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First Circuit Rules That “Incorporation by Reference” of Collateral Description in UCC Financing Statements May Not Perfect Lien

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Tolstoy warned that “if you look for perfection, you’ll never be content”; but Tolstoy wasn’t a bankruptcy lawyer. In the world of secured lending, perfection is paramount. A secured lender that has not properly perfected its lien can lose its collateral and end up with unsecured status if its borrower files bankruptcy.

Such was the quandary of bondholders of the Employee Retirement System of the Commonwealth of Puerto Rico (“ERS”) when their lien on ERS revenues was challenged on perfection grounds in the ERS’ Title III case (the “ERS Case”) and a lower court ruled that the bondholders’ financing statements were defective. The First Circuit recently reversed, holding that although the initial financing statements were defective, the deficiency was cured prior to ERS’s insolvency by the filing of amended financing statements that properly perfected the lien. In its opinion, the First Circuit addressed multiple issues, including whether a financing statement properly describes collateral by referencing an unattached document. Under the facts before the Court, the answer was no.

The Uniform Commercial Code (“UCC”) controls perfection of liens on personal property. To perfect its lien on most types of personal property, a secured lender must file a financing statement with the applicable filing office providing, among other things, a collateral description. One issue the First Circuit grappled with in the ERS Case was the sufficiency of the collateral description.

The financing statements in question 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.” The attached Security Agreement described the “Pledged Property” by reference to an unattached document (the Resolution)—thus the document actually defining “Pledged Property” was not included with the financing statement, nor was it available at the UCC filing office.

The First Circuit held that the financing statements failed to sufficiently describe the collateral because: (a) the collateral was not described, even by type(s), in the financing statements or the attachments; (b) the financing statements did not tell interested parties where to find the Resolution (defining “Pledged Property”); and (c) the Resolution was not at the UCC filing office. The Court explained that “[r]equiring interested parties to contact debtors at their own expense about encumbered collateral, with no guarantee of a timely or accurate answer, would run counter to the notice purpose of the UCC.” Therefore, the First Circuit concluded that the initial financing statements were ineffective as filed and did not perfect the bondholders’ lien.

In sum, the First Circuit issued a clear warning to secured creditors—ensure the financing statement itself satisfies the UCC’s collateral description requirements. Relying on unattached documents runs the risk of failing



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the basic tenet of the UCC: to notify other creditors of a secured creditor's interest in a debtor's property. The First Circuit's opinion, as well as lower court cases, do not necessarily preclude creditors from prevailing in perfection contests in circumstances where the collateral description in the filed financing statement and its attachments, though incomplete, is deemed to give sufficient notice of the type of collateral. But shortcuts in collateral description create a risk that a court will deem a financing statement ineffective, and a lien unperfected, in its entirety or as to particular types of collateral. Best practice is not to rely on defined terms in the transaction documents, particularly vague defined terms that may be argued not to connote specific types of collateral, unless the applicable definitions are also included with the financing statement, are readily publicly available or are the type expressly recognized in the UCC itself.

It should also be noted that the First Circuit separately considered whether the financing statements included the proper debtor name, another UCC requirement. While this was a big issue in the ERS Case, the holding turned on a particularly unusual set of facts and does not provide a broadly applicable takeaway—other than emphasizing the critical importance of using and maintaining the correct debtor name on a financing statement.

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