

**THE OVERLAP OF DIRT & CHATTELS:
COMPETING RIGHTS OF SECURED PARTIES,
LANDLORDS & EQUIPMENT LESSORS
IN COLLATERAL & FIXTURES IN
REAL ESTATE RELATED TRANSACTIONS**

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GENERAL RULES OF PERFECTION

I. General Collateral

A. Definition of General Collateral (Section 9-102 of the UCC)

The Uniform Commercial Code ("UCC") classifies "goods," i.e., tangible personal property, in four categories: equipment, inventory, farm products and consumer goods.

1. **Equipment.** Equipment is goods other than inventory, farm products or consumer goods.

2. **Inventory.** Goods are inventory, not equipment, if the debtor holds them for sale or lease or to be furnished under contracts of service, they are leased by a person as lessor or they consist of raw materials, work in process or materials used or consumed in a business. Thus, goods leased by the debtor to third parties are the debtor's inventory, even though they may be machinery or "equipment" in lay terms. Likewise, in the hands of a machinery or equipment dealer those goods are its inventory.

3. **Farm Products.** Farm products are the inventory of a farming operation that is, crops, including aquatic goods, livestock, supplies used or proceeds in farming and products of crops or livestock in their unmanufactured states. They should not be confused with equipment.

4. **Consumer Goods.** Goods are "consumer goods," not equipment, if they are used or bought for use primarily for personal, family or household purposes. If the goods are used for more than one purpose, their principal purpose governs.

B. Filing (Sections 9-501 - 9-528 of the UCC)

1. Sufficiency of Financing Statement (Section 9-502 of the UCC).

2. Financing Statements for collateral not including motor vehicles, fixtures or items requiring possession, are filed with the Secretary of State. If the collateral also includes fixtures, timber, or as-extracted collateral the Financing Statements also need to be filed with the

County Recorder or other place where real property records are maintained. (Section 9-501 of the UCC).

3. Financing Statements must provide the exact name of the Debtor to be sufficient. Fictitious Business Names are not needed and Financing Statements filed under Fictitious Business Names rather than the name of the individual Debtor are not sufficient (Section 9-503 of the UCC).

4. Sufficiency of Description of Collateral (Section 9-108 of the UCC).

(a) Must reasonably identify the collateral. Simply stating that all the Debtor's assets or all the Debtor's personal property is not sufficient. However, it is a sufficient description on the UCC-1 Financing Statement (Section 9-504(2) of the UCC).

(b) Using a collateral classification provides a "safe harbor" definition which is sufficient. For example, language such as "All Assets" is adequate in a Financing Statement although the actual collateral description with sufficient detail must still be detailed in the lease or security agreement.

5. Who can file Financing Statements (Section 9-509 of the UCC).

(a) The Secured Party if authorized by the Debtor.

(b) By signing a Security Agreement, the Debtor authorizes the filing.

6. Who can file Termination Statements (Section 9-513 and 9-509(c)(2) of the UCC).

(a) The Secured Party.

(b) The Debtor.

(i) If the Secured Party receives an authenticated demand to file a Termination Statement and the Secured Party fails to file it within 20 days, the Debtor can file a Termination Statement.

(ii) If the Debtor wrongfully files a Termination Statement, the Secured Party can file a Correction Statement. However, the ability to do this only stays open for one year so if the Secured Party does not know a Debtor filed a Termination Statement within one year, the record of the filing will be removed from the records and any subsequent lender taking a security interest in the collateral will have priority.

(iii) What should a secured party do besides change the law? Search, search, and search. UCC Searches should be conducted no less than once a year to make

certain that the Debtor has not wrongfully filed a Termination Statement.

C. Perfection and Priority (Sections 9-301 - 9-342 of the UCC)

1. Financing Statements must be filed to perfect a security interest in all collateral unless otherwise indicated in Revised Article 9. (Section 9-310 of the UCC).

(a) Section 9-310(b) of the UCC identifies those types of collateral where filing Financing Statements is not the proper method of perfection.

(b) Section 9-312 of the UCC provides for permissive filing to perfect a security interest in chattel paper or negotiable instruments—a potential assistance to assignees of leases who want to allow the assignor to continue to enforce the paper notwithstanding the assignment.

2. Except as otherwise provided in Revised Article 9, the local law of the Debtor's jurisdiction controls perfection and priority of security interests (Section 9-301 of the UCC).

3. Under revised Article 9, UCCs are filed where the Debtor is located. (Section 9-307 of the UCC).

(a) If the Debtor is an individual, the Debtor's location is where the Debtor's principal residence is.

(b) A Debtor that is an organization and has only one place of business is located at its place of business.

(c) A Debtor that has more than one place of business is located at its chief executive office.

(d) If none of the above are applicable, then the Debtor is deemed located in the District of Columbia.

(e) A registered organization that is organized under the law of a state is located in that state. Most corporate entities are registered organizations as defined in Section 9-102(70) of the UCC. Therefore, corporations and limited liability companies are located in the state of their incorporation.

(f) A Debtor organized under federal law or a Debtor organized under the laws of a foreign jurisdiction are deemed to be located in the District of Columbia.

4. Perfection by possession of collateral (Section 9-313 of the UCC).
5. Perfection by control (Section 9-314 of the UCC) covers electronic chattel paper, deposit accounts, letters of credit and investment property.

II. Fixture Filings

A. Definition of a Fixture (Section 9-313 of the UCC)

1. As set forth in Section 102(a)(41) of the UCC, "fixtures" means "goods that have become so attached to particular real property that an interest in them arises under real property law." Comment 18 to Section 9-102 of the UCC states that the definition of "fixtures" is "unchanged in substance" from the former definition; however, the definition still depends on local law.

2. The term fixtures is usually applied to articles that were once items of tangible personal property which have become physically attached to the real estate by someone having an interest in the soil so that it becomes a part thereof.

3. Generally, the question of whether particular property is a fixture is determined by consideration of: (1) the nature of the attachment of the personalty to the realty; (2) whether the property is appropriate and adapted to the use or purpose of that part of the realty to which it is connected; and (3) whether the party making the annexation intended it to be permanent. In a number of jurisdictions, the third element is described as accession to the realty or freehold.

4. Status of a good as a "fixture" is determined by real property law of the relevant state.

B. Filing (Section 9-502(b) of the UCC)

1. To be sufficient the Filing must:
 - a. Provide the name of debtor;
 - b. Provide the name of the secured party;
 - c. Indicate the collateral covered;
 - d. Indicate that it covers fixtures (so real estate searchers will know what it is);
 - e. Indicate it is to be filed in the real estate records (so filing officer will know what to do with it);

- f. Describe the real property (so real estate searcher can recognize it); and
- g. Provide the name of a record owner (so it will be in the chain of title if a fixture owner is not land owner).

C. Perfection (Section 9-308 - 9-316 of the UCC)

1. Section 9-109(a) of the UCC states that "fixtures" are within the scope of Article 9.

2. Fixtures and equipment are combined then Financing Statements are filed with the Secretary of State and Financing Statements also need to be filed with the County Recorder or other place where real property records are maintained. (Section 9-501 of the UCC).

3. If its just a fixture filing (other than a security interest in equipment which could be a fixture) the filing may be perfected by filing a "fixture filing" (a type of UCC financing statement) in the real property records where the fixtures are located. (Section 9-501 (a) (40) of the UCC). This is the same office where mortgages, deeds and other documents affecting real property are recorded.

4. To qualify as a "fixture filing", the filing must describe the fixtures; indicate that it's to be filed in the real property records; contain a legal description of the related real property; and, if the debtor doesn't own the real property, indicate the name of the record owner. (Section 9-502(b) of the UCC). As discussed below, a "fixture filing" gives the secured party greater rights against mortgage holders and other competing *real property claimants*.

5. A purchase-money security interest (PMSI) in consumer goods that become fixtures is perfected automatically. (Section 9-309(1) of the UCC). No filing (central, fixture or otherwise) is required. For goods to qualify as consumer goods, the debtor must be a consumer and the goods must be used primarily for personal, family or household purposes.

6. A lender, such as a mortgage lender, can also take a lien on fixtures under real property law. Most mortgages or deeds of trust typically encumber—in addition to the realty itself—all fixtures "now or hereafter owned" by the borrower. Accordingly, the collateral rights of mortgage lenders are frequently at odds with those of fixture financiers.

III. Real Estate Mortgages

A. Definition of a Mortgage

1. A mortgage is a specific lien on the particular real property included in its terms, to the extent of the mortgagor's interest or title therein. The title of this mortgage is defined by the acts and agreements of the parties, as well as by statute.

2. The lien of a mortgage is coextensive with the real debt secured or the sum actually advanced on the security of the mortgage.

3. As to the real property covered, the extent of this lien is determined primarily by the description on the mortgage.

B. Filing

1. A mortgage generally attaches at the time of its execution and delivery, or at the time of recording, and not before the debt comes into existence.

2. The law of each state controls where to file. The general rule is that a mortgage must be recorded in the Office of the Clerk of the county where such real property is situated.

C. Perfection

1. Generally, unless an instrument is recorded as prescribed by statute, the subsequent purchasers and encumbrancers are not on record notice of this mortgage. Unless a subsequent purchaser or encumbrancer has actively researched, it/he/she may have regrets.

2. As against a third person, a mortgage lien is deemed perfected from the time the mortgage is recorded or filed for recordation.

3. Failure to file a mortgage document does not invalidate the obligation as between the borrower and lender (absent a bankruptcy), but the obligation will not be good as against a bona fide purchaser of property or other parties/entities as prescribed by statute.

IV. Landlord Liens

A. Definition

1. At common law, a landlord has no lien upon the personal of his or her tenant merely by reason of the landlord-tenant relationship. Thus, a landlord generally has no lien upon any property of a tenant as security for rent by virtue of position, in the absence of contract or statute.

2. When making an assessment as to what property is subject to the contractual lien of the landlord, the terms of the lease are controlling as between the parties and a description in general terms of all personal property of a particular kind within the premises is sufficient. Parties to a lease may stipulate that a landlord is to have a lien on the personal property of the tenant which may be brought upon the leased premises.

3. A landlord may waive the contractual lien either expressly or by conduct. A contractual lien is not waived by acts which do not show an intention to abandon or relinquish the lien.

B. Filing

1. The requirement that security interests be filed in order to render them enforceable against bona fide purchasers or creditors is applicable to a landlord's liens on personal property.

2. To be effective against subsequent purchasers of real property the landlord must file where the mortgage is recorded.

3. To be effective against personal property, lessors should provide for contractual terms to secure performance of lessee's obligations by granting the lessor a security interest in the lessee's personal property such as equipment and inventory.

C. Perfection

1. A statutory lien exists from the creation of the tenancy. A landlord cannot permanently take possession of property on which the landlord has a lien without any legal process, such as by exercise of self-help.

2. A landlord with a lien given by statute must enforce it according to statute, and if the landlord does not, the landlord may be guilty of conversion.

3. The duration of a landlord's statutory lien depends on the terms of the statute in different jurisdictions. Under some statutes, a landlord's lien does not terminate at the end of the lease term, but continues in some cases for a specified time such as when the tenant vacates occupancy of the premises, or until all the rent has been paid.

4. The claims that are secured by the statutory lien of the landlord depend upon the terms of the statute conferring such lien. A statutory lien for rent does not include a claim for damages for breach of the general covenants in the lease, nor does it include a claim on account of unpaid taxes which the tenant covenanted to pay, unless the language of the lease expressly or by necessary implication shows that it was the intention of the parties.

GENERAL PRIORITY RULES FOR REAL PROPERTY, PERSONAL PROPERTY AND FIXTURES

Ordinarily, the first step in determining the appropriate priority scheme governing the relative priority of competing claims or interests in an item of property is to identify what type of property is involved, i.e., are the assets at issue purely real property, purely personal property or do they constitute a fixture?

I. Real Property

A. Overview. The priority rules of Article 9 of the UCC generally have no application to assets that constitute “real property” (as opposed to fixtures or personal property). *See* UCC §9-109(d)(11)(providing that subject to certain exceptions, Article 9 does not apply “to the creation or transfer of an interest in or lien on real property”). Instead, the relative priority of competing claims or interests in real property are governed by the real property laws in effect in the jurisdiction in which the real property is located.

B. Personal Property that is Completely Transformed into Real Property. In some situations, what starts off as personal property may become so incorporated and/or integrated into real property that it no longer possesses any identity as an item of personal property and, thus, does not even qualify as a “fixture.” In other words, the asset completely “skips” over the fixture classification—going directly from being a pure item of personal property to a pure item of real property.

1. Example. Assume a lender takes a personal property security interest in a pile of bricks that its borrower is storing at one of its facility. After the lender properly perfects its personal property security interest in the bricks by filing an appropriate UCC Financing Statement, the borrower uses the bricks to construct a warehouse structure on its premise. Because the bricks ultimately become such an inseparable and integrated part of the warehouse structure, they are transformed directly from an item of personal property into real property (i.e., an improvement on the borrower’s land). As a result, the bricks not only lose their identity as items of personal property, they also fail to retain a sufficient quantity of personal property characteristics to qualify as a fixture.

2. Priority Rule. In such circumstances, because the items of property have been completely transformed into real property, the priority of competing claims or interests are governed exclusively by local real estate law. Thus, in the example above, the personal property lender would generally have no rights or interests in the bricks and/or the warehouse structure because the lender only has a lien against the borrower’s personal property. Consequently, the personal property lender may have no recourse in such a situation other than to declare a default and accelerate the borrower’s loan (that is, assuming the lender had the foresight to put a default provision in the parties’ loan documents making the borrower’s conversion of personal property into real property an event of default). *Cf.* Official Comment 3 to UCC §9-334 (“the fact that no security interest exists

in ordinary building materials incorporated into an improvement on land does not prejudice any rights the secured party may have against the debtor or any other person who violated the secured party's rights by wrongfully incorporating the goods into real property.”).

3. What Law Determines Whether An Item of Property Has Been Completely Transformed from Personal Property to Real Property. UCC §9-334(a) provides that “[a] security interest does not exist under this article in ordinary building materials incorporated into an improvement on land.” As Official Comment 3 to the UCC §9-334 goes on to explain:

Certain goods that are the subject of personal-property (chattel) financing become so affixed or otherwise so related to real property that they become part of the real property . . . If the goods are ordinary building materials incorporated into an improvement on land, no security interest in them exists. Rather, the priority of the claims to the building materials are determined by the law governing claims to real property.

Beyond the foregoing, Article 9 of the UCC defers to local real estate law as to when an item of personal property becomes so incorporated into real estate that it fully transforms into and becomes real property.

II. Personal Property

A. Overview. Absent some form of independent personal property security interest or lien, real property interest holders (owners, consensual mortgagees, mechanic's lien claimants and other real property lien claimants) will ordinarily have no claim to or rights in assets that are purely items of personal property (as opposed to real property and/or fixtures). Thus, in the case of assets that are purely items of personal property, there will usually be no priority dispute between a personal property lessor/lender and a real property interest holder, for—between the two parties—the personal property lessor/lender is the only party that can rightfully claim any interest in the items of personal property.

There are, however, at least two significant exceptions to the foregoing generalizations: (a) items of personal property that were originally part of real property (*e.g.*, a fixture) but were subsequently severed from the property; and (b) landlord liens.

B. Severance Issues. As is true in the inverse situation described in the preceding section, what starts off as real property or a fixture may end-up becoming solely an item of personal property. Thus, for instance, a piece of equipment or machinery affixed to real property may subsequently be removed from the real property and thereby go from

being a fixture to being a free-standing item of personal property. The legal term for such an occurrence is “severance” (*i.e.*, the fixture has been “severed” from the real property).

In contrast to a personal property lender with a security interest in building products collateral who loses its lien once the building products are converted into real property, a mortgagee whose fixture collateral is severed from the real property and transformed into a pure item of personal property may be able to continue to assert lien rights in the item of property (that is, notwithstanding its severance from the real property).

This issue is not addressed in the UCC. Instead, it is generally governed by the common law in the jurisdiction where the property is located.

As indicated above, if the severance is unauthorized, many states will allow the mortgagee to continue to enforce its mortgage lien against the severed item. *See* A. Squillante, The Law of Fixtures: Common Law and The Uniform Commercial Code (Part 1: Common Law Fixtures), 15 Hofstra L. Rev. 191, 262 (1986-7)(hereinafter, “Squillante, Part I”)(in the case of an unauthorized or otherwise wrongful severance, “a mortgagee or lienor may be able to get foreclosure relief, or have a court direct that the fixtures be returned, or that he be given priority upon any distribution of proceeds, if the property is sold at a judicial sale); 5 H. Tiffany and B. Jones, Tiffany Real Property, §1428 (1939)(citing conflicting case law from different jurisdictions on whether a mortgagee can continue to exercise and enforce a lien interest against fixtures that have been wrongfully severed from real property); First Nat. Bank & Trust Co. of Woodbury v. Hager Oil Co., 105 N.J. Eq. 2, 146 A. 878 (N.J. Ch. 1929)(receiver appointed to return severed fixtures to real estate so that mortgagee could foreclose upon both real estate and severed fixtures).

C. Landlord Liens

1. **Overview.** As indicated above, a landlord may have a lien or similar recourse against a delinquent tenant’s personal property. Such liens and/or recourse may arise either under the common law, by statute or by consensual agreement between the landlord and the tenant.¹

2. **Priority Issues Outside of Bankruptcy.** With the exception of “agricultural liens,” Article 9 of the Uniform Commercial Code does not apply to non-consensual landlord liens. *See* UCC §9-109(d)(1)(“This article does not apply to a landlord’s lien . . .”). Accordingly, the relative priority of a personal property lender’s security interest and a non-consensual landlord’s lien is ordinarily governed by local, non-UCC law and, thus, varies from state-to-state. *See* Kuemmerle v. United New Mexico Bank at Roswell, N.A., 831 P.2d 976, 978

¹ For a fifty (50) state survey of the different landlord liens available under state law, see Orlando Lucerno, A Fifty State Survey of Commercial Statutory Landlord’s Liens *printed in* The Commercial Property Lease II 253 (Patrick A. Randolph Ed. 1997).

(N.M. 1992); Annotation, Secured Transactions: Priority As Between Statutory Landlord's Lien And Security Interests Perfected In Accordance With Uniform Commercial Code, 99 A.L.R.3d 1006 (2005).

Although the exclusionary language set forth in UCC §9-109(d)(1) does not draw any distinction between consensual and non-consensual landlord liens, courts have consistently held that Article 9's exclusion of landlord liens only applies to non-consensual landlord liens and, therefore, landlords obtaining a consensual lien on their tenants' property must comply with the provisions of Article 9 of the UCC. *See generally* D. Harvey, Article 9's Exclusion of Consensual Landlord's Liens: King Furniture City Revisited, 16 UCC L. J. 360, 371-5 (1984). Accordingly, priority battles between personal property lenders and landlords with consensual liens will generally be governed by the traditional first-to-file-or-perfect priority rules set forth in Article 9 of the UCC. *See, e.g., Shurlow v. Bonthuis*, 576 N.W.2d 159, 163 (Mich. 1998); Matter of King Furniture City, Inc., 240 F. Supp. 453, 456-8 (E.D. Ark. 1965).

3. Landlord Liens in Bankruptcy. Pursuant to Bankruptcy Code Section 545(4) and (5), a bankruptcy trustee is empowered to avoid the fixing of any statutory lien on property of the debtor to extent that such lien "is for rent" or "is a lien of distress for rent."² Note that this is true regardless of when such a lien arises or is perfected. Thus, a statutory lien for rent would remain voidable under Section 545 even if it arose and was deemed perfected more than 90 days (or even 1 year) before the debtor's bankruptcy filing. *See In re A & R Wholesale Distribution, Inc.*, 232 B.R. 616, 620 (Bankr. D. N.J. 1999)("if the lien is for rent or distress for rent, it is avoidable, regardless of when it is incurred.").

Courts have generally taken a broad view of what constitutes a lien "for rent" for purposes of Bankruptcy Code Section 545. *See, e.g., Matter of WRT Energy Corporation*, 169 F.3d 306, 309 (5th Cir. 1999)(lien in favor of lessor of oil, gas and mineral rights for unpaid royalties constituted a lien "for rent" for purposes of Bankruptcy Code Section 545 and, thus, was voidable by the lessee after the lessee filed bankruptcy.); *In re Zaisan, Inc.*, 80 B.R. 832 (Bankr. S.D.Tex 1987)(lien for storage charges incurred in connection with rent distress action held voidable under Bankruptcy Code Section 545(3)).

As in the case of other types of transfers or interests voidable under Chapter 5 of the Bankruptcy Code, liens avoidable under Bankruptcy Code Section 545(4) and/or (5) are preserved for the benefit of the bankruptcy estate. *See* 11 U.S.C.

² The term "distress for rent" refers to a remedy "whereby the landlord may seize personal property on the demised premises [and] is one of the oldest, as well as one of the most efficient, of the common-law remedies for the collection of rent. Broadly-defined, common-law distress allows the landlord to go upon the demised premises and seize anything that he might there find, as security for rent in arrears, and hold it without sale until the rent is paid." *In re M.A.P.P., Inc.*, 26 B.R. 391, 392 (Bankr. D. Vt. 1983)(quoting 42 Am. Jur.2d §675).

§551. *See, e.g., Schneider v. Ray (In re Roberts)*, 38 B.R. 128, 134 (Bankr. D. Kansas 1984)(Chapter 7 trustee that avoided landlord lien under Bankruptcy Code Section 545 had priority over lender's duly-perfected security interest in same collateral, for landlord lien primed Article 9 security interest under applicable state law).

If a landlord has executed a pre-petition waiver and/or subordination of its lien in favor of a personal property lessor/lender, is the waiver and/or subordination agreement enforceable against a bankruptcy trustee who subsequently voids the landlord's lien under Bankruptcy Code Section 545? The weight of authority suggests the answer is "yes," that is, the trustee would remain subject to the landlord's pre-petition waiver and/or subordination agreement. *See, e.g.*, 11 U.S.C. §510(a)(providing that subordination agreements remain enforceable in bankruptcy); *Connelly v. Marine Midland Bank, N.A.*, 61 B.R. 748, 750 (Bankr. W.N.Y. 1986)(citations omitted) ("preservation [of avoided liens under Bankruptcy Code Section 551] alone does not enhance the status of the trustee's lien, so that if the avoided liens would have been defeated by junior claimants while in the hands of the voided lienholders, they are also vulnerable in the trustee's. The trustee's preserved lien is therefore potentially worthless when the lien avoided is inferior under state law"); *see generally* J. McCoid, *Preservation of Avoided Transfers and Liens*, 77 Va. L. Rev. 1091, (Sept. 1991); *cf. Robinson v. The Howard Bank (In re Kors, Inc.)*, 819 F.2d 19 (2nd Cir. 1987)(Bankruptcy Code Section 551 did not entitle bankruptcy trustee who has avoided a secured lender's lien to enforce the lender's contractual rights under subordination agreement with third-party creditors); J. Chobot, *Preserving Liens Avoided in Bankruptcy—Limitations and Applications*, 62 Am. Bankr. L. J. 149, 150-5 (1998).

While the focus of Bankruptcy Code Section 545 is on "statutory liens," common law liens of distress for rent are also voidable under Bankruptcy Section 545. *See* 101 U.S.C. §101(53)(providing that the term "statutory lien" includes a "lien of distress, whether or not statutory, . . ."); *In re Allegheny Nursing Services, Inc.*, 17 B.R. 594 (Bankr. W.D. Pa. 1982)(Bankruptcy Code Section 545 applies to common law liens of distress for rent).

Although statutory landlord liens and common law liens of distress for rent are voidable under Bankruptcy Code Section 545, a landlord can obviously still obtain an enforceable and non-avoidable Article 9 security interest in a tenant's personal property by including an appropriate provision for such in the parties' lease agreement and duly filing an appropriate UCC Financing Statement. *See, e.g., In re GSYS Enterprises, Inc.*, 343 B.R. 568, 570 n.1 (Bankr. N.D. Tex. 2006); 5 *Collier on Bankruptcy*, ¶545.04 at 545-14 (15th Rev. Ed. 2005)("Consensual liens [between a tenant and a landlord] are governed by the trustee's other avoiding powers and if valid thereunder will be entitled to recognition under title 11.").

III. Fixtures

A. Choice of Law Rules

Pursuant to UCC §9-301(3), the law of the jurisdiction where the fixture is located governs the relative priority of those parties asserting competing claims or interest in the fixture. *See* Official Comment 5(b) to UCC 9-301(3). Note that the foregoing is true even if the transactional documents between the parties (*i.e.*, the lender and the debtor) designates another state's laws as controlling.

B. Priority Rules. UCC §2A-309 sets forth the priority rules applicable when a personal property lessor (under a "true" lease) and a real property interest holder have competing claims or interests in a fixture. UCC §9-334 sets forth the priority rules applicable when a personal property lender and a real property interest holder have competing claims or interests in a fixture. Except in a limited number of respects (which are identified below), the priority schemes set forth in UCC §2A-309 and UCC §9-334 closely parallel one another. Accordingly, both schemes are jointly described below.

CLAIMANTS ASSERTING COMPETING INTEREST CLAIMS IN FIXTURES			STATUTE SETTING FORTH PRIORITY SCHEME
Claimant 1	v.	Claimant 2	
Personal Property Lessor (<i>i.e.</i> "true" lease)	v.	Owner of Real Property (<i>i.e.</i> , Lessee's Landlord) and "Encumbrancers"* (<i>i.e.</i> , a Mortgagee, a Judgment Lien Creditor, or other parties with a lien or interest in the real property)	UCC §2A-309
Personal Property Lender	v.	Owner of Real Property (<i>i.e.</i> , Lessee's Landlord) and "Encumbrancers"* (<i>i.e.</i> , a Mortgagee, a Judgment Lien Creditor, or other parties with a lien or interest in the real property)	UCC §9-334

* UCC §2A-309(1)(e) defines "encumbrance" as including "real estate mortgages and other liens on real estate and all other rights in real estate that are not ownership interest." Similarly, UCC §9-102(32) defines "encumbrance" as "a right, other than an ownership interest, in real property, . . . [including] mortgages and other liens on real property." Both definitions would appear broad enough to include mechanics' liens. However, Article 9 expressly excludes from the scope of its coverage non-possessory mechanics' liens. *See* UCC §9-109(d)(2)(Article 9 does not apply to "a lien . . . given by statute or other rule of law for services or materials."). Thus, at least one set of outside commentators have asserted that notwithstanding the breadth of the

definition of “encumbrances,” the relative priority of the competing interests of a mechanics’ lien claimant and a personal property lessor/lender in a fixture is governed by non-UCC law. *See* J. White and R. Summers, Uniform Commercial Code—Practioner’s Treatise Series, §33-11 (4th Ed).

1. Purchase Money Lessor/Lender in Fixtures v. Real Property Interest

Holders. A personal property lender who finances a debtor’s acquisition of an item of property that is or becomes a fixture (or a “purchase money” lessor of an item of property that is or becomes a fixture) will have priority in the fixture over the competing claims of the borrower’s/lessee’s real property mortgagee and/or landlord provided the following conditions are met: (i) the lender finances the debtor’s acquisition of the fixture (or, in the case of a true lease, the lessor qualifies as a “purchaser money” lessor³); (ii) the borrower/lessee either is in possession of the real property to which the fixture is attached or has an interest of record in such real property; and (iii) the lessor/lender perfects its security interest in the fixture by filing a fixture filing with the local filing office on or before 20 days (10 days in the case of a lessor) of the date the fixture is attached to the real property. *See* UCC §2A-309(4)(a) and UCC §9-334(d).

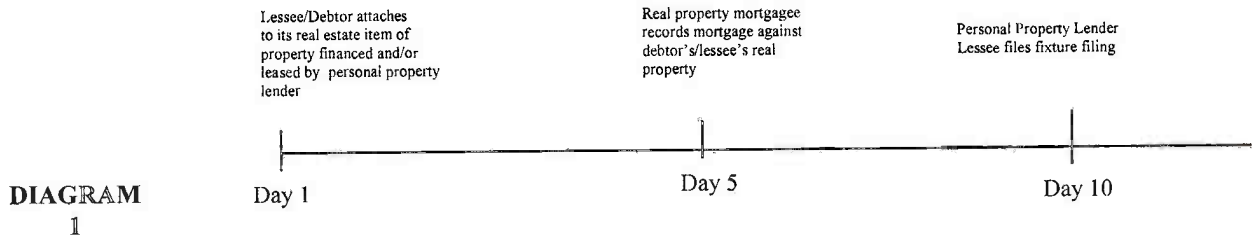
EXCEPTIONS:

(a) “Gap” Period Real Property Interest Holders. The purchase money priority afforded under the above rule only gives the personal property lessor/lender priority over real property interests arising *before* the fixture is attached to the real property (whereas other “first-to-file” rules—see below—protect the personal property lessor/lender against subsequent real property interests). *See* UCC §9-334(d)(2)(providing that a purchase money lender in fixtures has priority over “the interest of the encumbrancer or owner that arises *before* the goods become fixtures.”)(emphasis added); *see also* Official Comment 7 to UCC §9-334 (“It should be emphasized that this purchase-money priority with the 20-day grace period for filing is limited to rights against real-property interests that arise *before* the goods become fixtures. There is no such priority with the 20-day grace period as against real-property interests that subsequently arise.”)(emphasis in original).

Consequently, it is conceivable that if a personal property lessor/lender waits until “Day 20” after the property in question becomes a fixture to file its fixture filing (or “Day 10” in the case of a personal property lessor), a mortgage interest might arise and be recorded during the intervening 20 day period (see diagram below). In such circumstances,

³ UCC §2A-309(c) defines a “purchase money lease” as any type of lease other than one with respect to which the “lessee has possession or use of the goods or the right of possession or use of the goods before the lease agreement is enforceable.” Under this definition, “virtually all leases will be deemed to be ‘purchase money’ unless the lease arises in connection with a sale/leaseback transaction.” R. Boyer, Personal Property Leasing: Article 2A of the Uniform Commercial Code, 43 Bus. Law 1491, 1499, n.49 (1987-8).

the personal lessor/lender would not have purchase money priority over the intervening mortgage holder.



Real property mortgagee has priority over personal property lessor/lender notwithstanding lessor's/lender's purchase money status

Word to the Wise: If you are representing a purchase money lessor/lender of personal property that may become a fixture, get your fixture filing on file before the fixtures are attached to the real property, *i.e.*, do not rely on the 20 day (or 10 day, in the case of true leases) grace-period.

(b) Construction Mortgagees. The priority afforded to purchase money lessors/lenders that timely file a fixture filing does not apply when: (i) the competing real property claimant is a “construction mortgagee” (*i.e.*, a mortgagee that finances—or refinances—the construction of an improvement on land, including the acquisition cost of the land and whose recorded mortgage expressly states that it is a construction mortgage); (ii) the construction mortgagee’s mortgage is recorded before the fixtures are attached to the real property; and (iii) the items in question become a fixture before the construction is completed.

2. **Prior Perfected Security Interests/Lease Interests in Fixtures v. Subsequently Recorded Real Property Interest Holder.** A personal property lessor/lender will have priority in a fixture over any competing claims of the debtor’s/lessee’s landlord or mortgagee if the personal property lessor/lender perfects its interest in the fixture by filing a fixture filing in the local recording office before the landlord and/or the mortgagee (and/or their respective predecessors in title) have duly recorded their interests. *See* U.C.C. §§2A-309(4)(b) and 9-334(e)(1).

Exceptions:

(a) Real Property Interest Holder Who Acquires Title From Real Property Interest Holder That Had Priority Over Personal Property Lender/Lessee. If a real property owner who has priority over a subsequently filed fixture filing transfers its ownership interest in real property to a third-party and the third-party thereafter records its deed on the property, the third-party will have priority over the fixture filing (notwithstanding that the third-party's deed was recorded after the fixture filing) because the third-party effectively inherits the priority of its grantor (*i.e.*, the prior real property owner). *See* Official Comment 6 to UCC §9-334 (“if the fixture security interest is subordinate to the rights of an owner, it is subordinate to a subsequent grantee of the owner”).

3. Personal Property Lessor/Lender With Lien and/or Interest in Certain Types of Readily Removable Fixtures v. Real Property Interest Holders. Pursuant to the provisions of UCC §9-334(e)(2), a personal property lender that files either a general UCC financing statement or a fixture filing against an item of personal property before it becomes a fixture will have priority in the fixture over the debtor's pre-existing mortgagee and/or landlord if the item of property fits within any of the three following categories:

(a) factory or office machines;⁴

(b) equipment that is not primarily used or leased for use in the operation of the real property;⁵ or

⁴ Given that factory or office machines can often be easily detached and/or removed from real property, it might seem that these items would never qualify as fixtures in the first place. As indicated above, however, the common law in many jurisdiction recognizes what is known as the “assembled plant doctrine” under which “all machinery necessary to the operation of an industrial plant is a part of the real property and subject to a mortgage on the real property, regardless of the extent the machinery is annexed physically to the real property.” W.R. Clement and B. Dunaway, *Revised Article 9 and Real Property*, 36 *Real. Prop. Prob. & Tr. J.* 509, 519 n. 27 (Fall 2001); *see also* Squillante, Part I, at 211-14. Thus, UCC §9-334(e)(2) provides personal property lenders with a statutory means of defeating the priority that the assembled plant doctrine might otherwise bestow upon the debtor's/lessee's mortgagee and/or landlord.

⁵ This category of readily removable fixtures (to which a personal property lender may assert priority over a debtor's mortgagee and/or landlord) was added pursuant to the revisions to Article 9 (“Revised Article 9”) that went into effect (in most jurisdictions) on July 1, 2001. According to the study group report preceding the ultimate promulgation of Revised Article 9, the types of equipment considered “primarily for use in the operation of the real property include such items as “heating and air conditioning equipment.” Report of the Article 9 Study Committee of the Permanent Editorial Board for Uniform Commercial Code, Working Document No. 72 (August 30, 1992), p. 2-3; *see also* Official Comment 3 to UCC §2A-309 (indicating that “the qualifier” was intended to exclude from the category “equipment integral to the operation of the real estate, *e.g.*, heating and air conditioning equipment.”). Thus, equipment of the latter type (*e.g.*, heating and air conditioning units) should constitute “equipment that is primarily used or leased for use in the operation of real property” and, thus, would not qualify as a readily removable fixture with respect to which a personal property lender could achieve priority over a competing real

(c) replacements of domestic appliances that are consumer goods.

Similarly, under UCC §2A-309(5)(A), a personal property lessor will have priority over a lessee's pre-existing mortgagee and/or landlord in an item of leased equipment that becomes a fixture provided the lessor's lease agreement with the lessee becomes enforceable before the equipment becomes a fixture and the equipment falls into one of the three categories of readily removable equipment described above (*i.e.*, the equipment is factory or office machines, not primarily used or leased for use in the operation of the real property and/or replacements of domestic appliances that are consumer goods).

4. **Personal Property Lessor/Lender With Lien and/or Interest in Fixtures that Lessee/Debtor is Entitled to Remove v. Real Property Interest Holders.** A personal property lender/lessee will have priority in a fixture over a debtor's/lessee's mortgagee and/or landlord if the lessee/debtor has a right vis-à-vis its mortgagee or landlord to remove the fixture from the real property. *See* UCC §§2A-309(d) and 9-334(f)(2). Note that this is true regardless of whether the personal property lessor/lender have perfected their interest in the fixture in any way. *Id.* Moreover, in the event the debtor's/lessee's right to remove the fixture should terminate, the priority of the personal property lessor/lender under UCC §§2A-309(d) and 9-334(f)(2) is deemed to continue for a "reasonable time."

5. **Personal Property Lessor/Lender v. Creditor that Subsequently Obtains A Lien on the Lessee's/Debtor's Real Property.** A personal property lender will have priority in a fixture over a creditor that subsequently obtains a lien in the debtor's real property provided the lender files either a UCC financing statement and/or a fixture filing before the creditor obtains its judicial lien on the debtor's real property. UCC §9-334(e)(3).

A personal property lessor will have priority in a fixture over a creditor that subsequently obtains a lien in the lessee's real property provided the lease agreement between the lessor and the lessee becomes enforceable before the creditor obtains its judicial lien on the lessee's real property. UCC §2A-309(5)(b).

6. **Personal Property Lessor/Lender v. the Debtor's/Lessee's Bankruptcy Trustee.** Pursuant to the provisions of Bankruptcy Code Section 544(a)(1), a bankruptcy trustee is cloaked with the powers of a judicial lien creditor. Under the rules stated immediately above (*i.e.*, UCC §§2A-309(5)(b) and 9-334(e)(3)), a bankruptcy trustee will not be able to use his/her powers as a "hypothetical lien

property interest holder provided the lender files a general UCC financing statement and/or fixture filing before the equipment becomes a fixture.

creditor” to defeat the interests of a personal property lender or lessor in an item of personal property that becomes a fixture prior to bankruptcy unless the personal property lender failed to properly file either a general UCC financing statement or a fixture filing prior to the debtor’s bankruptcy filing (or, in the case of a personal property lender, the parties’ lease agreement did not become enforceable prior to the debtor’s bankruptcy filing).

Under the provisions of Bankruptcy Code Section 544(a)(3), a bankruptcy trustee is also cloaked with the powers of a “bona fide purchaser of real property.” As originally enacted, this provision provided a bankruptcy trustee with a number of possible avenues for attempting to attack the interests of a personal property lender/lessee in the debtor’s/lessee’s fixtures. Pursuant to the 1984 Amendments to the Bankruptcy Code,⁶ however, Congress expressly excluded “fixtures” from the scope of the bankruptcy trustee’s powers as a hypothetical lien creditor. *See* 11 U.S.C. §544(a)(3)(giving the trustee the rights and powers of “a bona fide purchaser of real property, *other than fixtures*, . . .”)(emphasis added). Thus, bankruptcy trustees can no longer use their powers under Bankruptcy Code Section 544(a)(3) to attack the interests of personal property lessors/lenders in fixtures. *See* M. Scarberry, Fixtures in Bankruptcy, 16 Cap. U. L. Rev. 403, 474-478 (1986).⁷

B. Consensual Agreements Regarding Priority. Both UCC §§2A-309 and 9-334 expressly recognize the ability of real property interests holders to enter into contractual agreements (*e.g.*, landlord waivers, subordination agreements, etc.) disclaiming and/or altering the priority that they might otherwise have in a fixture. *See* UCC §§2A-309(5)(c) and 9-334(f)(1).

C. Consequences of Personal Property Lessor’s/Lender’s Failure to Achieve Priority Under One of the Above-Referenced Rules. In the event a personal property lessor fails to achieve priority over a real property interest holder under one of the above-described rules, the relative priority of the parties’ competing interests in a fixture are determined under local real estate law. UCC §2A-309(7).

In contrast, if a personal property lender fails to achieve priority over a real property interest holder, the lender’s interest in a fixture is expressly deemed to be subordinate to

⁶ The Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 98-353, §459, 98 Stat. 333.

⁷ Note, also, that “fixtures” are carved-out from the delayed perfection rules applicable to real property interests under the Bankruptcy Code’s preference provisions. Specifically, Bankruptcy Code Section 547(e)(1)(A) provides that “a transfer of real property *other than fixtures* . . . is perfected when a bona fide purchaser of such property from the debtor . . . cannot acquire an interest that is superior to the interest of the transferee.” 11 U.S.C. §547(e)(1)(A) (emphasis added). Instead, Bankruptcy Code 547(e)(1)(B) lumps fixtures with personal property and provides that transfers involving either type of property are deemed perfected for purposes of the Bankruptcy Code’s preference provisions when “a creditor on a simple contract cannot acquire a judicial lien that is superior to the interests of the transferee.” 11 U.S.C. §547(e)(1)(B).

that of the real property interest holder (that is, irrespective of any consideration of local real estate law). UCC §9-334(c).

PRIORITY RULES IN ACTION

Hypothetical 1 (see graphic depiction and chronology of hypothetical on next page)

ABC Corporation ("ABC") is a New York corporation engaged in the business of manufacturing and selling widgets. ABC maintains its chief executive office at a campus facility in upstate New York, which it acquired in 2002. ABC obtained financing to purchase the facility from Ridiculous Rate Bank ("RRB"). In conjunction with financing ABC's acquisition of the foregoing real estate, RRB also provided ABC with a working capital loan.

To secure the repayment of the foregoing loans, RRB obtained a mortgage on ABC's upstate New York campus and took a security interest in all of ABC's existing and after-acquired furniture, fixtures, equipment, inventory, receivables and other tangible and/or intangible personal property. RRB promptly recorded its mortgage with the county recorder of deeds for the county where ABC's upstate New York facility is located and promptly filed UCC financing statements with the New York Secretary of State's Office and in every county where ABC has any of its manufacturing operations.

In addition to its upstate New York campus, ABC maintains two, principal manufacturing facilities, one in New Jersey and one in Pennsylvania. ABC leases both of these facilities from a real estate investment trust called Slumlords R US ("Slumlords").

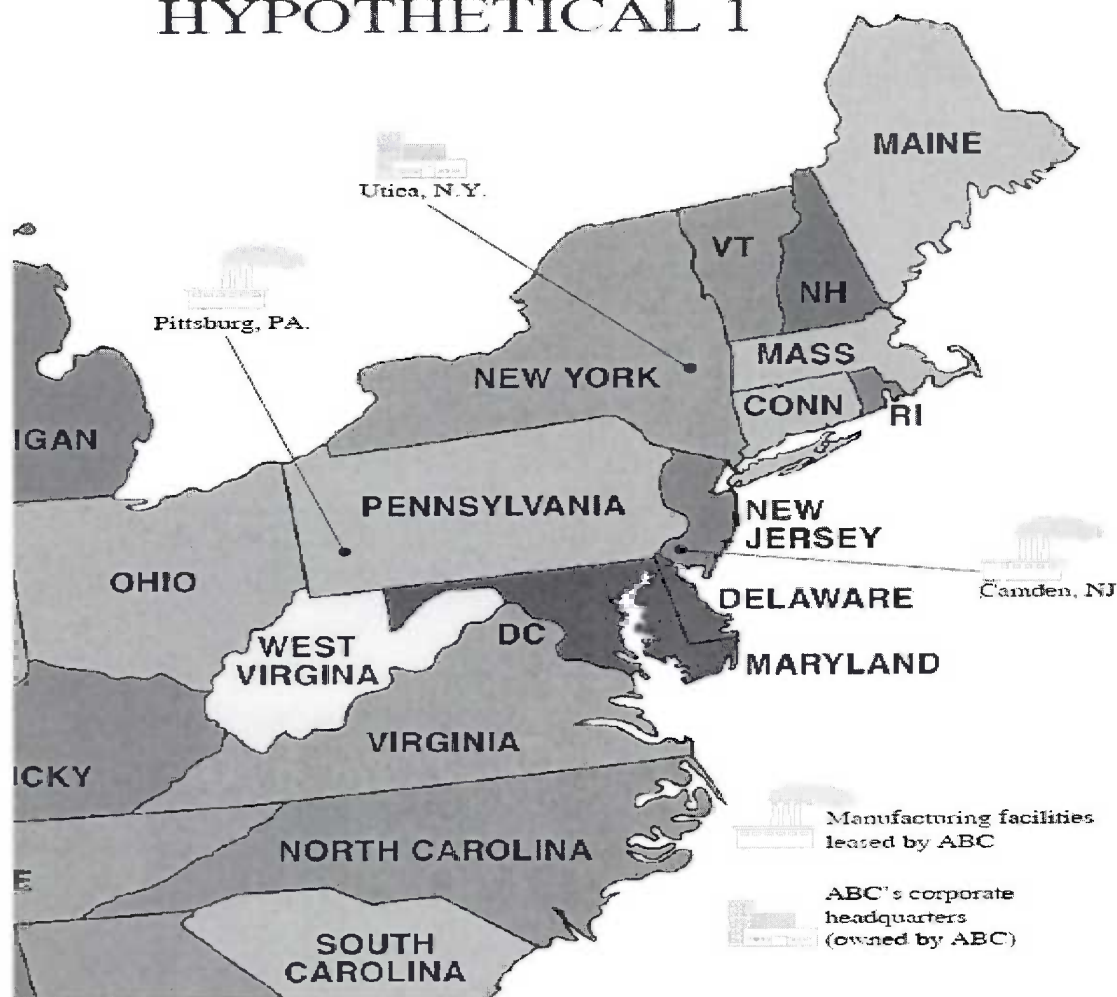
In April, 2004, ABC acquired some ultra-modern widget packaging equipment from Lessor-of-Last Resort Company ("LLRC") pursuant to an "Equipment Leasing and Acquisition Agreement" dated April 20, 2004 (the "Equipment Acquisition Agreement").

The packaging equipment was delivered and installed at ABC's New Jersey facility on May 1, 2004. On May 9, 2004, LLRC filed a "protective" UCC Financing Statement covering the equipment with the New York Secretary of State's Office.

Shortly after the installation of the new widget packaging equipment at its New Jersey facility, ABC ran into severe financial problems and became delinquent in: (a) repaying its loan from RRB; (b) paying the rent due and owing to Slumlords under the parties' real property lease agreements; and (c) making the payments required under its Equipment Acquisition Agreement with LLRC.

In July, 2004, ABC's trade creditors and unsecured bond holders forced ABC into a Chapter 7 bankruptcy. At the time of ABC's bankruptcy filing, ABC had significant past-due indebtedness owing to RRB, Slumlords and LLRC.

HYPOTHETICAL 1



CHRONOLOGICAL SUMMARY OF FACTS

- 2002 RRB provides a term loan and working capital facility to ABC, which it secures by obtaining a mortgage on ABC's upstate New York corporate campus and by taking a security interest in all of ABC's existing and after-acquired furniture, fixtures, equipment, inventory, receivables and other tangible and/or intangible personal property. RRB promptly records its mortgage with the appropriate county recorder of deeds' office and promptly files UCC financing statements with the N.Y. Sec'y of State and in every county in which ABC maintains manufacturing operations.
- April, 2004 ABC enters into an Equipment Acquisition Agreement with LLRC, pursuant to which it acquires some ultra-modern widget packaging equipment.
- May 1, 2004 The new packaging equipment is installed at ABC's manufacturing facility in New Jersey, which ABC leases from a real estate investment trust called Slumlords.
- May 9, 2004 LLRC files a UCC Financing Statement covering the equipment with the New York Secretary of State's Office.
- July, 2004 ABC is forced into Chapter 7 bankruptcy. At the time, it owes substantial past-due indebtedness to RRB, LLRC and Slumlord

Hypothetical 1 (cont.)—Issues:

1. Assuming the new widget packaging equipment is a fixture and the Equipment Acquisition Agreement is a true lease, who has priority in the equipment by and among RRB, Slumblords, LLRC and ABC's bankruptcy trustee?

2. Same question (assuming, however, that the new widget manufacturing equipment remains personal property)?

3. Same question (assuming, however, that the new widget manufacturing equipment is a fixture and the Equipment Acquisition Agreement is determined to be a disguised financing agreement rather than a true lease)?

4. Same question (assuming, however, that the new widget manufacturing equipment remains personal property and the Equipment Acquisition Agreement is determined to be a disguised financing agreement rather than a true lease)?

Hypothetical 2

Prudent Bank is considering making a long term mortgage loan to ABC Company to be secured by a first mortgage covering ABC's plant and existing and future equipment (whether or not fixtures). Prudent Bank is worried about its priority in the equipment. What can it do?

To the extent the equipment is not a fixture, we know what Prudent Bank should do:

- Get security interest in fixtures: Draft a mortgage to cover all equipment even if not a fixture;
- File ordinary Financing Statement in ordinary way to perfect;
- Do a lien search in regular Article 9 filing offices against ABC to make sure that nobody has filings that pre-date Prudent Bank's filing.
- Check to make sure nobody has perfected by possession.

Does this assure Prudent Bank of priority over any competing Article 9 Secured Party? No, not necessarily.

Prudent Bank may still be primed by subsequent PMSI in after-acquired equipment.

Can Prudent Bank do something to prevent that? No, not completely; however, there may be some preventive measures that Prudent Bank could undertake, such as:

- Putting a negative pledge covenant in the parties' security agreement or mortgage

making ABC promise not to allow a security interest to arise in any of its equipment. This wouldn't stop another lender from achieving PMSI priority if ABC violated the covenant, but the ability of Prudent Bank to declare default on ABC's loan might serve as a sufficient deterrent to discourage ABC from attempting to grant another lender a PMSI in the equipment; and

- Monitoring compliance, *i.e.*, check regular Article 9 filing records, see if any later filing covers equipment.

To extent the equipment is or will become a fixture, what then? Prudent Bank's first mortgage gives it a mortgage lien on those fixtures. [Also, Prudent Bank's mortgage serves as a fixture filing, so also Prudent Bank has a perfected security interest in the equipment under Article 9].

Who might have priority over Prudent Bank's mortgage lien? A competing mortgage lender. Search real estate records for existing mortgages.

What about competing personal property lender? Could a competing personal property lender obtain priority over Prudent Bank in fixtures? Baseline rule of UCC §9-334(c): Prudent Bank is claiming through its mortgage. Its mortgage will prime any Article 9 security interest, unless one of the statutory exception applies.

What exceptions might apply? *See* UCC §9-334.

- Subsequent PMSI may take priority over mortgage under subsection (d) of 9-334.
- Previous Secured Party who has filed fixture filing will take priority over Prudent Bank if the fixture filing was made before Prudent Bank recorded its mortgage.

DEFAULT AND ENFORCEMENT

I. Default (Sections 9-601 - 9-629 of the UCC)

1. Default sections in current Article 9 are in Sections 9-501- 9-508 of the UCC.
2. Procedure if Security Agreement covers Real Property or Fixtures (Mixed collateral) (Section 9-501 of the UCC).
3. Direct collection rights are covered in Section 9-607 of the UCC.

II. Sale of Collateral (Sections 9-610 - 9-613 of the UCC)

1. There is a form to use in Section 9-613 of the UCC.
2. Notice of sale must be sent to the Debtor, any secondary obligor (guarantor, holder of letter of credit, etc.), any person the secured party received notice from stating that the person claims an interest in the collateral, any person who claims a security interest in the collateral and filed a proper UCC-1 Financing Statement and any other person who filed a lien pursuant to any other statute or regulation (i.e. FAA, DMV).
3. The records search to determine liens must be done not later than twenty (20) days or earlier than thirty (30) days before the notification date.
4. Notice of sale must be given at least ten (10) days in advance of the sale date.
5. The Debtor can request an accounting as to the deficiency or surplus after sale (Section 9-616 of the UCC).
6. Acceptance of Collateral in full or Partial Satisfaction of the Debt (Section 9-620 of the UCC).
 - (a) This notice can be sent in partial satisfaction of the obligation.
 - (b) 20 days notice of full or partial satisfaction by taking collateral.
 - (c) The Debtor must affirmatively accept and the Secured Party must not receive an objection from any secondary obligor or any person who is entitled to receive notice of the acceptance. The same persons who must be sent notice of sale must also be sent notice of the proposal to accept the collateral in full or partial satisfaction of the debt (Sections 9-620 and 9-621 of the UCC).

7. Waiver of right to notification of disposition of collateral is effective only after default (Section 9-624).

8. Commercial Reasonableness is a Question of Fact (Section 9-627 of the UCC).

(a) A Sale is commercially reasonable if it is judicially approved or approved by a bona fide creditors' committee, a representative of creditors, or by an assignee for the benefit of creditors. Otherwise, it is a question of fact.

(b) New law opts for "rebuttal presumption" if the Debtor questions whether the deficiency (or surplus) following disposition of the collateral is proper. Section 9-626 of the UCC.

**III. Remedies for Failure to Comply with Chapter 9-601, et. seq.
(Section 9-625 of the UCC).**

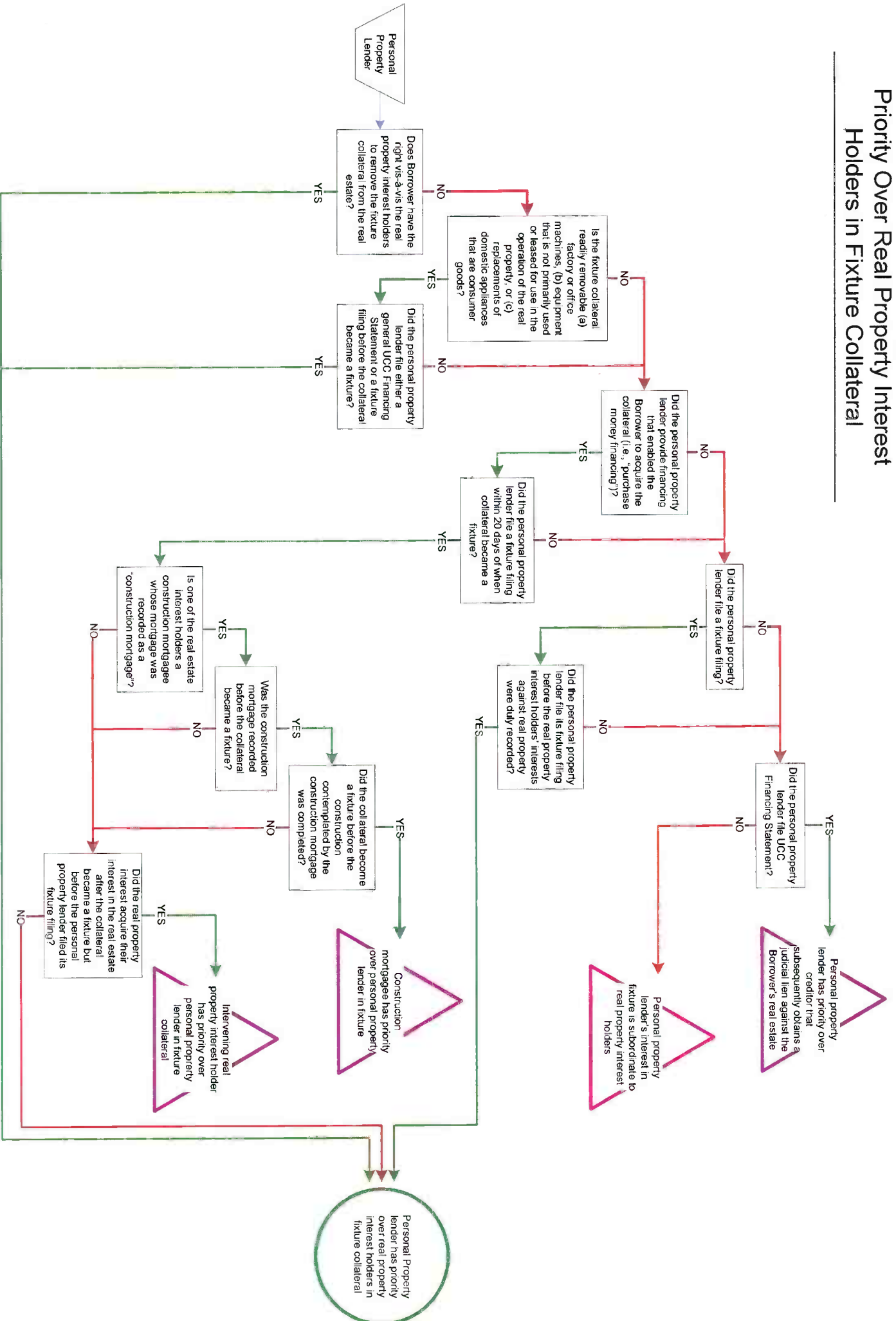
(a) Secured Party is liable for any loss with respect to new financing or costs incurred in connection with new financing such as:

(b) All damages proximately caused by the failure to comply;

(c) \$500.00 penalty for certain violations; and

(d) Lienholders and Secondary Obligors may also sue the Secured Party.

Roadmap to Priorities Under UCC §9-334: When Will Personal Property Lender Have Priority Over Real Property Interest Holders in Fixture Collateral



Roadmap to Priorities Under UCC §2A-309: When Will Personal Property Lessor Have Priority Over Real Property Interest Holders in Leased Property That Becomes a Fixture

