" and instead references a description in an underlying agreement, the financing statement should attach the document that contains the description. Incorporation by reference is permissible under the UCC only as long as the underlying purpose of the financing statement has been realized and potential subsequent creditors are notified that a lien may exist on the collateral.