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Uniform Commercial Code Financing Statement is Integral in Bond Defaults.

Proper attention to the unsexy “Uniform” Commercial Code financing statement may well be the single most consequential checklist item in a secured bond financing from the perspective of bondholder recovery in a default situation. Bizarrely, no transaction participant takes express responsibility for the initial filing of the UCC financing statement at a bond closing, and frequently no transaction participant other than the issuer or conduit obligor takes responsibility for the filing of required post-closing continuation statements. From a bondholder perspective, it is somewhat akin to expecting the fox to guard the chicken coop.

The result: a non-trivial number of transactions in which the lien promised to bondholders is never perfected, or becomes unperfected after the bonds are issued, in which case the lien is ineffective against other creditors with the consequence that bondholders that purchased bonds on the premise of secured status receive the greatly reduced recovery of unsecured creditors.

There are a few relatively simple — and largely costless —- steps that bondholders with sufficient leverage can insist upon before placing their purchase orders on a secured bond transaction to protect their investment and decrease the possibility that their investment will be unsecured when it matters most.

UCC Perfection Requirements

Each state and/or U.S. territory has its own version of the UCC, and some versions may have atypical provisions. Generally, however, the principles below are applicable in most jurisdictions.

The UCC governs the creation and perfection of security interests in personal property, including accounts and their proceeds and revenues, gross revenues, net revenues and receipts, which are not UCC terms. The UCC generally is inapplicable to a security interest created by a state governmental unit to the extent another state statute expressly governs the creation, perfection, priority, or enforcement of such security interest. Noncompliance with the UCC may not imperil secured creditor status with respect to security provided by a municipal issuer if such issuer’s enabling statute provides for an alternative to the UCC’s requirements as to, for example, creation or perfection of a lien and such alternative requirements have been satisfied. However, on a conduit bond issue, the UCC almost always applies to the security interest provided by the non-governmental conduit borrower, and noncompliance may result in unsecured status of the claim against the only party responsible for repayment of the bonds.

Most UCC noncompliance issues arise from the failure to properly perfect a security interest. A security interest in accounts and their proceeds must be perfected by the filing of a financing statement. A financing statement is sufficient for perfection purposes only if it provides the name of the obligor and the name of the secured party; and describes the collateral covered by the financing statement. A description of collateral is sufficient if it “reasonably identifies” what is described or if it describes the collateral as “all assets” or “all personal property.”

Certain events occurring after the filing of an initial financing statement may result in loss of perfected status.

For example, if the debtor/obligor's name changes such that a search under the name in the original financing statement would not disclose financing statements filed under the debtor's new name, the financing statement is ineffective to perfect a security interest in collateral acquired by the debtor more than four months after the name change, unless an amendment to the financing statement providing the new name is filed within four months after the name change.

In addition, a filed financing statement generally is effective for a period of five years after the date of filing, and lapses (and therefore perfection lapses) if a UCC continuation statement is not filed within the six-month period preceding the end of the five-year period. Timely filing of a continuation statement extends the effectiveness of the financing statement for additional five year periods.

A Short List of Perfection Safeguards

The UCC's requirements are technical and often unforgiving of unintended and arguably small inaccuracies, and the adverse consequences of noncompliance can be financially disastrous for a lender or bondholder. There are various steps bondholders can take that can eliminate or substantially reduce the risk of a UCC mishap.

1. Insist on a Disclosed and Meaningful Perfection Opinion

In most secured bond issues, the underwriters, as a closing condition, require a legal opinion as to the status of the liens securing the bonds. On non-conduit bond issues, the opinion regarding the lien may be included in the bond counsel opinion, and may be published in the official statement for the bonds. In the case of conduit bond issues, the key liens typically are addressed in the opinion of the conduit obligor's counsel, which typically is not published in the official statement. Given the importance of secured status on a secured transaction, bondholders should insist that the offering document include the legal opinions relating to lien perfection to be delivered at closing.

If disclosed, the legal opinions will often reveal common deficiencies that can and should be addressed, if noted by the bondholders, prior to closing. On a non-conduit deal, the opinion will often state that the lien or pledge provided by the issuer is "valid", which does not address perfection. The opinion should state that the lien is valid and perfected.

On conduit deals, the opinion of conduit obligor's counsel often says "upon filing of the UCC financing statement in [applicable UCC registry], the lien in the [revenues/other personal property collateral] will be perfected to the extent that such lien is capable of being perfected under the UCC by the filing of a financing statement." Such an opinion is not a perfection opinion, just an opinion that if the UCC is filed, the lien will be perfected. If the filing does not occur, the bondholders will be unsecured and, if damaged by such status, left with little recourse but to seek recovery from some solvent party to the transaction based on some purported implied duty to file the financing statement and subject to statute of limitations and other defenses. Such a situation is entirely avoidable through insistence that the UCC financing statement be filed prior to closing, which the UCC expressly authorizes.

2. Insist on a "Public Finance Transaction" Financing Statement When Applicable

UCC financing statement mishaps can occur either because of an inadequate or unfiled initial financing statement or because of lapse of a filed financing statement due to failure to file a timely continuation statement. For any bond issue with at least one maturity of at least 20 years secured by

a security interest governed by the UCC of a state that provides for public finance transaction financing statements, the statement should state that it is filed in connection with a public finance transaction and, in a conduit transaction, the secured obligation, be it the loan agreement or a master note, should run to the governmental issuer and be assigned to the bond trustee versus running directly to the bond trustee. Neither of these requirements is difficult or costs anything, and it makes continuation a non-issue for 30 years (versus the standard 5 years) — long enough for virtually all bond issues, taking into account likely refinancings.

3. Insist that the Bond Documents Require that the Bond Trustee or Master Trustee File Continuation Statements, and that Name Changes be Addressed

Because bond trustees traditionally have asserted that they are unwilling to take on the potential liability associated with assuming and then failing to fulfill a duty to file continuation statements, many indentures or master indentures place the responsibility for filing continuation statements on the issuer or conduit obligor. But there is no adverse consequence to an issuer or borrower for failing to continue a continuation statement.

There are trustees that will agree to undertake the obligation to timely file such continuation statements, in reliance on internal tickler systems. Insistence by bondholders on the use of such trustees contributes to the creation of a market standard that will encourage more reluctant trustees to join the club. In addition, bondholders should insist that reporting provisions in bond documents require the reporting on EMMA of any name change to the issuer or any obligor, accompanied by an opinion of counsel that UCC financing statements have been amended as required to continue perfection of the applicable liens.

4. In Times of Trouble, Review the UCC Financing Statements

Issuers and conduit obligors rarely file for bankruptcy out of the blue. Once a filing occurs, bondholders can be assured that counsel for the debtor and competing creditors will pore over the UCC financing statement filing status, and the contents of UCC financing statements, seeking to find some omission or flaw that can be argued to void or render ineffective all or a portion of the lien securing the bonds. Most financing statement mishaps can be cured by filing a new, correct financing statement if such cure occurs prior to the commencement of the preference period preceding a bankruptcy filing, typically 90 days. These days, financing statements are readily available online. As red flags arise concerning an issuer’s or obligor’s financial health, it behooves substantial bondholders to ask internal or external counsel to conduct a UCC financing statement review for the applicable issuer or obligor.

The Bond Buyer

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