Chapman and Cutler LLP

Chapman Client Alert

February 12, 2019 Current Issues Relevant to Our Clients

Second Time's a Charm: First Circuit Finds That Financing Statement Amendments Saved Defective Collateral Description

An adequate collateral description still matters when it comes to perfecting a security interest by filing a financing statement under the Uniform Commercial Code (the *"UCC"*). In August, we wrote about a decision by the court overseeing Puerto Rico's bankruptcy-like Title III proceeding,[1] where that court found that certain bondholders were unsecured because they filed inadequate financing statements with the Puerto Rico Secretary of State. Recently, the U.S. Court of Appeals for the First Circuit (the *"First Circuit"*) reversed the lower court's decision, in part, finding that a financing statement amendment correcting an inadequate collateral description, along with a poorly translated law and the absence of intervening liens, saved the day for secured creditors.[2] Specifically, the First Circuit found that a UCC filing amendment naming "Employees Retirement System of the Government of the Commonwealth of Puerto Rico" as the debtor contained an appropriate name and that, when coupled with a corrected collateral description in the amendment, the bondholders' lien was perfected and therefore unavoidable under the "strong-arm" provisions of the Bankruptcy Code.[3]

Although the First Circuit reversed the lower court's decision, the case continues to serve as a reminder for secured creditors to ensure that their financing statements conform to the requirements of the UCC (whether or not a third party agrees to be responsible for the filing). Secured lenders should review their collateral package to ensure that all collateral is adequately described and otherwise properly perfected according to applicable law.

The Facts

The facts in the case were not in dispute. In 2008, the Employees Retirement System of the Government of the Commonwealth of Puerto Rico (the *"ERS"*) issued about $2.9 billion of bonded debt (the *"Bonds"*). The Bonds were secured by "Pledged Property," which included, among other things, all revenues of the ERS. The revenues of the ERS included required employer contributions to the system, as well as the proceeds of those contributions. In June and July 2008, two UCC financing statements were filed with the Puerto Rico Department of State in order to perfect the lien on the Pledged Property (the *"2008 Financing Statements"*). The 2008 Financing Statements were in the name of the ERS and described the collateral as the pledged property designated in the security agreement that was attached to those statements. The security agreement, however, did not actually define "Pledged Property," but rather referenced a definition in another, unattached document—the bond resolution.

Then, in December 2015 and December 2016, four amendments to the 2008 Financing Statements were filed (the *"Financing Statement Amendments"*). The Financing Statement Amendments included a full definition of "Pledged Property" and continued to provide the name of the debtor as the "Employees Retirement System of the Government of Puerto Rico."

The Lower Court Decision

According to the lower court, the ERS bondholders' security interest was not properly perfected. The lower court first found that the 2008 Financing Statements did not provide an adequate collateral description because they did not include the actual definition of "Pledged Property." Consequently, the 2008 Financing Statements were insufficient to perfect the ERS bondholders' interest. The lower court then determined that the Financing Statement Amendments were also insufficient to perfect the ERS bondholders' security interest. Although the Financing Statement Amendments potentially could have cured the defective collateral description contained in the 2008 Financing Statements, the lower court concluded that the Financing Statement Amendments failed to include the debtor's current legal name, which the court found had been changed in 2013 to the "Retirement System for Employees of the Government of the Commonwealth of Puerto Rico."[4]

The First Circuit

The First Circuit agreed with the lower court that the 2008 Financing Statements were insufficient to create a perfected security interest in the ERS's "Pledged Property" because they did not include a definition of the term "Pledged Property." Importantly, it was not enough that the underlying bond resolution, which did include a definition of "Pledged Property," was a public document. The First Circuit noted that the

document was held at a different location than Puerto Rico's UCC filing office, and the 2008 Financing Statements did not provide any indication of the bond resolution's location or how to find it. In the view of the First Circuit, a third party should not have to spend a lot of resources figuring out the extent of a relatively generic collateral description. According to the First Circuit, requiring third parties to search for records outside of the filing office would "undercut[] several key goals of the UCC and its filing system. These goals include fair notice to other creditors and the public of a security interest."[5]

Although the First Circuit found that the 2008 Financing Statements were insufficient to perfect the bondholders' security interest in the ERS's "Pledged Property," the First Circuit found that the Financing Statement Amendments saved the day for the bondholders, at least from and after the time the amendments were filed. Specifically, the Financing Statement Amendments included an adequate collateral description, providing fair notice to other creditors.

The First Circuit also addressed whether the amendments adequately described the name of the debtor. According to the ERS, as well as the Unsecured Creditors Committee, both of whom were challenging the validity of the bondholders' lien, the English translation of a 2013 amendment to the ERS's enabling act changed the ERS's legal name in English to the "Retirement System for Employees of the Government of the Commonwealth of Puerto Rico." Because the Financing Statement Amendments did not use that name, the ERS and the Unsecured Creditors Committee asserted that the Financing Statement Amendments were not effective to perfect the bondholders' security interest. The lower court agreed with them.

The First Circuit overturned the lower court's decision, finding that the ERS's enabling act was internally inconsistent and used two different names for the ERS, one of which was identified on the Financing Statement Amendments. To the First Circuit, the use of one of these names was sufficient because "a searcher, whether another creditor or merely an interested party, would conclude that a search under the ERS name (which was used in the Financing Statement Amendments) was required. Similarly, a reasonable filer would have concluded that the ERS name was a correct name for the debtor for UCC purposes."[6]

Thus, the First Circuit found that each of the Financing Statement Amendments filed in December 2015 met all of the requirements for an effective financing statement. Therefore, the Financing Statement Amendments perfected the bondholders' security interest in ERS's "Pledged Property" before the ERS became subject to its bankruptcy-like proceeding under PROMESA in 2017. In light of the validly perfected security interest, the bondholders' lien could not be avoided pursuant to the "strong-arm" provisions of the Bankruptcy Code.

It is important to note, however, that had another creditor filed a UCC financing statement covering the "Pledged Property" between the 2008 Financing Statements and the Financing Statement Amendments in 2015, that creditor potentially would have had a prior perfected security interest that would have been senior to the bondholders' lien.

Conclusion

Taken as a whole, the decision serves as a cautionary tale to all secured lenders that they should (a) review and evaluate the sufficiency of their UCC financing statements (and any other required filings) for perfection, and (b) at the first signs of distress take any steps necessary to confirm perfection. As noted by the First Circuit, to properly perfect a security interest, a UCC-1 financing statement must include an adequate description of the property pledged and the correct legal name of the borrower, as well as the name of the secured party or its representative.

For More Information

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1 As discussed in prior Client Alerts, due to a serious and ongoing fiscal emergency in the Commonwealth, Congress enacted PROMESA in 2016. In addition to establishing the Title III proceeding for the Commonwealth and its instrumentalities, PROMESA also required that an oversight board (the *"Oversight Board"*) be established to develop a method for the Commonwealth to achieve fiscal responsibility and regain access to the capital markets. Among other things, PROMESA requires the Oversight Board to certify a fiscal plan for the Commonwealth and its instrumentalities. On May 3, 2017, the Oversight Board commenced a debt restructuring proceeding on behalf of the Commonwealth by filing a petition in the District Court under Title III of PROMESA. Shortly thereafter, the Oversight Board commenced Title III proceedings on behalf of certain Puerto Rican government instrumentalities, including the ERS.

2 *In re Fin. Oversight and Mgmt. Bd. for Puerto Rico*, __ F.3d ___, 2019 WL 364029 (1st Cir. Jan. 30, 2019) (the *"Op."*).

3 We note that one of the issues in the case centers around the appropriate English name or names for the ERS.

4 Interestingly, the Spanish name for the ERS remained the same.

5 *Op.* at 30.

6 *Op.* at 50. The First Circuit likewise noted that the ERS's name had been in use for over sixty years, making it highly reasonable to require a third party to search under that name as well, given the dual use of the names in the enabling statute.

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