

# MARKS & WEINBERG, P.C.

## DISPATCHES FROM THE TRENCHES

### Outside the Comfortable Confines of Article 9

Those who regularly read Dispatches from the Trenches know that I'm a big fan of Article 9 of the Uniform Commercial Code. Of course, I enjoy flipping back and forth from its varying sections in a Rubick's Cube-like manner (yes, I've always been a bit geeky). More importantly, I believe it to be an extremely thoughtful and thorough statute.

However, Article 9 is not the be all and end all of security interests. It is therefore prudent to remind ourselves from time to time of what is and is not covered by its broad scope.

Article 9 generally deals with consensual security interests in personal property. A security interest is defined by the Uniform Commercial Code to mean "an interest in personal property or fixtures which secures payment or performance of an obligation." See U.C.C. §1-201(37). There is not much detail in this basic definition but people in our industry have a good understanding of what that term means. In fact, those involved in equipment leasing and finance have grown sufficiently comfortable with the concept that we treat it as if it was a tangible "thing" that you can grab or place in a file (or use to beat a debtor over the head if necessary).

Mr. Borrower, you're gonna have to give us a security interest in that widget along with that commitment fee if you wanna borrow money from us.

Hey, deadbeat. . . if you don't pay us now, we're gonna enforce our security interest and take that widget away from you.

In reality, a security interest is a much more nebulous concept. The term describes a relationship between a lender to whom the interest is granted (called a "Secured Party") and the borrower or other obligor granting the interest (called a "Debtor"). It consists of the Secured Party's rights to access the collateral and to otherwise realize value from it if the Debtor fails to live up to the obligations secured by that collateral. It also addresses the relationship between competing Secured Parties claiming an interest in the same collateral.

### General Scope

It is important to understand that Article 9 generally deals only with consensual security interest. In other words, it addresses a security interest which a Debtor grants to a Secured Party in a contract or otherwise in a consensual manner. Article 9 is not particularly focused on non-consensual liens such as: (1) liens can arise by statute or under common law for the benefit of unpaid mechanics, laborers and materialmen whose services and materials have enhanced the value of property (often called mechanics liens or materialmen's liens); or (2) liens that arise under creditor's rights by way of attachment, levy and the like— for example judgment liens. It

should be noted, however, that Article 9 addresses the priority (or lack of priority) of these non-consensual liens.

Another important point is that Article 9 generally covers only personal property. Real property such as land or major improvements on land (like buildings) is not covered by Article 9. The exception to this general rule relates to Fixtures<sup>o</sup> which are defined to be "goods that have become so related to particular real property that an interest arises under real property law." This special classification of collateral was created to handle the fact that fixtures need to walk in both the "personal property world" addressed by the U.C.C. and the real property world of "dirt law."

### **Sometimes Broader than you may Think**

In some ways, the scope of Article 9 is broader than anticipated and, in true U.C.C. fashion, the definition of security interest is several lines longer than what that quoted above<sup>o</sup> involving additional intricacies. For example, Article 9 covers: (1) agricultural liens (meaning an interest other than a security interest in farm products which generally relates to a Debtors farming operation); (2) consignments (which are transactions where property owned by one party is delivered to a merchant for the purpose of sale although title still remains in the first party); and (3) the *sale of* accounts, chattel paper, payment intangibles and promissory notes.

Generally speaking, these are areas of the law which could benefit from the framework of Article 9 and are, in many ways, "forced" into its provisions. For example, as is well understood by those readers familiar with the syndication of leases or other transactions of a similar nature, it is sometimes difficult to distinguish a true sale of a lease from a loan secured by it<sup>o</sup> particularly where the seller retains some interest in the residual or where the buyer has some recourse against the seller. Consider the mystical line drawn around a 9.9% ultimate net loss provisions. By treating sales of chattel paper and security interests in chattel paper similarly, Article 9 manages to avoid some of the complexities of distinguishing the two. *See* U.C.C. §9-109 and comments (noting that Article 9 covers a security interest in chattel paper as well as the sale of chattel paper). However, accomplishing the desired result requires some strange drafting. *See* e.g. U.C.C. §9-102(71)(D)(defining "Secured Party" to include a purchaser of chattel paper that been sold); and §§1-201(32) and (33)(where the definitions of "purchase" and "purchaser" are broad enough to include lenders who take security interests in chattel paper, perfecting by possession, as well as outright purchasers of chattel paper).

### **Sometimes more narrow than you Think**

In other ways, Article 9 is narrower than some people would anticipate. Some of the most notable exclusions from Article 9 include the fact that 9 does not apply (1) *to the extent that* a statute, regulation, or treaty of the United States preempts Article 9; (2) with respect to perfection to the extent such issues are addressed pursuant to a state's Certificate of Title laws; and (3) with respect to certain insurance policies and certain other collateral.

#### **A. Trains, Boats and Planes**

Classing examples of preemption by United States law are familiar to those financing trains, boats and planes. For example, the United States Code provides that:

a í lease, í conditional sales agreement, or other instrument evidencing the mortgage, lease, conditional sale or bailment of or security interest in í railroad cars, locomotives, or other rolling stock, or accessories used on such railroad cars, locomotives, or other rolling stock (including superstructures and racks), intended for use related to interstate commerce shall be filed with the [Surface Transportation] Board in order to perfect the security interest that is the subject of such instrument.<sup>o</sup> Section 11,301 of Title 49 of the United States Code.

Because this federal statute explicitly governs perfection of security interests in railroad equipment, a UCC filing is not the proper method perfection and Secured Parties must file with the Surface Transportation Board (STB) in Washington DC.

For vessels, filings are necessary with the United States Coastguard which administers recordations through the central National Vessel Documentation Center in West Virginia. *See* 49 U.S.C. § 31301, et seq.

For aircraft, The Federal Aviation Act, in Section 44103 of Title 49 of the United States Code, provides for filing of leases and mortgages with the Federal Aviation Administration (FAA) in Oklahoma City, with the relatively recent overlay of internationally effective filings with the International Registry under procedures put into effect through the Cape Town Convention. *See* 49 U.S.C. § 44107(e).

It should be noted that the preemption exclusion only applies *to the extent* these United State Statutes preempt Article 9. As such, care should be taken when dealing with these types of collateral. For example, when foreclosing on an Aircraft owned by a U.S. debtor and located in the U.S., the default and enforcement provisions of Article 9 should be followed and a Secured Party should provide proper notices and conduct a commercially reasonable disposition.

## **B. Grants from the Federal Government**

Federal law also preempts Article 9 with respect to payments owed by the U.S. Government. A classic example is a security interest in tax grants payable to a developer/operator of certain renewable energy projects by the U.S. Department of the Treasury in lieu of the investment tax credit in accordance with the terms of the American Recovery and Reinvestment Act of 2009 (Pub. L. 1110-5).

Properly perfecting an interest in such rights, which can be substantial, requires strict compliance with the Federal Assignment of Claims Act of 1940, 31 U.S.C. §3727 and the provisions of 48 C.F.R. §32.8.

## **C. Certificate of Title Laws**

The drafters of Article 9 understood the detailed system already in place on a state level for recording ownership interest and liens on titled equipment. In light of this existing recording system, the U.C.C. provides that "the filing of a financing statement is not necessary or effective to perfect a security interest in property subject to . . . a certificate-of-title statute covering automobiles, trailers, manufactured homes, boats, farm tractors, or the like, which provides for a security interest to be indicated on the certificate as a condition or result of perfection . . . ." *See* U.C.C. §9-311. It is still good practice to file a UCC financing statement on transactions involving such equipment to cover accessions, proceeds and other collateral that may be relevant to the titled equipment but not covered by the Certificate of Title.

There is also a key exception to the general deference granted in Article 9 to state Certificate of Title laws. In order to facilitate the ability of lenders to offload planö or otherwise finance the acquisition of inventory by dealers of titled equipment, the U.C.C. provides that filing a financing statement is the proper method of perfection ö[d]uring any period in which collateral subject to a [state Certificate of Title law] is inventory held for sale or lease by a person or leased by that person as lessor and that person *is in the business of selling goods.*ö U.C.C. §9-311(d).

It is also worth noting that the version of §9-311 currently enacted in Idaho, Illinois, Louisiana, Missouri and Rhode Island includes a glitch which also technically requires UCC financing statements if the Debtor is in the business of leasing goods of that kind (i.e., those statute says you

must file a UCC [d]uring any period in which collateral subject to a [state Certificate of Title law] is inventory held for sale or lease by a person or leased by that person as lessor and that person *is in the business of selling or leasing goods.*)

#### **D. Insurance and Other Exclusions.**

Article 9 expressly excludes a transfer of an interest in or an assignment of a claim under a policy of insurance (other than certain health care insurance receivables). Key man life insurance policies or other collateral of this sort should be considered carefully. Special attention should be paid to hybrid products such certain variable annuities which essentially constitute insurance contracts joined at the hip with investment products. Are these variable annuities the type of insurance excluded from Article 9? Or, does the cash value nature of these annuities make them [investment property], [general intangibles] or some sort of other collateral within the scope of Article 9? It is always best to walk on both sides of the fence to protect yourself in these situations.

Other exclusions include an assignment of a claim for wages, salary, or other compensation of an employee.

The moral of the story is to be mindful that certain collateral requires actions and knowledge outside the comfortable confines of Article 9 of the U.C.C.

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