# Nine Points on Article Nine

## POINT ONE – TYPES OF COLLATERAL

### Tangible Collateral

*K.S.A. § 84-9-102*

Collateral that is moveable and has tangible physical form is known as "goods" under Article Nine and is divided into four sub-categories:

(1) Consumer goods – used or bought primarily for personal, family, or household purposes. K.S.A. § 84-9-102(a)(23);
(2) Inventory – held for sale or lease to others in the ordinary course of business. K.S.A. § 84-9-102(a)(48);
(3) Farm products – used or produced in farming operations and are in the possession of the farmer/debtor. K.S.A. § 84-9-102(a)(34); and
(4) Equipment – collateral that qualifies as goods but does not fit into any of the other three primary categories. K.S.A. § 84-9-102(a)(33).

### Intangible Collateral

*K.S.A. § 84-9-102*

Intangible collateral lacks physical form and includes the following:

(1) Instruments – includes checks, promissory notes, chattel paper and certificates of deposit; K.S.A. § 84-9-102(a)(47);
(2) Accounts – a right of payment that is not evidenced by an instrument or chattel paper;
(3) Deposit Accounts – includes checking and savings accounts that are not evidenced by an instrument and that do not qualify as investment property;
(4) Investment property – certificated or uncertificated securities. K.S.A. § 84-9-102(a)(49); and
(5) General intangibles – includes any intangible property that does not fit into other Article Nine categories. This category includes uncertificated member interests in a limited liability company.

# POINT TWO – CREATION OF A SECURITY INTEREST

**Creation of a Security Interest**

*K.S.A. § 84-9-203*

In order to create a valid security interest, a lender and debtor must reach an agreement wherein both parties intend for a security interest to attach against certain collateral for the purpose of securing repayment of a debt; the lender must give value (i.e. loan proceeds) to the debtor; and the debtor must have "rights" in the collateral.

Description of the Collateral. The security agreement must reasonably identify the collateral. K.S.A. § 84-9-108. While a financing statement may utilize a super-generic description such as "all debtor's property", a security agreement must be more specific. K.S.A. § 84-9-108; 84-9-504. A security agreement can encumber the debtor's after-acquired property. K.S.A. § 84-9-204(a).

Debtor has Rights in the Collateral. A debtor must have sufficient rights in the collateral in order to pledge it as security. Rights, however, is not equated with ownership. The phrase "rights in the collateral" is not defined in the UCC. However, the UCC does not require that a debtor possess full ownership rights. *Kinetics Technology Int'l Corp. v. Fourth Nat'l Bank of Tulsa*, 705 F.2d 396, 398 (10th Cir. 1983) (stating that the requirement of rights in the collateral illustrates the general principal that "one cannot encumber another man's property in the absence of consent, estoppel, or some other special rule."). Sufficient rights in the collateral exist provided the debtor has "some degree of control or authority over collateral placed in the debtor's possession." *Id* at 399. The requisite authority exists "where a debtor gains possession of collateral pursuant to an agreement endowing him with any interest other than naked possession." *Id* (adopting the rule set forth by the Oklahoma Supreme Court in *Morton Booth Co. v. Tiara Furniture, Inc.*, 564 P.2d. 210, 214 (Okla. 1977)). The *Morton Booth* definition of authority "strongly supports the Article Nine purpose of promoting certainty in commercial loan transactions." *Kinetics*, 705 F.2d at 399 (stating that with a contrary definition, "a would-be creditor could easily be misled into making a loan under an ineffective security agreement . . . . defeated by the sort of hidden-title subterfuge the Code was intended to prevent."). See also *U.S. v. Ables*, 739 F. Supp. 1439, 1443 – 44 (D. Kan. 1990) (stating "authority, control, and exclusive use of collateral placed in a debtor's possession is a highly relevant (and possibly determinative) factor in determining whether a debtor has rights in the collateral under 9-203."); B. CLARK, *The Law of Secured Transactions Under the Uniform Commercial Code* at 2-14. Courts construing the meaning of "rights in the collateral" have ruled that an owner's permission to use goods as collateral

creates rights in the debtor sufficient to give rise to an enforceable security interest. See *In re Atchison*, 832 F.2d 1236, 1239 (11th Cir. 1987) (citing 1 G. GILMORE, *Security Interests in Personal Property* § 11.5, at 353 (1965) for the proposition that "the drafters of the Code intended that rights in the collateral not be equated with ownership."); *In re Pubs, Inc. of Champaign*, 618 F.2d 432, 436 (7th Cir.1980) (individual debtor; corporate owner); *K.N.C. Wholesale, Inc. v. AWMCO, Inc.*, 56 Cal. App. 3d 315, 128 Cal. Rptr. 345, 348 (1976) (parent corporation debtor; subsidiary owner); *Murray v. Conrad*, 346 N.W.2d 814, 820 (Iowa 1984) (individual debtor; corporate owner); *GMAC v. Washington Trust Co. of Westerly*, 120 R.I. 197, 386 A.2d 1096, 1098 (1978) (husband debtor; wife owner). Other courts have held that a debtor has sufficient rights in the collateral when the debtor has any rights going beyond mere possession, such as the right to use and control the collateral. *See Douglas-Guardian Warehouse Corp. v. Esslair Endsley Co.*, 10 U.C.C. Rep. Serv. (Callaghan) 176, 184 (W.D.Mich.1971); *Bellrose v. Denver Florists' Federal Credit Union*, 682 P.2d 1224, 1226 (Colo. Ct. App.1983); *Morton Booth Co. v. Tiara Furniture, Inc.*, 564 P.2d 210, 214 (Okla.1977); *Uniroyal, Inc. v. Michigan Bank*, 12 U.C.C. Rep. Serv. (Callaghan) 745, 750 (Mich.Cir.Ct.1972). A debtor also has "rights in the collateral" if the "true owner of the collateral has agreed to the debtor's use of the collateral as security or if the true owner has become estopped to deny the creation or existence of the security interest." In re *Pubs, Inc*., 618 F.2d 432, 436 (7th Cir. 1980) (stating the "consent of the true owner of the collateral is enough to give the debtor rights in the collateral for purposes of § 9-203."). See also *Avco Delta Corporation Canada Ltd. v. U.S.*, 459 F.2d 436 (7th Cir. 1972) (holding that a security interest alleged to be unenforceable because the corporate debtor had no rights in the collateral can "be created by estoppel through acts or omissions (including silence) of the true corporate owner.").

**Perfection of a Security Interest**

*K.S.A. §§ 84-9-317, 84-9-310, 84-9-308*

Article Nine generally provides four primary means for perfecting a security interest. These include: (1) filing a UCC-1 financing statement; (2) taking possession of the collateral; (3) control; and (4) compliance with applicable certificate of title laws. K.S.A. § 84-9-310, 9-313. "A security interest is perfected if it has attached and all of the applicable requirements for perfection in K.S.A. § 84-9-310 through K.S.A. § 84-9-316 and amendments thereto, have been satisfied." K.S.A. § 84-9-308.

# POINT THREE – DEFAULT AND DISPOSITION

**Rights Following Default**

*K.S.A. §§ 84-9-609, 610 and 615*

In the absence of a bankruptcy filing, a secured lender is entitled to possession or control of its collateral following a default. The Kansas Uniform Commercial Code in § 84-9-609 provides that following a default, a secured party:

(1) May take possession of the collateral; and
(2) Without removal, may render equipment unusable and dispose of collateral on a debtor's premises under K.S.A. § 84-9-610.

This same statute goes on to clarify that a secured party may exercise these rights pursuant to judicial process or without judicial process if it proceeds without breach of the peace. See K.S.A. § 84-9-609(b).

**What is Breach of the Peace?**

In *Riley State Bank v. Spillman*, 242 Kan. 696, 703-05, 750 P.2d 1024 (1988), agents from the Bank deactivated an alarm system and used a locksmith to gain access to a shop and repossess inventory collateral. The Kansas Supreme Court found this to be a breach of the peace and put forth the following guidance:

> A creditor must obtain possession of the collateral through the courts if entry to the debtor's premises, whether residential or commercial, can only be obtained through force.

However, no breach of the peace was found where an agent used his own key to unlock a debtor's car and drive it away in the middle of the night. See *Wade v. Ford Motor Credit Co.*, 8 Kan. App. 2d 737, 745 (1983).

**How is the Collateral Sold?**

K.S.A. § 84-9-611 requires a secured party to send a written notice of the date, time and manner of a proposed sale of collateral to the debtor, secondary obligors and otherwise interested parties generally at least ten days prior to the sale. K.S.A. § 84-9-615 provides that a junior secured party's lien will attach to the proceeds of such sale. However, the senior party conducting the sale only has a duty to distribute excess sale proceeds to a junior secured creditor upon a timely written demand. See *Trailmobile, Inc. v. Guthrie Trailer Sales, Inc*. 713 P.2d 494 (Kan. App. 1985) (secured party is only required to pay over remaining proceeds to junior lien holder upon written demand and proof of interest). With regard to the debtor, once the sale is complete, all of the debtor's legal or equitable interests in the collateral terminate and the collateral is not subject to a

subsequently filed bankruptcy. See In re *Hundley*, 2007 U.S. Dist. LEXIS 26206 (D. Kan. 2007).

# POINT FOUR – TRUE LEASE VS. DISGUISED LIEN

**Traps Inherent in Lease Financing**

*K.S.A. § 84-1-201(35)*

Community Banks may work in concert with equipment dealerships to offer lease financing in additional to traditional financing as an alternative to traditional financing. The risks associated with lease financing do not differ significantly from those of traditional financing but come with the potential for hazard without careful planning.

The rights of parties to a personal property lease are governed by Article 2A of the KUCC. Most lease financing relationships utilize a non-cancellable lease meaning the lessor is entitled to recover all of the unpaid lease payments from the lessee in the event of a default. See In re *Hoskins*, 266 B.R. 154, 160 (Bankr. W.D. Mo. 2001). The lessor is also customarily entitled to recover from the lessee costs associated with the default including attorney's fees. Following the default, Article 2A of the KUCC permits the lessor to either sell the leased property at a private or public sale and apply the proceeds to the balance due under the lease or lease the property to a third party in order to mitigate damages. K.S.A. § 84-2a-527(1).

When engaging in lease financing, it is important to keep in mind that a lease could be subject to attack under the theory that the lease is not a "true lease" but rather is a disguised security interest for a loan. This argument relies on the definition of a security interest found in K.S.A. § 84-1-201(35) and judicial decisions interpreting that definition. If the lease is characterized as a loan and security interest, rather than a true lease, then the lessor will be treated as a secured creditor subject to Article Nine of the UCC rather than a lessor under Article 2A. Under Article Nine, if the lessor failed to perfect the "disguised security interest" by filing a UCC-1 financing statement, then the lessor's rights against the leased property will be junior to intervening perfected creditors such as a federal tax lien, state tax lien or a bankruptcy trustee. See 11 U.S.C. § 544(a).

The UCC contains a two-part "bright-line" test for purposes of distinguishing a true lease from a disguised security interest. The first part of the test looks at whether the lease contains a termination provision in favor of the lessee. If the lessee can terminate the lease without further obligation for lease payments, then the transaction qualifies as a true lease without further inquiry. In re *Owen*, 221 B.R. 56, 60-61 (Bankr. N.D.N.Y. 1998). In the absence of a termination provision, a transaction constitutes a disguised security interest if one or more of the following conditions are met:

(1) The original term of the lease is equal to or greater than the remaining

economic life of the goods;

(2) the lessee is bound to renew the lease for the remaining economic life of the goods or is bound to become the owner of the goods;

(3) the lessee has an option to renew the lease for the remaining economic life of the goods for no additional consideration or for nominal additional consideration upon compliance with the lease agreement; or

(4) the lessee has an option to become the owner of the goods for no additional consideration or for nominal additional consideration upon compliance with the lease agreement. K.S.A. § 84-1-203.

In order to qualify as a true lease, the lessor must retain some level of meaningful residual value in the leased property at the conclusion of the lease term. An "economic realities" test has developed which provides that if the purchase option is so attractive to the lessee that the only sensible alternative is to exercise the purchase option, then the transaction constitutes a financed sale with a disguised security interest rather than a true lease. A purchase option that approximates the fair market value of the leased property would likely support a finding that the transaction is a true lease. In re *Edison Bros. Stores*, 207 B.R. 801, 811-12 (Bankr. D. Del. 1997). See In re *Hoskins*, 266 B.R. 154, 160 (Bankr. W.D. Mo. 2001) (option to purchase at residual value supported finding of true lease). In light of the potential for a lease to be characterized as an Article Nine security interest, the prudent lender should treat the lease as if it were a security interest and perfect that security interest under Article Nine generally by filing a UCC-1 financing statement or by registering notice of the lien on any applicable certificates of title.

# POINT FIVE – BE CAUTIOUS OF NAME CHANGES

**Sufficiency of Corporate Debtor's Name**

*K.S.A. § 84-9-503*

With respect to a registered organization such as a corporation, limited liability company, etc., the name used on the UCC-1 should match exactly how the name is registered with the Secretary of State. K.S.A. § 84-9-503. It is important to keep in mind that K.S.A. § 17-7674 permits a limited liability company to amend its articles of organization for any proper purpose. This can include an amendment to change its legal name. Domestic limited liability companies can file a name change amendment online with the Secretary of State. These options create the potential for a debtor to alter the enforceability of a lender's security interest unilaterally. If a corporate debtor decides to change its name, the lender will need to modify its UCC-1 within four months pursuant to K.S.A. § 84-9-507 or else the UCC-1 will be deemed seriously misleading.

# POINT SIX – FINANCING STATEMENTS LAPSE

**A Continuation Statement Alone does not Remedy a Lapsed UCC-1**

*K.S.A. § 84-9-515*

Article Nine requires that a continuation statement be filed prior to the time that the original UCC-1 financing statement lapses in order to maintain perfection of the security interest. If the continuation statement is not timely filed, the appropriate action is to file a new UCC-1. Filing a delinquent continuation statement will not cause the now unperfected security interest to become perfected.

# POINT SEVEN – IMPACT OF SUBSEQUENT IRS LIEN

**A Future Advance May Lose Priority to a Subsequent IRS Lien**

*26 U.S.C. § 6323*

Kansas permits the use of dragnet clauses wherein a mortgage or security agreement secures both present obligations owed to the lender and "future advances". The Kansas Supreme Court has stated the following regarding dragnet clauses:

> [I]n the absence of clear, supportive evidence of a contrary intention a mortgage containing a dragnet type clause will not be extended to cover future advances unless the advances are of the same kind and quality or relate to the same transaction or series of transactions as the principal obligation secured or unless the document evidencing the subsequent advance refers to the mortgage as providing security therefore. *Emporia State Bank and Trust Co. v. Mounkes*, 519 P.2d 618 (Kan. 1974).

Generally, a subsequent advance secured by a previously recorded security agreement or mortgage will take priority over a subsequently perfected security interest. However, the Internal Revenue Code creates an exception to this general rule once the IRS has filed a notice of lien. 26 U.S.C. § 6323(c) and (d) provide that where a future advance is disbursed more than 45 days after the IRS files a notice of federal tax lien, the future advance will be junior in priority to the IRS tax lien. For this reason, it is unwise to make future advances after receiving notice that a federal tax lien has been filed.

# POINT EIGHT – LIENS IN OIL AND GAS INTERESTS

**What is the Methodology for Perfecting a Lien in an Oil and Gas Interest?**

An oil and gas interest can be considered to be a personal property interest for some purposes and a real property interest for other purposes. In *Ingram v. Ingram*, 214 Kan. 415 (1974), it was stated that an oil and gas leasehold interest must be recorded in the manner of a real property conveyance. Subsequent courts have stated that a lessor's unaccrued royalty interests are real property only until the time that production begins. At the time that production begins, accrued royalty interests become personal property rather than real property. In re *Estate of Sellens*, 637 P.2d 483 (1982). See also In re *Thexton*, 39 B.R. 367 (Bankr. D. Kan. 1984). In light of this case law, the approach of a prudent lender is to secure an oil and gas interest by filing (1) a mortgage with the register of deeds; (2) a UCC-1 financing statement and addendum with the register of deeds cross-indexed to the real estate; and (3) a UCC-1 financing statement with the Secretary of State.

# POINT NINE – HYPOTHETICAL LIEN CREDITOR

**Article Nine Priority Rules Hinder Unperfected Creditors in Bankruptcy**

*K.S.A. § 84-9-317 and 11 U.S.C. § 544(a)*

K.S.A. § 84-9-102(a)(52) defines a lien creditor as one who has acquired a lien on the property involved by attachment, levy or the like and expressly includes a bankruptcy trustee as a hypothetical lien creditor. The source of the bankruptcy trustee's status as a "hypothetical lien creditor" is found at 11 U.S.C. § 544(a). That statute provides that when a bankruptcy is filed, the bankruptcy trustee obtains a lien on all property of the bankruptcy estate just as if he had served a writ of attachment against all of the property which would have created a lien against such property under state law. Kansas, like most states, recognizes that a successful garnishment, levy or attachment creates a lien against the personal property that was garnished, levied or attached. The effect of § 544(a) is that once a bankruptcy is filed, the bankruptcy trustee's hypothetical lien will be measured by reference to state law for lien priority against the other secured creditors that claim an interest in the property of the bankruptcy estate. The applicable state law is K.S.A. § 84-9-317. This statute provides that a lien creditor takes priority over a prior unperfected security interest. Thus, these statutes operating in combination allow a trustee to avoid any interest in a bankruptcy debtor's property that is unperfected at the time the bankruptcy petition is filed. See *Gray v. Giant Wholesale Corp*., 758 F.2d 1000 (4th Cir. 1985).