



# Commercial Lending

## Bulletin

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*“Responsive service and practical advice when you need it.”*

### ***When Financing Statement Is Pre-Filed, Perfection Occurs Upon Execution of Security Agreement***

The North Carolina Court of Appeals ruled earlier this year that if a security agreement is executed after a financing statement has been filed, perfection of the security interest will occur upon execution of the security agreement, as long as the same collateral is listed in both instruments.

In *Rentenchach Constructors, Inc. v. CM Partnership et. al.*, Lexington State Bank loaned money to Forsyth Drywall and Fireproofing LLC, secured by Forsyth’s inventory, accounts, equipment, and other collateral. Lexington Bank filed its UCC financing statement on February 12, 1999.

In 2001, United Capital Funding Corp. was interested in loaning money to Forsyth secured by some of Forsyth’s accounts receivable, but requested a “first lien position” before it would do so. On September 24, 2001, Lexington Bank filed an amendment to its financing statement, purporting to make a partial assignment to United Capital of its security interest in a certain amount of Forsyth’s accounts receivable. On June 20, 2002 Forsyth entered into a factoring agreement with CM Partnership to finance all of Forsyth’s accounts receivable. CM advanced money to Forsyth, which Forsyth used to repay the United Capital loan. Forsyth and CM had executed a security agreement, however CM did not file a UCC financing statement until January 2003.

On June 26 2002, Lexington Bank extended a second loan to Forsyth, secured by the same collateral as the 1999 loan. The Bank perfected its security interest in this collateral by relying on its 1999 financing statement. In February 2003, United Capital executed a “reassignment” of the first lien position to Lexington Bank. Forsyth later defaulted on its obligations to both Lexington Bank and CM, and filed a Chapter 7 bankruptcy petition in March 2003. Thereafter, Lexington Bank and CM each claimed a first priority, perfected security interest in a portion of Forsyth’s accounts receivable.

Lexington Bank argued that it had priority in the account receivable because its June 2002 security interest related back to its 1999 financing statement. CM conceded that it did not perfect its security interest until January 2003 but that Lexington Bank lost its perfected security interest in Forsyth’s accounts when it assigned its rights to United Capital. The trial court ruled in favor of Lexington Bank and CM Appealed.

To answer the question of priority, the North Carolina Court of Appeals found that under Article 9 of the Uniform Commercial Code, the “first party to perfect its security interest in collateral by filing a UCC financing statement generally will have priority over subsequent lenders who

rely on the same collateral to secure the loan.” The Court stressed that a financing statement may be filed before the security agreement is drafted. In such a case, a security interest is perfected when the security agreement is executed, assuming all of the applicable requirements have been met. The Court also noted that the financing statement is effective for five years, during which time it may be relied on to perfect multiple security interests, including those that attach after the filing of the financing statement.

In this case, the Court of Appeals held that Lexington Bank’s security interest became perfected when the Bank and Forsyth executed a security agreement in June 2002 listing the accounts receivable as collateral. Since CM did not perfect its security interest until the following year, Lexington Bank’s security interest had priority over CM’s. The Court further held that the financing statement amendment purporting to assign Lexington Bank’s security interest to United Capital had no effect because a security interest cannot be transferred unless the underlying debt is also assigned.

This case reminds us of the importance of obtaining lien searches prior to advancing any sums to a debtor to determine priority in the collateral pledged. In addition, there may be situations when it is advantageous to record a financing statement prior to closing a loan. Please contact us to discuss the proper procedures for pre-filing financing statements.

The case is cited as *Rentenchach Constructors, Inc. v. CM Partnership et. al.*, No. COA06-242 (N.C. Ct. App. 01/02/07)

### ***Lender Can Pursue Prepayment Premium After Default***

In January, the U.S. District Court, Southern District of Ohio, found that a lender did not breach a contract when it imposed prepayment penalties on a defaulted loan.

In 2002 Chillicothe Telephone Company entered into two loan agreements with Variable Annuity Life Insurance Company and Modern Woodmen of America in order to borrow \$42 million. Included in the terms of the agreements were provisions that required Chillicothe to (1) maintain a certain net worth (approximately \$30 million) and (2) have minimum total debt. If Chillicothe defaulted on either of these covenants the lenders could, at their option and after written notice was sent, accelerate the loan and assess a prepayment premium as a penalty.

In 2004 Chillicothe transitioned from a publicly-owned company to a privately-owned company. Chillicothe and the lenders amended the note agreements in order to permit Chillicothe to remain in compliance with the covenants regarding total net worth and minimum debt. Unfortunately for Chillicothe, the cost associated with the transfer from public to private was more than twice the original estimate and caused the company to be in violation of the amended covenants regarding both total net worth and minimum debt. Variable and Woodmen demanded that Chillicothe obtain new financing to pay off the principal balance of the loan as well as the amount needed for the prepayment premium. In July 2005 Chillicothe obtained replacement financing and attempted to pay off the principal balance of the loan but not the prepayment premium. The payment was rejected by the lenders. In October 2005 Chillicothe tendered total payment to the lenders, including the prepayment premium and filed suit against the lenders for recovery of the prepayment premium. Chillicothe asserted that the lenders (1) imposed an improper penalty, (2) breached the loan agreements, (3) breached the duty of good faith and fair dealing and (4) imposed improper acceleration.

The Court dismissed the improper penalty claim because as long as the penalty was an express term of the note agreement, it was enforceable, provided that the “parties involved were ‘knowledgeable, had a reasonable chance to understand the terms of the agreement and were sufficiently sophisticated and experienced to be aware of the import of the agreement.’” The Court found that both Chillicothe and the lenders were sophisticated commercial entities and that Chillicothe failed to assert that it did not expressly bargain for the loan’s terms. Regarding the second and third counts, the Court stated that Ohio law is “crystal clear that an actor does not act in ‘bad faith’ when it decides to enforce its contractual rights [and a] party may even enforce contractual rights to the ‘great discomfort’ of the other party without violating its duty of good faith.” Because the note agreement expressly included terms that allowed for the prepayment premium, the lenders were not in breach, even when they rejected Chillicothe’s tender of only the principal balance of the loans. The Court granted the lenders motion to dismiss the case against them.

The case above is cited as *Chillicothe Telephone Co. v. Variable Annuity Life Insurance Co., et al.*, No. 2:05-CT-00973 (S.D. Ohio 01/31/07)

### ***Tip of the Month: The Proof Is In The Perfection***

One of the articles in this month’s *Bulletin* focused on issues faced by lenders when dealing with security interests in non-real estate collateral. When it comes to perfection of this type of collateral, lenders need to be extra careful to be certain that the security interest is properly perfected. In most instances, it is sufficient to properly file a UCC-1 financing statement in the proper filing offices. However, some collateral requires different methods of perfection. For example:

- In the instance of motor vehicles, most, if not all, states require that motor vehicle liens be perfected through a lien filing with the state motor vehicle bureau. However, to the extent that collateral includes truck bodies, under the UCC it may also be necessary to file a UCC-1 filing as well. Most automobiles and other vehicles held for sale on a dealer’s lot may be subject to a floor plan financing arrangement which can be perfected by filing a financing statement.
- In the instance of brokerage securities held by a stock brokerage firm or a bank, in most instances it is necessary to enter into a control agreement with the firm that has custody and control of the stock certificates or mutual funds.
- A security interest in a bank account is deemed perfected if the bank that has the account relationship is also the secured party. If the account relationship is with another banking institution, here again, it is necessary to enter into a control agreement.
- A security interest in boats and aircraft is also perfected by filing against the certificate of title with the appropriate governmental agency.

Not all collateral is created equal when it comes to perfection. Feel free to contact us to the extent that you have any questions concerning proper perfection of a lien.

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### ***Save the Date!***

On Tuesday, May 22, Arnie Spevack and Alison Rind will present a breakfast seminar for lenders on 504 loans. This seminar is ideal for lenders who may have questions or want to learn more about the 504 loan process. Be sure to watch for an official invitation in your email inbox during the coming weeks, or contact Benjamin Harris at [bjharris@lerchearly.com](mailto:bjharris@lerchearly.com) for more details.

### ***Coming Soon – an Electronic Bulletin***

Beginning in June 2007, the *Commercial Lending Bulletin* will be sent via email and will no longer be published in printed form. This is being done in an effort to make the information contained in the *Bulletin* more timely, as well as to be able to provide additional information relevant to lenders without being constrained by the size of the page.

We recognize that a number of our readers appreciate the convenience of being able to read a printed version of the *Bulletin*, thus each edition will have a link to a “print ready version” that can be quickly printed and taken home. Additionally, all issues of the *Bulletin* will continue to be archived on our website. If we do not have your email address on file, please contact Benjamin Harris at [bjharris@lerchearly.com](mailto:bjharris@lerchearly.com) in order to ensure that you continue to receive the *Bulletin* on a monthly basis. Our group looks forward to continuing to publish the *Bulletin* in order to inform and educate our clients on the latest issues and trends in the commercial lending field.

If you do not wish to receive the *Bulletin* in the future or you would like to receive this *Bulletin* only by e-mail, please call Ben Harris at (301) 961-6096 or e-mail him at [BJHarris@lerchearly.com](mailto:BJHarris@lerchearly.com).

*The information in this Bulletin is not intended to render legal, accounting or other professional advice and should not be acted upon without consulting an attorney or other professional.*