By Kathleen L. DiSanto

When Less Is Not More

Sufficient Identification of Collateral in Financing Statements

Editor's Note: *For additional perspective on the* I80 Equipment *case, see the article on p. 34.*

Skimping on collateral descriptions might come at a cost, depending on the jurisdiction, as evidenced by recent decisions from two courts of appeals that reached very different conclusions in analyzing the issue. In January 2019, the First Circuit Court of Appeals held that a financing statement, which made reference to "pledged property" as defined in the security agreement, was insufficient under Puerto Rico's version of the Uniform Commercial Code (UCC).[1] However, just nine months later, the Seventh Circuit Court of Appeals reached the exact opposite conclusion, finding that a financing statement that merely referenced the collateral description in the security agreement sufficiently described the collateral under Illinois law, which adopts the UCC.[2] Surprisingly, the Seventh Circuit's opinion failed to acknowledge the circuit split or even mention, let alone discuss, the First Circuit's ruling in the *Puerto Rico* decision.

The First and Seventh Circuit's analyses turn on several provisions of the UCC, which govern the sufficiency of collateral descriptions in financing agreements. Pursuant to § 9-502 of the UCC, a financing statement is sufficient if it "(1) provides the name of the debtor; (2) provides the name of the secured party or a representative of the secured party; and (3) indicates the collateral covered by the financing statement."

Section 9-504 also addresses the sufficiency of a financing statement. Under § 9-504 of the UCC, the financing statement must provide "a description of the collateral pursuant to Section 9-108" or "an indication that the financing statement covers all assets or all personal property." In turn, § 9-108(a) provides that a description of collateral is sufficient "whether or not it is specific, if it reasonably identifies what is described." Pursuant to § 9-108(b), a description reasonably identifies the collateral if it identifies the collateral in one of six ways: (1) specific listing; (2) category; (3) type of collateral defined in the UCC; (4) quantity; (5) computational or allocational formula or procedure; and (6) "any other method, if the identity of collateral is objectively determinable."

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The *Puerto Rico* Decision

The *Puerto Rico* case involved bonds issued in 2008 by the employee retirement system of the Puerto Rican government and efforts by the Commonwealth of Puerto Rico to avoid the bondholders' interests in the retirement system's property under the Puerto Rico Oversight, Management and Economic Stability Act (PROMESA), which incorporated various provisions of the Bankruptcy Code, including § 544.[3] The bondholders asserted security interests in property owned by the retirement system, including certain employer contributions to the system, and contended that their interests were properly perfected in accordance with Puerto Rico's UCC.[4] The security agreement made reference to a pension funding bond resolution, which identified the property subject to the bondholders' security interest.[5] However, the resolution was not attached to the security agreement, which did not specify the collateral, incorporate the description of the collateral set forth in the resolution, or otherwise describe the pledged property.[6] The financing statement, which was filed with the Puerto Rico Department of State in 2008, described the collateral as "[t]he pledged property described in the Security Agreement attached as Exhibit A hereto and by reference made a part thereof."[7] The security agreement was attached to the financing statement, but the resolution was not.[8] Thus, the financing statement did not define the "pledged property," nor was the "pledged property" defined in the documents attached to the financing statement.

Amendments to the financing statement were filed in 2015 and 2016.[9] Similar to the initial financing statement, the amendments described the collateral as "[t]he Pledged Property and all proceeds thereof and all after-acquired property as described more fully in Exhibit A attached hereto and incorporated by reference."[10] However, unlike the initial financing statement, the definition of "pledged property" excerpted from the resolution was attached as Exhibit A.[11]

1 *In re Fin. Oversight & Mgmt. Bd. for Puerto Rico*, 914 F.3d 694 (1st Cir. 2019) (hereinafter the "Puerto Rico decision" or "Puerto Rico case").
2 *First Midwest Bank v. Reinbold (In re I80 Equip. LLC)*, 938 F.3d 866 (7th Cir. 2019).
3 *Puerto Rico*, 914 F.3d at 703.
4 *Id.*
5 *Id.* at 704-05.
6 *Id.*
7 *Id.* at 705.
8 *Id.*
9 *Id.*
10 *Id.*
11 *Id.*

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In addition to the collateral description, there was also a question as to whether the amendments to the financing statements sufficiently named the debtor due to a change in Puerto Rican law. After the filing of the initial financing statement in 2008, but before the filing of the amendment in 2015, Puerto Rico amended the act establishing the employee retirement system in 2014.[12] Among other things, the 2014 amendments did not exclusively refer to the employee retirement system as the "Employees Retirement System of the Government of the Commonwealth of Puerto Rico" and interchangeably referred to the system as either the "Employees Retirement System of the Government of the Commonwealth of Puerto Rico" or the "Retirement System for Employees of the Government of the Commonwealth of Puerto Rico."[13] However, notwithstanding the changes to Puerto Rican laws, the amendments to the financing statement continued to identify the debtor as the "Employees Retirement System of the Government of the Commonwealth of Puerto Rico."[14]

Under these facts, the First Circuit concluded that the 2008 financing statements satisfied the requirements of Article 9, with one critical exception: They failed to sufficiently describe the collateral.[15] In so holding, the First Circuit rejected the bondholders' invitation to adopt a more relaxed understanding of the collateral description requirement.[16] The First Circuit noted that the 2008 financing statements "do not describe even the type(s) of collateral, much less the items at issue," and that the resolution describing the collateral was not attached.[17] Thus, the First Circuit concluded that the "total combination of facts undercuts several key goals of the UCC and its filing system," including "fair notice to other creditors and the public of a security interest" and "facilitat[ing] the expansion of commercial practices."[18] However, the case had a happy ending for the bondholders on the perfection issue, as the First Circuit determined that the amendments to the financing statements cured the defects created by the 2008 filings and that the debtor was properly named in the 2015 and 2016 amendments.[19] Although the bondholders did not meet the requirements for perfection until December 2015, their interest was properly perfected prior to the enactment of the PROMESA legislation, which provided the basis for the attempted avoidance of the bondholders' liens.[20]

I80 Equipment LLC

Faced with an issue of first impression in an interlocutory appeal of the bankruptcy court's order, the issue before the Seventh Circuit was whether a financing statement sufficiently "indicates" the collateral by making reference to an unattached security agreement. The debtor, I80 Equipment, purchased and refurbished trucks and obtained a commercial loan from First Midwest Bank.[21] The security agreement granted the lender a security interest in 26 categories of collateral, and First Midwest Bank timely filed its financing statement, which described the collateral as "all collateral described in the security agreement."[22] However, when the borrower defaulted on the loan and filed a chapter 7 case two years later, the lender sued the trustee and sought declaratory relief that its security interest was properly perfected and senior in priority to all other claimants.[23]

While a financing statement must describe the collateral, the threshold for adequacy of a collateral description in a financing statement is much lower than in a security agreement.

The chapter 7 trustee took the position that the security interest was unenforceable, arguing that the financing statement lacked a sufficient description of the collateral, and asserted a counterclaim to avoid the lien.[24] The trustee argued that based on the principles of *ejusdem generis*, the meaning of "any other method" as used in § 9-108(b)(6) of the Illinois Code should be interpreted narrowly to mean "of a like kind" or "similar to" the specifically enumerated classes of things.[25]

The bankruptcy court concluded that the security interest was voidable because the financing statement, on its face, failed to include a description of the collateral. In so holding, the court analyzed the Illinois Code Comment to Article 9, which provides that "[t]he security agreement and the financing statement are double screens through which the secured party's rights to collateral are viewed, and his rights are measured by the narrower of the two."[26] The bankruptcy court also cited two bankruptcy court opinions that addressed the sufficiency of a collateral description, both of which concluded that the collateral descriptions were insufficient.[27] The Seventh Circuit accepted the lender's request for a direct appeal.[28]

In reversing the bankruptcy court's judgment, the Seventh Circuit held that the financing statement was sufficient by applying the "plain and ordinary meaning" of Illinois's version of the UCC.[29] Hon. Michael B. Brennan, who authored

12 *Id.* at 706.
13 *Id.* at 706-07. The changes to the statute summarized herein are based on the official translation of the Puerto Rican Laws from Spanish to English.
14 *Id.* at 706.
15 *Id.* at 710.
16 *Id.*
17 *Id.*
18 *Id.* at 711.
19 *Id.* at 713.
20 *Id.* at 721.
21 *I80 Equip. LLC*, 938 F.3d at 869.
22 *Id.*
23 *Id.*
24 *Id.*
25 *First Midwest Bank v. Reinbold (In re I80 Equip. LLC)*, 591 B.R. 353, 358 (Bankr. C.D. Ill. 2018).
26 *Id.* at 359 (citing Ill. Ann. Stat. ch. 26, § 9-110, Illinois Code Comment at p. 85 (Smith-Hurd 1974)).
27 *Id.* at 360. (citing *In re Lynch*, 313 B.R. 798 (Bankr. W.D. Wis. 2004) (mere filing of financing statement is insufficient and collateral must be identified or described); *In re Lexington Hospitality Grp. LLC*, 2017 WL 5035081 (Bankr. E.D. Ky. Nov. 1, 2017) (reference to security agreement that fully described collateral but was not attached was insufficient description of collateral)).
28 *I80 Equip. LLC*, 938 F.3d at 869.
29 *Id.* at 868.

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the court's opinion, focused on the 2001 revisions to the UCC and the difference between including a "description of the collateral" versus "indicating the collateral."[30] Based on the reduced requirement to "indicate" rather than "describe" the collateral, the lender's description of the collateral in the financing statement was adequate under the Seventh Circuit's analysis and application of the Illinois UCC.[31] The Seventh Circuit's interpretation is consistent with the UCC's notice function recognized by other courts and "the goal of the filing system … to make known to the public whatever outstanding security interests exist in the property of debtors."[32]

The court also noted the different functions served by a security agreement and a financing statement: "[T]he security agreement defines and limits the collateral, while the financing statement puts third parties on notice that a creditor may have an existing security interest in the property and further inquiry may be necessary."[33] While a financing statement must describe the collateral, the threshold for adequacy of a collateral description in a financing statement is much lower than in a security agreement.[34] Essentially, the Seventh Circuit puts the onus on creditors to request a copy of the security agreement if they need to resolve questions regarding the collateral description indicated in a financing statement. The takeaway from the Seventh Circuit's ruling is that a financing statement is sufficient if it "puts third parties on notice that a creditor may have an existing security interest."[35]

Given the circuit split (the U.S. Supreme Court denied *certiorari* of the *I80 Equipment LLC* appeal and provides some clarity on the issue),[36] a savvy professional will err on the side of caution. Ideally, even if arguably not required by the UCC, practitioners should continue to include more robust descriptions of collateral in financing statements or attach the security agreement to the financing statement in order to avoid challenges to their security interests based on the adequacy of the "indication" of collateral. abi

30 *Id.* at 871.
31 *Id.*
32 *Id.* at 872 (citing and quoting *In re Blanchard*, 819 F.3d 981, 986, 988 (7th Cir. 2016)).
33 *Id.*; *see also In re Grabowski*, 277 B.R. 388, 391 (Bankr. S.D. Ill. 2002).
34 *Id.* at 873.
35 *Id.* at 872.
36 The trustee docketed a petition for *certiorari* on Jan. 14, 2020; *cert. denied*, *Reinbold v. First Midwest Bank*, No. 19-870, 2020 WL 871954 (U.S. Feb. 24, 2020).