

## Common In-Lieu Error Makes Financing Statement Ineffective

By Paul Hodnefield, Associate General Counsel

**A**mong other important changes of prior law, Revised Article 9 (“RA9”) changed the proper place to file a financing statement from the location of the collateral to the location of the debtor. During the five-year RA9 transition period, secured parties had to bring pre-effective date financing statements in compliance with the new filing location rules. This was done through the filing of an “in-lieu” financing statement. Now it appears many of these in-lieu financing statements contain a common error that will leave the secured party imperfect.

The requirements for an in-lieu financing statement are found in §9-706(c). To be sufficient, the in-lieu financing statement must meet all the requirements for an initial financing statement found in §9-502(a), but it also must identify the pre-effective date financing statement and indicate the pre-effective date financing statement remained effective.

Section 9-502(a) has three requirements.

A financing statement is sufficient only if it

1. Provides the name of the debtor.
2. Provides the name of the secured party.
3. Indicates the collateral covered by the financing statement.

Filers often overlooked the collateral requirement when preparing in-lieu financing statements. Lenders and law firms alike tended to focus too much on identification of the pre-effective date financing statements and the indication that they remain effective. The result is that a significant percentage of filed in-lieu financing statements lack the collateral description.

Now, a bankruptcy court has offered opinions on the effect of such an error. The court in *Duesterhaus Fertilizer Inc.*, 2006 Bankr. LEXIS 1902 (C.D. Ill. Aug. 28, 2006), addressed whether an in-lieu financing statement that omitted collateral was still sufficient to perfect the security interest.

*Duesterhaus Fertilizer Inc.* (“Duesterhaus”) was an Iowa corporation with its place of business in Illinois. In 1994, Duesterhaus borrowed money from the Small Business Administration (SBA) in exchange for a security interest in its inventory, accounts receivable, and some other assets. The SBA promptly filed its financing statement in Illinois, the location of the collateral.

The SBA later assigned its interest to Capital Crossing Bank (Capital Crossing). Capital Crossing continued the financing statement in 1999. In 2002, after RA9 was in effect, Capital Crossing filed an in-lieu

financing statement with the Iowa secretary of state. The in-lieu financing statement referenced the pre-effective date financing statement from Illinois and indicated it remained effective, as required by §9-706. However, the financing statement omitted any mention of the collateral.

Duesterhaus filed for Chapter 11 bankruptcy in 2005 and remained a debtor in possession. As part of its Chapter 11 Plan, Duesterhaus sought to avoid Capital Crossing's security interest on the basis that the in-lieu financing statement failed to comply with §9-706(c).

Capital Crossing argued that the in-lieu financing statement's reference to the original financing statement in Illinois would lead searchers to the collateral description. Therefore, the financing statement was sufficient to perfect its security interest.

The court held that the in-lieu financing statement was not effective to perfect the security interest. The court reasoned that the original financing statement had already lapsed, and the filing office could have destroyed the documents well before this action commenced. The code contemplated that the original documents would not be available, so the new documents must control. RA9 expressly requires a collateral description on an in-lieu financing statement. In this case the new documents lacked a collateral description.

The Duesterhaus decision has serious implications for any filers that didn't pay attention to all the requirements of §9-706(c). Filers that omitted collateral from the in-lieu financing statement likely

have an imperfect security interest. Even in the unlikely event that the original financing statement has not passed its lapse date, the transition period ended in most states on June 30, 2006. An in-lieu statement filed today would have no more effect than any other initial financing statement.

Secured parties that filed in-lieu financing statements need to review their file copies. If they filed any in-lieu financing statements without the collateral description, they must assume the security interest is imperfect.

The secured party has only two options in this situation. First, the secured party can file a new financing statement that meets the requirements of §9-502(a). This will perfect the security interest, but only as of the date of filing. It will not have "reach-back" priority.

The second option is for the secured party to add the collateral through an amendment to the in-lieu financing statement. The amendment should give the in-lieu financing statement effect by bringing it into compliance with §9-502(a). However, it would only perfect the security interest with priority as of the amendment filing date.

Neither of these options do much to help where in-lieu errors allowed other parties to gain superior priority. If that has happened, the secured party's only option may be to seek subordination agreements from those with superior interests.

Please contact the author with questions or comments by email at [phodnefi@cscinfo.com](mailto:phodnefi@cscinfo.com), or call at 800-927-9801, extension 2375.