1.D. How to Structure and Manage Secured Transactions under New Article 9.

Structuring and managing secured transactions is complicated and cannot be adequately addressed in this brief introduction to the revisions to Article 9. Needless to say, if you get involved in a complex commercial transaction, please make sure that you do not rely upon anything said herein as legal advice on the handling of these transactions. Included at the end of the material is a check list of items to consider when being involved in a secured transaction. Again, do not rely upon the check list as being a list of everything that you need to be concerned with.

This section will attempt to provide a primer on some of the more fundamental aspects of secured transactions. If the parties start talking about "Securitization Transactions," "Asset Securitization," "Asset-Backed Securities," "Special Purpose Vehicles or SPVs," or "Bankruptcy Remote Options," nothing in this discussions will help you. You may want to consult with such articles as The Committee on Bankruptcy and Corporate Reorganization of the Association of the Bar of the City of New York, *Structured Financing Techniques*, 50 BUS. LAW. 527, 528 (1995); Ellis, R., *Securitization Vehicles, Fiduciary Duties, and Bondholder's Rights*, 24 J. CORP. L. 295 (1999); Lahny, P. *Asset Securitization: a Discussion of the Traditional Bankruptcy Attacks and an Analysis of the Next Potential Attack, Substantive Consolidation*, AMERICAN BANKRUPTCY INSTITUTE LAW REVIEW, Vol. 9, Number 2, (Winter 2001). Revised Article 9 was drafted with the desire to facilitate these advanced commercial transactions. Nevertheless, this discussion was drafted for the more mundane aspects of secured transactions.

To overly simplify the basic commercial transaction, the three documents necessary to create a secured transaction are: (1) the promissory note; (2) the security agreement and (3) the financing statement. The promissory note is the document that creates the obligation. The security agreement is the document that pledges the collateral. The financing statement is the document that puts the world on notice that the collateral has been pledged as collateral for the obligation.

To complicate things, the promissory note may not be a promissory note, but instead simply a writing or act that manifests one person's obligation to pay another person. For example, the obligation may be an amount due on an open account, the amount due on an invoice, the obligation to pay rent, the obligation to pay on a credit card, or any other obligation in which one entity owes or may owe another the obligation to pay them money. To further complicate the discussion, the security agreement is not necessarily a separate document from the document manifesting the initial obligation. Most lending institutions combine the security agreement with the document creating the obligation. When signing the note for a car loan, a section of the note will include a pledge of collateral that will be filled in with the vehicle make, model and identification number. This section of the document is the security agreement in which the borrower pledges the car as collateral for the loan. In vehicle financing, the financing statement is actually performed through the certificate of title laws wherein the secured party's lien is manifested on the car's title. The title to the car puts

the world on notice that the secured party has a lien on the car. In non-certificate of title situations, the financing statement filed with the Secretary of State's Office serves this function.

To complicate matters even further, for some types of collateral, the secured lender does not need a security agreement. Instead, the secured lender's control over or possession of the collateral takes the place of the security agreement. In addition, for some types of agreements, they are deemed to be a security agreement even though the parties may attempt to characterize them as something else, like a lease.

Thus, caution is advised when structuring and managing commercial transactions. Recently, *In the Matter of Sean Bannon Zenner*, Opinion Number 25418, Shearhouse Advance Sheet No. 5, p. 32 (February 24, 2002), an attorney became involved in the collection of debt purchased by one company from many other companies. The attorney was publicly reprimanded for his improper management of the collection efforts. Not only can an attorney be subject to personal liability for making mistakes in the structuring and managing of secured transactions, but his ability to practice law may be placed into question.

1.D.1. Tapping into New Types of Collateral

A comparison between the collateral under the old and Revised Article 9 is presented in the following chart, prepared and presented in Ahern, L. *"Workouts" Under Revised Article 9: A Review of Changes and Proposal for Study*, AMERICAN BANKRUPTCY INSTITUTE LAW REVIEW, p. 176-177, Volume 9, Number 1 Spring 2001.

Collateral	Former Article 9	Revised Article 9	Comment

Rights to payments for - Property disposed of other than by sale, lease or license -property licensed (e.g. fees & royalties from licenses of patents, copyrights, trademarks, software) - non-goods sold or leased - premium for issuance of insurance policy and surety bond premium - manufacturer's rebates - lottery winnings - provision of electricity	General Intangibles	Accounts	Purchasers of accounts must still file financing statements in order to defeat lien creditors and trustees in bankruptcy
credit card receivables	unclear		
Payment stream under real estate contract			
Health Care Insurance Receivable	non-Article 9	Account	Assignment to provider is automatically perfected
Payment Intangible (general intangible where obligation is money payment)	general intangible	new sub-categories	no UCC-1 must be filed by purchaser of payment intangibles or notes
promissory notes	instrument		
software embedded in goods	unclear	goods	inventory, equipment or consumer
other software	unclear	general intangible	
payments under letter of credit	proceeds of a letter of credit	letter of credit rights	perfect by control, not possession
deposit account	non-Article 9	new categories of collateral	only non-consumer as original collateral; perfect by control

commercial tort claims			must arise from debtor's business, exist at time of security agreement and be specifically described
electronic chattel paper			perfect by "control" based on electronic identification method
supporting obligations (letters of credit, guaranties and other third-party enhancements)	unclear		automatically perfected by perfection of underlying security
rights under lease or license of collateral	unclear	new types of proceeds	no longer limited to proceeds of sale, exchange, collection or other disposition of collateral
claims arising out of defects in or damage to collateral	unclear		

Thus, the secured creditor needs to correctly identify the item that it seeks to have as collateral. Further, while general descriptions are sufficient for financing statements, a more detailed description is going to be required of the collateral in the security agreement between the parties. *See Section II.A.4. above*.

It should be noted that some of the new types of collateral require that the security interest be perfected through control and some of the new types of collateral may allow the security interest to be perfected through the filing of a financing statement. Section 312 provides as follows:

> *Section 36-9-312.* ***Perfection of security interests in chattel paper, deposit accounts, documents, goods covered by documents, instruments, investment property, letter-of-credit rights, and money; perfection by permissive filing; temporary perfection without filing or transfer of possession.***
>
> *(a) A security interest in chattel paper, negotiable documents, instruments, or investment property may be perfected by filing.*
>
> *(b) Except as otherwise provided in Section 36-9-315(c) and (d) for proceeds:*
> *(1) a security interest in a deposit account may be perfected only by control under Section 36-9-314;*
> *(2) and except as otherwise provided in Section 36-9-308(d), a security interest in a letter-of-credit right may be perfected only by control under Section 36-*

9-314; and

(3) a security interest in money may be perfected only by the secured party's taking possession under Section 36-9-313.

(c) While goods are in the possession of a bailee that has issued a negotiable document covering the goods:

(1) a security interest in the goods may be perfected by perfecting a security interest in the document; and

(2) a security interest perfected in the document has priority over any security interest that becomes perfected in the goods by another method during that time.

Thus, money can only be perfected through possession.

For deposit accounts and letter of credit rights, a security interest is created through control. Control is not synonymous with possession. A secured creditor may obtain control over a deposit account in another institution's possession. See Section 36-9-327 (control takes priority over the maintaining bank's interest). Control over a deposit account is defined as:

Section 36-9-104. ***Control of deposit account.***

(a) A secured party has control of a deposit account if:

(1) the secured party is the bank with which the deposit account is maintained;

(2) the debtor, secured party, and bank have agreed in an authenticated record that the bank will comply with instructions originated by the secured party directing disposition of the funds in the deposit account without further consent by the debtor; or

(3) the secured party becomes the bank's customer with respect to the deposit account.

(b) A secured party that has satisfied subsection (a) has control, even if the debtor retains the right to direct the disposition of funds from the deposit account.

Thus, the code bifurcates control and possession, allowing secured creditors with control to be ahead of creditors with possession.

Similarly, control over a letter of credit right is defined as:

Section 36-9-107. ***Control of letter-of-credit right.***

A secured party has control of a letter-of-credit right to the extent of any right to

> *payment or performance by the issuer or any nominated person if the issuer or nominated person has consented to an assignment of proceeds of the letter of credit under Section 36-5-114(c) or otherwise applicable law or practice.*

Thus, by having the issuer consent to an assignment, a secured party can gain control over the letter-of-credit right. This private agreement, without notice to anyone other than the parties involved, becomes a perfected security interest. Of note, the South Carolina's reporter's comments remind us that at present the reference to Section 36-5-114(c) may confuse the application of this section. Specifically, the reporter comments:

> *For a secured party to obtain control of a beneficiary's letter-of-credit right, Section 36-9-107 requires the beneficiary to assign the proceeds of the letter of credit to the secured party and for the issuer or the nominated party to consent to the assignment. In stating these requirements section 36-9-107 refers to consent under Section 36- 5-114(c). This reference is misleading because it refers to a provision in the 1995 revision of Article 5 that has not been enacted in South Carolina. Section 5-114(c) of the 1995 revision states the requirements for an effective assignment of the proceeds of a letter of credit. Under that provision an assignment of the right to the proceeds of a letter of credit is not effective unless the issuer or nominated person consents to the assignment.*
>
> *The failure of South Carolina to enact the 1995 revision of Article 5 raises a number of problems under Section 36-9-107. First, there is no section 36-5-114(c), the provision referenced in Section 36-9-107. The provision of the South Carolina Code addressing the assignment of proceeds of a letter of credit is Section 36-5-116. Second, and more significantly, Section 36-5-116 does not condition the effectiveness of an assignment of the proceeds of a letter of credit upon the issuer's or nominated party's consent to the assignment. These problems should not, however, affect the application of Section 36-9-107.*

Perhaps in South Carolina, one can obtain a security interest in a letter-of-credit right without the consent of the entity extending the letter of credit.

For the following other types of collateral, the code creates a bifurcated system of perfection of security interests: chattel paper, negotiable documents, instruments or investment property. Previously, these types of negotiable documents could only be perfected through possession. Now, creditors can claim a security interest that defeats a bankruptcy trustee's lien rights in these types of collateral by filing a financing statement. Thus, it is best to obtain control and possession over these types of collateral, however, having a financing statement will not hurt.

Generally, control takes priority over financing statements. For the requirements for control of deposit accounts, see Section 36-9-104. For the priority of security interests in deposit accounts,

see Section 36-9-327. For the requirements for control of electronic chattel paper see Section 36-9-105. For the priority of purchases of chattel, see Section 36-9-330. For the requirements for control of investment property, see Sections 36-9-106 and 36-8-106. For the priority of security interests in investment property, see Section 36-9-328. For the requirements for control of letter-of-credit right, see Section 36-9-107. For the priority of security interests in letter-of-credit rights, see Section 36-9-329.

The secured party with control has priority over the secured party relying upon the filed financing statement. But, the secured party filing the financing statement has priority over the judgment lien creditor and the bankruptcy trustee.

As it relates to the filing of the financing statement, one wants to make sure that the collateral description included in the financing statement is sufficiently broad so as to encompass not just the particular collateral pledged but also the possible proceeds of the collateral pledged. For example and the most obvious example, if the collateral pledged is inventory, you want to describe the collateral as inventory and accounts. When inventory is sold, the proceeds of the inventory are accounts. While automatic perfection will allow for a temporary security interest in the accounts for a period of twenty days, on day 21, without this additional description, the security interest could be lost. Similarly, the security agreement should be specific enough to meet the requirements of a security agreement under the code and broad enough to include the types of collateral intended to be pledged.

As previously mentioned, Revised Article 9 allows for "all assets" as a description for financing statements. For security agreements, Revised Article 9 requires more detail. Specifically, the security agreement may provide for certain categories of collateral and it is suspected that most of the "all assets" security agreements will include a pledge of the following:

> All assets of the debtor including but not limited to: accounts, agricultural liens, as-extracted collateral, chattel paper (including electronic chattel paper), commercial tort claims, deposit accounts, documents, general intangibles, goods (including consumer goods, fixtures, equipment, inventory,), instruments (including promissory notes), investment property, letter of credit rights, manufactured homes and proceeds.

All of the types of collateral defined by the Revised Article 9 are included in this list. It is likely that some security agreements may even modify this list to delete the agricultural liens and manufactured homes in the appropriate settings. Specifically, as it relates to the description of the collateral, Section 36-9-108 provides for the sufficiency of the description:

Section 36-9-108. ***Sufficiency of description.***

(a) Except as otherwise provided in subsections (c), (d), and (e), a description of personal or real property is sufficient, whether or not it is specific, if it reasonably identifies what is described.

(b) Except as otherwise provided in subsection (d), a description of collateral reasonably identifies the collateral if it identifies the collateral by:
(1) specific listing;
(2) category;
(3) except as otherwise provided in subsection (e), a type of collateral defined in the Uniform Commercial Code;
(4) quantity;
(5) computational or allocational formula or procedure; or
(6) except as otherwise provided in subsection (c), any other method, if the identity of the collateral is objectively determinable.

(c) A description of collateral as 'all the debtor's assets' or 'all the debtor's personal property' or using words of similar import does not reasonably identify the collateral.

(d) Except as otherwise provided in subsection (e), a description of a security entitlement, securities account, or commodity account is sufficient if it describes:
(1) the collateral by those terms or as investment property; or
(2) the underlying financial asset or commodity contract.

(e) A description only by type of collateral defined in the Uniform Commercial Code is an insufficient description of:
(1) a commercial tort claim; or
(2) in a consumer transaction, consumer goods, a security entitlement, a securities account, or a commodity account.

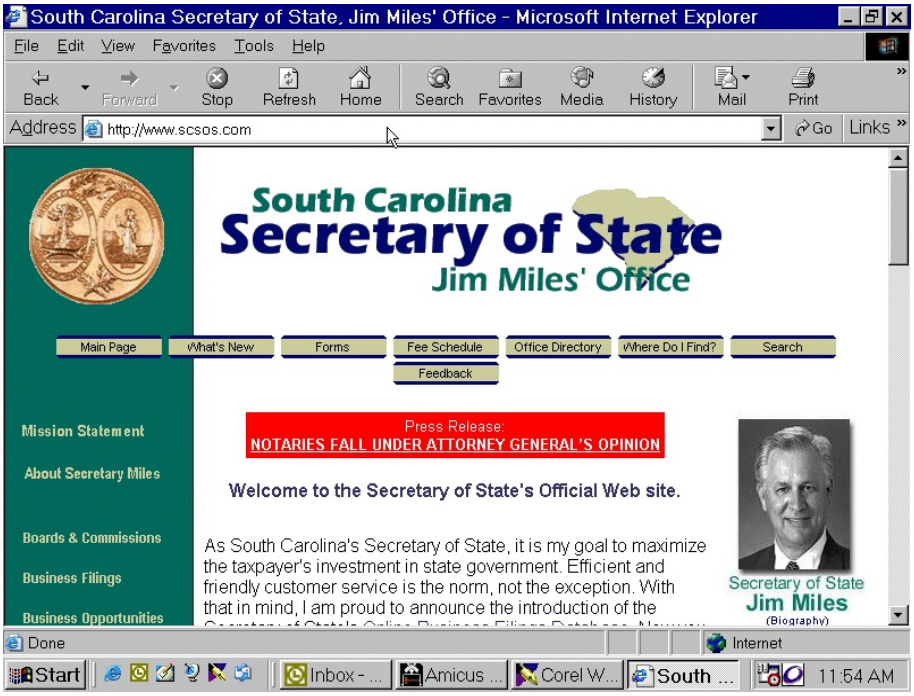
Thus, the general listing should be sufficient for everything except, as provided for in section (e): a security interest in commercial tort claims or a security interest in consumer transactions. In these instances, a greater description of the items involved is required. In an effort to clarify what might be sufficient in these circumstances, the Official comments states:

The reference to "only by type" in subsection (e) means that a description is sufficient if it satisfies subsection (a) and contains a descriptive component beyond the "type" alone. Moreover, if the collateral consists of a securities account or commodity account, a

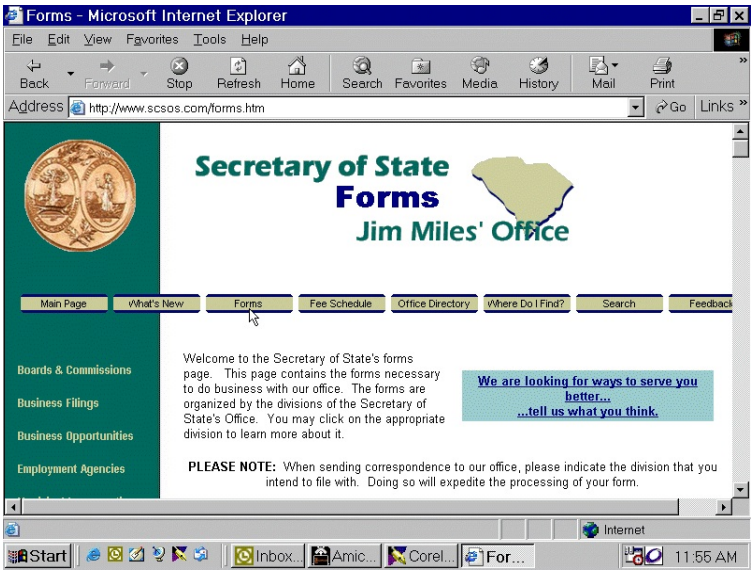
> *description of the account is sufficient to cover all existing and future security entitlements or commodity contracts carried in the account. See Section 9-203(h), (i).*
>
> *Under Section 9-204, an after-acquired collateral clause in a security agreement will not reach future commercial tort claims. It follows that when an effective security agreement covering a commercial tort claim is entered into the claim already will exist. Subsection (e) does not require a description to be specific. For example, a description such as "all tort claims arising out of the explosion of debtor's factory" would suffice, even if the exact amount of the claim, the theory on which it may be based, and the identity of the tortfeasor(s) are not described. (Indeed, those facts may not be known at the time.)*

Thus, you need to be careful if the collateral intended is one of these types of collateral.

1.D.2. Taking Advantage of new Perfection Procedures

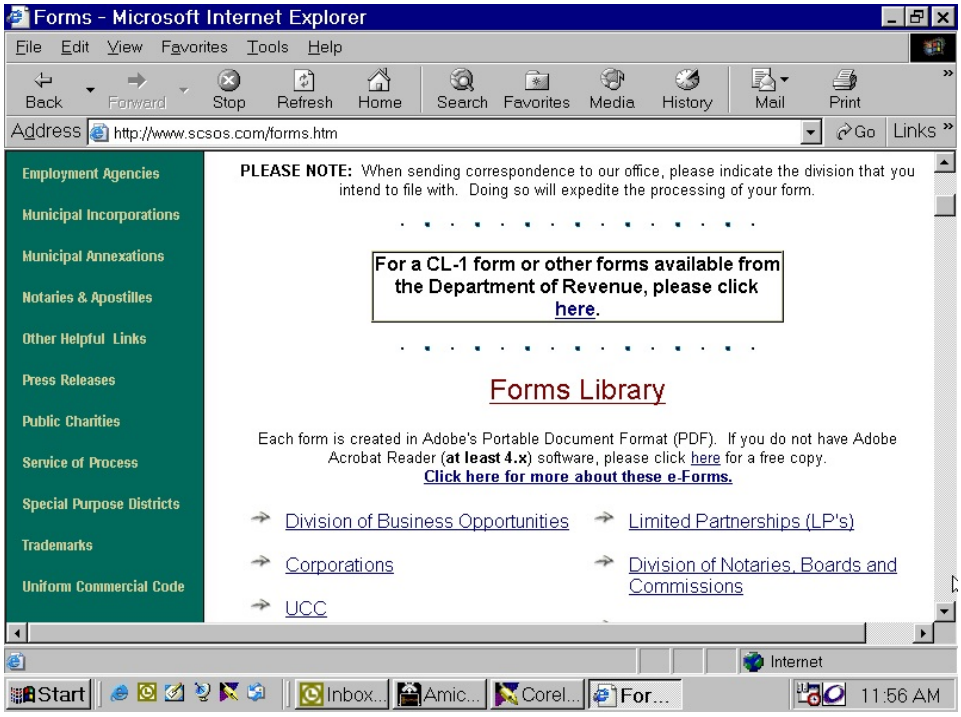


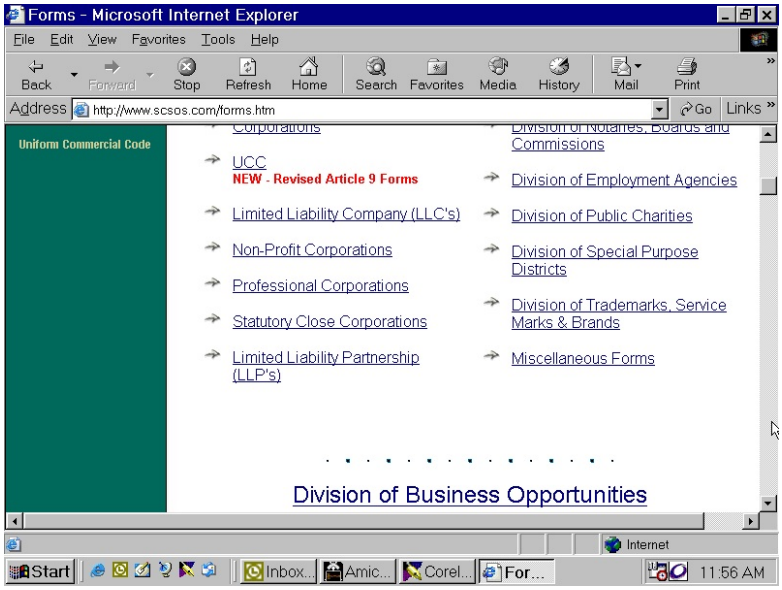
Most jurisdictions have sites on the world wide web from which the practitioner can download the forms associated with the filing of financing statements. South Carolina's Secretary of State can be found at www.scsos.com. The web-site changes from time to time and now that a new secretary of state has been elected, please expect it to change in the near future. Historically, the web site in South Carolina looked like the figure to the left. Of course, the web-site is in color and the reproduction of this document is in black and white.



To access the forms portion of the web-site, you click on the forms section and the screen to the left will appear.

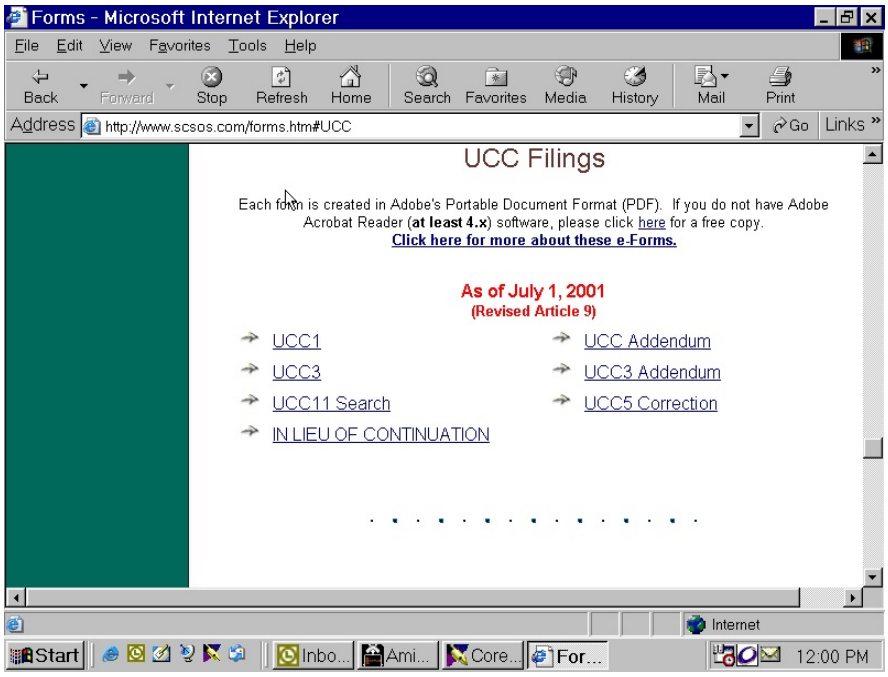
By paging down, you will see the following screen and then, by paging down again you will be able to see the next screen:





This screen contains a link to the forms associated with the Uniform Commercial Code in South Carolina.

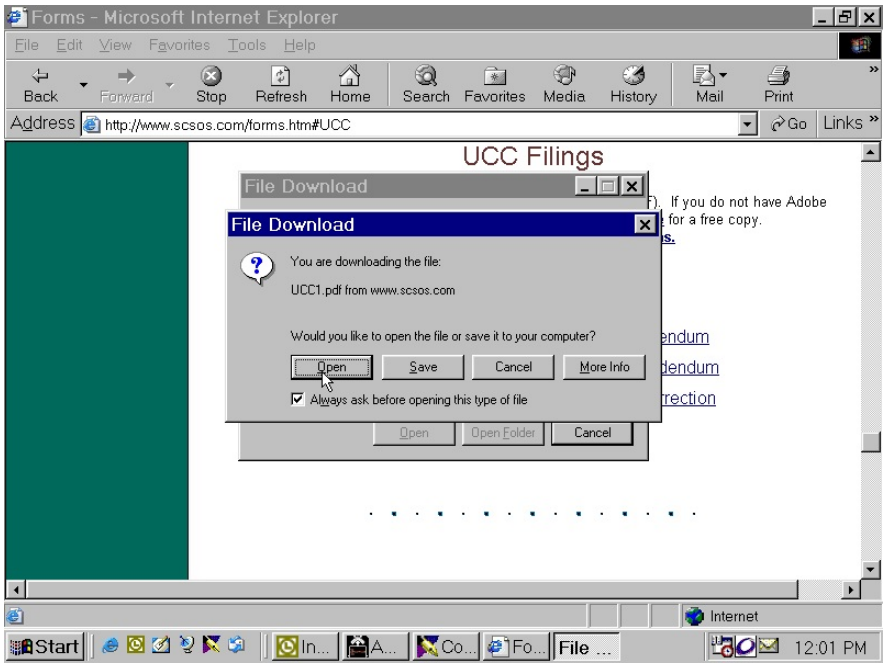
By clicking on the UCC link, the following screen will appear



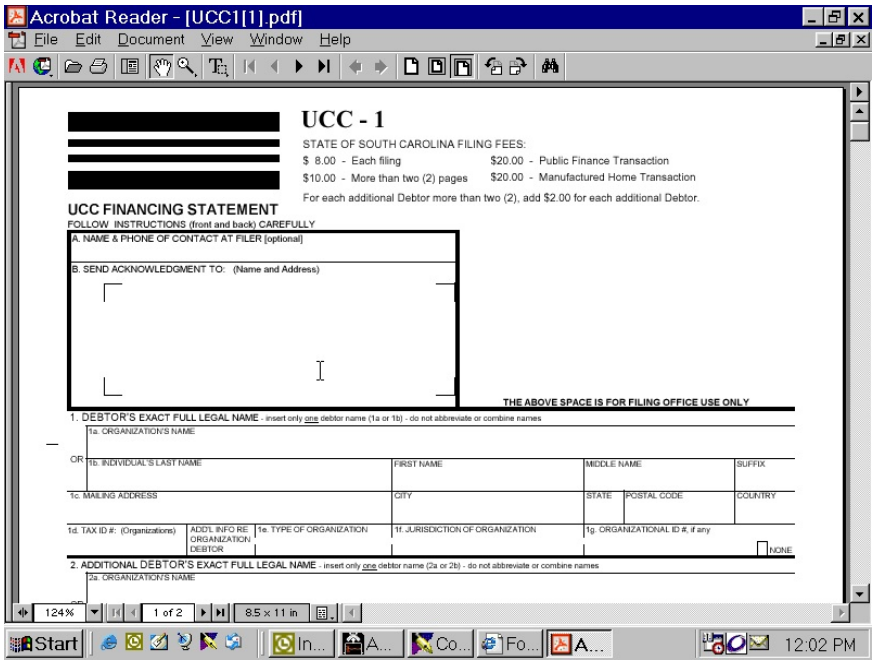
This screen gives you the option of choosing the particular form that you want to download.

All of the forms are in Adobe Acrobat reader. If you do not have this software on your computer you can click the section for more information and download a free version of this program so that you can use the forms.

By clicking on the UCC1 link, the following screen appears:



This screen asks if you want to save the form directly to you computer or simply open it. If you choose to open the document directly from the Secretary of State's web-site, Adobe should automatically open and provide you with the following screen:



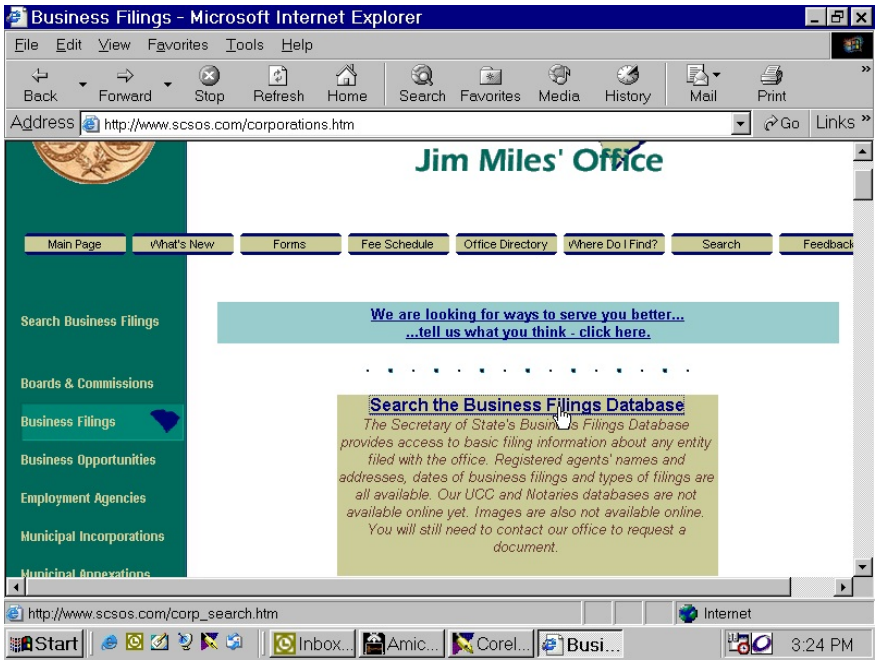
This screen shows the UCC-1 form as approved for filing in the State of South Carolina. A copy of the form, along with the other forms available from the Secretary of State's office is provided in these materials at the end of this section.

Adobe will allow you to type the information onto the form and then print the form, with the information inserted.

At present, earlier versions of Adobe did not allow you to save the form with the information inserted. If you cannot save the information, you will need to update your version of Adobe.

As it relates to the information required by the form, Sections A and B, name of the contact person and place to send the acknowledgment are optional but should be included in the event that the Secretary of State's office has some follow up question. The debtor's full name, address, type of organization, jurisdiction of the organization and organization number, are required. As it relates to the organizational number, this requirement is new. In establishing this system, most states went through all of the organizations incorporated or listed at their secretary of state's offices and gave them a unique organizational number. Many of the secretary of state's allow you to access this information on the world wide web. In those states that did give numbers to their organizations, you must include this number or else your financing statement will be rejected.

In South Carolina, our Secretary of State did not give the organization a number. Thus, in South Carolina, you can file without a number and you must check the none box for the organization number. Nevertheless, in South Carolina, you are able to get the formal name of the organization by accessing the Secretary of State's web site. To do search for filings, one goes to the web-site and clicks on the "Business Filings" option on the left hand portion of the home page. As a result, the following screen will appear:



By selecting the Search the Business Filings Database, you are then guided to a search screen that allows you to enter the name of the corporation that you want to examine.

The screen to the left is the search screen. If you were to enter a common first name of a corporation, like Southern, the search engine will return all of the corporations, limited partnerships, etc., that have that common first word beginning.

Then by clicking on the link to the corporate information, the user is able to obtain the information about that particular corporation. If only one corporation is found, the system provides this information.

For example, by clicking on Southern Abstractors, Inc., the following information is obtained:

By paging down, the user is able to obtain additional information about the corporation including date of incorporation and registered agent for service of process.

In South Carolina, the importance of this information is that the user is able to verify the actual legal name of the corporation before filing the financing statement. Thereby eliminating any guess work on the correct corporation or the correct spelling of the name.

1.D.3. Preparing Security Agreements

Sometimes Revised Article 9 states the obvious. Section 36-9-201 states:

Section 36-9-201. ***General effectiveness of security agreement.***

(a) Except as otherwise provided in the Uniform Commercial Code, a security agreement is effective according to its terms between the parties, against purchasers of the collateral, and against creditors.

Obviously, a security agreement is going to be effective according to its terms. So when preparing a security agreement, the attorney should attempt to fulfill his obligations of resolving as many uncertainties associated with the written agreement as possible so that it manifests the intent of the parties.

As it relates to security agreements in particular, Section 36-9-203 relates to the creation of security interests including the creation through security agreements. This section states:

Section 36-9-203. ***Attachment and enforceability of security interest; proceeds; supporting obligations; formal requisites.***

(a) A security interest attaches to collateral when it becomes enforceable against the debtor with respect to the collateral, unless an agreement expressly postpones the time of attachment.

(b) Except as otherwise provided in subsections (c) through (i), a security interest is enforceable against the debtor and third parties with respect to the collateral only if :
- *(1) value has been given;*
- *(2) the debtor has rights in the collateral or the power to transfer rights in the collateral to a secured party; and*
- *(3) one of the following conditions is met:*
  - *(A) the debtor has authenticated a security agreement that provides a description of the collateral and, if the security interest covers timber to be cut, a description of the land concerned;*
  - *(B) the collateral is not a certificated security and is in the possession of the secured party under Section 36-9-313 pursuant to the debtor's security agreement;*
  - *(C) the collateral is a certificated security in registered form and the security certificate has been delivered to the secured party under*

Section 36-8-301 pursuant to the debtor's security agreement; or

(D) the collateral is deposit accounts, electronic chattel paper, investment property, or letter-of-credit rights, and the secured party has control under Section 36-9-104, 36-9-105, 36-9-106, or 36-9-107 pursuant to the debtor's security agreement.

(c) Subsection (b) is subject to Section 36-4-208 on the security interest of a collecting bank, Section 36-5-118 on the security interest of a letter-of-credit issuer or nominated person, Section 36-9-110 on a security interest arising under Chapter 2 or 2A, and Section 36-9-206 on security interests in investment property.

(d) A person becomes bound as debtor by a security agreement entered into by another person if, by operation of law other than this chapter or by contract:

(1) the security agreement becomes effective to create a security interest in the person's property; or

(2) the person becomes generally obligated for the obligations of the other person, including the obligation secured under the security agreement, and acquires or succeeds to all or substantially all of the assets of the other person.

(e) If a new debtor becomes bound as debtor by a security agreement entered into by another person:

(1) the agreement satisfies subsection (b)(3) with respect to existing or after-acquired property of the new debtor to the extent the property is described in the agreement; and

(2) another agreement is not necessary to make a security interest in the property enforceable.

(f) The attachment of a security interest in collateral gives the secured party the rights to proceeds provided by Section 36-9-315 and is also attachment of a security interest in a supporting obligation for the collateral.

(g) The attachment of a security interest in a right to payment or performance secured by a security interest or other lien on personal or real property is also attachment of a security interest in the security interest, mortgage, or other lien.

(h) The attachment of a security interest in a securities account is also attachment of a security interest in the security entitlements carried in the securities account.

(i) The attachment of a security interest in a commodity account is also attachment of

a security interest in the commodity contracts carried in the commodity account.

Subsection (b) provides updates the former requirements that a security agreement be in writing, signed by the debtor that has been given value for an interest in collateral in which the debtor has rights. *See* Former Section 36-9-203. The Revised Article 9 changes the requirement that the security agreement be in writing for certain types of collateral where a security interest may be created through other means. *See* Section V.A. above. It also updates the requirement that the agreement be signed by the debtor so that the agreement need be authenticated by the debtor. In this way, electronic authentication is allowed. However, the requirement that value be given and the debtor having rights in the collateral is still maintained.

1.D.4. Conducting Due Diligence

Many states allow access to their secretary of state's office's computer records over the Internet (e.g. North Carolina). Some allow direct access to their records through a modem and direct dial connection (e.g. Virginia). In the South Carolina Secretary of State's Office, they have a public computer that the public can use to conduct searches of the Uniform Commercial Code filings. In addition, Secretary of State's web site allows the user to access the most recent UCC information for the corporation. .

Even if the researcher access the web site, it is a good idea to submit an information request to the Secretary of State's Office and they will search their records and provide the researcher with the search results. Form 4, the old three part form has been replaced with Form UCC-11. This form can be accessed from the Secretary of State's Office's web-site and like the other forms is in adobe acrobat reader format. Again, the information can be typed directly onto the form, but these changes cannot be saved. A copy of Form UCC-11 is included at the end of these materials.

Caution should be taken and the researcher should remember that for the next five years, security interests could be filed in different locations: (1) where the collateral is located (pursuant to the old Article 9); (2) where the principal office of the debtor is located (pursuant to the Revised Article 9); (3) for individuals, where the debtor resides; (4) where the debtor is incorporated (pursuant to the Revised Article 9); or (5) where the debtor use to have its principal office. For a general discussion of the filing requirements and changes in those requirements, see section I.E. of the materials. In addition, in addition, if the collateral includes real property and/or fixtures, title searches of the property should be requested and conducted.

If the lender wants a first priority lien on the property, you need to make sure that no one is ahead of him in the records and depending on the collateral, you may need to instruct the lender to make sure that he has "control" or "possession" of the collateral.