

Expert Q&A on Priority Issues Relating to Existing UCC-1s

PLC Finance

An expert Q&A with Darrell W. Pierce of Dykema Gossett PLLC on whether existing UCC-1 financing statements establish priority for future loan advances.

WHY ARE THERE SOMETIMES PRIORITY ISSUES WITH EXISTING FINANCING STATEMENTS?

The primary rule of priority under Article 9 of the Uniform Commercial Code (UCC) is the "first-to-file-or-perfect" rule found in Section 9-322 of the UCC. This rule provides that a secured party's priority is based on "the time a filing covering the collateral is first made" as long as the filing or perfection by other means is then maintained. Section 9-204 of the UCC makes it clear that security interests may secure future loan advances, even if there is no commitment to make any advances at the time the debtor enters into its security agreement with the secured party.

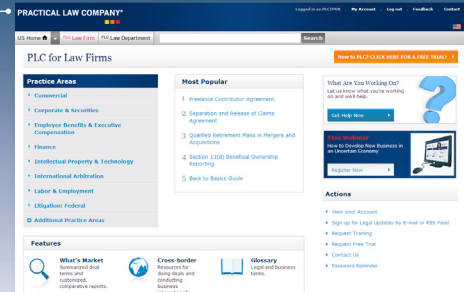
Does this mean that a secured creditor who is first to file and whose security interest secures all present and future obligations of the debtor to the secured party may rely on its first-to-file status and be assured of priority for all future advances it might make? In general, that is the case, but there are some potentially important limitations.

This issue will be examined by using a basic hypothetical and considering different types of future advances that might be made by the secured party. In this hypothetical, there is a traditional commercial lender (Lender) with a security interest in all of a debtor's (Debtor) equipment to secure any and all obligations of the Debtor to the Lender, now existing or hereafter arising, expressly including uncommitted and uncontemplated future advances. The security interest is properly created, has attached to existing collateral and will attach immediately to future collateral as soon as the Debtor obtains rights in that collateral. The Lender's security interest is properly perfected by the filing of an authorized UCC-1 financing statement (UCC-1) in the proper filing office.

For this hypothetical, it is also assumed that:

- The filed UCC-1 has not lapsed.

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- The collateral has not changed.
- The Debtor's location state has not changed.
- The Debtor is a registered organization.
- None of the transactions involve real estate collateral, consumer goods or purchase-money security interests.
- There is no accession to the collateral.
- The collateral is not subject to a certificate of title statute.
- There has not been a request by the Debtor to terminate the filed UCC-1 at any time.

However, this hypothetical is not a comprehensive analysis of every potential priority issue. Tax liens, for example, can have priority despite a secured party's first-to-file status. The focus here is on priority as against a competing secured party (a Subsequent Filer) who takes a security interest in the Lender's collateral and perfects by filing a UCC-1 after the Lender has filed but before the Lender makes a future advance. However, there are also some priorities rules regarding lien creditors and prospective purchasers of the collateral that will be noted.

Based on these assumptions, it must be determined whether the Lender can rely on its previously filed UCC-1 for priority over a Subsequent Filer if:

- The Lender wants to make substantial amendments to the terms of the original loan relating to the UCC-1 (see *Amendments to the Loan*).
- The original loan relating to that UCC-1 is still outstanding and the Lender now wants to make a new loan (see *Future Advances*).
- The original loan relating to that UCC-1 was repaid a while ago and the Lender now wants to make a new loan (see *New Loan*).

For more information on perfection and priority of security interests under the UCC, see *Practice Note, UCC Creation, Perfection and Priority of Security Interests* (www.practicallaw.com/6-381-0551).

UCC FIRST-TO-FILE RULE

There are historical reasons for the Lender to be concerned that the first-to-file-or-perfect rule may not be literally applied. While courts have consistently enforced the first-to-file-or-perfect priority rule regarding future advances that were specifically described in the initial security agreement, some courts under prior versions of UCC Article 9 imposed limitations on the priority of future advances that were not contemplated at the time the security agreement was executed and delivered (see *Coin-O-Matic Serv. Co. v. R.I. Hospital Trust Co.*, 1966 WL 8987, 3 UCC 1112 (R.I. Super. 1966)).

Cases like *Coin-O-Matic* sometimes couch the issue in terms of whether or not the security agreement adequately describes the future advance in question as being covered. This ignores the limited notice-filing function of UCC Article 9's filing system where a searcher expects to find only the identity and address of the secured party of record and an indication of the collateral. A UCC-1 does not have to provide any information on the character or amount of the related secured obligations.

Other cases under prior versions of UCC Article 9 found that first-to-file priority was obtained whether the future advances were contemplated in the original security agreement or not (see *Allis-Chalmers Credit Corp. v. Cheney Inv., Inc.*, 227 Kan. 4, 605 P. 2d 525, 28 UCC 574 (1980)).

Another rationale used by courts under prior versions of UCC Article 9 to avoid the first-to-file priority rule was to find that when the debtor paid off its line of credit for a period of time, the security interest was terminated (see *In re Hagler*, 1972 WL 20786, 10 UCC 1285 (Bankr. E.D. Tenn. 1972) and *ITT Industrial Credit Co., v. Union Bank and Trust Co.*, 615 S.W.2d 2, 30 UCC 1701 (Ky. App. 1981)).

If UCC Article 9 is properly read and enforced, these historical concerns should no longer be relevant. As provided in Official Comment 5 to Section 9-204 of the UCC:

"the parties are free to agree that a security interest secures any obligation whatsoever. Determining the obligations secured by collateral is solely a matter of construing the parties' agreement under applicable law. This Article rejects the holdings of cases decided under former Article 9 that applied other tests, such as whether a future advance or other subsequently incurred obligation was of the same or similar type or class as earlier advances and obligations secured by the collateral."

As previously noted, the primary priority rule is found in Section 9-322(a)(1) of the UCC:

"Priority dates from the earlier of the time a filing covering the collateral is first made or the security interest ... is first perfected, if there is no period thereafter when there is neither filing nor perfection."

Official Comment 4 to Section 9-322 of the UCC notes that the first-to-file rule is not absolute, citing purchase-money priority as an example, but goes on to state that:

"[i]n general, the [first-to-file-or-perfect rule] does not distinguish among the various advances made by a secured party. The priority of every advance dates from the earlier of filing or perfection. However, in rare instances, the priority of an advance dates from the time the advance is made. See Example 3 and Section 9-323."

Section 9-323 Exceptions

Section 9-323 of the UCC specifically addresses the priority of future advances and as indicated by the Section 9-322 Official Comment, creates some limited exceptions to the first-to-file-or-perfect priority rule. Section 9-323 of the UCC requires careful reading because of the way it is drafted. Rather than re-affirm the first-to-file-or-perfect rule, it instead describes limited circumstances when an advance is afforded priority only from the time of the advance. Those limited circumstances do not include a security interest perfected by filing because they are limited to cases where the secured party is perfected by either:

- Automatic perfection or temporary perfection without filing under Section 9-309 ("automatic perfection" transactions, including sales of promissory notes and sales of payment intangibles).
- Sections 9-312(e), (f) or (g) of the UCC (temporary automatic perfection of security interests in certain goods, documents, certificated securities and instruments made available to the debtor).

However, these limited circumstances do not arise necessarily under any of the questions being addressed here.

In any event, the proper reading of Section 9-323(a) of the UCC is expressed in Official Comment 3:

"Under a proper reading of the first-to-file-or-perfect rule of section 9-322(a)(1) (and former section 9-312(5)), it is abundantly clear that the time when an advance is made plays no role in determining priorities among conflicting security interests except when a financing statement was not filed and the advance is the giving of value as the last step for attachment and perfection. Thus, a secured party takes subject to all advances secured by a competing security interest having priority under section 9-322(a)(1)."



Section 9-323 of the UCC also modifies the first-to-file-or-perfect rule regarding future advances and competing claims of lien creditors and purchasers (and lessees) of collateral. It provides that future advances made more than 45 days after a lien creditor arises with knowledge of the lien and not made pursuant to a commitment made without knowledge of the lien are junior to the lien creditor. It also provides that purchasers and lessees of collateral take free and clear of advances made after the earlier of 45 days after the purchase or the time the secured party obtains knowledge of the purchase, unless the advance is made pursuant to a commitment entered into before that time.

However, purchasers and lessees who are in the ordinary course take free and clear under different provisions, Sections 9-320 and 9-321 of the UCC, so the 9-323 rule is limited to non-ordinary-course purchasers and lessees.

UCC Article 9 Filing Policies

UCC Article 9 priority issues should be analyzed in light of Article 9's policies, particularly those that relate to Article 9's filing system.

The UCC Article 9 filing system is merely a notice filing system. It does not provide a searcher with comprehensive information concerning a debtor's prior credits. Under Section 9-502 of the UCC, a secured party is required only to provide information concerning the debtor, itself and an indication of collateral for a legally effective UCC-1. It does not need to provide information concerning the character or amount of the obligations secured. All the information the filing system is intended to provide is that for any particular debtor, a secured party of record has a financing statement that indicates a possible priority position in the indicated collateral. The searcher must assume that the secured obligations are significant and must make other inquiries to confirm the true state of affairs.

Given that the filing of a UCC-1 perfects the Lender's security interest and a Subsequent Filer is given all the information the UCC-1 is intended to provide, what purpose is served in limiting the secured party's potential priority? Typically a Subsequent Filer would care about its priority and conduct a search. There is little point in protecting a Subsequent Filer who does not search because it apparently does not care about its priority.

A Subsequent Filer who searches and finds a prior UCC-1 bears the responsibility to determine the extent of the secured obligations with priority. This is always the case, whether the Lender has made a future advance or not, so there would appear to be no reason for a court to impose additional limitations on the scope of the priority obligations.

Indeed, a new comment being added in the 2010 amendments to UCC Article 9, which become effective July 1, 2013, reinforces that Article 9's priority rules should be interpreted and applied in light of its notice-filing system. The following new language, addressing the effectiveness of a UCC-1 filed prior to the debtor authorizing the filing and which is later authorized by the debtor, was added to Official Comment 4 to Section 9-322 of the UCC:

"Under a notice-filing system, a filed financing statement indicates to third parties that a person may have a security interest in the collateral indicated. With further inquiry, they may discover the complete state of affairs. When a financing statement that is ineffective when filed becomes effective thereafter, the policy underlying the notice-filing system determines the 'time of filing' for purposes of subsection (a) (1). ... Because the authorization or ratification does not increase the notice value of the financing statement, the time of the unauthorized filing is the 'time of filing' for purposes of subsection (a)(1). *The same policy applies to the other priority rules in this part.*" (emphasis supplied)

With the foregoing history and principles in mind, can the Lender rely on its previously filed UCC-1 to assure priority after the Subsequent Filer files its UCC-1?

APPLICATION OF THE UCC RULES TO THE HYPOTHETICAL

Amendments to the Loan

The first question posed above assumes that the Lender's original loan remains unpaid and does not raise the issue of a future advance. The Lender is, however, making significant amendments to the terms of the original loan. It is also assumed the amendments are truly significant, substantially increasing the interest rate and extending the maturity.

The Lender is protected under Section 9-322 of the UCC. Filing is maintained at all relevant times and the Subsequent Filer received all of the information the filing system was intended to provide. As noted in the Official Comment to Section 9-322 of the UCC, the Lender's knowledge of the Subsequent Filer's security interest is irrelevant. There does not appear to be any case law that imposes any additional judicial restrictions or "gloss" on the straightforward application of the first-to-file-or-perfect rule when a loan has been amended.

Future Advances

The second question posed above raises the issue of a future advance that was not contemplated at the time the initial loan was made. The "relatedness doctrine" applied in some cases under former Article 9 has been rejected, so the fact that the new advance may not have been contemplated is irrelevant. The new loan seems to fall directly under the rule that future advances get the same priority as initial advances. With perfection achieved by filing at all relevant times, none of the exceptions to the relation-back priority rule found in Section 9-323 of the UCC apply (see *Section 9-323 Exceptions*).

The facts presented here anticipate that the Lender's security agreement clearly covers future advances that were not committed to or contemplated at the time the security agreement was entered into, so the Lender should enjoy priority over the Subsequent Filer regarding the new loan. The security agreement language must be clear because some courts still are inclined to find reasons to limit the scope of future advance clauses.

For example, one court interpreted a standard future advance clause not to cover an indemnification claim arising out of separate litigation, but only when the primary loan was fully paid and the debtor was demanding a release of collateral (see *M. L. Private Finance LLC v. Minor*, 2011 WL 1900613 (S.D.N.Y. 2011)).

But barring unusual facts not included in this hypothetical, there is no appropriate basis for a court to conclude that a clear future advance clause should not be given effect with priority relating back to the time of filing. Even if the new loan was not part of a committed line of credit and was not contemplated at the time the initial loan was made, priority is clear under the basic priority rule for future advances and the Official Comment that rejects the "relatedness" doctrine.

A recent case, right on point, agrees that a bank's financing statement from a secured transaction was sufficient to perfect subsequent secured transactions and to give the bank priority over an intervening secured party (see *Union Bank v. Heban*, 2012 WL 32102 (Ohio Ct. App. 2012)). But again, the future advance language and the other documents must be clear. The court in *Union Bank* also held that despite dragnet language in the security agreement, the fact that one of the bank's notes recited that it was unsecured caused it to be unsecured. There is simply no substitute for clear and consistent drafting. If a full "dragnet" is intended, then make it clearly so and expressly cover uncommitted and unanticipated advances.

New Loan

The third question adds an additional element. Because the original loan was paid off for a period of time, there is an argument that the Lender was no longer providing value to support attachment of a security interest so no security interest existed for a period of time. In this case, the Lender has a "naked" financing statement. The Debtor can then make a legitimate demand for termination of the financing statement under Section 9-513 of the UCC when no loan was outstanding, but the facts here assume that no demand was made, so the Lender's financing statement has remained of record. This precise "break in attachment" scenario lead some courts to decide that the first-to-file lender should not have priority under former versions of UCC Article 9. Presumably Official Comment 5 to Section 9-204 of the UCC rejecting these cases will carry the day.

With a new loan, the Lender should still enjoy priority (see *Commercial Capital Bank v. House*, 2012 WL 220214 (W.D. La. 2012)). In *House*, a secured party with a 1997 financing statement (as continued) and dragnet clause prevailed over a secured party with a 2003 filing even though the original loan was paid off. The "relatedness doctrine" was therefore rejected and a proper understanding of the notice-filing system leads to the conclusion that it is the Subsequent Filer's problem to see to it that the Lender either:

- Terminates its first-to-file financing statement.
- Agrees to limit the character or amount of obligations that may be secured by its first-priority security interests.

Of course, the Lender's future advance clause must clearly cover the new loan. If there is any doubt, the Lender should have the Debtor re-affirm the security interest and the scope of the obligations secured. But such re-affirmation should not affect the priority afforded by first-to-file status.

This conclusion is supported by Example 1 of Official Comment 4 to Section 9-322 of the UCC. In Example 1, A files on February 1, B files on March 1, B obtains its security agreement and lends (causing attachment and perfection) on April 1 and, finally, on May 1, A obtains its security agreement and lends. As stated in Example 1, "A has priority even though B's loan was made earlier and was perfected when made. It makes no difference whether A knew of B's security interest when A made its advance." Equities mean little in this case because, as Official Comment 4 continues:

"The problem stated in Example 1 is peculiar to a notice-filing system under which filing may occur before the security interest attaches (see Section 9-502). The justification for determining priority by order of filing lies in the necessity of protecting the filing system – that is, of allowing the first secured party who has filed to make subsequent advances without each time having to check for subsequent filings as a condition of protection."

The overall efficacy and integrity of the filing system are at stake. The equities of a single transaction are outweighed by the need for a reliable establishment of a priority position by filing. Besides, subsequent searchers, who by now are well-aware of UCC Article 9's basic rule of priority, can protect themselves by:

- Making further inquiries.
- Causing the debtor to obtain terminations of "naked" financing statements.
- Obtaining agreements limiting the secured obligations of secured parties with priority positions.



Article 9's drafters have emphasized that future advances are to enjoy relation-back priority. The limited exceptions in Section 9-323 of the UCC rarely apply and do not apply to the questions presented here. While some courts were reluctant to enforce UCC Article 9's first-to-file-or-perfect rule, they were in the minority of related decisions under old Article 9 and the current comments should prevent those cases from having precedential value going forward. Where a debtor clearly agrees to future advances being secured, there appears to be no reason to prefer a subsequent secured party who is charged with knowledge of UCC Article 9's priority rule and who knew (or should have known) of the first-to-file secured party's UCC-1. Indeed, the author's experience is that subsequent searchers do not rely on the handful of cases where the first-to-file priority rule has been limited in its application. Instead, they assume it will be applied literally. Lenders with first-to-file status should be confident as long as their future advance language clearly covers the future advance in question.

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