SURETY TODAY PRESENTATION

Given by
Michael A. Stover and Lisa D. Sparks
Wright, Constable & Skeen, LLP
Baltimore, MD
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THE SURETY AND SECURITY INTERESTS (UCC ARTICLE 9)

Mike: Our topic today is The Surety and Security Interests (UCC Article 9), and I will lead off with an Article 9 Overview. Then Lisa and I will talk about some of the issues and case law that deal with this subject.

ARTICLE 9 OVERVIEW

Article 9 covers security interests in all personal property whether they are tangible or intangible. Section 9-109 of the UCC defines the scope of Article 9 and identifies what is included and also lists what is not included. The primary innovation of Article 9 is that it establishes a uniform and orderly method for obtaining a security interest in collateral by standardizing the forms, process and procedures. This standardization allows for greater certainty in one's security interest and greater ability to search for and locate other interests that may exist in the debtor you are dealing with.

Article 9, like other UCC Titles, is laid out with a number of subtitles. It begins with a subtitle addressing general provisions and definitions, the next subtitle deals with effectiveness of security agreements and attachment, the largest subtitle in Article 9, not surprisingly, deals with perfection and priority. This subtitle is followed by subtitles addressing the rights of third parties, the filing requirements and procedures and finally default.

I want to talk about security interests and perfection. These issues are relevant for a surety claims handler in the event you are filing your own security interests or in the event you need to evaluate other security interests to see if they are valid and entitled to a higher priority than your security interest or other rights.

The first concept to discuss is the "security agreement." UCC § 1-201(35) defines a "Security Interest" as "an interest in personal property or fixtures that secures payment or performance of an obligation." A security agreement is a written document that conveys a security interest. In the context of suretyship, the security agreement is usually found in the Indemnity Agreement. Although the security agreement is sometimes an elaborate document negotiated between the debtor and creditor, it can be as informal and as simple as a single page. There is no magic form or format.

The primary purpose of a "security agreement" is to show, to an objective observer, that the debtor intended to transfer an interest in personal property as a security to a creditor. A security agreement must contain a description of the collateral. Section 9-108 requires that the

description of the collateral provide "reasonable identification" of the property. Examples of what is considered to be reasonable identification include identification of the collateral by specific listing, category, by type of the collateral defined in the UCC, by quantity, computational formulas or other procedures, as long as the identity of the collateral is "objectively determinable." Section 9-108(c) states that "super generic" descriptions such as "all the debtor's assets" or "all the debtor's property" do not reasonably identify the collateral for purposes of a security agreement.

The next concept to discuss is "attachment". For a security interest to be enforceable it must "attach" to the collateral. Section 9-203 sets forth the requirements for attachment and enforceability of security interests. In general: (1) the creditor must give value, (2) the debtor must have rights in the collateral, and (3) there must be a security agreement or other action indicating an intent to convey a security interest. Once the security interest has "attached," it is effective between the debtor and the creditor.

This brings us to the next concept – "Perfection." Perfection is the step necessary to place the world on notice that a creditor has an interest in the collateral and perfection is also necessary to give a creditor priority with respect to other creditors over the same collateral. Typically, perfection is achieved by filing a document called a "financing statement," sometimes referred to as a "UCC 1." The financing statement must identify the debtor, the creditor, and the collateral against which the creditor has a claim. Unlike Security Agreements, the financing statement only needs to provide an "indication of the collateral" that is covered. Section 9-504 of the UCC states that a financing statement may use the super generic identification of collateral such as "all assets" or "all personal property," which is directly contrary to the security agreements which do not allow that. So, the UCC adopts the approach of "Notice Filing" which only requires a simple record with a limited amount of information for notice purposes. An interested party must then inquire further to obtain the details of the secured transaction and collateral covered. The financing statement need not be signed by the debtor and will be effective for five years after filing.

I will turn this over to Lisa.

PRIORITIES

Lisa: So, I'm going to talk a little bit about priorities among various security interests and other types of liens. Because of the priority system, your security interest or your lien is only as good as your place in line. We're talking about situations where two creditors have an interest in the same exact collateral. I point that out because as Mike said, a UCC-1 is permitted to simply say "all of the debtor's assets" or "all of the debtor's personal property" so it may not be immediately obvious what a security interest is in when you do a basic public records search. You'll get a good idea of who has the security interest, but you have to do a little bit more research to get a hold of competing security agreements and sort out whose interest is in what. So, assuming that we're talking about that same collateral, there are a couple of different basic rules. First, I'll just mention that there are different methods of perfecting that may control priorities and as a baseline, you can always file a UCC-1. Every single time, it will not hurt you to file a financing statement. That is always permissible. There are a couple of categories of

collateral where we prefer something else, however. That's going to be possession of the collateral for cash, negotiable instruments, which include promissory notes, drafts and checks, as well as chattel paper, which is the combination of a promissory note and a security agreement, such as what you would find if you were financing the purchase of furniture in a retail transaction. They tend to be in triplicate forms, premade, pretty common in the consumer world. The reason you have to possess those types of collateral is because of the holder ship aspect of whoever has possession of them has better rights than anyone else in the world. So, we want you to possess those, which is better than filing. Similarly, control is the preferred means of perfecting a security interest in deposit accounts, and that means a savings account, checking account, or a similar account at a financial institution, as well as certain investment property. Again, because whoever is in control of those types of collateral has the ability to liquidate, freeze, or setoff other debts, control is the preferred method there. You often see in a commercial loan arrangement that the bank requires the debtor to keep all of their operating accounts within that bank so that they have that control. As far as what the surety is looking for and the main assets that you would see with the principal, there is the "big three" and that's inventory, equipment and accounts receivable. Those are all going to be covered by the UCC-1's. We're also going to frequently see payment intangibles and general intangibles, which may relate to different contract rights, that that principal has for an executory contract or funds for work performed. Another one that might pop up in this commercial arena is a commercial tort claim. For example, if a principal has a tort claim arising out of a project that may somehow be related, that's something you might have an interest in also. All of those are going to be UCC-1 financing statement perfection. Important to note as well is that under the current code, and this wasn't always the case, proceeds from the disposition of any of these forms of collateral are automatically attached, at least until they change their form. So, getting down to some rules, and I think for those of you who have been with us for 14 months, we've alluded to these sometime last summer, the internal Article 9 rules come up under § 9-322. They are luckily straightforward. If you have a perfected security interest and somebody else has an unperfected security interest, the perfected guy wins. If you have two perfected security interests, the winner is whoever was first to file or "perfect wins." There is an opportunity to pre-file before attaching the security interest. It's sort of like staking out your place in line, and that's permissible. The third rule is if you have two secured parties who have attached, but neither of whom has perfected, whoever attached first wins. So, those are really straightforward. We give you a reward for perfecting and a reward for perfecting sooner. Things get a little more complicated under § 9-317. That's where we look at a conflict between an Article 9 creditor and a creditor arising under some other law, either a judgment creditor who is attempting to levy collateral or a bankruptcy trustee, who is marshalling assets for the benefit of the estate. In that case, in order to win as an Article 9 secured creditor against either or those outside parties, you need a signed security agreement with an adequate description of the collateral, as Mike discussed, along with that perfection by filing a UCC-1 before the levy takes place or before the bankruptcy has been filed. It's okay if the grant of value from the creditor follows a little bit later. Certainly, in commercial lending, you will see that all of the paperwork is done before funds are disbursed. I think, though in the surety world, we would tend to see those things little more contemporaneous where the issuance of the bond follows very quickly after all of the other documentation, unless it's a very longstanding relationship, and the GAI is pretty old. Since I brought up bankruptcy, I will mention to you here as well that the preference period is an issue with Article 9. As always,

no matter what, we are looking out for bankruptcy filings and what the trustee is going to try to undo retrospectively, and they can undo either an attachment or a perfection, if it's occurred during that preference period. All of your other bankruptcy defenses, like new value, would apply to avoid that from happening. The last thing I want to mention in terms of priorities is the concept of the PMSI, which stands for purchase money security interest. Both the Code and the Courts treat PMSI's a little extra special. The concept of the PMSI is that the secured party enabled the debtor to obtain the collateral. This is what many of us have done when we have gone out to buy a car with financing; that's a PMSI, and it's very analogist to the purchase money mortgage that you would use to buy a house or other real property. A special rule applies there in that the purchase money secured party has a 20-day grace period in order to file a UCC-1, and as long as they do that within 20 days of the debtor taking position of the collateral, then they're going to get a retroactive effect to the date of attachment and any other secured parties that happen to arise in the meantime get sort of bumped out by that. In addition, the purchase money rule offers some line-jumping priorities for inventory equipment lenders, so once a commercial entity has a floating lien, that is they've granted a security interest in all of their inventory, equipment and accounts now owned, hereafter acquired and forever obtained to some big bank, they can still offer a security interest to a secured party that finances the purchase of new inventory or equipment and with a little bit of paperwork, they will get a super priority and jump in line ahead of that big bank.

Mike: I'm just going to spend a couple of minutes talking about equitable subrogation under Article 9.

EQUITABLE SUBROGATION

The surety's right of equitable subrogation is not affected or modified by the UCC. Section 1-103 of the UCC expressly states that it does not displace the particular provisions of the principles of law in equity, which are deemed to supplement the UCC. Thus, the contemplation of the UCC is not that it has done away or supplanted the rights of equity, but rather it has supplemented those equitable rights.. Section 9-109 regards the general scope of Title 9 and provides that the title applies to a transaction, regardless of its form, that creates a security interest in personal property or fixtures "**by contract.**" The surety's right of equitable subrogation arises by operation of law. It is not a right that arises by contract, therefore, equitable subrogation is not governed by Article 9.

The great weight of authority holds that the surety's rights of equitable subrogation are not subject to the UCC and so there is no need to file a financing statement or comply with Article 9 for the equitable subrogation rights to be valid. There are a large number of cases on this point, one in particular, *In re Modular Structures, Inc.*, 27 F.3d 72 (3rd Cir. 1994) states that "the overwhelming and essentially unanimous post-UCC decisions in federal as well as state courts have held that no UCC filing is necessary to perfect a surety's interest."

Notwithstanding the fact that the surety's equitable rights of subrogation are not governed by the UCC, the surety should give serious thought to using its rights under the Indemnity Agreement to perfect a secured party status under the UCC. By perfecting as a secured creditor

the surety will be protecting some of its interests in the event that there are any gaps or timing issues in respect to its equitable subrogation rights. As George and I discussed in our Surety Today segment in March of this year on the limits of the surety's equitable subrogation rights, there are certain instances where equitable subrogation may not apply. In addition, courts generally have a better understanding and greater experience with the UCC security interests as opposed to a surety's equitable rights and the surety may find a more understanding and sympathetic court as a secured party under the UCC. So just some food for thought, even though equitable subrogation rights are not governed by the UCC, it still might make sense for the surety to perfect its security interest under the UCC and try to use both of its rights or one or the other to its advantage.

PURCHASE MONEY SECURITY INTEREST

Lisa: Certainly, I tend to agree with Mike. Even if equitable subrogation wins the day, perfecting with that filed financing statement UCC-1 by electronic upload in most jurisdiction now, maybe $30-$40 filing fee, can be done in-house by the surety may get you to the same ends faster, easier, cheaper than pursuing the subrogation matter. Similarly, there is an opportunity with a perfected security interest by means of filing the UCC-1 with the indemnity agreement attached to it to utilize the contract assignment rights, and there are some really interesting arguments that have been made into legal scholarship over the years. I've not been able to find a case where this has clearly worked or not clearly worked, so I think it's worthwhile to keep the argument in mind. So, in combining the concept of PMSI, which comes up and is defined in § 9-103 and I'm paraphrasing here – a purchase money obligation, means the obligation of the principal is an obligation incurred for value given to enable the debtor to acquire rights in or the use of the collateral if the value is in fact so used. So while the surety's not extending credit in the traditional sense of the word, the issuance of the bond is really necessary for the principal to get the contract and the project that they've bid on. So, the position here would sort of "but for our bond, the principal and debtor wouldn't have the contract." Therefore, we are a PMSI secured party as to contract funds and also as a broader concept of contract assignment. So, the argument would be that the surety is a super priority PMSI lender. They have slightly higher, slightly better rights than maybe a pre-existing bank with some sort of loan arrangement with that same principal and debtor. The use of an after acquired property clause or similar language in the GAI could also get you ahead of that floating lien if it is a longstanding bonding relationship and you've entered into that agreement many years ago before they took out their financing. I will note that some states have looked at intangibles and said that they cannot be PMSI's. Some states have been very specific about certain kinds of intangibles. Some have been broader, so this is not a clear cut argument with a lot of great case law to cite, but I think it's an interesting argument that could be useful if the surety finds itself up against the bank and everybody scrambling for some contract funds without any other arguments or opportunities available.

PRACTICAL ARGUMENTS

Mike: I wanted to touch on just a few practical arguments or issues that can be raised in response to a secured creditor who might be seeking the same assets that the surety might be looking at.

In a circumstance where a secured creditor is seeking to recover the bonded contract funds, if you will recall I said that in order for attachment to occur, the debtor must have rights in those funds. In a typical case with bonded contract funds at issue, the debtor or the principal has gone into default under the contract and then the claim has been made for the surety to respond. In that circumstance, under most construction contracts that the principal will have executed, whether it's a subcontract or even a general contract, they will not be entitled to the contract funds because they haven't performed. They are in default, and if they're in default and haven't performed, the obligee has no obligation to pay, and therefore, there is no debt due, there is no right in those funds until those funds have been "earned" and they haven't been "earned" as long as the debtor or the principal is in default. Of course, when the surety performs, the surety is entitled to payment of the bonded contract funds – which is the "return performance" it is entitled to those funds ahead of the principal and the secured party claiming through the principal.

In a circumstance where a secured party is seeking to assert its interests in stored materials of the principal or the debtor, the surety must look to see whether title has passed to such materials, because if the principal or the debtor does not have title to the materials, then those materials cannot be the subject to a security interest. So, you would look at the contract documents. You would look at Article 2 talking about the sale and transfer of goods. Article 3.3 of the AIA A201 provides that title transfers to the owner at the time of payment for materials. In addition, typically, in order for materials offsite to be paid by the contract by the obligee, you typically have to provide a bill of sale or some other type of document expressly transferring title. So, keep in mind that's an argument to be made.

In a circumstance where a secured party is seeking to assert its interests in stored materials of the principal or the debtor, the surety may also be able to assert that it was a buyer in the ordinary course. Under Section 9-320(a), a buyer in the ordinary course of business takes free of the security interest created by the buyer's seller, even if the security interest is perfected and the buyer knows of its existence. So, you've got to look through the Code there and see what qualifies as a " buyer in the ordinary course," what qualifies as "good faith," but that argument may be able to be asserted to get around a security interest that is in place. Another argument that could be made with respect to inventory is that you can take inventory free and clear of a security interest under Section 9-315(a)(1) if two conditions are met. The first is that the sale of the inventory has to be authorized and the second is that there is a continuation of a security interest in the proceeds of that sale. If you think about it, it makes sense. If a lender has a security interest on inventory of the principal (they want that inventory to be sold so that the money can be generated to pay back the loan), the Code has provided a process for getting that type of material free and clear of security interest because the secured party now has a security interest in the proceeds; the cash that was paid for the inventory materials. So, it makes sense.

The court's have recognized that if there is an implied authorization in that context where inventory is being sold and there's a secured lender.

EQUIPMENT

Lisa: Yes, and probably akin to that, we may also have some conflicts with a lessor under Article 2A in a similar fashion as we would have with a lender who financed the purchase of equipment or materials that are onsite with the project. I know the only thing that's scarier than the UCC is when we talk about two different articles of the UCC together, but it really is important to sort out both areas, as Mike was discussing, title ownership issues and the rights to the collateral in Article 2 mixing in. Here, we have 2A as a lessee for Article 9 if it was secured and preliminarily, I want to note that if you have equipment onsite that the surety would like to utilize for completion of the project, maybe you are picking up subcontractors directly to complete a project, maybe you're bringing in a completion contractor, but in any case, the agreements always virtually say that the surety has the right to retain and use that equipment for efficiency. We know that it can make a huge difference in the cost and time to complete, particularly not just for equipment but for materials and if they're custom manufactured goods, to meet the project needs, going back to re-procure those can take a lot of time and money. On the equipment side, you want to differentiate between financed equipment and financed leased equipment, and that can be difficult to do. Regular leased equipment is usually pretty obvious because it's got a big sticker on the side of it if it says "Sunbelt" or "United Rentals" or maybe some other company out on the west coast that I'm not familiar with. They tend to show up to take that pretty quickly after a default of the principal who has not been paying them either. The financed leased equipment is going to be financed usually through some sort of bank or similar lending institution, not going to bear all those insignia of the lessor, and the payments were being made to that banking entity. So, if it's a true financing arrangement; if the money is loaned, then title should be in the principal. If it's a financed lease, then title lies with that bank instead. So you really need to sort out, is it a financed lease? Then you should determine the best course of action. If it's a financed lease, much like you would do with a regular lease, you might just want to pick up the lease payment if you really want to use that equipment. If you are up against a financing entity, a true secured party under Article 9, then you're going to start looking into these priority issues and determine if it's possible that you have priority under an agreement of indemnity, under a UCC-1 that was filed before them. You want to look at whether they're a PSMI lender with super priority. Did they blow that 20-day deadline while it took them 45 days to file their UCC-1? If so, they don't get to jump in line ahead of the surety. In any case, you're going to want to examine those items, figure out which bodies of law are at issue, Article 2, Article 9, Article 2A and Article 9, and determine the appropriate priorities to streamline that process.

Mike: Thanks, Lisa. We are at the end here. The next edition of Surety Today will be Monday, July 10 at 12:30. Our topic will be "The Surety and Arbitration." I will be joined by my partner, Jason Potter.