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# Law Firm Economics and the Risk Management Functionality of UCC Insurance

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The greatest risk to the loss of secured creditor status in a debtor bankruptcy proceeding results from work performed by those with the least amount of expertise and the lowest profit point in the law firm economic structure. This disconnect between expertise and risk creates significant economic exposure to the law firm. Two solutions are presented: 1) increase the level of expertise and attendant cost; or 2) utilize the risk management functionality of UCC insurance, a lower cost option.

**Figure 1**

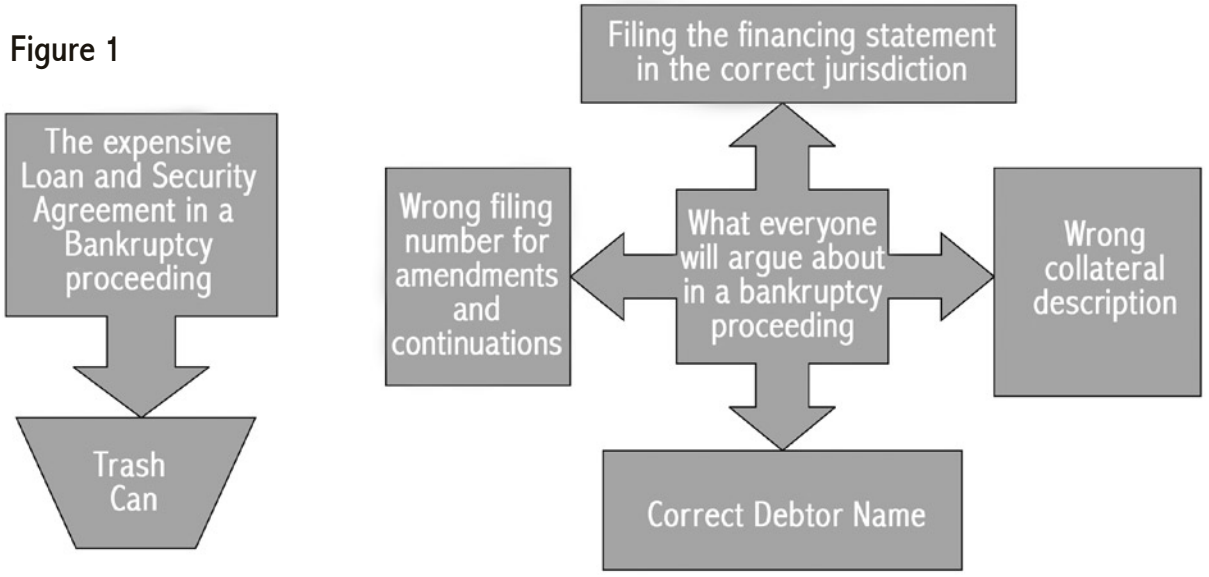



Figure 1 portrays the distinction between the loan and security agreement, a drafting effort requiring significant legal expertise and attendant cost, and the preparation of the UCC Financing Statement upon which hangs the perfection of the security interest of the lender. The left of Figure 1 shows the Loan and Security Agreement, and the expensive and time-consuming loan documentation legal effort it represents, ending up in the trash upon the filing of the petition in Bankruptcy. No one really cares about financial covenants, complicated reporting provisions, endless pages of permitted indebtedness provisions, or the waterfall between junior and senior tranches, or other affirmative and negative covenants. The significant legal work on loan documentation is intended to operate outside of a chapter proceeding, provide a useful early warning system for the financial condition of the borrower and other operational necessities. However, once the debtor files for bankruptcy protection, the focus will shift from the loan documentation to one very simple document: the UCC Financing Statement.

Revised Article 9 significantly expanded the scope of collateral coverage from former Article 9.[1] Because of this increased scope, many during the revision process argued against adoption on the ground that little collateral was left over for the debtor to fund reorganization. Given this reality, the trustee in bankruptcy or a creditors' committee will scour

the countryside for a way to garner assets to the estate. A useful avenue of attack for the trustee or creditors' committee will be the perfection position of secured creditors and their filed UCC Financing Statements.

If the trustee or Committee can diminish the effectiveness of the UCC Financing Statement, they may be able to convert the lender from a secured to an unsecured creditor. Should this happen, the lender could be looking at a significant diminution in secured status, from 90¢ on the dollar and a partially undersecured creditor to 2¢ on the dollar as an unsecured creditor. The life of an unsecured creditor is not a happy one.

The bankruptcy trustee or unsecured creditors' committee will attack your client's secured creditor status from one of three directions: 1) the secured party filed in the wrong jurisdiction, 2) the collateral description is incorrect in some manner, or 3), and most important, the name of the debtor is seriously misleading. Putting aside in lieu filings during the transition period between former and Revised Article 9, filing under Revised Article 9 is no longer difficult, especially for registered organizations which comprise the bulk of significant financial transactions. There may also be unique collateral, such as vehicles, rolling stock, aircraft and other types of collateral where perfection is in another registry than the central state filing office for UCC Financing Statements, but a discussion of these collateral subtypes is beyond the purpose of this article.

Collateral description may pose a greater problem, but here the error is usually not a typographical error but the deletion of a collateral type or other error between the lien granting document's collateral description and the collateral description in the UCC Financing Statement. Significant errors can occur if care is not taken. For example, in the *Shelby* Case[2], the collateral description basically read as follows: [a]ll inventory, including but not limited to agricultural chemicals, fertilizers and fertilizer materials, sold to Debtor by Van Diest Supply Co. whether now owned or hereafter acquired, including all replacements, substitutions and additions thereto, and the accounts, notes, and any other proceeds therefrom. The Court, noticing the commas, effectively deleted the subordinate clause in the collateral description and read the collateral description as: [a]ll inventory sold to Debtor…by Van Diest Supply Co. whether now owned or hereafter acquired, including all replacements, substitutions and additions thereto, and the accounts, notes, and any other proceeds therefrom. The lender thought it had a blanket lien against all inventory. The court disagreed saying that, given the force of good grammar, the lien was only against inventory actually sold to the debtor by Van Diest. At the relevant time, the debtor had no collateral left from purchases from Van Diest, so no inventory collateral. That conclusion turned out not to be the worst news. Because Van Diest did not have any inventory, it could not track identifiable cash proceeds into the debtor's deposit accounts and therefore had no proceeds either. No inventory plus no proceeds equaled no collateral at all.

If the collateral description had had one less comma, "[a]ll inventory**[,]** including but not limited to agricultural chemicals, fertilizers, and fertilizer materials, sold to Debtor by Van Diest Supply Co. whether now owned or hereafter acquired, including all replacements, substitutions and additions thereto, and the accounts, notes, and any other proceeds therefrom;" the security interest would have encumbered all inventory. (A comma, a comma, my kingdom for a comma.)

The third and most important area of fatally defective UCC Financing Statements involves the name of the debtor. Revised Article 9 is, in many ways, more restrictive and less forgiving than Former Article 9. The reason for this apparent reduction in name flexibility is that Revised Article 9 falls back on the "standard" search logic of the state, as provided in §9-506(c), for a safe-harbor to provide a minimal flexibility to the requirement for debtor name "correctness":

**§ 9-506. Effect of errors or omissions**

(a) [Minor errors and omissions.]
A financing statement substantially satisfying the requirements of this part is effective, even if it has minor errors or omissions, unless the errors or omissions make the financing statement seriously misleading.

(b) [Financing statement seriously misleading.]
Except as otherwise provided in subsection (c), a financing statement that fails sufficiently to provide the name of the debtor in accordance with Section 9-503(a) is seriously misleading.

(c) [Financing statement not seriously misleading.]
If a search of the records of the filing office under the *debtor's correct name*, using the filing office's standard search logic, if any, would disclose a financing statement that fails sufficiently to provide the name of the debtor in accordance with Section 9-503(a), the name provided does not make the financing statement seriously misleading. (Emphasis added)

(d) ["Debtor's correct name."]
For purposes of Section 9-508(b), the "debtor's correct name" in subsection (c) means the correct name of the new debtor.

Section 9-503(a) gives us the rules on the name of the debtor:

**§ 9-503. Name of debt and secured party**

(a) [Sufficiency of debtor's name.]
A financing statement sufficiently provides the name of the debtor:

(1) if the debtor is a registered organization, only if the financing statement provides the name of the debtor indicated on the public record of the debtor's jurisdiction of organization which shows the debtor to have been organized;

(2) if the debtor is a decedent's estate, only if the financing statement provides the name of the decedent and indicates that the debtor is an estate;

(3) if the debtor is a trust or a trustee acting with respect to property held in trust, only if the financing statement:

(A) provides the name specified for the trust in its organic documents or, if no name is specified,

provides the name of the settlor and additional information sufficient to distinguish the debtor from other trusts having one or more of the same settlors; and

(B) indicates, in the debtor's name or otherwise, that the debtor is a trust or is a trustee acting with respect to property held in trust; and

(4) in other cases:

(A) if the debtor has a name, only if it provides the individual or organizational name of the debtor; and

(B) if the debtor does not have a name, only if it provides the names of the partners, members, associates, or other persons comprising the debtor.

So the filing secured party is faced with two related issues: 1) what is the "correct" name of the debtor? and, 2) if I get the name wrong, is it still sufficient enough to be discovered when using the "correct" name and the state's standard search logic? There has been endless discussion among those who take these issues seriously as to the "correct" name for individuals, especially for individuals from cultural backgrounds with different naming conventions. But going beyond that, many experts have concluded that an individual may have more than one correct name, remembering Vickie Lynn Marshall, also known as Anna Nicole Smith. Complicating the issue with individuals is the ability to unilaterally change your name at common law and under the laws of many states.

Registered organizations provide a somewhat easier target. The name of the entity will be in the "public records" so pull up the articles of incorporation from Delaware and there you are. One glitch: the term "public record" is not defined. (See Official Comment 2 to §9-503). But what if the "public record" is reproduced within the state, for example, a report sheet from the secretary of state listing an incorporated entity and filings against the record, and the name in the state-generated search report, arguably part of the "public record," differs from the originally filed articles of incorporation due to clerical error? What name works for the UCC Financing Statement? There has been no case of which this author is aware that addresses what comprises the "public record" and what name wins if there is a dispute.

So, for the sake of argument, let's assume that we do know the "correct" name of the debtor. We now face two additional related problems: 1) entering the "correct" debtor name accurately on the UCC Financing Statement form, and 2) the state's "standard" search logic. If the debtor name is listed correctly on the UCC Financing Statement, the "standard" search logic should retrieve the "correct" debtor name if the "correct" debtor name is used to search the record.

All of this leads into a brief review of recent cases that have considered the adequacy of the filed debtor name and whether that name, different from the "correct" debtor name, is sufficient for purposes of §9-506(c). The following chart sets forth the names of certain recent cases, the name debate, and whether the case is Good or Bad Law. "Good Law" categorizes a case that, in this author's opinion, follows the language or intent of Revised Article 9 in reaching its conclusion, regardless of whether the case reaches an equitable or "fair" result. "Bad Law" describes a case where the court did not fully grasp the intent of Revised Article 9 or the language of the statute, whether or not the decision is correct under other law, such as *Spearing Tool*.[3]

And what's the moral of the story (besides never lending to someone named Michael)? Well, in most of the cases, the court got the test of §9-506(c) correct. If the filed UCC Financing Statement is not retrieved through a search using the debtor's "correct" name, the filed UCC Financing Statement is ineffective to perfect the security interest. However, this test can be very unforgiving if the standard search logic of the state is exact match. This was the case in *Tyringham Holdings*.[19] The "correct" name of the debtor was Tyringham Holdings, Inc. The secured party filed its UCC Financing Statement against Tyringham Holdings, leaving out the comma and "Inc.". At the time Virginia had exact match standard search logic and did not follow the IACA model search logic that drops certain "noise" words such as "Inc.". The computerized search in the office of the Virginia State Corporation Commission (its UCC filing office) using the name "Tyringham Holdings, Inc." did not bring up the filing under "Tyringham Holdings." So the court ruled, reading §9-506(c) correctly, that the filing was seriously misleading and thereby invalidated the security interest in its entirety.

In summary, the filer must get the name of the debtor correct, which requires a determination of the "correct" debtor name, and then filing exactly against that name. Standard search logics can be changed by the state, so relying on forgiving search logic is probably unwise. Typographical errors resulting in the loss of perfection are not a malpractice risk any lawyer should be willing to assume.

The Revised Article 9 requirement of exactness in "correct" debtor name highlights a significant difference between Revised Article 9 and Former Article 9. Former Article 9, growing out of a paper-filing world, had much more flexibility than the digital exactness of the searching methodologies of Revised Article 9. Dropping "Inc." or using "Roger" rather than "Rodger" or "Mike" instead of "Michael" probably would have gotten by under Former Article 9 as harmless error. Now, in preparing and filing UCC Financing Statements, creditors are required to play bet your life on the "one true name" and the creditor's law firm is betting its malpractice coverage along side them.

So the law firm preparing the UCC Financing Statement is faced with two related issues: the "correct" name of the debtor and the state standard search logic. Carl Ernst, CEO of Ernst Publishing Co., has estimated that, depending on how the courts decide to interpret UCC §9-506(b):

- If the legal standard for a registered organization "debtor's correct name" is exact, more than 50 percent of outstanding filed UCC Financing Statements are seriously misleading;
- If the courts decide that punctuation does not count as

| Name of Case | Name of Debtor as Filed | "Correct" Name of the Debtor | Effective Filing | Ineffective Filing | Good UCC Law[4] | Bad UCC Law |
|---|---|---|---|---|---|---|
| *Spearing Tool*[5] | **Spearing Tool & Mfg. Company.** | **Spearing Tool and Manufacturing Co., Inc.** |  | | |  |
| *Kinderknecht*[6] | **Terry** | **Terrance** | |  |  | |
| *Planned Furniture*[7] | **Benjamin S. Youngblood** | **Benjamin S. Youngblood, Inc.** |  | | |  |
| *Host American*[8] | **K W M Electronics Company** | **K. W. M. Electronics Company** | |  |  | |
| *Pankratz*[9] | **Roger** | **Rodger** | |  |  | |
| *Tyringham*[10] | **Tyringham Holdings** | **Tyringham Holdings, Inc.** | |  |  | |
| *Receivables Purchasing Company*[11] | **Net work Solutions, Inc.** | **Network Solutions, Inc.** | |  |  | |
| *Summit Staffing*[12] | **Summit Staffing** | **Summit Staffing of Polk County, Inc.** |  | | |  |
| *Michael A. Erwin*[13] | **Mike Erwin** | **Michael A. Erwin** |  | | |  |
| *Genoa National Bank*[14] | **Mike Borden** | **Michael Borden** | |  |  | |
| *In re Berry*[15] | **Mike Berry** | **Michael Berry** | |  |  | |
| *Corona Foods*[16] | **Armando Munoz** | **Armando Munoz Juarez** | |  |  | |
| *Morris*[17] | **Richard Stewart** | **Richard Morgan Stewart IV** | |  |  | |
| *All Business Corp.*[18] | **SangWoo Gu** | **Sang Woo Gu** | |  |  | |

part of "debtor's correct name," 33 percent remain seriously misleading;

- If the filing office provides standard search logic according to Rev. UCC §9-506(c), 25 percent of outstanding filed financing statements are still not saved from being deemed ineffective.

If these estimates are accurate, we can make the following conclusions about the effect of the debtor name errors on perfection of the underlying security agreement. (Remember ineffective UCC Financing Statement equals unperfected security interest):

- If a filing office provides a search using standard search logic, no less than 25 percent of UCC Financing Statements that include a registered organization debtor name are ineffective.
- If a filing office does not provide a form of standard search logic, more than 50 percent of UCC Financing Statements that include registered organization debtor names may be ineffective.


But search logic and exactness of name are not the only issues facing the law firm preparing and filing the Financing Statement. The other, and perhaps more serious issue, is the problem of human error, whether carelessness or otherwise. Now that the debtor does not sign UCC Financing Statements, our experience has been that preparers are taking less care in preparation and attorneys are exercising less care in the review process. As a result, typos are creeping into the system, a system now less forgiving of typos. Dropping the "d" in "Rodger" or not separating "Sang Woo" can have a catastrophic result —failure of perfection of the security interest. Accuracy is the key, both to perfection and to malpractice exposure. Going from an oversecured creditor to an unsecured creditor because a clerk typist left "Inc." off a corporate name is a frightening possibility. What makes this reality even worse is that law firms are not charging for the risk they are assuming.

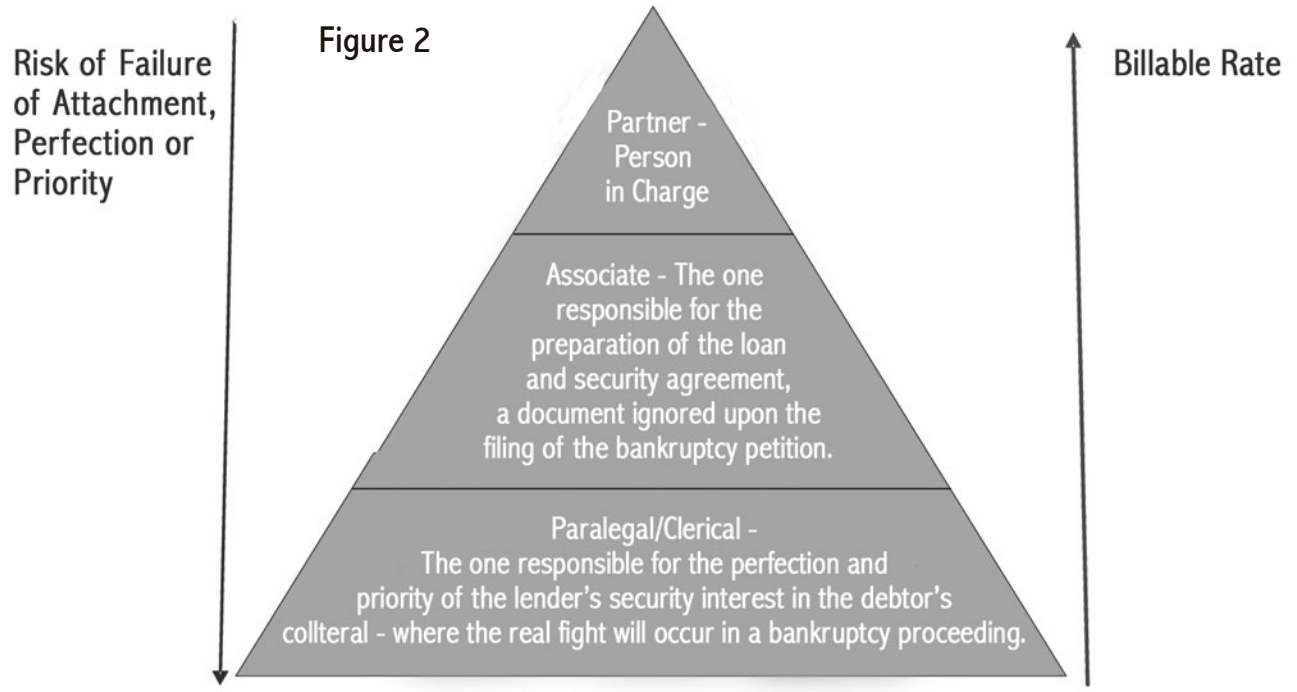
Figure 2 depicts the relationship between the billable rate at various skill levels within the law firm and the perfection (and attachment and priority) risk in the preparation of the UCC Financing Statement. The partner bills at the highest rate and has little or nothing to do with the preparation or review of the UCC Financing Statement. The clerical personnel, or perhaps a paralegal, bill at a much lower rate than the partner and in fact prepare and file the UCC Financing Statement. Often filing is electronic, portal-to-portal, and once that send button is punched, the probability of perfection or failure of perfection is set.

And this is where UCC insurance can provide a cost-effective risk management tool to the law firm. Given the risk involved, one approach would be for the law firm to use senior associates to prepare and file a UCC Financing Statement, thus balancing expertise with attendant risk. However, for a modest insurance premium, given the risks and cost offsets involved, the UCC insurance carrier will assume the entire UCC burden of perfection and move the risk of the "correct" debtor name off the law firm. By spreading the risk of a mistake over hundreds of transactions, the insurance carrier can give the law firm not only the benefit of UCC experience but the actuarial benefit of spreading the probability of error over a significant pool of transactions. The law firm has only the one transaction over which to spread the transaction risk.

Keep in mind the difference is approach to risk management. The law firm's risk model is accuracy. The law firm is undertaking to file a UCC Financing Statement that is accurate as to debtor name and collateral description in the correct jurisdiction in order to perfect its client's security interest. If that client is unperfected as a result of a typo in the debtor name, then the law firm has a malpractice problem, the probability of damage exposure and the loss of the client.

The insurance underwriter on the other hand has a different risk model. The insurance carrier works on a cash-flow model and only has to be more accurate than wrong. Claims will occur because human beings are human. The risk of error becomes acceptable because risk is spread over a large pool of transactions and the insurance company personnel are extremely skilled professionals that have been involved in hundreds of search and filing transactions. Further, as an insurance company, payment on a claim usually doesn't result in the loss of a customer but rather confirms in the customer's mind the utility of the insurance. The law firm making a perfection mistake can undermine the confidence of the client in the law firm generally and threaten the entire attorney-client relationship.

In conclusion, the strict name requirement of Revised Article 9, the lack of forgiveness in the search logics of many states, the speed of electronic filing, and the lack of adequate compensation for the risk assumed, argues for the law firm to off-load to the UCC insurance company the UCC perfection risk in commercial finance transactions. ▲




*Nothing contained in this article is to be considered as the rendering of legal advice for specific cases, and readers are responsible for obtaining such advice from their own legal counsel. This article and any forms and agreements herein are intended for educational and informational purposes only.*

**Endnotes**

1 See, e.g., Edwin E. Smith, *An Introduction to Revised UCC Article 9 (1999)*, The New Article 9, Second Edition, (American Bar Association 1999), p.17.

2 *Shelby County State Bank v. Van Diest Supply Company,* 303 F.3d 832 (7th Cir., Sept. 17, 2002).

3 *United States v. Crestmark Bank (In re Spearing Tool & Mfg. Co.)*, 412 F.3d 653 (6th Cir. 2005), en banc rehearing denied, 12/30/05, 2005 U.S. App. LEXIS 29219, U.S. cert denied, Dkt. No. 05-1271, 127 S. Ct. 41; 10/02/06.

4 But not necessarily good public policy or an equitable result because of the effect of "exact" search logics.

5 See footnote 4.

6 *In re Kinderknecht,* 308 Bankr. 71 (B.A.P. 10th Cir. 2004).

7 *Planned Furniture Promotions, Inc., Plaintiff v. Benjamin S. Youngblood, Inc., d/b/a/ Honey Creek Home Furnishings; Benjamin S. Youngblood; Laura Youngblood; Citizens Bank of Fort Valley, Georgia; United States Internal Revenue Service; State of Georgia Department of Revenue, Defendants,* 374 F. Supp 1227 (M.D. Ga, 2005).

8 *Host American Corp. v. Coastline Financial, Inc.,* 60 U.C.C. Rep. Serv. 2d (Callaghan) 120, 2006 U.S. Dist. LEXIS 35727, (D. Utah, May 30, 2006); 60 U.C.C. Rep. Serv. 2d (Callaghan) 120, 2006 U.S. Dist. LEXIS 46251 (D. Utah, May 30,2006).

9 *Pankratz Implement Company v. Citizens National Bank,* 33 Kan. App. 2d 279, 102 P. 3d 1165, 2004 Kan. App. LEXIS 1173 (Kansas Ct. App. 2004).

10 *The Official Committee of Unsecured Creditors for Tyringham Holdings, Inc. v. Suna Bros. Inc. (In re Tyringham Holdings, Inc.),* Case No. 06-32385-DOT, Adversary Proceeding No. 06-03142-DOT, 2006 Bankr. LEXIS 3332 (Bankr. E.D. VA., December 1, 2006).

11 *Receivables Purchasing Company, Inc. v. R&R Directional Drilling,* 263 Ga. App. 649; 588 S.E.2d 831, 2003 Ga./ App. LEXIS 1284; (Georgia Ct. App., 4th Div. 2003).

12 *In re: Summit Staffing of Polk County, Inc*., 305 B.R. 347; 2003 Bank. LEXIS 1911; (Bankr. Middle District of Florida, 2003).

13 *In re: Michael A. Erwin v. Bucklin National Bank*, 50 U.C.C. Rep. Serv. 2d (Callaghan) 933; 2003 Bankr. LEXIS 692 (Bankr. District of Kansas, June 27, 2003),

14 *Genoa National Bank v. Southwest Implement, Inc. (In re Borden),* Case No. BK05-41272, A06-4013, 2006 Bankr. LEXIS 2911, (Bankr. District of Nebraska, November 2, 2006).

15 *Parks v. Berry (In re Berry)*, Case No. 05-14423, Chapter 7, Adv. No. 05-5755; 2006 Bankr. LEXIS 3361 (Bankr. District of Kansas, December 1, 2006).

16 *Corona Foods & Veggies, Inc. v. Frozsun Foods, Inc.*, 143 Cal. App. 4th 319, 48 Cal. Rpt. 3d 868, 2006 Cal. App. LEXIS 1479 (California Ct. App. 2006).

17 *Morris v. Snap On Credit, L.L.C., f/k/a Snap-On Credit Corporation (In re Stewart),* Case No. 04-16838, Chapter 7, Adv. No. 05-5090; 2006 Bankr. LEXIS 3014 (Bankr. District of Kansas, November 1, 2006).

18 *All Business Corp. v. Choi,* 280 Ga. App. 618, 634 S.E.2d 400, 2006 Ga. App. LEXIS 669 (Georgia Ct. App. 2006), cert. denied, 11/20/06, 2006 Ga. LEXIS 1016 (Ga. Supreme Ct. 2006).

19 See Footnote 11 above.

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