

## ARTICLE 9 JOINT REVIEW COMMITTEE

### A PRELIMINARY ANALYSIS OF DIFFERENT PROPOSED RULES FOR THE SUFFICIENCY OF THE DEBTOR'S NAME ON A FINANCING STATEMENT IN THE CASE OF A DEBTOR WHO IS AN INDIVIDUAL

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The Article 9 Joint Review Committee is considering whether there is a need for revisions to Article 9 of the Uniform Commercial Code to provide further guidance relating to the sufficiency of the debtor's name provided on a financing statement in the case of a debtor who is an individual. Proposals have been made to take into account the name on the debtor's driver's license or state identification card if the debtor has a driver's license or state identification card. The proposals would obviate the need for a filer to determine the actual name of such a debtor in order to perfect a security interest in the personal property assets of the debtor by the filing of a financing statement although, in at least some cases, such a determination would nevertheless have to be made in order to assure priority against competing claimants. An explanation of the proposals made and how they might work in practice are explored in this paper in the context of a hypothetical.

#### Hypothetical

Debtor is an individual. Debtor was born with the name of L.H. Smith. L.H. Smith is the name provided on Debtor's birth certificate, social security card, passport and credit cards. Debtor signs his checks and credit applications and documents under the name of L.H. Smith and files his tax returns under that name. Debtor is also widely known in his community as L.H. Smith.

However, in 2007, when Debtor applied for a driver's license in State X, the state in which Debtor resides, Debtor was required to complete the driver's license application with a full first and middle name. Debtor showed his birth certificate and passport to the clerk receiving the application and tried to explain to the clerk that Debtor had no full first and middle name, but the clerk would not accept the application. In the end, in order for the application to be accepted, Debtor filled out the application showing his first full name as Lester and his middle full name as Henry. The driver's license was issued to Debtor showing Debtor's name as Lester Henry Smith.

After the issuance by State X of the driver's license, the following events occurred:

In January of 2008, Debtor borrowed money from Finance Company and, to secure the loan, gave to Finance Company a security interest in all existing and after-acquired equipment, inventory and accounts arising or used by Debtor in his sole proprietorship. Finance Company investigated Debtor's name and filed a financing in State X against Debtor covering equipment, inventory and accounts and providing Debtor's name as L.H. Smith.

In June of 2008, Debtor borrowed money from Bank and, to secure the loan, gave to Bank a security interest in all existing and after-acquired equipment, inventory and accounts arising or used by Debtor in his sole proprietorship. Bank inspected Debtor's driver's license and filed a financing statement in State X against Debtor covering equipment, inventory and accounts and providing Debtor's name as Lester Henry Smith.

In December of 2008, Supplier sold a piece of equipment to Debtor on secured credit for use in Debtor's sole proprietorship. Supplier investigated Debtor's name and filed a financing in State X against Debtor covering the equipment and providing Debtor's name as L.H. Smith. The financing statement was filed within 20 days after Debtor received possession of the equipment.

In March of 2009, Debtor filed for bankruptcy.

Debtor's bankruptcy trustee conducted a UCC search in State X under L.H. Smith; the search disclosed Finance Company's and Supplier's financing statements but did not disclose Bank's financing statement. Debtor's bankruptcy trustee also conducted a UCC search in State X under Lester Henry Smith; the search disclosed Bank's financing statement but did not disclose Finance Company's or Supplier's financing statement.

### Questions

Is each security interest perfected? What are the relative priorities of the security interests?

### Current Law

*Under current Article 9 a financing statement must provide the name of Debtor. A financing statement that does not provide the name of Debtor is not sufficient, and is ineffective to perfect, if a search conducted under Debtor's name would not disclose the financing statement.*

Bank's security interest is unperfected since Bank's financing statement did not provide Debtor's name. Each of Finance Company's and Supplier's security interest is perfected since each of Finance Company's and Supplier's financing statement did provide Debtor's name.

Each of Finance Company's and Supplier's perfected security interest is senior to Bank's unperfected security interest. In Debtor's bankruptcy, the bankruptcy trustee will set aside Bank's unperfected security interest under the trustee's "strong arm" power.<sup>1</sup> Supplier's purchase-money priority security interest in the equipment supplied by Supplier is senior to Finance Company's ordinary security interest in that piece of equipment.

### "Safe Harbor" Proposal

*Under the "safe harbor" proposal a financing statement providing the name on Debtor's driver's license issued by the state of Debtor's principal residence at the time of the filing of*

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<sup>1</sup> The "strong arm" power permits the bankruptcy trustee to set aside any security interest that would be junior to the lien of a hypothetical levying creditor on the date of the bankruptcy. An unperfected security interest is subordinate to the lien of a lien creditor under UCC Article 9.

*the financing statement is sufficient even if the name on the driver's license is not Debtor's name. A financing statement providing Debtor's name is also sufficient. The normal priority rules of Article 9 apply.*

Bank's security interest is perfected since Bank's financing statement provided the name on Debtor's driver's license. Each of Finance Company's and Supplier's security interest is perfected since each of their financing statements provided Debtor's name.

Finance Company's perfected security interest is senior to Bank's security interest since Finance Company's financing statement was filed first. Supplier's purchase-money priority security interest in the equipment supplied by Supplier is senior to both Finance Company's and Bank's ordinary (i.e., non-purchase-money) security interest in that piece of equipment. In Debtor's bankruptcy, the bankruptcy trustee will not be able to set aside any of the security interests under the trustee's "strong arm" power.

#### "Only if" Proposal

*Under the "only if" proposal a financing statement providing the name on Debtor's driver's license issued by the state of Debtor's principal residence at the time of the filing of the financing statement is sufficient, even if the name on the driver's license is not Debtor's name. A financing statement providing a name other than that on Debtor's driver's license is not sufficient, and is ineffective to perfect, unless a search conducted under the name on the driver's license would disclose the financing statement.*

Bank's security interest is perfected since Bank's financing statement provided the name on Debtor's driver's license. Each of Finance Company's and Supplier's security interest is not perfected since neither Finance Company's nor Supplier's financing statement provided the name on Debtor's driver's license.

Bank's perfected security interest is senior to Finance Company's and Supplier's unperfected security interests. In Debtor's bankruptcy, the bankruptcy trustee will set aside Finance Company's and Supplier's unperfected security interests under the trustee's "strong arm" power.

#### Priority Proposal

*The priority proposal is a variation of the "safe harbor" proposal. Under both proposals, a financing statement providing the name on Debtor's driver's license issued by the state of Debtor's principal residence at the time of the filing of the financing statement is sufficient even if the name on the driver's license is not Debtors' name. A financing statement providing Debtor's name is also sufficient. However, unlike the "safe harbor" proposal, if the name on Debtor's driver's license is not Debtor's name, a security interest perfected by the filing of a financing statement providing the name on Debtor's driver's license would have priority over a security interest perfected by the filing of a financing statement providing Debtor's name.*

Bank's security interest is perfected since Bank's financing statement provided the name on Debtor's driver's license. Each of Finance Company's and Supplier's purchase-money security interests is perfected since each of their financing statements provided Debtor's name.

Bank's security interest is senior to Finance Company's security interest and Supplier's purchase-money security interest since Bank's financing statement provided the name on Debtor's driver's license and the other two financing statements did not. Supplier's purchase-money priority security interest in the equipment supplied by Supplier is senior to Finance Company's ordinary security interest in that piece of equipment. In Debtor's bankruptcy, the bankruptcy trustee will not be able to set aside any of the security interests under the trustee's "strong arm" power.

The priority proposal raises a number of issues explored below.

### *Filing and Search Issues*

It is unclear under the priority proposal whether Bank's security interest would be senior to Finance Company's or Supplier's security interest if a search conducted under the name on the drivers' license or state identification card would have disclosed Finance Company's or Supplier's financing statement. Presumably, under the priority proposal, Bank's security interest would not be entitled to priority in that instance since Bank would have found Finance Company's or Supplier's security interest had Bank conducted a search. However, that result would need to be clarified.

### *Purchase-Money Priority*

That Supplier's purchase-money security interest is junior to Bank's ordinary security interest is contrary to the basic policy underlying purchase-money priority and also would seem unfair to Supplier since Bank neither relied upon nor financed Debtor's purchase of the equipment.

An alternative rule would give Supplier's purchase-money security interest priority over Bank's ordinary security interest. But that rule could result in circular priorities.

Consider the following situation:

In January of 2008, Debtor borrowed money from Finance Company and, to secure the loan, gave to Finance Company a security interest in all existing and after-acquired equipment, inventory and accounts arising or used by Debtor in his sole proprietorship. Finance Company filed a financing statement in State X against Debtor covering equipment, inventory and accounts and providing Debtor's name as Lester Henry Smith.

In June of 2008, Supplier sold a piece of equipment to Debtor on secured credit for use in Debtor's sole proprietorship. Supplier filed a financing statement in State X against Debtor covering the equipment and providing Debtor's name as L.H. Smith. The financing statement was filed within 20 days after Debtor received possession of the equipment.

In December of 2008, Debtor borrowed money from Bank and, to secure the loan, gave to Bank a security interest in all existing and after-acquired equipment, inventory and accounts arising or used by Debtor in his sole proprietorship. Bank

filed a financing statement in State X against Debtor covering equipment, inventory and accounts and providing Debtor's name as Lester Henry Smith.

If Supplier's purchase-money security interest in the equipment supplied by Supplier has priority over Finance Company's ordinary security interest in that equipment, then circular priorities would result. Supplier's security interest in the equipment would have priority over Finance Company's security interest in the equipment under the purchase-money priority rules. Bank's security interest in the equipment would have priority over Supplier's security interest in the equipment since Bank's financing statement provided the name on Debtor's driver's license. But Finance Company's security interest in the equipment would have priority over Bank's security interest in the equipment since Finance Company filed its financing statement before Bank filed its financing statement. Accordingly, Supplier beats Finance Company, who beats Bank, who beats Supplier, who beats Finance Company, who beats Bank, and so on.

### *Priority Rules Affected Generally*

The effect of the priority proposal is to alter the traditional first-in-time and purchase-money priority rules historically a part of Article 9. The priority proposal may affect other priority rules as well, such as the rules relating to priority among purchase-money security interests and priority resulting from incorrect indexing by the filing office or from incorrect information being on the financing statement. A complete examination of all of the possible priority rules affected by the priority proposal has not been undertaken.

### Other Issues

In the hypothetical, and regardless of whether any proposal is adopted, Bank and Finance Company would still need to search under L.H. Smith to locate any federal tax liens filed against Debtor. It is most unlikely that the Internal Revenue Service would file a notice of federal tax lien against Lester Henry Smith.

This paper has not explored:

- issues that might arise in states in which the intake capabilities of a state's Uniform Commercial Code filing office and the state agency that issues driver's licenses or state identification cards are not identical (e.g., type of characters accepted, field size of name elements, and the like);
- whether in any particular state the state's filing office's search logic might magnify or minimize the frequency of instances in which a search under the name on the driver's license or state identification card might reveal filings under the debtor's name;
- the full implications of the adoption of a particular proposal on the transition rules that would be required to implement the proposal,<sup>2</sup> or

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<sup>2</sup> The adoption of the "safe harbor" proposal, in contrast to the "only if" proposal or the priority proposal, would seem to require the least complicated transition rules.

- the drafting difficulties and the additional complexity that would be introduced into Part 5 of Article 9 and the transition rules as a result of the adoption of any of the proposals.